Examine, critically, the various approaches a state may adopt to justify its jurisdiction to tax corporate profits generated by multinational enterprises.

The object of this essay is to critically examine various approaches which might be adopted by a State to assume jurisdiction to tax corporate profits generated by multinational enterprises (MNE). This essay has been divided into eleven parts. Part I is introductory and highlights significance of taxation in background tremendously increased international trade mainly undertaken by MNE in past few decades. Part II gives some basic definitions and concepts relevant to the topic. Part III takes up the question whether jurisdiction to tax is unlimited. Part IV focuses on the importance of issue of fiscal jurisdiction. Part V briefly enumerates various bases for assumption of jurisdiction. Parts VI, VII and VIII discuss in detail the taxation based on nationality, residence and source respectively. Part IX deals with functional link based taxation. Part X examines salient features of the worldwide unitary taxation. Part XI concludes the discussion after summing up various approaches.

I) INTRODUCTION

In the current era, the pattern of international trade shows a number of momentous developments. Firstly, the volume and extent of international trade has increased on enormous scale thanks to technological innovations especially in information technology, communication and transportation, decrease in barriers to international trade, easy cross-border mobility of goods and capital and rule based regulation of the international trade by the World Trade Organization (WTO). Secondly, the main chunk of trade is in the hands of MNE which operate beyond their country of origin. About ten years ago, MNE accounted for 25% of the world trade and 25% of world's GNP.[1] The same trend continues to rise and now the world is dominated by 500 MNE which control 90% of all the world foreign direct investment and over 50% of the trade. More than 40% of the global market has been captured by US-based MNE like Coca-Cola, Gillette, Lucent,

[1] Paul Kirkbride, Paul Pinnington and Karen Ward, Globalization: The Internal Dynamic (Edited by Paul Kirkbride and Karen Ward) (2001), John Wiley & Sons Ltd, Page 4

Boeing and GE Power System in Asia.[2] Noreena Hertz claims," out of world's 100 largest economies, 51 are now corporations, only 49 states."[3] Thirdly, there is decline in custom duties and other indirect taxes. Substantial reduction in tariff is one of the major goals of WTO as it is considered to be a trade barrier.[4] In the Preamble to the WTO Agreement, the member states committed to pursue its objectives by, *inter alia*, "entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade."[5] Fourthly, the patterns of fiscal transaction and international trade have become highly technical and very complex. The above mentioned facts establish that on one hand, there is increase in corporate profits of MNE and on the other hand, there is shortfall in revenue from indirect taxes.

Every state is obviously interested in receiving its fair share in tax revenue out of incomes or profits derived by all persons especially MNE which have any connection with it. But at the same time, every State is cognizant of the fact that MNE have become very mobile and there is perpetual fear of flight of capital, if, *inter alia*, taxes are unjust or inappropriate. The Ruding Committee (Commission of the European Communities, 1992) also expressed the fear of flight of capital with imposition of withholding tax.[6]

Every Sovereign State has jurisdiction to tax persons and transactions having some link with it. However, exercise of this jurisdiction to tax has been always been considered to be difficult and necessitates prudence and sanity. Unjust taxation resulted in rebellions in the past and loss of elections in the modern time. Mahabharata thinks that "the Ruler should act like a bee which collects honey without causing pain to the plant"[7] and Jean Baptiste Colbert concludes that "the art of taxation consists in so plucking the goose to obtain the largest amount of feathers, with the least possible amount of hissing."[8] Therefore, a State while exercising its fiscal sovereignty and tax jurisdiction cannot be

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[2] Paul Kirkbride, Paul Pinnington and Karen Ward, Globalization: The Internal Dynamic (Edited by Paul Kirkbride and Karen Ward) (2001), John Wiley & Sons Ltd, Page 4

[3] Noreena Hertz, The Silent Takeover, (2001) Random House, quoted by Alasdair Murray, Corporate Social Responsibility in the EU, Centre For European Reforms, Page 2

[4] Peter Van Den Bossche, The Law and Policy of the World Trade Organization, Text, Cases and Materials (2005), Cambridge University Press, Page 376.

[5] Ibid, Page 376.

[6] International Fiscal Association, Vision of the Tax Systems of the XXIst Century, Volume 21d (1997), Kluwer Law International, Page 28

[7] Victor Thuronyi, Tax Law Design and Drafting, (1996), International Monetary Fund, Page 95

[8] Willian J. Craig, Taxation of e-Commerce, Fiscal Regulation of the Internet (2000), Tolley Publishing. Page 1

oblivious of the prevalent political and socio-economic circumstances. The lesson from history and the current international economic trends demand exercise of tax jurisdiction based on just principles consistent with the international law including WTO law, without discouraging investment in the State or causing flight of capital out of the country in this highly competitive world.

II) BASIC CONCEPTS AND DEFINITIONS

The power to levy tax is an important prerogative of a sovereign. There is no universally agreed definition of sovereignty. **Sovereignty** as defined in the Encyclopedia of Public International law as "basic international legal status that is not subject, within its territorial jurisdiction, to the governmental, executive, legislative or judicial jurisdiction of a foreign State or foreign law, other than public international law."[9] **Jurisdiction** has been defined in the Encyclopedia of Public International law as "lawful power to act and hence to its power to decide whether and if so how to act."[10]

The concept of jurisdiction has been further elaborated by the same author as under:

> "The term "jurisdiction" is most often used to describe the lawful power of a State to define and enforce the rights and duties and control the conduct of natural and judicial persons. A Sate exercises its jurisdiction by establishing rules (sometimes called legislative jurisdiction or prescriptive competence), by establishing procedures for identifying breeches of the rules and the precise consequences thereof (sometimes called judicial jurisdiction or adjudicative competence) and by forcibly imposing consequences such as loss of liberty or property for breeches or pending adjudication, alleged breeches of rules (sometimes called enforcement jurisdiction or competence)."[11]

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[9] Encyclopedia of Public International Law, Volume 4, (1997), North-Holland Elsevier, Page 511-512
[10] Encyclopedia of Public International Law, Volume 3, (1997), North-Holland Elsevier, Page 55
[11] Ibid, Page 55

The relationship between sovereignty and jurisdiction has been summed up by Brownlie as under:

> "In brief, 'sovereignty' is legal shorthand for legal personality of certain kind, that of statehood; "jurisdiction' refers to particular aspects of the substance, especially rights (or claims), liberties, and powers."[12]

Fiscal (or tax) jurisdiction is entitlement or competence of a State to tax persons, property and transactions or events.[13]

III) LIMITATION TO TAX JURISDICTION

The issue of jurisdiction gains more significant when a national carries out taxable extraterritorially or an alien earns profits connected with the state. There is no unanimity of opinion regarding limits of the jurisdiction to tax. In the opinion of various authors notably Martin Norr, Dr. Arnold Knechtle and Asif H. Qureshi, there is no limit on state's jurisdiction to tax according to the international law.[14] Qureshi, however, admits that this unlimitedness is subject to minimum standard for treatment of aliens and a rule against extraterritorial enforcement.[15] On the other hand, various authors like Friedrich[16] suggest that there are limits to taxing power of a State. The role of international law on jurisdiction to tax has been accepted by the US Supreme Court in tax case *Burnet v Brooks*[17] and the Permanent Court of International Justice.[18]

Additionally, the concept of fiscal sovereignty has to be viewed vis-à-vis concept of sovereignty in general. The absolute sovereignty without limits does not exist anymore in the contemporary world and the sovereignty of a State is subject to limitations imposed in

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[12] Ian Brownlie, Principles of Public International Law (6th Edition), Oxford University Press, Page 105
[13] Asif H. Qureshi, The Public International Law of Taxation, Text, Cases and Materials (1994), Graham & Trotman/Martinus Nijhoff, Page 22
[14] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 12-18
[15] International Fiscal Association, Visions of the Tax System of the XXIst Century, (1997), Kluwer Law International, Page 60
[16] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 30
[17] Ibid, Page 31
[18] Ibid, Page 31

public international law. Therefore, the fiscal sovereignty and tax jurisdiction cannot be absolute and unlimited. Moreover, in the bilateral tax treaties concluded between States, there are restrictions on exercise of tax jurisdiction subordinate to the provisions of the treaties. All above facts lead to the conclusion that tax jurisdiction of a State is not unlimited

IV) IMPORTANCE OF FISCAL JURISDICTION

Despite the fact that a State has almost unlimited jurisdiction to tax (with some restrictions and limitations), it is vital to have clear-cut and well defined basis of jurisdiction in international taxation, for following reasons:

Firstly, it is the first question to be considered while enacting legislation, as it is of no use without having enforcement jurisdiction. On the other hand, a taxpayer's first line of defense is also contesting jurisdiction.[19] Secondly, double taxation resulting from overlapping fiscal jurisdictions can be resolved by negotiating double taxation treaties, for which consideration of jurisdiction factor is vital.[20]

V) DIFFERENT APPROACHES FOR EXERCISE OF TAX JURISDICTION

The fiscal jurisdiction can be divided into three portions: personal, territorial and functional sovereignty.[21] The **personal sovereignty** is exercise of authority over persons, both natural and juristic.[22] The **territorial sovereignty** is competence over all persons within territory.[23] The **functional sovereignty** involves situations where there is some form of government but no territory. e.g., international organizations, though without any territory, still enjoy authority.[24] A State may adopt jurisdiction on basis of personal sovereignty (nationality based taxation), territorial sovereignty (residence-based taxation

[19] Asif H. Qureshi, The Public International Law of Taxation, Text, Cases and Materials (1994), Graham & Trotman/Martinus Nijhoff, Page 23
[20] Ibid, Page 23
[21] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 43
[22] Ibid, Page 43
[23] Ibid, Page 45
[24] Ibid, Page 45-46

i.e. jurisdiction on taxable person and source-based taxation i.e. jurisdiction on taxable item) and functional sovereignty.[25] The tax jurisdiction can also be assumed on the basis of Unitary Taxation.[26] Therefore, corporate profits of MNE can be taxed on basis of nationality, residence and source and also on basis of functional sovereignty and unitary taxation.

VI) NATIONALITY-BASED TAXATION

Nationally-based taxation is an exercise of personal sovereignty and means creation of fiscal or tax liability on persons (both natural and juristic) by virtue of their nationality.

1) Basic Features

Nationality is the traditional base for assumption of jurisdiction over persons. This approach is being practiced by very few States like USA and some other countries.[27] Just as natural person is born through biological process on certain date and at certain place, which establishes his nationality, the company being a juristic person comes into existence on certain date and at certain place, through legal process of incorporation under domestic law. The place of incorporation under domestic law determines its nationality or citizenship in the State incorporating it. In other words, just as birth and ancestry of natural person establishes his citizenship, incorporation establishes nationality of the company.[28] The taxation based on citizenship is generally on worldwide income of such persons, which is sometimes called "full (unlimited, general) tax liability."[29]

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[25] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 43-46

[26] Sol Picciotto, International Business Taxation-A Study in the Internationalization of Business Regulation (1992), Weildenfeld and Nicolson, Page 230

[27] Michel W.E. Glautier and Frederick W. Bassinger, A Reference Guide to International Taxation-Profiting from Your International Operations,(1987), Lexington Books DC Heath & Company/Lexington/Massachusetts/Toronto, Page 40

[28] Ibid, Page 40

Ramon J. Jeffery, The Impact of the State Sovereignty on Global Trade and International Taxation,(1999), Kluwer Law International, Page 77

[29] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 48

It generally prevails over taxation based on residence and source[30] and so the corporate citizen is liable to tax even if it neither carries out any economic activities, nor is resident in that State. Tax liability arises even if its central management or control or registered office is located outside territorial limits of that State and even when their income derived in the State of residence is exempt from taxation by revenue laws of the resident State.[31] All citizens are under legal obligation to file return of income for tax purposes irrespective of their residence and geographical source of income.[32] The citizen can avoid or escape nationality-base taxation only by renouncing citizenship.[33]

2) Critical analysis

a) Merits

Its legitimacy has been accepted by a number of judicial authorities. The US Court in case *Cook v Tait,* 265 U.S. 47 (1924), while deciding the question whether a US national permanently residing abroad was liable to tax by US tax authorities, held that authority to tax is not always incidental to the *lex situs*.[34] The American Law Institute, Restatement of the Law recognizes nationality as basis for taxation of natural and juristic persons.[35] The concept of corporate citizenship has been recognized by courts in a number of cases like *Baasch and Romer* case (1903) and *Barcelona Traction Light and Power Co. Ltd* etc.[36]

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[30] Michel W.E. Glautier and Frederick W. Bassinger, A Reference Guide to International Taxation-Profiting from Your International Operations,(1987), Lexington Books DC Heath & Company/Lexington/Massachusetts/Toronto, Page 40

[31] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 49-50

[32] Michel W.E. Glautier and Frederick W. Bassinger, A Reference Guide to International Taxation-Profiting from Your International Operations,(1987), Lexington Books DC Heath & Company/Lexington/Massachusetts/Toronto, Page 40

[33] Ibid, Page 40

[34] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 49

[35] Asif H. Qureshi, The Public International Law of Taxation, Text, Cases and Materials (1994), Graham & Trotman/Martinus Nijhoff, Page 65

[36] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 77

b) Demerits

Firstly, its legality and legitimacy have been questioned by a number of authors. Von Bar termed nationality based taxation as undesirable.[37] Mann opined that in present international economic milieu of free mobility of capital and person, political allegiance, as opposed to economic allegiance, was not adequate base to create a fiscal liability.[38] The League of Nations Economic and Finance Committee declared nationality as anachronistic basis for taxation.[39] Knechtle was doubtful about legitimacy of nationality-based jurisdiction.[40]

Secondly, all other approaches are based on economic link between taxable person or taxable event and the State, while nationality-based taxation creates tax liability because of political allegiance. Therefore, it is unjust and unfair in present age of free mobility of persons and capital.[41] Georg Schanz opined in 1892 that the most appropriate manner for taxation might be economic allegiance or economic affiliation.[42]

Thirdly, the administration of nationality-based taxation may not always be cost-effective. Rigorous efforts and huge expensive may be required for proper enforcement and the resultant revenue may not be proportionate to the expenditures.[43]

Fourthly, there a lot of administrative problems while dealing with persons who are national but neither resident, nor have any source of income in the country of nationality. Such problems include: difficulty in enforcement of filing of returns, lack of information regarding their addresses and quantum and nature of economic activities, problems in

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[37] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Pages 66-67

[38] Ramon J. Jeffery, The Impact of State Sovereignty on Global Trade and International Taxation, (1999), Kluwer Law International, Page 49

[39] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 67

[40] Ibid, Page 67

[41] Boris I. Bittker and Lawrence F. Ebb, United States Taxation of Foreign Income and Foreign Persons (2nd Edition), Federal Tax Press Inc, Page 2

[42] Peter Andrew Harris, Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries, (1996), IBFD Publications, Page 276

[43] Income Taxation and International Mobility, Edited by Jagdesh N. Bhagwati and John Doughlas Wilson (1989), The MIT Press, Page 47

conducting audit, recovery or collection of taxes, compliance problems, difficulties in verification of information etc. [44]

Fifthly, nationality-based approach has not been adopted by overwhelming majority of States, which implies that it does not enjoy support of majority of the world community.

Finally, it renders nationals liable to double and even triple taxation; firstly on the basis of nationality (by the State of nationality), secondly on the basis of residence (by the State of residence) and thirdly on the basis of source (by the source State),[45] which need to be avoided by bilateral double taxation treaties.[46]

Therefore, the nationality is not a fair and judicious approach of taxation and needs to be discontinued.

VII) RESIDENCE-BASED TAXATION

A State may place a person under tax jurisdiction because of some nexus or connecting factor between the person engaged in taxable economic activities and the State. The assumption of jurisdiction on this basis is called residence-based taxation[47] and is an exercise of territorial sovereignty of a State like source-based taxation.

1) Basic Features

Residence status includes both citizens and non-citizens based on fiscal link between person and the State.[48] The persons are divided into Residents and Non-residents based on criteria prescribed in the domestic fiscal laws of the State. Residents are generally

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[44] Income Taxation and International Mobility, Edited by Jagdesh N. Bhagwati and John Doughlas Wilson (1989), The MIT Press, Pages 44-48

[45] Michel W.E. Glautier and Frederick W. Bassinger, A Reference Guide to International Taxation-Profiting from Your International Operations,(1987), Lexington Books DC Heath & Company/Lexington/Massachusetts/Toronto, Page 167

[46] Ibid, Page 167

[47] Brian J. Arnold and Michael McIntyre, International Tax Primer, (2nd Edition), Kluwer Law International, Page 15

[48] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 90

liable to tax on their worldwide income.[49] Non-residents are liable to tax only on income, as defined under domestic legislation, derived from or relatable to that State and may further be treated differently vis-à-vis residents like taxation at different rates, or different tax basis, liability to pay additional taxes, exemptions from certain types of income, different requirements for withholding taxes, exemptions from certain statutory obligations and different compliance rules.[50] Tax residence rules are defined in domestic Acts or established by practices or judicial pronouncements[51] and vary from state to state and so may give rise to conflicts resulting in "dual residence"(resident in more than one State) or "non-residence" in all states (the person not resident in any State).[52] Where the resident status is determined by location of central management and control or economic activities, companies can avoid resident status either by shifting head office or corporate activities in another State.[53]

2) Tax Residence Rules for Companies

There is no uniformity of parameters for assigning status of resident to companies. Most commonly employed rules are as under:

a) The test of place of incorporation or registration or legal seat may be used as the only factor or as one of the factor in addition to others.[54]

b) The location of management or real seat may be employed as the only factor for determining residence status or management and or control may be used as one of the determining factor.[55]

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[49] Daniel Sandler, Pushing the Boundaries: The Interaction between Tax Treaties and Controlled Foreign Company Legislation, (1994), The Institute of Taxation, in collaboration with The Institute for Fiscal Studies, Pages 2-3

[50] Roy Rohatgi, Basic International Taxation, Volume 1, (2nd Edition) Richmond, Page 197

[51] Ibid, Page 199

[52] Ibid, Page 199

[53] Michel W.E. Glautier and Frederick W. Bassinger, A Reference Guide to International Taxation-Profiting from Your International Operations,(1987), Lexington Books DC Heath & Company/Lexington/Massachusetts/Toronto, Page 44

[54] Roy Rohatgi, Basic International Taxation, Volume 1, (2nd Edition) Richmond, Page 213

[55] Ibid, Pages 213-214

c) Other criteria like location of head or main office or principal activity or nationality or tax residence of controlling shareholders or directors may be used for determination of residence.[56]

3) Conflict of Residence Status

A company may be resident in more than one State ("dual resident") because of variation in definition of residence from State to State. For example, it may be resident in one State on the basis of incorporation and also resident in another State on the basis of place of central management and control. The OECD Model Convention (OECD MC) recognizes this anomaly and provides tie-breaker rule in the Article 4(3) which states that whenever a non-individual person (including company) is resident in more than one State, it shall be deemed to be resident in State in which its "place of effective management" is located.[57]

The Article 4(3) of the United Nations Model Convention (UN MC) however, provides that in case of such conflict, the company shall be deemed to be resident in State wherein it was created under its domestic laws.[58] The Article 4(4) of the UN MC further empowers the States to settle the question of residence by mutual agreement, if the matter is not resolved under the provisions of the Article 4(3) of UN MC.[59]

4) Critical analysis

a) Merits

Firstly, the tax on worldwide income of residents does not violates territoriality principle of the public international law, as the charge of tax is not on (extra-territorial or foreign) income but on the (domestic) person who is within the territorial limits of a State.[60]

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[56] Roy Rohatgi, Basic International Taxation, Volume 1, (2nd Edition) Richmond, Pages 213-214
[57] Ibid, Page 343
[58] Ibid, Page 377
[59] Ibid, Page 377
[60] Robert Couzin, Corporate Residence and International Taxation (2002), International Bureau of Fiscal Documentation (IFBD), Page 7

Therefore, the total world income of the resident person is in accordance with the fundamental principles of the international law.

Secondly, the residence-based taxation has generally been consensually recognized as legitimate basis for taxation [61]and has been adopted almost by all the States.

Thirdly, there are very few administrative problems regarding compliance and recovery, as the residents have assets and economic interests within the State.

b) Demerits

Firstly, different definitions of resident under domestic legislations of the States may give rise to conflict necessitating resolution either in light of Article 4(3) of OECD MC or Article 4(3) of the UN MC or by negotiating bilateral treaties.

Secondly, residence-based taxation is not the completely undisputed approach. Some authors raise voice against the notion of worldwide taxation of residents. Vogel is of view that State should only be entitled to tax income which has source within the State.[62]

Thirdly, if a State concurrently employs other bases of taxation like source etc, there may be double taxation, which needs corrective measures in form of unilateral relief or conclusion of double taxation avoidance treaties.

VIII) SOURCE-BASED TAXATION

Source-based taxation is an exercise of territorial sovereignty of a State whereby it creates tax liability on non-residents by taxing their income which has source in that State (domestic-source income). In other words, a State assumes tax jurisdiction on basis of nexus between income-generating economic activities and the State.[63] In the contemporary era of globalization when the MNE are operating beyond territorial boundaries of their State of origin, it is the most significant way the host state (where the

[61] Ramon J. Jeffery, The Impact of the State Sovereignty on Global Trade and International Taxation,(1999), Kluwer Law International Page 45

[62] Ibid, Page 45, Footnote No. 106

[63] Brian J. Arnold and Michael McIntyre, International Tax Primer, (2nd Edition), Kluwer Law International, Page 15

MNE are engaged in income-generating economic activities) can legitimately tax the income that has connection within its territory.

1) Basic Features

The term "source" may be used in two main senses: Firstly, in terms of geographical sense i.e. area or territory within which certain income is derived. Secondly, it may be used in income category sense which refers to certain categories of income like business profits, interests and dividends etc.[64] Before taxing the income, it is necessary to identify the source from which income was derived in order to assume lawful jurisdiction over the income. Unless the source comes into the ambit of jurisdiction of a State in accordance with the provisions of its domestic legislation, the income derived from the source cannot be taxed.[65] The connecting factors between source and the State are called the "source rules" which identify the area wherein the income was generated as well as the State having lawful jurisdiction to tax the income derived from that source.[66] Each State has its own source rules.

Some of the important basic source rules are as under:

a) Source of personal services (e.g. performance of a non-resident singer) is usually the State wherein such services are rendered.[67]
b) Source of the active business income (e.g. manufacturing) is usually is the State wherein such income-generating operations are carried on.[68]
c) Source of the passive business income (e.g. royalties, interests and dividends etc.) is usually in the State of the person making such payments (the payer).[69]
d) Location of tangible property determines source of income derived from it.[70]

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[64] Michel W.E. Glautier and Frederick W. Bassinger, A Reference Guide to International Taxation-Profiting from Your International Operations,(1987), Lexington Books DC Heath & Company/Lexington/Massachusetts/Toronto, Pages 47-48
[65] Ibid, Page 48
[66] Roy Rohatgi, Basic International Taxation, Volume 1, (2nd Edition) Richmond, Page 222
[67] Ibid, Page 222
[68] Ibid, Page 222
[69] Ibid, Page 222
[70] Ibid, Page 222

e) Source of intangible property rights is usually either in State where these are used or in the State of payer.[71]

2) critical analysis

a) Merits

Firstly, it is the most important way in which a State can assume legitimate jurisdiction over non-resident aliens on income derived within the host state.
Secondly, there is almost unanimity among the world community on its legitimacy and is almost universally practiced by the States.

b) Demerits

Firstly, most States use source-based and residence-based taxation simultaneously resulting in double taxation, as the home State tax worldwide income (domestic and foreign) on basis of residence principle and the host State on basis of source principle. This anomaly has to be resolved by granting unilateral relief in domestic legislation or by negotiating bilateral double taxation agreements. The relief may be granted by exemption method (by full exemption or exemption with progression of foreign-source income), by credit method (by allowing the credit of foreign tax paid in the host State which may be full, ordinary or restricted credit) or by tax sparing.[72]
Secondly, the law on source taxation is relatively less developed in tax literature and domestic legislation, which may leave ambiguities and confusion in certain circumstances.[73]

[71] Ibid, Page 223
[72] Michel W.E. Glautier and Frederick W. Bassinger, A Reference Guide to International Taxation-Profiting from Your International Operations,(1987), Lexington Books DC Heath & Company/Lexington/Massachusetts/Toronto, Pages 179-182
[73] Brian J. Arnold and Michael McIntyre, International Tax Primer, (2nd Edition), Kluwer Law International, Page 21

Thirdly, the source-based taxation has to be used in very prudent manner by the host State. If the taxation is harsh or confiscatory, there is risk of flight of capital which no State can afford in this era.

Fourthly, because of different source rules, income arising from same source may be taxed by two States, resulting in double taxation. For example, source of rental income from immoveable property may be taken in the State of where that is located or where rent agreement is executed.[74]

IX) FUNCTIONAL LINK BASED TAXATION

In certain situations like space occupied by sea (like the Continental Shelf, the Exclusive Economic Zone, the Deep Seabed etc.) and air space,[75] it is difficult to tax using classical approaches and hence, taxing non-resident aliens is particularly problematic. In such situation, it has been suggested that functional link could be used as basis for taxation.[76] It is however a new concept and highly controversial.

X) WORLDWIDE UNITARY TAXATION (GLOBAL FORMULARY APPORTIONMENT SYSTEM)

1) Basic Features

Under this approach of taxation of US origin, all affiliated entities doing business in more than one State, are treated as one person, doing a "unitary business" and their total taxable income (domestic and foreign) is determined. Then share of income of each State is computed in a pre-determined mathematical formula and is distributed in all States wherein these affiliated entities carried on income generating economic activities. Each State then applies its own tax rates according to its domestic legislation.[77]

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[74] Roy Rohatgi, Basic International Taxation, Volume 1, (2nd Edition) Richmond, Page 226

[75] Asif H. Qureshi, The Public International Law of Taxation, Text, Cases and Materials (1994), Graham & Trotman/Martinus Nijhoff, Page 75

[76] Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law, (1989) Kluwer Law and Taxation Publishers, Page 55

[77] Brian J. Arnold and Michael McIntyre, International Tax Primer, (2nd Edition), Kluwer Law International, Page 78

2) Critical Analysis

a) Merits

Firstly, the MNE operating in different States will be taxed only once and tax liability would be determined only once.[78]

Secondly, if the system goes well, it would enable the developing and least developed States to receive fair share in the tax.[79]

Thirdly, it will discourage harmful tax competition.[80]

Fourthly, it will facilitate the trade by removing restrictions on cross-border trade and by allowing transactions between affiliated entities un-questioned.[81]

b) Demerits

Firstly, the taxation systems and accounting standards of the States would have to be harmonized before this system is placed in practice.

Secondly, this system cannot work without co-operation between States.

XI) CONCLUDING REMARKS

The public international law does not approve any particular basis for taxation. Each State is free to choose bases of taxation. Generally more than one approach is adopted to ensure that the State is not deprived of its legitimate share in revenue. Residence and source are the most widely employed bases for taxation among majority of States and have. These two approaches have been recognized as legitimate bases by the Committee of Four (economic experts appointed by the League of Nations)[82] and are practiced by the overwhelming majority of the States. Any double taxation resulting from overlapping

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[78] Brian J. Arnold and Michael McIntyre, International Tax Primer, (2nd Edition), Kluwer Law International, Page 79

[79] Ibid, Page 79

[80] Ibid, Page 79

[81] S.O. Lodin and M.Gammie, Home State Taxation (2001), IBFD Research Department, Page 16

[82] Peter Andrew Harris, Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries, (1996), IBFD Publications, Page 301

jurisdiction is easily manageable by unilateral relief or double taxation treaties. The nationality bases jurisdiction is not much favored and lacks legitimacy. The Unitary Taxation is by and large idealistic model in the context of MNE and practicable only after harmonization of the taxation systems and accounting standards of the States and ensuring cooperation between the States.

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