NYU | LAW

ITP @20

1996 – 2016

ITP

@20

1996 - 2016

NEW YORK UNIVERSITY
School of Law
INTERNATIONAL TAX PROGRAM

ITP@20

[1996 - 2016]

BOARD OF EDITORS

Editor-in-Chief
H. DAVID ROSENBLOOM
DIRECTOR
INTERNATIONAL TAX PROGRAM

Editors
IGOR ALEXANDRE FELIPE DE MACÊDO, LL.M.'13
AMANDA KAZACOS, LL.M.'16
FRANCISCO LISBOA MOREIRA, LL.M.'14

Managing Editor
CARLO U. OLIVAR, LL.M. '15

Copyright © 2016 Respective Authors and New York University School of Law. All rights reserved.

Editorial Office at 40 Washington Square South, Room 430C, New York, New York 10012-1099.

Celebrating Twenty Years of the International Tax Program of the New York University School of Law

Introduction .... by H. DAVID ROSENBLOOM 1
Faculty Director, International Tax Program

Part I: The ITP 20th Anniversary Tax Landscape

The Tillinghast Lectures 2006-2016:

The David R. Tillinghast Lectures on International Taxation 9

PASCAL SAINT-AMANS, *BEPS and Automatic Exchange of Information: Towards a New Architecture for International Tax Cooperation* 13

MANAL CORWIN, *Sense and Sensibility – BEPS Policy and Politics: Will Global Tax Policy Consensus Translate into Coordinated Implementation?* 29

JEFFREY OWENS, *Tax Competition: To Welcome or Not?* 45

DANIEL N. SHAVIRO, *The Rising Tax-Electivity of U.S. Corporate Residence* 71

JEAN-PIERRE LEGALL, *Can a Subsidiary be the Permanent Establishment of its Foreign Parent?* 125

The Global Faculty:

BRIAN J. ARNOLD, *The New Article on Fees for Technical Services in the United Nations Model Convention* 161

SIJBREN CNOSSEN, *A Brief Taxonomy of Corporation Tax Regimes* 185

CARLO GARBARINO, *Taxation of Cross-Border EU Corporate Dividends: Convergence of Policies and Tax Competition* 209

JOHANNA HEY and RUTH HEILMEIER, *The New World of Tax Transparency: Common Standard – Cultural and Legal Differences* 239

MICHAEL KOBETSKY, *Are the OECD Transfer Pricing Guidelines Part of the OECD Commentary?* 263

MICHAEL LANG, *The Requirements of Union Law for Tax Legislation* .. 299

CHANG HEE LEE, *Controlled Foreign Corporation Rules in Korea* 325

YOSHIHIRO MASUI, *Interaction between Tax Treaties and Domestic Law in Japan – the Role of a Coordinating Statute* 335

WOLFGANG SCHÖN, *Tax Law Scholarship in Germany and the United States* 349

LUIS EDUARDO SCHOUERI, *Revisiting Territoriality as a Fundamental Principle of International Tax Law* 377

RICHARD VANN and GRAEME COOPER, *Transfer Pricing Money – The Chevron Case* 407

The International Monetary Fund:

IMF LEGAL DEPARTMENT, *Tax Law Design and Drafting in an International Context: The Longstanding Association between the IMF's Legal Department and the International Tax Program (ITP) at New York University (NYU)* 447

Part II: Reminiscences

The Faculty:

NOËL B. CUNNINGHAM, *A Brief History of the Origins of the International Tax Program* 467

JOHN P. STEINES, JR., *The International Tax Program – Reflections on the First Two Decades* 471
VICTOR ZONANA, *IBT* 473
The Alumni
REIMAR G. PINKERNELL '97, *Fast Forward 20 Years: From International Business Transactions to BEPS (and Beyond)* 487
SEUNG-JONG YANG '05, *NYU, New York and My Life!* 495
PEDRO VIANNA DE ULHÔA CANTO '06, *My NYU Experience* 497
CARMEN L. ENCARNACION '08 501
THALES STUCKY '08 505
JORGE JRAIGE '09 507
AIKERIM KAZIYEVA '09, *Some thoughts from Aikerim Kaziyeva about the ITP Program* 509
WANGARI MWANGI '11 513
JUAN F. VALLES '11, *The Truth About Networking,. . . your life and barbeque* 515
HEEJAE AN '13, *My Life in NYU and Later* 519
SHUN TOSAKA '13 521
FRANCISCO LISBOA MOREIRA '14, *The ITP Experience* 525
LUIS R. SALINAS '14 527
MATTHIEU SABONNADIERE '15 529
ADITI SHETH '15 531
CHUKWUEBUKA UYANWA '15, *The Most Exciting Year of My Life* 533
Class Portraits 535
The Practice Council of the NYU International Tax Program: List of Members 555

s on
..... 471
..... 473
..... 487
..... 495
..... 497
..... 501
..... 505
..... 507
about
..... 509
..... 513
d
..... 515
..... 519
..... 521
..... 525
..... 527
..... 529
..... 531
Life... 533
..... 535
..... 555

Introduction

H. DAVID ROSENBLOOM*

This Volume marks the 20th year of the International Tax Program at New York University School of Law. The first academic year of the one-year Master of Laws program commonly referred to as the ITP was 1996-97. I succeeded the late Paul McDaniel for the academic year 2002-03, and have had the immense privilege and pleasure of serving as Director of the ITP for the following thirteen years. It is with pride and a sense of accomplishment that I introduce this Volume and provide a few observations about the Program.

The Volume bears a resemblance to, but is different from, the Volume published by the ITP in 2006 to celebrate the 10th anniversary of the ITP. That Volume focused on the Tillinghast Lecture, which is given in the fall and effectively signals the intellectual start of another academic year. The 2006 Volume contained texts of each of the Tillinghast Lectures from 1996 to 2005. Compiling these texts was relatively easy, since each of them had been published in NYU's Tax Law Review. The requirement of a written text for each Tillinghast Lecture has since been suspended, with the result that for the years 2006 through 2015 we have only five of the Lectures to reprint here (one a modified transcript of the Lecture as given). A complete list of the Tillinghast Lectures appears in this Volume, which deals with the International Tax Program as a whole and not solely the Lecture series.

The core of the ITP is, of course, its students, who have all earned a first law degree from a non-U.S. institution when they come to New York. They may be U.S. citizens — there have been a few over the years — but the Program is aimed at foreign lawyers. Neither U.S. trained lawyers nor foreign tax experts lacking a legal degree are eligible. As of the end of the 2015-16 academic year, the Program has approximately 420 alumni, from more than 45 countries. Having earned a Master's degree in International Taxation, most have returned to their native countries, through some have secured permanent employment in U.S. law firms, accounting firms, or companies and remain in the United States, and some have found employment in third countries. Many have been employed temporarily in the United

* Director, International Tax Program, and James S. Eustice Visiting Professor of Practice & Taxation, New York University School of Law

States after graduation before departing for their countries of origin or elsewhere.

ITP alumni have proceeded from NYU to distinguished careers in professional firms, companies, governments, and academia. Not all have remained in the field of international taxation or for that matter in taxation of any sort. They are scattered throughout the world, and it has become a challenge to maintain contact with even a majority of them. My sense is that most found their time at the Law School to be a highlight of their educational experience and, in some cases, much more than that. (Marriages have been known to occur.) This Volume contains several brief essays by ITP alumni describing their experiences at NYU.

The International Tax Program is not simply a course of study of the technical aspects of taxation. Indeed, it is broader in spirit than taxation itself. The ITP serves as a sort of introduction to the United States for many students who never previously had much of a personal knowledge of this country. Of course, some students come to New York already familiar with U.S. customs and society; some have visited on more than one occasion; some have prior knowledge of the U.S. student experience. The Program, however, represents a deeper and more intense immersion in the United States than almost all ITP students have previously had, and they invariably leave with a greater knowledge of and appreciation for U.S. law and U.S. life. I think of the Program as a sort U.S. government program —one that could not possibly be run by the U.S. government.

The number of students arriving for the nine-month academic year has ranged over the years from 14 to 28, depending on many variables: individual choice of institution or city, economic developments, finances, currency fluctuations, trends in student interests, personal issues, and much else. Close examination of both the applicant pool and those who actually appear for class in late August reveals a great deal about what is happening in the countries from which the students come. It is possible to discern, in some cases, a growing interest in the subject matter of our Program, or greater curiosity about the United States or about the subject of taxation broadly, a desire to break out of traditional educational molds, in reflection of economic developments in the home country. Of course, there is a considerable leap between applying for admission to the Program and actually being admitted, and a second leap between admission and finally joining us. Many things may steer an applicant away from the ultimate decision to join the ITP.

A student with an interest in pursuing a course of study in international taxation at NYU is confronted with a confusing situation.

There is another, much older, Master of Laws tax program at the Law School. The Graduate Tax Program began in 1945, fifty-one years before the ITP, and has educated many generations of tax experts over its 70 years. It is not specifically focused on international taxation but the requirements of the GTP curriculum are flexible and a student can easily adapt that curriculum to specialize in international tax matters, or for that matter to replicate the course requirements of ITP students. Moreover, the GTP is much larger than the ITP, is open to foreign lawyers, and at this writing includes students from outside the United States to the extent of one-quarter of its student body. Yet the Graduate Tax Program is different from the ITP in the experience it offers students. The greater size of the GTP, the flexibility it allows in the selection of courses, and the presence in the GTP of many U.S. trained lawyers are all important distinguishing features.

The International Tax Program is about one-fifth the size of the GTP, limited to foreign-trained lawyers, and more rigid in its requirements. Like the GTP, the ITP floats independently of the courses offered at the Law School, in the sense that all courses are open to all students (subject to limitations on the size of the class imposed in some courses). An ITP degree requires 24 credits, or 48 classroom hours of instruction. Many students opt for more, a practice that sometimes occasions worry because the courses are demanding and taking too many of them is not a formula for success or enjoyment. There are required courses covering 16 credits in the ITP, so electives are limited. Students are sometimes frustrated by the array of choices that NYU provides but that they cannot manage to make. Every year I endeavor to discourage one or more students from taking more than 14 credits in a semester.

The required ITP curriculum includes courses on U.S. Corporate Taxation, International Taxation, Tax Treaties, International Business Transactions, and a tax policy course of some type. Much of the curriculum is taught by a small group of NYU faculty: John Steines in International Taxation; Noel Cunningham in U.S. Corporate Taxation; Victor Zonana in International Business Transactions. (Sometimes they switch course assignments.) These NYU professors have all prepared essays for this Volume discussing aspects of the ITP and their views of it. In recent years I have taught in the Tax Treaties course, which has two parts in its current formulation — one focused on U.S. treaties and treaty jurisprudence and the other dealing with tax treaty matters outside the United States. The latter part of the course has been taught by a foreign professor visiting New York for at least half of the spring semester (*i.e.*, seven weeks), and its content has varied depending on the background and interests of the particular profes-

sor. Those coming from countries belonging to the Organisation for Economic Co-operation and Development have tended to emphasize the work of the OECD, although professors from Australia and Canada (both OECD countries) can call upon substantial bodies of treaty jurisprudence in those countries as well.

The ITP is highly competitive — that is to say, it is difficult to gain admission. The Admissions Office at the Law School, working from a thick applications package, seeks to identify past academic achievement as well as employment and other experience. This is something of an art form because admissions personnel charged with initial review of applications must have, or gain familiarity with, grades and grading practices of educational institutions throughout the world — and some countries have scores, if not hundreds, of them. The Program also has a requirement of high proficiency in English, as there must be for students who will be asked to decipher some of the most complex prose they will ever see in any language. I review applications after the Admissions Office has made initial recommendations. My tendency is to accept positive recommendations and rarely to contest those that are decidedly negative. Many applications, however, do not receive a clear favorable or unfavorable recommendation from Admissions and we attempt, on a closely collaborative basis, to sort through that middle range with care and impartiality. There is no limit on the number accepted from any one country, and no predisposition to have a diverse class. I am generally looking for applicants displaying academic talent and clarity about their goals and expectations, whether directly or in the recommendation letters that I read closely. I do, however, favor to some extent applications from countries that have been underrepresented in the Program, and applications from persons having government experience. These applicants are likely to make exceptional contributions to the texture of a group that will spend eight and a half close-knit months in New York. The mission of the ITP extends beyond the enhancement of private sector skills in wealthy countries.

Those of us who work solely or exclusively in the Program aim to make the year in New York an intellectual challenge and an agreeable experience, on both academic and social fronts. We are conscious that students from different countries are thrown together in intense, competitive circumstances. We try to make the year as comfortable as possible for a population that has excelled at home but that is likely to be in the relatively early stage of a career and that now finds itself in unfamiliar surroundings. One of the points I emphasize to ITP students in the meetings I have with them in the first few weeks of the academic year is that they are likely to learn more from their col-

leagues than they will in the classroom. There are, I say, some students whose accents in English may prove difficult, but all students should realize that their colleagues are highly talented, have an excellent command of English, and can claim a solid record of past academic performance. I also say that it is likely they will bond with at least some of their fellow students and as a result establish friendships and professional connections that will endure.

Another point I insist upon in those early meetings is that the Program is probably unlike, and far more demanding than, any previous learning experience they have had in their native countries. I recommend, therefore, that students take the Program's demands seriously, not attempt to overstretch by choosing too many course credits, and not attempt to leave their studies to the last minute. Somewhat discordantly, I also say that students should make sure to leave sufficient time to explore and become acquainted with New York City and its multi-faceted offerings, perhaps by setting aside a certain period of time each week for that express purpose. New York City is very much a part of a year at the ITP and it would be a significant waste to allow the year to go by without sampling what New York has to offer. I believe — from all I have heard —the students have an exceptionally good and fruitful time of it.

Foreign professors have been a permanent feature of the International Tax Program from the first. We have welcomed at least one such professor in every year of the ITP — 14 in all, as there have been several repeat visitors — and have made arrangements to continue the practice of inviting professors from abroad in future years. The Program, of course, deals with "international taxation" and not, as the original designations of some course offerings maintained, "foreign taxation." If the Law School wishes to be "international," it must provide more than U.S. learning and the U.S. experience. For that reason (and others), the presence in our midst of a non-U.S. professor of taxation for a sustained period of time seems essential. In addition to the non-U.S. portion of the course on treaties, that professor may teach comparative tax policy, comparative anti-abuse rules, the jurisprudence of the European Court of Justice, or the concepts inherent in the OECD's Base Erosion and Profit Shifting Project. Students thus have exposure to subjects not usually taught by U.S. professors. This Volume contains a compendium of superb articles, on various international or comparative taxation topics, by the foreign professors who have taught in the ITP.

In addition to the visiting foreign professor, I generally welcome foreign researchers on an "informal" basis. By that I mean that if they can manage to support themselves, obtain the requisite visa on their

own, and find suitable housing in New York, I will enable them to have access to our library and invite them to our many public events. I firmly believe that our discussions are enriched when there are participating voices from many backgrounds and many countries.

The presence of experienced professors and researchers from other countries is a great advantage to the Program, and not just in the classroom. It is important, for example, in the regular Friday seminars that are organized primarily for ITP students but open to the public. These seminars deal with a variety of topics having some relation to international taxation, from recent court decisions to legislative developments, policy questions to career choices, questions of ethics, the organization of corporate tax departments, tax treaty matters, and a great deal more. There are regular presentations by representatives of the International Monetary Fund and the United Nations, presentations on financial accounting (an undervalued topic among law students), and presentations by economists. Government officials preside when their schedules permit. Presenters are not limited to U.S. persons. We sometimes invite visiting foreign professors to lead seminars, and it is common for practitioners from outside the United States to come to New York for that express purpose.

The benefit to students lies in seeing for themselves the practical application of the complex material they are studying in the classroom, and the various ways in which that material can translate into a professional life focused on cross-border tax matters. Thus we have hosted speakers not only from the United States but from Germany, Mexico, Brazil, the Netherlands, Austria, Italy, Canada, Israel, Japan, Switzerland, Ireland, Spain, and the United Kingdom. In all, there have been nearly 200 of these seminars since they began in the academic year 2002-03. In addition to exploring international tax concepts from many different angles, the seminars allow students to meet and interact with tax professionals operating in different worlds, from academia to law and accounting firms to government, in the United States and elsewhere. Attendance at the seminars is not mandatory but in my meetings with ITP students I make a point of urging them to attend as frequently as they can. Many alumni of the ITP have told me they found the seminars to be one of the highlights of their time at NYU. Of course, with 13 to 17 of these seminars each academic year, some will inevitably be more interesting and useful than others.

For the past few years I have looked for seminar presenters to the Practice Council that was organized for the International Tax Program in 2011. The Council is our advisory board and both its history and its current operation deserve a few words. A listing of members of the Practice Council appears later in this Volume.

When I became the ITP Director in the fall of 2002, I inherited an advisory board that Professor McDaniel had organized. That board met once each year and discussed various aspects of the Program, but the timing of the yearly breakfast meeting was inconvenient for some board members and, although I added members to the board, attendance grew sparse. I had the sense that there might be a better approach, and that a larger role for an outside advisory body might be desirable. The ITP is, after all, intended to train professionals, and ITP students look forward to successful careers following graduation. Contacts with persons employed in the international tax field can be helpful to the students. It is also clear that many practitioners welcome the opportunity to meet and mingle with students and to have a direct role in advising the ITP.

In 2011, I had the good fortune to consult with my long-time friend Leonard Terr, now sadly deceased, about what might be done to enhance the practical side of the International Tax Program. From our discussions grew the idea of a "Practice Council," a group of private sector international tax experts who would take an interest and a more active role in the Program. The idea meshed nicely with our goal of providing funding for the ITP that could be used for modest lunches at our Friday seminars, receptions at the annual Congress of the International Fiscal Association, small stipends for ITP students doing internships at the International Monetary Fund, the United Nations, or elsewhere, and other purposes beneficial to the Program. Len's law firm, Baker & McKenzie, had been underwriting the Tillinghast Lecture in the years following David Tillinghast's transfer from Chadbourne & Parke (which had previously supported the Lecture). It seemed to me that the Lecture should rest on a broader and more stable financial footing. David Tillinghast had long been the leader of U.S. international tax professionals but he was, at the time, beginning to wind down his practice at Baker & McKenzie. So Len and I came to the idea of forming a new sort of advisory board, one that would entail a financial contribution from members, and one that would hold regular and serious meetings, with detailed agendas, and discuss a range of ITP problems, issues, and opportunities.

Thus was launched the Practice Council, which at this writing consists of 62 members from 24 countries. We meet twice a year, once in the spring at the Law School for a business meeting, reception, and dinner, and once at the site of the IFA Congress for a shorter meeting that precedes an ITP reception. This has worked well. Members of the Council seem to enjoy the opportunity to come together in a group of manageable size (approximately one-half of the Council attends each meeting but the composition changes considerably from

meeting to meeting). They discuss ITP issues, exchange views regarding current developments in the international tax world, and come to know each other. Given the broad geographic dispersion of Council members, the meetings offer an opportunity for experts to meet counterparts they might not otherwise have the opportunity to know. Approximately one-quarter of Practice Council members are alumni of the ITP.

Practice Council members have the first choice of most available seminar dates each year, and in recent years the available dates have been quickly claimed. The result is that approximately two-thirds of our seminar presenters each year are from the Council. In addition, if a particular Council member wishes to arrange for a meeting of his or her firm or professional organization at the Law School, or to host a conference or other event elsewhere at which the presence of NYU faculty might be helpful, we do our best to accommodate. In other words, we at the ITP do our best to make the Council work to the benefit not only of the Law School but to that of Council members as well.

All in all, the International Tax Program has succeeded well over its 20 years of existence. It has provided a unique educational experience to a remarkable body of students from 47 countries. Many — I would hope all, or virtually all — have left NYU with a deep sense of loyalty to the institution and an awareness of how much they have assimilated during their time in New York.

My hope is that the Program will continue indefinitely, and that it will continue, doubtless with improvements, to provide students from around the world an intense familiarity with international tax principles, and the student experience in the United States, as well as the realization that there is an institution in Greenwich Village that understands the meaning of "international."

For their very generous assistance in creating this Volume, I want to express my gratitude to my research assistant Carlo Olivar, from the Philippines, and his predecessor Igor Alexandre, from Brazil, as well as Francisco Lisboa Moreira, from Brazil, and Amanda Kazacos, from Australia.

Revisiting Territoriality as a Fundamental Principle of International Tax Law

LUÍS EDUARDO SCHOUERI*

I. Introduction

Principles in Law are considered as elements inherent to the coherence and rationality of the system, as well as vectors of interpretation of other rules. The existence of guiding principles derives from equality[1]. From such perspective, identifying principles underlying international tax rules seems to be an interesting way to test the their coherence, i.e., to verify whether legislators are guided by parameters (comparison criteria), in order to distinguish those taxpayers who are not in a similar situation.

The legislator is bound to apply consistently the criteria which were elected; otherwise the principle of equality is violated. According to Klaus Tipke[2], without the adoption of criteria (which he calls "principles"), comparison is not possible; the application of the principle of equality would lack means of comparison. Only with comprehensive and relevant "principles" one can say whether the principle of equality has been observed or violated.

When one turns to the International Tax Law, it is also important to identify criteria guiding the decisions of lawmakers. This is especially true when one takes into consideration that, besides treaties and international customs, the principles of law generally recognized by civilized nations are expressly acknowledged as source of International Law by Article 38 of the Statute of the International Court of Justice. Such principles, in turn, are not extracted only from doctrine and precedents (deductive method), but also from the consistent practice

* Global Professor in NYU in the Spring Semester 2016. Professor of Tax Law at the University of São Paulo. Vice President of the Brazilian Tax Law Institute.

[1] See K. Tipke, *Princípio de Igualdade e Ideia de Sistema no Direito Tributário*, in *Direito Tributário – Estudos em Homenagem ao* Prof. Ruy Barbosa Nogueira, Brandão Machado (org.), São Paulo, Saraiva, 1984, pp. 515-527 (520).

[2] See K. Tipke, *Die Steurrechtsordnung*, Köln, Verlag, Dr. Otto Schmidt, 1993, vol. 1, at 354.

of States (inductive method)[3]. Hence, looking for fundamental principles is a relevant topic in International Tax Law.

The present article examines the Principles of Territoriality as one of the basis of International Tax Law, considering such principle from several perspectives.

II. Territoriality Principle

The idea of territoriality and its limits is fundamental for the very object of International Tax Law. Accordingly, territoriality principle is related to the spatial aspect of the taxable event. Given the statement that "there is no state without territory"[4], the notion of territoriality keeps a strict connection with the evolution of the theory of the State and its international relations.

In general terms, territoriality in tax matters is a general principle which delimits fiscal sovereignty of States, so that States can only tax events that have a *nexus* with their territory. However, the proper meaning of the term is ambiguous. This is one of the causes that lead some authors to affirm the existence of territoriality while others deny it, without noting that they may be referring to diverse concepts, different aspects, or viewing it from different angles.

Territoriality appears, in the first sense, as a mere criterion of economic policy[5]. For instance, in taxation on consumption, this criterion appears in the search for taxing goods in the country of its producer (origin) or its consumer (destination)[6].

II.1. Objective and Subjective Territoriality

One possible classification of territoriality is to segregate it into objective and subjective territoriality. While the subjective sense requires that taxation must be limited to target people established, domiciled or resident in the territory, the objective sense demands that taxable events have link with the territory (source of production, source of payment, the location of the permanent establishment, the place of performance of the activity or where the property is situated,

---

[3] Regarding principles of Law generally recognized by civilized nations, see Luís Eduardo Schoueri, *Planejamento Fiscal através de Acordos de Bitributação: "Treaty Shopping"*, São Paulo, Revista dos Tribunais, 1995.

[4] See D. de Abreu Dallari, *Elementos de Teoria Geral do Estado,* 15ª ed., São Paulo, Saraiva, 1991, at 76.

[5] See C. Sacchetto, "Territorialità" (headword). *Enciclopedia del Diritto,* Milano, Giuffrè, 1992, vol. 44, pp. 303-332.

[6] See R. Lobo Torres, *Curso de Direito Financeiro e Tributário*, 10ª ed., Rio de Janeiro, Renovar, 2003, at 90.

etc.)[7]. Bulhões Pedreira calls "economic" the criterion of determining the power to tax based on the income locally produced (objective) and "political" the criterion based on the place of residence of the income beneficiary (subjective)[8]. The territoriality in its objective sense is what scholars call today principle of source (see item III, below), while the principle of residence is linked to territoriality in its subjective sense, in most cases combined with worldwide taxation (see item IV, below).

II.2. Validity and Efficacy

Beside the source-residence conflict, the principle of territoriality allows two other meanings, considering the aspects of validity (*domaine de validité, Geltungsraum*) and efficacy (*sphère d'efficacité, Wirkungsraum*) of tax law.

The analysis of the validity of tax law, from the point of view of territoriality, questions whether it is legal that the tax law contemplates both domestic and foreign facts and, if deemed legal, whether the absence of nexus with the territory invalidates, or not, the tax law. Here, one can speak of material territoriality. Thus, in the material sense, the principle of territoriality would relate only to the abstract scope of the rules[9].

Regarding the efficacy of tax law, the focus is on whether it is possible to enforce the tax law, i.e., on the enforceability of the taxing right (formal territoriality). From the point of view of territoriality, then, the main question concerns the possibility of enforcing tax law outside the limits of the territory, which could imply a violation, by a State, to the sovereignty exercised by another or to international law. Such analysis could be described as territoriality in the formal sense.

II.3. Internal and External Aspects

Validity and effectiveness, in turn, can unfold in their internal and external aspects.

One may speak of internal aspect of territoriality[10] when one questions which laws apply (validity and efficacy) in a given territory. Thus, domestic tax laws are applicable in the national territory in a general sense, including to non-nationals (territoriality in a positive sense), but the application of foreign law by local jurisdictions (territo-

---

[7] See A. Xavier, *Direito Tributário Internacional do Brasil,* 6ª ed., Rio de Janeiro, Forense, 2003, at 24.

[8] See J. L. Bulhões Pedreira, *Imposto de Renda,* Rio de Janeiro, Justec, 1971, pp. 2-67.

[9] See O. Bühler, *Prinzipien des Internationalen Steuerrechts,* 1964, pp. 163-164.

[10] See C. Sacchetto, "Territorialità"..., *cit,* at 305.

riality in a negative sense)[11] is prohibited, unless, of course, the proper national law provides for the application of the foreign law, which can occur, for example, in case of qualification of the income. In this sense, it may be said that the principle of territoriality is fully accepted in tax matters.

The external aspect of territoriality will consider the validity and efficacy of tax law outside the territory of the State[12]. In other words, the external aspect deals with the validity of a rule that reaches facts outside the territory and its effectiveness in foreign lands.

II.4. The Lotus Case

The discussion on the existence of material and formal territorialities in its external aspect dates back to a case decided by the Permanent Court of International Justice in 1927. Although this was not a tax issue, in the Lotus Case, the Court handed down a decision where the possibility of extending a law of a country to situations that occurred abroad was acknowledged[13].

"Lotus" was a French vessel that, in 1926, collided with a Turkish boat, the "Boz-Kourt", which sank, killing eight people. When "Lotus" arrived in Constantinople, the French official, Desmons, called by local authorities to testify, was sentenced to ninety days in jail for manslaughter. The same sentence was applied to the captain of the Turkish ship. The French government protested against the decision, which ended up being taken to the Permanent Court of International Justice.

The Court ruled that the independence of States is the general rule in International Law; limitations to such independence are not assumed, but are only likely to arise from international agreements or from general principles of the law recognized by civilized nations. In the Lotus Case, neither did the Turkish act conflict with any principle of law, nor was it subject to limitations derived from international agreements. The Court, then, established the principle that the freedom of States is only limited by international agreements or by common principles[14]. According to the Court:

> "Now the first and foremost restriction imposed by international law upon a State is that-failing the existence of a per-

---

[11] See A. Xavier, *Direito Tributário Internacional do Brasil. . ., cit*, at 23.

[12] See C. Sacchetto, "Territorialità". . ., *cit*, at 305.

[13] See *Publications de la Cour Permanente de Justice Internationale*, series A, n° 10, pp. 18.

[14] See L. Le Fur, *Précis de Droit International Public*, 3ª ed., Paris, Dalloz, 1937, pp. 501-503.

missive rule to the contrary-it may not exercise its power in any form in the territory of another State. In this sense jurisdiction is certainly territorial; it cannot be exercised by a State outside its territory except by virtue of a permissive rule derived from international custom or from a convention.

It does not, however, follow that international law prohibits a State from exercising jurisdiction in its own territory, in respect of any case which relates to acts which have taken place abroad, and in which it cannot rely on some permissive rule of international law. Such a view would only be tenable if international law contained a general prohibition to States to extend the application of their laws and the jurisdiction of their courts to persons, property and acts outside their territory, and if, as an exception to this general prohibition, it allowed States to do so in certain specific cases. But this is certainly not the case under international law as it stands at present. Far from laying down a general prohibition to the effect that States may not extend the application of their laws and the jurisdiction of their courts to persons, property and acts outside their territory, it leaves them in this respect a wide measure of discretion which is only limited in certain cases by prohibitive rules; as regards other cases, every State remains free to adopt the principles which it regards as best and most suitable".

The same distinction between material and formal territoriality may be seen in Verdross and Simma, according to whom the Lotus Case stems from the need to distinguish the spatial scope of validity of the primary rule (the one that prescribes a certain behavior) and the sanction. The first refers to the *jurisdiction to prescribe* and the latter to the *jurisdiction to enforce*, because only the latter would be limited by the territorial aspect[15]. From this reasoning, it is concluded that Public International Law does not prevent a State from making prescriptions regarding circumstances that are beyond their territorial scope, provided such laws are not enforced beyond a State's territory.

Nevertheless, it is worth noting the opinion of Martha, according to whom the decision in the Lotus Case has been misinterpreted by international scholars and, as consequence, by tax scholars. Indeed, the author maintains that tax jurisdiction of States is confined to events within the scope of their respective sovereignties, being thus necessary

[15] See A. Verdross e B. Simma, *Universelles Völkerrecht – Theorie und Praxis,* Berlin, Duncker & Humblot, 1976, pp. 635-636.

to identify the limits of such sovereignty. Hence, cases of conflict may arise if one State exceeds the limits of its own sovereignty and, therefore, with excessive jurisdiction, or if there is a legitimate jurisdiction competition[16].

Referring specifically to the Lotus case, Martha explains that this precedent should not be seen as an evidence against the principle of material territoriality. Accordingly, in spite of the excerpt transcribed above, one should see it as an "obiter dictum", which was irrelevant for the decision of the Court. As Martha correctly notes, Lotus was not a case where a State was authorized to exert is jurisdiction beyond its territory. On the contrary, Lotus had a Turkish flag and it is generally accepted that a ship sailing with the flag of a State is part of the territory of that State. In this manner, the shipwreck that affects a Turkish vessel has consequences in the (extended) Turkish territory, which legitimizes the legislative intention of Turkey[17]. From there, the author argues that Public International Law would require the rule to include facts with some connection with the State. Its territory may, however, be extended to national vessels sailing in international waters.

While Martha was right when he observed that, in the Lotus Case, a debate on existence of the principle of material territoriality was not necessary, since in that case there was a connective factor with Turkish territory, the precedent does not lose its importance. In the decision, the Court clearly stated that States are free to prescribe rules regarding cross-borders situations.

II.5. Territoriality in tax matters

The extension of the Lotus Case conclusions to tax matters has been accepted by scholars, which have also denied the existence of a principle of territoriality in it material sense, *i.e.*, able to prevent tax law from embracing events that occurred outside the territory[18]. Absent the principle of material territoriality, it has already been said that a State could, in theory, address situations that occur anywhere,

---

[16] See R. Silvestre J. Martha. *The jurisdiction to tax in international Law: theory and practice of legislative fiscal jurisdiction.* (series on international taxation, n° 9), Deventer, Kluwer, 1989, at 7.

[17] See R. Silvestre J. Martha. *The jurisdiction to tax in international Law. . ., cit.*, pp. 40-41.

[18] See E. Herzfeld, *Probleme des internationalen Steuerrechts unter besonderer Berürcksichtigung des Territorialitätsproblems und des Qualifikationsproblems,* Doctorâte thesis, Heidelberg Law School, 1932, p. 432; K. Vogel, "Theorie und Praxis im Internationalen Steurrecht", in *Deutsches Steuerrecht*, year 6, 1968, pp. 427-434 (429-430); ____. Moris Lehner, *Doppelbseteuerungsabkommen der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkomen und Vermögen,* 4ª ed., München, Beck, 2003, at 119.

even if they lack connection with the State's territory, without violating the international law[19].

Notwithstanding this position, one should acknowledge Martha's argument, reproduced above, in the sense that the jurisdiction may not exceed the sovereign power of the State. This is especially correct if one takes into account that taxing power derives from sovereignty; thus, there would be no sense in admitting a State's taxing power where there is no jurisdiction. Hence, the possibility of States reaching situations with which they bear no connection (*i.e.*, material territoriality) is awkward. Martha also sustains that the State only holds jurisdiction over its citizens (principle of nationality) or over events that occur in its territory. This means that the claim of taxing foreign income earned by foreigners, even if residents, cannot be derived from the principle of sovereignty. The taxation of foreigners, although internationally valid, would have grounds on international customary law, therefore, without a connection with the principle of sovereignty[20]. As a result, territoriality would be delimited: (i) by the principle of sovereignty, which comprises (worldwide) income earned by nationals or events occurring in the territory; (ii) by an international custom, which embraces income earned by residents (non-nationals), outside the territory. It can be identified, thus, criteria (nexus) recognized for the purpose of taxation: nationality, source and residence. The connection of one of these elements to the territory would allow the exercise of taxing rights.

Martha's objection can find precedents on the ideas of Isay and Blumenstein, who, in many arguments, also supported territoriality.

Blumenstein's opinion is very similar to Martha's argument, as Blumenstein argued that there is a correlation between tax sovereignty and territorial sovereignty[21]. This argument is rejected by Spitaler, who alleges that substantive jurisdiction of States is geographically unlimited; States can take advantage of mechanisms as the substitution or succession to achieve circumstances which are not related to their territories[22]. It should be noted, at this point, that the presented response only refers to the need for the territorial element in the exercise of sovereignty; scholars do not deny, however, that the exercise of

[19] See A. Borrás, *La doble imposición: problemas jurídico-internacionales,* Madrid, Instituto de Estudios Fiscales, 1974, at 20.

[20] See R. Silvestre J. Martha. *The jurisdiction to tax in international Law. . ., cit.*, at 53.

[21] See E. Blumenstein, *System dês Steuerrechts*, 4ª ed. Revised by Peter Lochter, Zurich, Schulthess, 1992, at 1. The idea seems to have been accepted by Ruy Barbosa Nogueira, for whom the State has also the possibility, in law and in fact, to require taxes because of sovereignty or power of the empire that the State has on people and things in its territory. See *Curso de Direito Tributário*, 6ª ed., São Paulo, Saraiva, 1986, at 123.

[22] See A. Spitaler, *Das Doppelbesteuerungsproblem bei den direkten Steuren,* 2ª ed., Köln, Otto Schmidt, 1967, pp. 159-169.

sovereign power is necessary for taxation (formal territoriality – jurisdiction to enforce).

In this sense, the Santa Clara States Claim's Case seems paradigmatic. In the case, it became clear that in the absence of sovereignty, taxation is impossible. The Santa Clara Estates Company was a British legal entity, which operated in the district of Orinoco, in Venezuela, in an area *de facto* occupied by the revolutionary regime of General Matos, from May 1902 to May 1903. In the exercise of the effective control over the district, Matos' regime obliged companies to provide the regime with foodstuff. After his defeat, General Matos fled to the island of Curacao, where he declared, in June 1903, the end of the war. *Ipso facto*, the Venezuelan government took back its territory and intended to exercise, retroactively, its sovereign power, including the collection of taxes for the period in which the Matos Government controlled that area. The case was taken to the British-Venezuelan Commission of Complaints, which considered the Venezuelan act legally, logically and ethically indefensible, given that the Venezuelan Government had not exercised sovereignty during that period[23].

Isay already based his arguments on international custom, revealing that the common practice of States - of not to tax income which had no connection with its territory - would reveal an international customary law[24].

This argument is opposed by Spitaler, who confronts the claim that States should observe limits to their right to tax. Even if States observe some sort of limitation, Spitaler argues that such limits are not uniform. For this author, the idea of an international custom reveals an optimistic view of Isay, once Isay's observation can at best be considered as something desirable, a "right to come" (*werdendes Recht*)[25].

Although one cannot disagree with the argument that the limits accepted by States for exercising their power to tax vary, Spitaler's critiques do not seem strong enough to make one abandon the pursuit for principles aimed at limiting the power to tax of a sovereign State. Isay's position does not need a single limit, universally observed for exercising jurisdiction. After all, if it is true that States adopt different limits, it also seems true that legislators, to a greater or a lesser extent, limit the tax claim to events which have a nexus (subjective or objective) with the State. The nexus, of course, varies; however, absent a nexus, there is no taxation.

---

[23] See R. Silvestre J. Martha. *The jurisdiction to tax in international Law. . ., cit.*, pp. 14-15.

[24] See Isay, *Internationales Finanzrecht*, Stuttgart-Berlin, 1934, at 29 *apud* Gerd W. Rothmann, *Interpretação e Aplicação. . ., cit.*, at 2.

[25] See A. Spitaler, *Das Doppelbesteuerungsproblem. . ., cit.*, pp. 165-166.

In this sense, the territoriality principle is also supported by the proper idea of ability to pay. As a justification[26] of the choice of those events that will give rise to tax liability, the ability to pay was accepted in many different legal systems, implicitly or expressly[27], as a criterion for the implementation of the principle of equality. The adoption of this principle, in turn, requires that the taxpayer is, before the State, in a situation susceptible of economic evaluation. Hence, the residence appears as a legal fiction[28], since the personal element points to the existence of economic relations within the State, either the use of goods, or their participation in acts or facts with an economic content[29].

The relationship between the ability to pay and the limitation to the taxation of non-residents is also defended by Ezio Vanoni, who poses a link between that principle, accepted by legal orders of civilized States[30], and the international custom (and, as such, a legal norm). The custom is derived from the ethical perception that a foreigner can only be taxed as he participates in the economic life of the State that welcomes him, and to the extent of such participation. Also, Maffezzoni relies on the principle of ability to pay to limit the power to tax to facts that are presented as objective manifestations of the utility of public services offered by the State (influenced by the benefit theory), or as impeding facts of such enjoyment by others[31].

In addition to these fundamentals, we must consider the practical aspect that States will only be able to measure the ability to pay of those who are in a closer relationship with the State (residence, permanent abode, place of management). The elements denoting relationship with the State are reduced in the case of non-residents, whose ability to pay will only be reached by the States with respect to facts related to them[32].

---

[26] Regarding the acceptance of the *ability to pay* principle as a justification, or cause, for charging taxes, see Luís Eduardo Schoueri, *Contribuição ao Estudo do Regime Jurídico das Normas Tributárias Indutoras como instrumento de Intervenção sobre o Domínio Econômico*, Full Professor's Thesis, São Paulo, University of São Paulo, 2002, pp. 167-190; 340-347.

[27] In Brazil, Article 45, paragraph 1, of Brazilian Federal Constitution; in Italy, Article 53, of Italian Constitution. Besides France and Italy, recent research made by Fernando Aurélio Zilveti shows the existence of ability to pay principle in Constitutions of Albania, Argentina, Bulgaria, Burundi, Chile, Ecuador, Spain, Greece, Ireland, Yugoslavia, Liechtenstein and Syria. See ______. *Princípios de Direito Tributário e a Capacidade Contributiva*, São Paulo, Quartier Latin, 2003, pp. 153-159.

[28] See C. Sacchetto, "Territorialità". . ., *cit*, at 316.

[29] See M. Udina, *Il Diritto Internazionale Tributario*, Padova, CEDAM, 1949, pp. 58-59.

[30] See E. Vanoni, *Natura ed Interpretazione delle Leggi Tributarie*, Padova, CEDAM, 1932, at 77.

[31] See Frederico Maffezzoni, *Il Principio di Capacitá Contributiva nel Diritto Finanzario*, Torino, UTET, 1970, pp. 17-18.

[32] See K. Tipke e J. im Lang *Steuerrecht,* 16ª ed., Köln, Otto Schmidt, 1998, at 33.

It is important to mention, however, that the nexus with the State is not exclusively made with reference to the territory. Should the subjective element also be considered, the nexus is not limited to cases of residence (where, after all, there is a connection to the territory), but is extended to nationality. This nexus, though abandoned by most countries, is still not entirely rejected: the most notorious case of its application is the United States of America. Adopting nationality as a nexus, it is considered that nationals which are not residents in that State, even when earning income outside the territory, are subject to taxation.

Hence, it seems reasonable to maintain that territoriality, in the strict sense (connection to a territory), cannot be accepted as the sole form of nexus. Contending the existence of a territoriality principle, in International Tax Law, is not to limit taxation to events in a territory, but to demand that the situation affected by taxation has some connection with the taxing State. It is the "limited material territoriality"[33].

As noted by Sacchetto, the nexus is not necessarily linked to the territory, but to the State[34]. In this sense, Sacchetto[35], quoting Kruger, speaks of a "decline" of the territoriality principle, pointing to the "dematerialization" of the original notion of territory as the referential concept to justify the taxation by a State. The connection to the State may be subjective (residence, nationality) or objective (source, economic allegiance, source of payment, etc.). Thus, it is understood that territoriality can be used both for the definition of the taxpayers (in which case only individuals residing in the country and legal persons established therein will be subject to taxation) and of the income which will be subject to tax[36]. Moreover, absent a connection to the State, the impossibility of taxation is an established practice (customary international law) or even a generally accepted principle.

In conclusion, therefore, being an international custom, the principle of territoriality is grounded on International Law. The principle is also a consequence of the principle of ability to pay and, as such, it may be deemed as a legal principle generally recognized by civilized nations. At the same time, it must be noted that, although the expression "territoriality" has been maintained, the principle has lost its original link with the *territory*, and is understood in a broader sense, as requiring a connection to the taxing *State*.

---

[33] See W. Hebing, Internationales Steuerrecht, *Handwörterbuch des Steuerrechts und der Steuerwissenschaften*, vol. 1, 2nd ed., München, Beck, 1981, pp. 798-802 (799-800).

[34] See C. Sacchetto, "Territorialità". . ., *cit*, pp. 313-314.

[35] See C. Sacchetto, "Territorialità". . ., *cit*, pp. 310 and 313.

[36] See J. L. Bulhões Pedreira, *Imposto de Renda*. . ., *cit*, pp. 201-202.

When there is a link with the territory of the taxing State (economic criterion), one may speak of "principle of source", *i.e.*, the taxation is linked with a (material) event in the territory. When linked to a subjective element, one may speak of "residence principle" or "nationality principle", depending on the nexus set forth by legislation.

Given the existence of several criteria, it is possible that a system reaches: (i) residents (or nationals) on the income derived in the territory (sum of subjective and objective nexus); (ii) residents (or nationals) on their worldwide income (subjective nexus - the worldwide principle); (iii) non-residents on the income derived in the territory (objective nexus – source principle); and (iv) non-residents on their worldwide income. Of all these cases, only the latter is potentially in breach of the territoriality principle, given the impossibility of the State taxing events which have no connection with the State.

III. Objective Territoriality: Source Principle

In International Tax Law, the source principle is a criterion adopted by several domestic legislations to define the jurisdiction to tax. As seen above, while the residence principle is based on a subjective nexus, the source principle is based on the objective aspect of the tax event. Generally speaking, by adopting the source principle, the State will tax all income sourced within its territory.

The source principle cannot be mistaken with the territoriality principle, unless one applies the expression in the sense of objective territoriality. On a broader sense, considering external and internal validity and efficacy, the principle of territoriality contains, in logical terms, the source principle, but the source principle does not exhaust the principle of territoriality.

Neither is it correct to understand source and residence as incompatible standards: nothing prevents the same law system from adopting these two principles (i.e., taxes all residents, regardless of the source location and, simultaneously, reaches the entire local source income, regardless of who the beneficiary is). Then, there will be situations of double connection (source and residence), which do not give rise to a normative conflict. In fact, as noted by Klaus Vogel, there is no country that taxes worldwide income of its residents and refrains from taxing those of domestic source, regardless of the beneficiary[37].

Nevertheless, the *source versus residence* debate is still controversial. Under this controversy, there is the discussion on which country

[37] See K. Vogel, "World-wide VS. Source Taxation of Income – A Review and Reevaluation of Arguments", in S; Mclure; Musgrave et al, *Influence of Tax Differentials on International Competitiveness*, Amsterdam Kluwer, 1989, pp. 117-166 (119).

shall tax the income of an international transaction: the country of source of income or the country in which the beneficiary is a resident (the latter adopting, thus, the worldwide taxation principle). Recently, the issue of source is gaining momentum in the international debate due to the challenges brought by e-commerce, since, both for theoretical reasons and practical reasons it seems to be the best solution for taxation[38].

The problems arising from the source principle are manifold. As alerted by Vogel, the unanimity concerning the legitimacy of source taxation is obtained merely in abstract discussions, since the term "source" has no univocal meaning ("*source is not self-defining*"), ranging from country to country, and even in the same country, in different contexts[39].

Indeed, one can distinguish, *e.g.*, the "source of production" from the "source of payment". The first concept has an economic nature, requiring a link between the income and the activity from which it is derived. The second has a factual meaning, being related to the person from whose assets the payment was made[40]. In other words, the source of income may refer to the place where it was generated (source of production) or to the country where the funds used to pay were provided (source of payment). Although, both elements may coincide, it is not uncommon that these elements are located in different countries. It's up to domestic legislation to choose one of the criteria, or even for both. As an example, it is worth mentioning that Brazil requires, as a rule, the combination of both criteria for source taxation. At the same time, this rule is excepted in case of services rendered by non-residents, when taxation occurs with the mere presence of the source of payment in the country. More recently, the location of the property has become sufficient for the taxation of capital gains in Brazil.

The mere distinction between source of production and source of payment, however, does not exhaust the complexity of the issue, since both concepts rely on further definition.

In fact, considering the criterion of the source of payment, it appears that this will be located where the person responsible for the payment is resident or domiciled. The immediate issue is the definition of residence or domicile, which can vary greatly. Cases of dual resident companies, *i.e.*, companies that meet the residence criteria in more than one State, may occur, giving rise to multiple sources of pay-

[38] See R. França de Vasconcellos, *Tributação de Comércio Eletrônico Internacional,* Doctorate Thesis, São Paulo, University of São Paulo, 2002.

[39] See K. Vogel, "World-wide VS. Source Taxation of Income". . ., *cit.*, at 127.

[40] A. Xavier, *Direito Tributário Internacional do Brasil. . .*, *cit*, at 258.

ment. To this question, it must be added the issue of whether it is necessary that the payer is deemed as a person in the State, to be qualified as a payer, or a mere permanent establishment located in a third country could be considered as a payer for this purpose.

The issue becomes even more complex if one intends to determine the source of production of the income. Conceptually, one may resort to the lesson of Bulhões Pedreira, according to whom source is defined as originating from State income produced in the country, or derived from business carried on in that territory[41]. If from the conceptual point of view this definition may be seemed satisfactory, its practical application reveals its shortcomings. One takes the following example:

> On this bright and sunny spring day, Linda Jones wakes up in her Boston townhouse and decides that this, finally, is the day she is going to get her new dream kitchen. No more browsing in boring furniture stores or leafing through old-fashioned mail order catalogues! No, she is going to do this differently, as befits the new millennium: Linda is going to order her kitchen on the Web. A few quick clicks of the mouse, and Linda finds what she is looking for: kitchens.com, an all-encompassing kitchen design and sales Web site owned by KitchenCo, a multinational whose parent company is incorporated and managed in Guyana. Linda quickly enters into an electronic conversation with the company's marketing representative in Guyana. She answers his questions and e-mails him a copy of her kitchen's measurements. He, in turn, conveys her wishes to a designer, who works from his beachfront condo in Bermuda. The designer is able to fulfill Linda's specifications by accessing a mainframe computer in Buenos Aires. A company employee residing in Sydney, Australia, where the company had no other business, wrote the design software on the computer specifically for this purpose.
>
> The Buenos Aires computer is able to do some of the design work itself: It can check Linda's measurements, compare them to available materials and appliances, make up a list of possibilities within Linda's budget, and check each possibility for safety and durability. The designer in Bermuda can use the options he downloaded from the computer, as well as a database of design options from the same source, to come up

[41] J. L. Bulhões Pedreira, *Imposto de Renda. . ., cit,* at 208.

with Linda's dream kitchen. After obtaining Linda's electronic approval, the work order then is forwarded to skilled artisans working in the Italian countryside, who serve as consultants while the actual construction of the kitchen itself is performed at the company's factory on the Penang Peninsula of Malaysia, with the appliances supplied from Germany. Finally, after Linda pays for the order by using her e-money account on the Web, the finished kitchen is shipped to her from Malaysia for installation in Boston. For the installation, Linda also receives a copy of the design software, so that she can make last minute changes in case any of the features did not match her vision as they were actually installed.

As well expressed by Reuven Avi-Yonah[42], author of this example, Linda's dream is the nightmare of tax authorities, since, at least potentially, several jurisdictions could claim the right to tax the income earned by KitchenCo: Guyana (company headquarters and where the sales force is located); United States (Linda's residence and where consumption takes place); Bermuda (where the designer works); Argentina (where the server that stores the requests and participates in the drawing is located); Australia (where the software that made possible the design was developed); Italy (where the consultants are located); Germany (where the equipment is produced); and Malaysia (where the kitchen was produced).

Faced with this dilemma, some jurisdictions choose to discipline, normatively, the concept of source. Roy Rohatgi proposes the following rules of source or of origin generally applied by national legal systems:

(a) "Sale of tangible goods or services
- where the title passes
- where the payment is received or delivery made
- where the commercial cycle is completed
- where the Sales contracts are concluded
- where the business is carried on (OECD MC Art. 7)

(b) Sale of employment services
- where the service is performed or rendered (OECD MC Art. 15[43])
- where the results of the service are used

[42] See R. Avi-Yonah, *International Taxation of Electronic Commerce*, Ad Hoc Group of Experts on International Cooperation in Tax Matters. Eleventh Meeting. United Nations (document ST/SG/AC.8/2003/CRP.9).

[43] The former OECD MC Art. 15.

- where the payer is resident
- where the payment is received
- where the service contract is made
- where the related sales takes place

(c) Dividend Income
- where the paying company is resident (OECD MC Art. 10)
- where the underlying profits are sourced
- where the shares are registered

(d) Interest income
- where the payer is resident (OECD MC Art. 11)
- where the debtor is resident
- where the loan contract is entered
- where the money is lent
- where the borrowed funds are used (OECD MC Art. 11)
- where the income arises from which it is paid
- where the debt can be enforced
- where the collateralized assets are located
- where the interest is remitted from

(e) Royalty income
- where the payer is resident (UM MC Art. 12)
- where the intangible rights are used
- where the inventor resides
- where the intangible rights are registered
- where the intangible rights are transferable
- where the agreement is made

(f) Equipment/immovable property rentals
- where the PE is situated (OECD MC Art. 7)
- where the assets are physically located
- where the payer is resident

(g) Income from real property
- where situated (OECD MC Art. 6)

(h) Capital Gains
- immovable or real property: where situated (OECD MC Art. 13)
- debt: where the creditor is resident
- shares and securities: where registered
- ships and aircraft: where the effective management is situated (OECD MC Art. 13)

- goodwill: where the trade, business or profession is carried out
- copyrights, franchises, rights and licenses: where the rights are exercisable or used
- judgement debt: where the judgment is recorded
- gains other than from immovable property, ships and aircraft and PE: the state of residence (OECD MC Art. 13)"[44].

The list above, which is not exhaustive, reveals the multiplicity of solutions for defining the source of income, justifying the assertion that the definition of the source of income is something that one should look for in each legal system[45].

In some domestic legal systems, as in the United States, the definition is explicit (Sections 861 and 862 of the Internal Revenue Code). In such situations, the location of the source of income becomes an issue of income qualification[46], since, once the type of income is defined, there will be a specific rule to define the source. At the same time, the explicit definition of source allows the legislator to set aside economic criteria, such as the location of goods or the place where the activity is carried out. As a consequence, there will be cases where the income is deemed as being of a domestic source, even if in principle it would not be considered as such. Some examples of such situations, described by Rohatgi, are the following:

(a) "Deeming provisions in countries with the territorial tax regime that extend their taxing rights over certain foreign-source income.
   i. Israel treats certain foreign income of residents as Israeli-source income from a similar profession or vocation of an Israeli resident, employment income from work performed abroad within four years (or longer period) of leaving Israel, profits from a business managed and controlled in Israel, capital gains abroad, etc.
   ii. In Namibia, the following foreign-source income is deemed as domestic-source: foreign interest income, foreign income derived from a domestic trading ac-

---

[44] R. Rohatgi, *Basic International Taxation*, London, The Hague, New York, Kluwer, 2002, pp. 155-157.

[45] See H. Tôrres, *Pluritributação Internacional. . ., cit.*, at 120.

[46] Regarding the qualification concept, see L.E. Schoueri, "Direito Tributário Internacional – Qualificação e Substituição – Tributação no Brasil, de Rendimentos Provenientes de Sociedades de Pessoas Residentes na Alemanha", in *Revista Dialética de Direito Tributário*, n° 54, pp. 125-139.

tivity, and royalty and similar payments for the use of intellectual property in Namibia.

(b) Several countries with the worldwide tax regime have extended the source rules to tax certain foreign-source income of nonresidents.

i. US taxes foreign income as US source if there is a nexus with a trade or business conducted in the US. Moreover, a pro-rata share of the dividends paid by a foreign corporation is treated as US source, if 25% or more of its gross income in the three preceding years is effectively connected with a trade or business in the US. On the other hand, interest and dividends from a domestic company may be treated as foreign-source income if at least 80% of the gross income during the previous three years was active foreign business income.

ii. India treats certain overseas income of nonresidents as taxable under its deeming provisions. They are deemed to accrue or arise in India. For example, foreign income is subject to tax if it is derived directly or indirectly through, or from, a "business connection" in India. Foreign interest, royalties and technical services for use in India are deemed to arise in India, if an Indian tax resident pays them to nonresidents.

iii. The income from unconnected activities undertaken by a nonresident entity may be taxable as business income under a "force of attraction" principle, if it has a branch in that country (e.g. India, Indonesia, Latvia, United States). This principle usually involves an independent set of source rules"[47].

In other systems, however, including the Brazilian, the legislator did not define what it meant by source of production of income. Hence, two interpretations are possible: consider as domestic source the income that, for whatever reason, is linked to the country; or seek, in a systematic interpretation, limits that are not expressed in the legal text.

After discussing the conflict source *vs.* residence and concluding for the primacy of the first criterion, Endriss[48] points out that the source

[47] R. Rohatig, *Basic International Taxation. . ., cit.*, pp. 157-158.

[48] See H. Walter Endriss, *Wohnsitz- oder Ursprungsprinzip?* Die Vermeidung der Internationalen Doppelbesteurung sowle der internationalen Steuerflucht durch Wohnsitzverlagerung bei ausschliesslicher Anwendung des Ursprungsprinzips, Köln, Otto Schmidt, s.d. (1967), pp. 78-81.

principle appears in double taxation agreements where the presence of a permanent establishment or a fixed place of business is required. At the same time, Endriss recognizes that such elements are not enough for a uniform adoption of the source principle, and poses four other criteria to determine the State that would have legitimacy to tax according to a source-based system:

- Source is the location where the development (*Erarbeitung*) or enhancement (*Erwitschaftung*) of the income takes place. Quoting Bühler, the author claims that this definition is, as a rule, plausible, depending, however, on some external features, as, for example, the location of land, in case of real estate income; the establishment, in case of income from business activities; the center of interests, in case of income from labor; the headquarters or the place of management of a capital company, etc. If such external features are not present, then other criteria are needed.

- Hence, in case of doubt, the source is determined with basis on the costs incurred. It can be considered that the source of the income is the place where it was demanded that expenses be incurred in order to generate the income. However, there are revenues that do not require significant costs, or whose cost location is very difficult to determine. Thus, another rule arises.

- The separation between the origin of the cost and its utilization occurs if the cost arises, is caused, in one place, but it is used in another. The origin of the cost (*Entstebung*) is related to the activity that caused the cost, as, for example, the rendering of services, the consumption of material or energy, etc. The use (*Verwertung*) of the cost may take place in the same location or in another (one can import a service to meet a need that arose locally). For the application of the source principle, the origin of the cost is what matters, not the place of its utilization, since the latter can be diverted arbitrarily. Such diversion is, after all, what the principle of source seeks to prevent. The determination of the source should be based only on the place where the costs were originated, which, in a transaction involving goods, the author (who wrote forty years ago) believed it should not be difficult to determine. However, in the rendering of services, the determination of the source could

be less clear, unless it was possible to determine, by the practice, where the activity is exercised.

- Finally, residence would work as a mere substitute in exceptional cases. Only if it was not possible to determine where the source is, the author considered valid to transfer the right to tax to the State of residence of the recipient. This would not be a deviation from the source principle, but would only mean that the source, in the absence of another possibility, would be deemed to be located in the residence/establishment of the taxpayer. Such is the case of sea and air transport or of the transfer of intellectual rights.

In the Brazilian system, some cases are regulated in the legislation. Thus, for example, capital gains derived by a non-resident, if related to a property located in Brazil, are considered as being sourced in Brazil and taxed accordingly. There is no inquiry with respect to the location where the transaction took place, being the *locus rei sitae,* the sole relevant criterion.

The existence of an establishment of a foreign entity in Brazil is sufficient to justify the taxation of the establishment by Brazil. The concept of source of production, in this case, seems to be related to the access to the domestic market, since the legislator seeks, with the taxation of non-residents who develop their activities in Brazil, to ensure the implementation of the principle of equality[49].

In cases where the solution is not explicit, it seems correct to carry out an interpretation of the concept of income in order to determine the source. In other words: if the taxable income arises from work, its source will be where the work is performed; if it is arising from capital (interest), one will investigate where the capital is applied and so on. Such reasoning, however, does not exhaust the question, since the definition of income may be based not only on the concept whereby income derives from a source, but also one can say that income is there where an increase in one's wealth is detected, irrespective of its source. Hence, there may be events which are taxable via income tax, but whose source (labor or capital) is not defined. One must, then, continue the inquiry towards the economic basis for taxation. The source will be located in the State where the wealth arose.

This idea may be related to the modern theories on the cause of taxation, which pose an investigation of the justification for taxation.

[49] For a justification to this assertion, see L. E. Schoueri, *Imposto de Renda e Comércio Eletrônico. Internet. O Direito na Era Virtual*, Luís Eduardo Schoueri (org.), 2ª ed., Rio de Janeiro, Forense, 2001, pp. 39-55 (52-53).

In this sense, it seems useful to draw on Kirchhoff's ideas. He developed a theory combining elements of the sacrifice and the benefit theories. With respect to the first theory, Kirchhoff notes that taxes provide means for the maintenance of the State. He argues that, to the extent that the State is distanced by constitutional strength from the economic activity, by granting the individual power over economic goods, the State can only be financed through participation in private economic wealth. Under this conception, taxes would be the State's participation in the economic success of individuals[50].

Under Kirchhoff's theory, if an individual derives income, this is due both to his personal effort and to the existence of the market (it would be a waste of effort if there was not a market where one could act). That is why the State, through the market, could receive its share.

Thus, the justification (and cause) of taxation lies in the fact that the State is financed through its participation in the individual success of private agents[51]. One notes, in this theory, that the author has a clear vision of the State as a representative of the community, being the tax the portion which the individual pays the community, for offering the conditions of his enrichment. At this point, it is revealed that Kirchhoff, despite apparently starting his reasoning under the terms defended by the sacrifice theory, only retakes, with new arguments, the benefit theory.

Kirchhoff's theory offers an element that cannot be neglected in the pursuit of the source of the economic income: the market, already referred above, in the case of taxation of permanent establishments. Now, the question becomes: which is the market that offered conditions for the production of income? By identifying such market, one can locate the source of the income increase.

Naturally, the subject is not yet exhausted. After all, it is possible that more than one market is related to the income increase. Just imagine a corporate interest held in a company based in country A, whose shares are traded in the stock market of the country B. Here, both countries may legitimately be considered the source of the income increase resulting from the trading of shares. Two tax claims will then emerge. In Brazil, for instance, the *locus rei sitae* rule would prevail, excluding, in principle, the tax on capital gains derived by nonresidents in respect of property situated abroad, although the gain was derived from trades in the national territory.

---

[50] See P. Kirchhof, Die verfassungsrechtliche Rechtfertigung der Steuer, in *Steuern im Verfassungsstaat: Sympostum zu Ehren von Klaus Vogel aus Anlaß seines Geburtstags,* Paul Kirchhof et al., München, Beck, pp. 27-63 (32).

[51] See P. Kirchhof, Die verfassungsrechtliche Rechtfertigung der Steuer, in *Steuern im Verfassungsstaat: Sympostum zu Ehren von Klaus Vogel aus Anlaß seines Geburtstags,* Paul Kirchhof et al., München, Beck, pp. 27-63 (37 and 44).

IV. Worldwide Taxation Principle as an Opposition to the "Pure Territoriality"

In International Tax Law, the adoption of the worldwide principle enables the taxation of events that take place beyond the territory of the State. The worldwide principle is opposed to the principle of pure territoriality (source) in its economic sense, which limits the taxation of residents to domestic events[52]. The worldwide-territoriality binomial points out two options offered to the domestic legislator to tax those who have a subjective relation with the State (residence or nationality).

It is important to emphasize that, while opposed to "pure territoriality", the worldwide principle does not imply the exclusion of the territoriality principle itself. In fact, all countries adopting the worldwide principle require a personal nexus with the State, which, at the end of the day, complies with the territoriality principle, since the requirement of a nexus with the State (residence or nationality) is present. In this case, the source criterion can be applied (material territoriality in the definition of the income that is subject to tax), which implies a limitation to the scope of tax law (*beschränkte Steuerpflicht*).

On the other hand, there is no mandatory link between the residence principle and the universality of taxation, being possible that the government which adopts the residence criterion limits the scope of its law to circumstances that occurred in its territory (pure territoriality). This may occur, for example, if one does not take into account manifestations of economic capacity occurred outside the territory when determining the progressive rate applicable to the taxpayer. As an example, it is worth mentioning that Brazil, until the enactment of Law No. 9,249/95, would tax corporations established in Brazil (residence principle), but only in relation to events occurred in the Brazilian territory.

The possibility of a State taxing its residents (or nationals) based on the worldwide principle, besides taxing non-residents based on the source principle, leads to one of the main issues of International Tax Law: which is the State with legitimacy to tax the income derived in an

[52] One points out that territoriality principle, today, is no longer understood as a link to a territory, but the requirement of a connection, subjective or objective, between tax situation and taxing power. In this sense, one must agree with Heleno Tôrres when he says that the adoption of worldwide principle cannot be considered an exception to territoriality principle, since the worldwide principle is adopted when the taxpayer has a bond (personal) with the taxing State. As already mentioned, Heleno Tôrres names the situation as "pure territoriality" when the State is considering the option to tax only situations that has objective and subjective links with this State. See H. Tôrres, *Pluritributação Internacional. . ., cit.*, at 62. The expression *"principio di territorialità" pure* was used, before, by C. Sacchetto, "Territorialità". . ., *cit*, at 329.

international transaction: the State of residence (adopting the worldwide principle) or the source State? The studies developed in the late nineteenth century by two finance scholars, Wagner and Schanz, are worth mentioning with this regard.

In Wagner's study, one may find the basis for the worldwide principle, which legitimized the State where the taxpayer was a resident to claim taxation not only of the income derived within the limits of its territory, but on a worldwide basis[53]. Wagner's study did not consider the merits of the likely double taxation that his solution could entail. Klaus Vogel understands that Wagner did not consider the investment abroad as particularly desirable, which, moreover, merely reflected the prevalent nationalist and isolationist trend at the time Wagner's study was written[54].

Writing in 1892[55], Schanz brought further arguments to the discussion, contending that neither the home nor the nationality nor the mere physical presence could serve as unique criteria to determine the jurisdiction to tax, since such criteria would allow the taxation of people who do not benefit (or benefit very little) from the State's activities. In this sense, it would be unfair to require that these taxpayers bear the burden of a State that would mostly benefit third parties. Therefore, Schanz contends the introduction of a criterion that, since consistently, could inhibit such injustice: the principle of economic allegiance (*wirtschaftliche Zugehörigkeit*), understood as the link between the individual and the State, so that this individual participates in the economic and social life of this State[56]. The economic allegiance would be found on a case-by-case basis, according to the nature of the tax. So when it came to taxation on consumption, the economic allegiance could be determined at the discretion of residence (although in combination with other criteria). In the case of tax on income, however, Schanz argues that the residence loses much force in terms of economic allegiance, since, although the income of a taxpayer may be related to the place of residence, the source State will have greater economic importance. For this reason, Schanz suggested that taxation should be shared between the source State and the State of residence, according to economic allegiance. In the case of income taxation, he poses a formula under which three-quarters of the tax should be allo-

---

[53] See A. Wagner, "*Finanzwissenschaft, Zweiter Teil: Gebühren- und allgemeine Steuerlehre*", 1880, at 296, *apud* K. Vogel, "World-wide VS. Source Taxation of Income"..., *cit.*, pp. 117-166.

[54] See K. Vogel, "World-wide vs. Source Taxation of Income"..., *cit.*, at 121.

[55] See Schanz,"Zur Frage der Steuerpflicht. *Finanzarchiv* " 1, 4 (1892), at 122, *apud* K. Vogel, "World-wide VS. Source Taxation of Income"..., *cit.*, pp. 117-166.

[56] See E. Allix, "Repetitions ecrites de science financière", in *Les cours de droit*, Paris, Répétitions Ecrites & Orales, 1937-1938, at 178.

cated to the source State, being the residence State with the remaining quarter of tax revenue.

In 1921, the Financial Committee of the League of Nations requested four public finance specialists, Bruins (The Netherlands), Einaudi (Italy), Seligman (USA) and Stamp (United Kingdom) to write a report on the problems relating to the double taxation phenomenon, as well the possible solutions to eliminate them. The report was published in 1923, referring to economic allegiance but, as noted by Klaus Vogel[57], its result was almost opposite to Schanz's suggestion, since in the view of the experts, States should reciprocally exempt non-residents from taxation, so that taxation would be left to the State of residence, based on the worldwide principle. In this sense, the concept of "economic allegiance" was replaced by the broader "state economic allegiance": the first concept, seeking economic links, enabled by a plurality of States that considered themselves entitled to tax; and the latter concept, later explained by Dorn and published, among others, by Spitaler, investigates which State would more easily establish and collect taxes[58]. Between 1926 and 1927, with the collaboration of experts mainly from other European countries and from the United States, the commission produced four models of conventions, regarding, respectively, income tax, inheritance tax, administrative assistance and judiciary assistance, which were approved in 1928 by representatives of twenty-eight States. In this model, for "personal" taxes, the criterion of residence, based on the worldwide principle, prevailed, and the source criterion was applied in relation to "real" taxes[59]. In the same year, a permanent committee on the subject was established and, later in 1943, meeting in Mexico, posed a model agreement to avoid the double taxation of income, in which the interests of capital importing countries were better taken into consideration. It must be remembered that the latter collegiate was composed primarily of representatives of Latin American countries (as the US and European countries were involved in World War II). This model was followed by another, concluded in London (1946), in whose drafting the interests of industrialized countries prevailed. While the Mexican model gave greater weight to source, benefiting, thus, capital importing countries, the London Model returned to the priority of the State of residence, with the adoption of the worldwide principle.

The work of the League of Nations continued through the Organization for Economic Cooperation and Development - OECD - whose

---

[57] See K. Vogel, "World-wide vs. Source Taxation of Income". . ., *cit.*, at 121.

[58] See E. Allix, "Repetitions ecrites de science financière". . ., *cit.*, at 181.

[59] See V. Uckmar, "I Trattati Internazionali in Materia Tributaria". In: ____. (Coord.). *Corso di Diritto Tributario Internacionale*, Milano, CEDAM, 1999, at 84.

Council, in 1956, established a Committee on Fiscal Affairs, composed by Government officials in charge of the negotiation of double taxation agreements. Between 1956 and 1963, the Committee on Fiscal Affairs worked on the development of a model of double taxation agreements, adopted on July 30, 1963, together with its commentaries. The revision of this Model and of the respective commentaries started in 1973, resulting in a new publication, in 1977. The OECD Model undoubtedly favors the State of residence. Opposing to this Model, one may refer to the model convention developed in 1971 by the countries of the Andean Pact, which emphasizes the source principle[60].

Considering that the OECD Model had not been able to take the diversity of levels of development that may exist between the Contracting Parties, the United Nations Secretary-General required a group of experts, representing both developed and developing countries, to work on a new model convention. The group met eight times between 1968 and 1979, culminating in the production of a model agreement with commentaries. As reported by Francisco Dornelles, a Brazilian representative in these meetings, even though many countries insisted on the need to change the concepts included in the OECD Model, by enthroning the source principle and, consequently, the non-levy of tax in the country of residence of the beneficiary of the income (thus rejecting the worldwide principle), the position of developed countries prevailed. Accordingly, the group based their work on the OECD Model, introducing amendments aimed at expanding the right to tax of the developing country. Thus, the author argues that the UN model, contrary to what one might expect, is not based on the source principle, but in the domicile, while admitting, in some parts, the taxation in the country of origin[61].

Despite the great majority of authors that are in favor of the worldwide principle as a criterion for taxation, such understanding used to have been opposed, historically, by Latin-American countries, which used to defend the territoriality principle in taxation. Scholars stood out in favor of the principle, recognized by authors such as Dino Jarach[62], Nuñez and Molina[63] and Ramon Valdes Costa[64], among

---

[60] See *Bulletin for International Fiscal Documentation*, 1974, Supp. D, at 309.

[61] See F. Dornelles, "O modelo da ONU para eliminar a dupla tributação da renda, e os países em desenvolvimento", in *Princípios tributários no direito brasileiro e comparado. Estudos em Homenagem a Gilberto de Ulhôa Canto,* Rio de Janeiro, Forense, 1988, at 201.

[62] See D. Jarach, "Aspectos da hipótese de incidência", *Revista de Direito Público*, São Paulo, v. 17, n. 298, jul./ sep. 1971, pp. 287-304.

[63] See T. Núñez; H. Molina, *De la Doble Tributación Internacional,* Santiago, Editorial Juridica de Chile, 1970, at 29.

[64] See R. Costa, *Estudios de Derecho Tributario Internacional*, Montevideo, 1978.

others. However, gradually, tax laws of these countries have been moving away from territoriality, while also accepting the worldwide taxation of income. For instance, one may refer to the case of Brazil, with Law No. 9,249/95, which established worldwide taxation for legal entities, and Argentina, upon the enactment of laws No. 24,073 and 25,063.

Most scholars, however, have never ceased to criticize the choice of worldwide principle, being important to highlight the leadership[65] of Klaus Vogel[66]. This author defended, firstly, that the concept of "source" would be ambiguous (each country adopts its concept to determine what is the "source" of income and such definition may, moreover, refer both to the source of production of the income or to the source of payment). In defending the source principle, Klaus Vogel examined arguments brought by public finance scholars (whose motto is efficiency) and by lawyers (whose motto is justice).

Turning to the question of efficiency, Vogel pointed out that in public finance, efficiency can be addressed from the point of view of taxation, in terms of neutrality, which, in turn, is divided into capital export neutrality ("CEN") and capital import neutrality ("CIN"). When it comes to CEN, the focus is located on the investor, *i.e.*, the idea is that the investor must be subject to the same tax burden when investing in his country or anywhere else, so that the tax is not a factor that influences his decision on where to invest. CEN implies taxation grounded on the worldwide principle, assuring the investor the right to credit the taxes paid abroad. On the other hand, CIN is based on the source principle, while focused on the investment itself. In other words, wherever the investor is a resident, he will be subject to the same taxation as his competitors when investing in a given territory. In order to assure CIN, the State of residence should be limited to tax income arising in its territory, exempting, therefore, foreign-sourced income, thus rejecting the worldwide principle.

Only in an ideal setting, harmonized calculation basis and tax rates in all countries, could one think of a convergence between CIN and CEN. In most cases, the pursuit of CEN will prevent CIN and vice versa, making necessary an option that public finance scholars pro-

[65] Also defending the taxation by Source State, see H. Meyer, *Die Vermeidung Internationaler Doppel- und Minderbesteuerung auf der Grundlage des Ursprungsprinzips.* Doctorate thesis, University of Göttingen Faculty of Economic and Social Sciences. Göttingen: Ed. Particular, 1970; H. W. Endriss, *Wohnsitz- oder Ursprungsprinzip?* Doctorate thesis, University of Cologne Faculty of Management, Economics and Social Sciences. Köln: Ed. Particular, 1967. See also references to American scholars who defend source principle, K. Vogel. "Neuere Befürworter des Quellenprinzips (Territorialprinzips) in den Vereinigten Staaten". In: KLEINEIDAM, Hans Jochen (Org.). *Unternehmenspolitik und Internationale Besteuerung. Festschrift für Lutz Fischer.* Berlin: Erich Schmidt, 1999, pp. 1007-1019.

[66] See K.Vogel, "World-wide vs. Source Taxation of Income". . ., *cit.*

pose from the parameter of efficiency. In this sense, classically, it has been argued that the most efficient solution would be CEN: by this criterion, the investor would take his decisions from a purely economic logic, seeking to allocate his resources where he produces a higher return, assuring, thus, the optimization of the allocation of assets. Such reasoning can be opposed, however, by the evidence that CEN only restricts foreign investments[67]. The theme is approached by Gandenberger, who clarifies that, in case of CEN, the investor is subject to tax at his residence, which ends up reducing his ability to reinvest. Thus, two investors subject to different tax burdens in their respective countries of residence will have different reinvestment abilities. Gandenberger considers that, if the level of taxation in any country must match the level of services offered by the State, lowering taxation in a country corresponds to proportionally increasing costs for a private investment to achieve the same degree of satisfaction. Thus, if the investor, residing in a developed country (and therefore with high tax burden and high level of public services) is subject in a developing country to the same tax burden as in his country of residence, despite the fact that other State does not offer him the same public services, he will prefer staying at his residence. In this case, it is evidenced that one may not speak of neutrality: in fact, taxation will be an element which certainly distorts the investor's decision[68].

In fact, even the distinction between CEN and CIN is disputed, as one can sustain, as put forth by True[69], that neutrality cannot be considered in isolation, from the point of view of each country. Instead, there should be a pursuit of neutrality among States (interstate). In this sense, from the definition of neutrality as taxation that does not modify the (explicit or implicit) relative prices of goods, services, activities, production factors, in the private sector, neutrality among countries would only mean that no country should seek to use its power to tax in order to further modify the relative prices in another country, which would be modified if taxes did not exist.

As considered by Klaus Vogel, for a correct judgment of neutrality, one should not consider only taxes but also benefits, as, for the investor, the level of benefits is as important as the level of taxation. Thus, security, economic stability, infrastructure, direct subsidies, public

---

[67] See T. Horst. "A Note on the Optimal Taxation of International Investment Income". 94 *The Quarterly Journal of Economics,* 693 (1980), *apud* K. Vogel, "World-wide vs. Source Taxation of Income". . ., *cit,* at 139.

[68] See Gandenberger, Kapitalexportneutralität versus Kapitalimportneutralität, 7 *Aufsätze zur Wirtschaftspolitik, Forschungsinstitut für Wirtschaftspolitik an der Universität Mainz* (1983), *apud* K. Vogel, id. ibid., at 140.

[69] See True, Taxing Foreign Source Income, in *U.S. Taxation of American Business Abroad,* 37 (195=75), *apud* K. Vogel, id. ibid., at 141.

health and education level are factors able to counterbalance taxation. This redefines neutrality among countries as a condition under which a taxpayer who carries out activities in another country - or market - and uses facilities offered by that other country (public goods), can be sure that he will not be taxed more than any other, under the same circumstances, and uses those facilities equivalently[70]. If the worldwide principle prevails, taxpayers will be subject to the same taxation when investing in a country that grants certainty or in another which presents great risks[71]. In other words, CEN makes nothing more than discouraging investments in countries that really need them; CIN, moreover, ensures that the taxpayer bears a tax burden counterbalanced by his difficulties. It is understood, then, that from a financial point of view, CIN should be preferred, thus justifying the preference for the source principle.

Even if one does not consider direct investments in productive activities, the principle of residence is also facing obstacles of an economic nature. This is, for example, the case of income from financial investments, in which increasing taxation leads the creditor to demand higher interest rates, in order to assure the same net return from the investment. Hence, one can conclude that it is more efficient to consider the level of taxation of where the debtor is (source) as the appropriate parameter to ensure neutrality between domestic and foreign investors.

However, it's not just from the point of view of efficiency that the issue deserves to be dealt with. Also among jurists, positions are defended under the motto of *justice* and *equality*, which are reflected in the principle of the ability-to-pay[72]. In this sense, one may refer to the decision of the German Federal Fiscal Court, in which, dealing with Article 48 of the European Economic Community, it was decided that the worldwide taxation of income earned by taxpayers was a necessary consequence of the principle of ability to pay[73]. The decision was subject to the critiques of Klaus Vogel[74], who revised the relevant literature and showed that the position that only taxation of worldwide income would meet the ability-to-pay principle does not stand, even quoting several countries where the principle of territoriality has been adopted. Moreover, as emphasized by Vogel, if one wanted to

---

[70] See K. Vogel, "World-wide vs. Source Taxation of Income". . ., *cit.*, pp. 141-143.

[71] See H. W. Endriss, *Wohnsitz- oder Ursprungsprinzip?*. Köln: Otto Schmidt, s.d., at 66.

[72] See C. Sacchetto, "Territorialità". . ., *cit*, at 314: "*La conseguenza di questa concezione è che "tutti i residenti" (per appartenerenza politica ed economica) "devono" concorrere com "tutti" i loro redditi ovunque prodotti".*

[73] See Bundesfinanzhof, Judgment of the Court of 14 April 1993, in *IstR* 1993, at 272.

[74] See K. Vogel, "Tributação da Renda Mundial", *Cadernos de Direito Tributário e Finanças Públicas*, v. 7, 1994, pp. 133-143.

pursue full equality between taxpayers who invest in their country (subject only to local taxation) or abroad (subject to taxation at his residence and in source State), then it would be necessary to demand that those who invest locally are subject twice to local taxation, to have, therefore, equal treatment to those who invest abroad. Vogel discusses the issue of equality, tackling the argument of ability-to-pay, according to which it would be unfair that a State imposes lower taxation on foreign income obtained by residents than on income earned locally. According to Vogel, this argument ignores the fact that foreign revenues are earned in substantially different local conditions. As the author recalls, if taxation of the source state is lower - and only in this case the argument based on equality would fit -, often public services that benefit the taxpayer are also lower, and the risks are increased. If the taxpayer is an entrepreneur, he is, in the foreign country, in competition with other entrepreneurs, who also pay the lowest tax required by that State; an additional tax on the part of his State of residence affects his competitive conditions. Finally, he cannot even be sure that he can transfer to his State of residence the income he has earned abroad.

The argument seems convincing, revealing that, in fact, one cannot think of equality between taxpayers who, ultimately, were subject to completely disparate risks, and it may happen that the same financial outcome derives from very different investments, either in volume or in level of risks. From the standpoint of equality, it seems much more certain to affirm that those who bear the same risk in a market should be subject to the same taxation. This reasoning leads to taxation by the source State. It must be added to this argument, which considers the equality from the taxpayer's point of view, the issue of inter-state justice. In this sense, one sees that the State of residence has already benefited from the tax on the taxpayers' consumption, and it would be unfair that it is also benefited from the taxation of income based on the worldwide principle, forcing the taxpayer to bring part of the resources allocated in the source State to satisfy the tax liability in the State of residence. Considering these arguments, the discussion should be renewed, now based on justice issues, in order to ensure to the source State the jurisdiction to tax the income.

In summary, it appears that, although international practice is giving preference to taxation by the State of residence, with the adoption of worldwide principle, there are strong arguments, both from the perspective of efficiency, as from the perspective of justice, which establish the legitimacy of the exclusive taxation by the source State.

V. Conclusion

Although being a fundamental principle of International Tax Law, territoriality still demands further discussion in order to be generally adopted in the International Scenario.

When one considers territoriality as a limit for validity of laws, this article has shown that in spite of some diverting opinions, it is generally accepted that a *nexus* must be found for a State to legitimately tax a situation. This *nexus*, however, may vary from State to State and the only conclusion one may derive from such variety is that in case there is absolutely no nexus to a State (its territory or its population), then taxation would breach International order.

Source is a *nexus* adopted both by countries which adopt "pure territoriality", as well as by those which tax their residents on a worldwide basis. However, also this *nexus* may not be seen as a uniform Principle in International Tax Law, since there are several different meanings for "source" and even within one jurisdiction, source may be applied diversely according to the type of income.

On the debate whether territoriality would limit taxation of a State's residents, there are very relevant arguments in favoring "pure territoriality". However, the prevailing practice has been that States would adopt a worldwide taxation.

Concerning the latter issue, it may be relevant to point out that although worldwide taxation is generally adopted, States have gradually noted that a CEN position might jeopardize the competitiveness of their companies. Thus, gradually, the idea of participation exemptions have increased, covering not only Continental Europe, but also the United Kingdom and, to some extent, even Japan. It is true that the United States still tax their companies on a worldwide basis, but one could expect that international competition may be a factor to reduce this State's resistance.

While there is hope that a consensus will be found on the concept of source, the movement towards Capital Import Neutrality seems strong enough for one to believe that pure territoriality, as a basis for international competition, may become a new Fundamental Principle of International Tax.