ECTOPIA, TAX LAW, AND INTERNATIONAL TAXATION [1997]

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Ectopia, Tax Law and International Taxation*

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Introduction

THE term "ectopia" is not in common use in the English language,[1] though its adjective is found in the expression "ectopic pregnancy", which describes a pregnancy that occurs in the wrong place. Just as an ectopic pregnancy is a pathological, serious, and incurable condition (in the sense that one cannot save the baby), so is the ectopia of income tax law pathological, serious, and incurable, though governments strive to alleviate the problems to which the condition gives rise.

"Ectopia" is used here as a label for a characteristic of income tax law that distinguishes it from most other forms of law. This characteristic is that income tax law is, in a fundamental sense, dislocated from the facts to which it relates. One result is that income tax law is and must always be fundamentally flawed. The flaws of income tax law are not always obvious at first sight and, when they are identified, they are not necessarily recognised as fundamental and pathological to the system.

There is a tendency to think that with goodwill, application, intelligence, industry, and the necessary resources, humans will be able to resolve the problem of being unable to create an unflawed income tax system. That thought is wrong, which is not to say that it is impossible to mitigate some of the problems of income tax law as they manifest themselves in some cases, nor that it is impossible to make some aspects of an income tax system work very well in some situations. The thesis of this article is that problems that result from the ectopia of income tax law are generally acute and particularly resistant to cure. This is particularly true of problems that are associated with the taxation of international trade and investment. The first part of this article introduces the reader to the elements of income taxation that bring about these problems in the international arena. The second part considers several specific aspects of the taxation of international transactions that are caused by ectopia. First, how is income tax law ectopic?

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[1] "Ectopia *Pathol.* Displacement; anomaly of situation or relation." *Oxford English Dictionary.* The use of "ectopia" to refer to the jurisprudential concept that is discussed in this article has attracted some support. Lord Cooke of Thorndon in "A Real Thing", Turning Points of the Common Law (The 1996 Hamlyn Lectures), 1996, Sweet & Maxwell, London) 1, 12. See also United Kingdom Inland Revenue Tax Rewrite Project Team, "The audience for tax legislation, is it different from that for other legislation? Should it be considered to be the same for all sections or Parts?", a paper presented to the New Zealand Inland Revenue Department Tax Drafting Conference, Auckland, November 1996, at p. 10, para. 33.

Symbiosis between law and its subject matter

The answer to the question can best be approached by first describing some relevant features of a paradigm of law. Comparison of income tax law with the paradigm can then show what is meant by the ectopia of income tax law, and how income tax law departs from the paradigm.

In the present context, the relevant feature of law in general is that there is a symbiosis between law and its subject matter. That is, there is a natural, almost organic, relationship between law and what law is about. This natural relationship is so sensible and expected that we take it for granted.

For example, if a sovereign decides to make a law to inhibit and to punish theft, it is no surprise that the product of the sovereign's labours are rules that describe theft and other larcenous activities in their various forms, and that prescribe penalties for actions that answer these descriptions. The better the words of the sovereign's laws accord with the facts of the actions that the sovereign wants to punish, the more efficiently will her objective be achieved. If the sovereign's will is clear from the text of her laws, judges will more efficiently give effect to that will. This is so even if the sovereign is a feared dictator with a dependent judiciary willing to bend to her wishes. If they can understand the sovereign's laws, dependent judges will not have to ask her what she means. In the more desirable case of an independent judiciary, careful drafting of laws is even more important because the sovereign cannot influence her judges in the exercise of their function.

The factors mentioned are so obvious that, doubtless, law-makers give them little thought as they go about their business. Nevertheless, these factors, together with such things as pride in their work, persuade law-makers to ensure that laws are as closely related to their subject matter as can be managed. The same influences act on law makers when they are drafting income tax laws as is the case with any other laws. But the results are inevitably different. The reason is that the ordinary symbiosis that exists between law and its subject matter is absent from the foundations of income tax law.

Concept of income

A convenient starting point for an explanation of the lack of symbiosis between income tax law and its subject matter is the question of the concept of income. Income tax is one of a group of taxes that tax *gains*. That is, income tax is not, for example, a transaction tax, such as a value added tax or a sales tax, nor is it a wealth tax, such as a death duty or the typical property tax (rates) levied by local governments. Income tax taxes gains, but not all gains. Typically, income tax does not tax capital gains and many income taxes do not tax gains in the form of lottery winnings or intra-family gifts. Most income taxes do not tax windfalls, such as finding someone's wallet and being allowed to keep it when the police cannot trace the owner.

The fact that income taxes by definition do not tax *all* gains means that it is fundamental to income tax law that there must be a concept of income. This concept is necessary so that people may know which gains are subject to the tax and which are not. Some income tax laws have more than one concept of income. In particular, schedular income tax laws such as are found in the United Kingdom and Hong Kong have different rules for different kinds of income (for example, salaries, business profits, farming profits, interest, and so on). Such laws contemplate more than one concept of income, but that consideration has no implications for the present discussion. It is the existence of, and the crucial role of,

concepts of income that are important, whether a particular income tax system employs one or several concepts.

The ectopia of income tax law lies in the law's dependence on the existence of a concept of income. The problem is that the concept of income is not something that ultimately can be defined by law because it is not something that exists either as a physical fact or as an abstract thought. This characteristic distinguishes income from other subjects of law that, typically, can be defined by law because they are either physical facts (for example, a "blunt instrument" used in an "assault") or abstract thoughts (for example, "*mens rea*").

Of course, many subjects of law, particularly abstract thoughts, are difficult to define. There are, for example, many hundreds of thousands of words written on what the law means by *mens rea*. But there is no ultimate conceptual impossibility in defining what the law means by "guilty mind" in the sense that there is an ultimate conceptual impossibility in defining "income". The problem of defining *mens rea* is simply very difficult in some cases, but not impossible.

To say that it is conceptually impossible to define "income" does not mean that tax law can never recognise a particular receipt as income. Indeed it can. For example, rent, salaries, wages, and interest are usually recognisable as income without any doubt. Though, to make doubly sure, legislation that taxes "income" may specifically state that it extends to rent, salaries, wages, and interest, together with a long list of other receipts. What is meant by the impossibility of defining "income" is that one cannot identify the borders of the concept because, at its borders, income is a fiction, invented for the purposes of income tax legislation, that does not have independent existence in the world of physical fact or abstract thought. This fictional characteristic of income stems primarily from two factors: space and time.

Space

In this context, the term "space" refers to the consideration that all countries place geographical limits on the income that they tax. Some countries tax only income that finds its source within their own jurisdiction. Others tax foreign-source income as well if it is derived by a resident or, possibly, by a citizen. All countries that levy income tax assess income that is sourced within their boundaries and is derived by a resident.

These rules are self-imposed. There is no principle of international law that prevents a country from trying to tax foreign-source income that is derived by someone who is neither a resident nor a citizen. In fact, countries sometimes do tax income derivd by non-residents that has a foreign source according to general principles.

Take, for example, interest on money lent in Europe by one European company to another, that the borrower uses for purpose of a business that it carries on through a fixed establishment in New Zealand. Section OE4(1)(n)(ii) of the New Zealand Income Tax Act 1994 deems such interest to have a New Zealand source for tax purposes. However, in the absence of such a provision, the New Zealand Court of Appeal (to say nothing of courts in other jurisdictions) would hold that the interest finds its source in Europe.[2]

The example of this New Zealand source rule that applies to interest is far from isolated, but, ordinarily, countries do not try to tax income that is neither sourced within their borders nor is derived by a resident or citizen. One reason is comity: a reluctance to tax something in someone else's jurisdiction. A second is practicality: it is hard to collect tax on

[2] *Commissioner of Inland Revenue v. Philips Gloeilampenfabrieken N.V.* [1955] N.Z.L.R. 868.

income that has little or no connection with one's own jurisdiction. A third is, no doubt, a common understanding among law-makers of what income tax law is about, and a common understanding as to the reach of a nation's public law in general. Ordinarily, states do not purport to accord to their public law an ability to operate beyond its home jurisdiction and individual subjects.

Source

Once a state has decided that it will tax domestic-source income, and foreign-source income only when derived by a resident, the state must come to grips with the concepts of source and residence. Both of these present problems, but, probably, source is the most difficult.

Countries are defined primarily by reference to geography, a discipline that deals with physical phenomena. Certainly, countries are so defined for tax purposes. Income, on the other hand, is not a physical phenomenon. It may be represented by physical things, most notably by coins and bank notes, and it may be calculated and recorded on physical media, either paper or electronic. But income itself, like money, is an abstract concept.

Despite the abstract nature of income, the juridical system must treat income as if it has a physical source in a geographical location in the same manner as a river has a physical source in some place. As an Australian judge once said, for tax purposes the source of income is "a hard, practical, matter of fact".[3] In truth, however, income can no more have a physical source than can, say, patriotism or capitalism. And yet source rules, a crucial aspect of the juridical concept of income, are based on this contradiction.

The sort of problem to which this contradiction leads is readily demonstrated. Take interest on a loan from a German-resident creditor to a French-resident debtor pursuant to a contract negotiated and signed in England. Assume that the loan is secured over property in Canada and that the principal is used in a business that is carried on in the United States. The interest is paid by automatic transfer between accounts in the same Hong Kong bank. Such a loan would almost certainly never occur, if only because an alert adviser would point out the tax pitfalls (deemed source in several jurisdictions, leading to several imposts of tax on the same interest). However, the hypothetical loan illustrates the point made here: there is no logical or sensible way in which to accord a jurisdictional source to the interest, and yet for tax purposes that must be done. The answers (and there will be several answers as one moves from one jurisdiction to another) must be fictions.

Instructively, these fictions may be compared with the operation of other laws that may have an impact on the interest. None of the jurisdictions mentioned would have theoretical difficulty (and seldom any practical difficulty) in deciding whether the right to interest on the loan is enforceable, in giving judgment for debt in respect of unpaid interest, or in enforcing a foreign judgment to that effect. But note that these decisions relate to physical facts: whether the parties' actions amount to an enforceable loan contract; whether interest due has been noted as transferred from one account to another; and whether a foreign court has pronounced judgment.

In contrast, a judgment that the interest arises in one jurisdiction and not in the others must execute the action of fitting a metaphysical fact into a physical, geographical place, which is a logical impossibility. Law-makers are apt to respond in the only way possible: to pass laws that deem certain formal, physical facts that relate to a loan to determine the

[3] *Nathan v. Federal Commissioner of Taxation* (1918) 25 C.L.R. 183 at 189–190, *per* Isaacs J.

source of the interest. In the case of section OE4(1) of the New Zealand Income Tax Act 1994 such facts include: place of contracting of loan, place of security, and residence of borrower.

Business profits

Business profits furnish a second example of the difficulty of ascribing a jurisdictional source to particular income. Take, for example, the profit made by an airline from a sector of an intercontinental flight that passes over international waters, as well as over several countries. The passengers will share among them a number of points of departure and destination. They will have bought their tickets in a wider range of jurisdictions, using agents and credit that are connected with even more jurisdictions. The question: "What is the source of the profit derived by the flight through the sector in question?" is almost meaningless in any sense that can have any connection with factual reality, and yet for tax purposes this question must be resolved.

Import-export contracts give rise to similar problems, though, ordinarily, fewer jurisdictions are involved. When a manufacturer in Taiwan sells goods to a customer in New Zealand, what is the source of the profit, assuming that there is a profit? Does it make any difference whether the sale is in response to an order placed direct by the New Zealand customer, or through a New Zealand branch that is maintained by the manufacturer, or through a New Zealand subsidiary? The answer to the first question is difficult. The answer to the second is yes, in that the structure of the transaction and the business vehicle employed by the manufacturer to make the sale will make a difference.

Jurisdictions as fictions

Like the interest in the earlier example, these business profits cannot logically be said to be sourced in one jurisdiction rather than another. The physical facts that have been mentioned are related to the interest or to the profits but cannot be connected with them in the sense that two physical facts can be connected, nor in the sense, for instance, that an abstract premise can be connected by logic with an abstract conclusion.

The logical separation of the world of physical facts and the world of abstract concepts is the fundamental reason for the difficulty of relating income to a particular jurisdiction. Previous work by the author has suggested another reason: that jurisdictions and their borders are fictions that are invented by people, not naturally occurring phenomena, whereas profit is something that occurs naturally. It is true that many national borders follow sea coasts, rivers, ranges, and other natural geographical features. But these incidents of topography are not necessarily borders: they are borders only because people say that they are borders. National borders form a matrix, created by humans, that lies over the natural world.

The natural world is formed, most obviously, by sea and land, but people occur in the natural world, and so does economic activity. Economic activity can occur without any law at all: for example, barter with immediate delivery between people who do not trust one another, or trade with credit between people who rely on trust but who know they have no remedy if the other party fails to perform. More so, economic activity has no need of national borders. Indeed, international borders are at best an irrelevancy and more commonly a hindrance to international trade and investment.

In previous articles it has been pointed out that profit from economic activity is a naturally occurring phenomenon, but national borders are not. From these facts, it has been argued that there is no connection between profits (or interest, for that matter) and jurisdictions that are surrounded by borders or, at least, no connection that helps to locate the source of profits in a particular jurisdiction.[4] The conclusion is correct, but the logic is wrong. The reason that prevents a connection being made between profit and jurisdiction is the reason that has already been explained: that is, profits are an abstraction, but jurisdictions are part of the world of physical facts. This is so, even though the borders of jurisdictions are not naturally occurring but are defined by people.

It is the ectopia between the physical and the abstract that is responsible for the phenomenon that the source of income cannot be located in a particular jurisdiction or, at least, it cannot be so located by dint of logical argument based on *a priori* principles. The phenomenon is not caused by the distinction between income being naturally occurring and borders being defined by humans.

This conclusion can be demonstrated by considering naturally occurring physical things. We can say that the source of the Seine is in France or that Kilimanjaro is in Tanzania and be certain that we are correct, at least at the time of speaking. That is because although France and Tanzania are defined by the actions and agreements of people, not by nature, the definitions that we employ are definitions (borders) that themselves are defined by reference to natural, physical features of the landscape. We can therefore make the required logical connection between a country and a mountain or a river in that country; the mountain and the river are physical facts, as are the features of the landscape that we use to define the borders of the country. Accordingly, if income, which is a naturally occurring phenomenon, were a physical thing its source could be located in a country, even though the country has been defined by humans, and not by nature.

Residence

As mentioned earlier, the question of space is, with time, one of the two factors that helps to explain the ectopia of income tax law. A sub-issue within the category of space is the question of source of income, which has been discussed. The second sub-issue within space is residence. If states rule, as many do, that their residents must pay tax on foreign-source income simply because they are resident in the jurisdiction, then states' laws must define "residence". Further, there must be definitions in respect of both individuals and corporations.

As far as humans are concerned, the problems of definition of residence are practical rather than conceptual. Individuals are physical facts, and the legal concept of residence relates them to another physical fact: a taxing jurisdiction. Making this relationship is conceptually a possible goal, because the two elements are both physical. This is in contrast to the object that the concept of source has as its goal, to relate jurisdiction, a physical thing, and income, which is at most an abstract fact.

Although the goal of rules of residence is conceptually a possible goal, it is difficult. People's habit of moving makes it more difficult to decide whether someone is resident in a

[4] John Prebble, "Ectopia, Formalism, and Anti-avoidance Rules in Income Tax Law" in W. Krawietz, N. MacCormick and G. H. von Wright (eds), *Prescriptive Formality and Normative Rationality in Modern Legal Systems, Festschrift for Robert S. Summers* (Duncker and Humblot, Berlin, 1994) p. 367, at 373–375; John Prebble, "Why is Tax Law Incomprehensible?" [1994] B.T.R. 380 at 384.

jurisdiction than, for example, whether a particular mountain is within the borders of that jurisdiction. Depending on the rules that jurisdictions may adopt, there are many facts that may be relevant to deciding where someone is resident: location of home, place where family lives, time spent within the borders, and so on. Depending on law-makers, residence rules may take account not only of physical facts like those just mentioned but also of metaphysical facts such as intention. Also, most, perhaps all, jurisdictions admit the possibility that people may have more than one fiscal residence. These difficulties lead some jurisdictions to pass laws that determine the bulk of residence questions by reference to formal, arbitrary criteria: typically, has the individual been present in the jurisdiction for at least a certain minimum number of days?

It is tempting to suggest that, like the rules of source, such arbitrary rules create an ectopia between tax law and its subject matter. The suggestion is correct, but only in the sense that in any particular case any formal rule is apt to create a gap between the rule and the facts to which it applies. Theoretically, a law-maker *could* pass a law that by one or more of hundreds of detailed, express provisions, without arbitrariness, would enable an individual to be connected with his or her appropriate jurisdiction or jurisdictions by rules that could be called the rules of residence. In practice, that cannot occur because of the multifarious variety of possible human behaviour. The arbitrariness of residence rules results, as stated, from practical difficulty, not from conceptual impossibility.

Corporate residence

The same cannot be said of rules that are calculated to determine corporate residence. A company is represented by physical facts (its documents of incorporation) but it is itself not even an abstract fact. It is a fiction. Nevertheless, for tax systems to operate companies must be accorded residences in jurisdictions just as humans are accorded residences in jurisdictions.

Countries often legislate to say that companies that are incorporated in their jurisdictions are resident there. This solution has the merit of certainty, but it is even more formalistic than a rule that says people remain forever resident for fiscal purposes where they were born. No jurisdiction is known to the present writer to adopt this test for people, yet the test has a slightly closer connection with reality than the common place-of-incorporation test that is employed for companies.

If, despite logic, it is possible for companies in law to have a substantive connection with a geographical locality, that connection can only be in terms of residence of shareholders, directors, or employees, or in terms of the place or places where directors or employees carry out their work for the company.

Humans must have spent at least *some* time in the jurisdictions where they were born, but (to the extent that companies are capable of having a substantive connection with any geographical place) companies may have no substantive connection at all with the place of their incorporation. The result is that the place-of-incorporation test of corporate residence for some companies reaches a result that is purely formal and devoid of any substance.

The solution is only a little happier when courts or legislatures try to compose substantive corporate residence rules. They employ expressions like, "Where the company's real business is carried on",[5] and "where what we should call the head office in

[5] *De Beers Consolidated Mines Ltd v. Howe* [1906] A.C. 455, H.L.

popular language is, and where the business of the company is really directed",[6] and "centre of management".[7] These expressions relate to the actions of people or, in the case of "head office", to the bricks and mortar that surround some of the people in question. At least the expressions relate current facts (of human action and place) to another fact (geographical jurisdiction). In this respect, the expressions are part of a law that more closely reflects reality than a law that turns on the location of a formal act of incorporation that may have occurred many years ago. But, nevertheless, the relationship of fact to fact is via an intermediate step that comprises a fiction: the corporation itself.

The question of corporate residence is compounded by another factor: because a company is a fiction, the statement that a company derives income is also a fiction. Nevertheless, parliaments are forced to draft income tax laws that assume that companies can derive income because so much of commercial life is organised on this very assumption. The assumption leads to a number of anomalies, the most obvious of which may be noted in passing: corporate profits are apt to be taxed twice, once in the hands of the company, and again as dividends derived by shareholders. Many countries enact imputation systems to overcome this difficulty. Be that as it may, the importance in the present context of the factor of fictional derivation of income by corporations is that income tax law in this area finds itself two steps away from reality: it must attribute income to a fictional entity that cannot in truth derive income (nor, indeed, do anything else), and this attribution must be done on the basis of the entity's connection with a fictional residence where the entity is assumed by law to live.

Where does this discussion lead? To a conclusion that the rules of corporate residence for fiscal purposes require the law to do two things that are conceptually impossible: to attribute a real, geographical residence to a fiction and to do so for the purpose and in the context of assuming that the fiction can derive income. This paragraph thus describes a second gap between tax law and its subject matter that may be classified as a problem of space.

Time

The second major factor that separates income tax law from its subject matter is time. On one hand, the paradigm of income is a stream that goes on more or less indefinitely. This is particularly true of the profits of a successful business. Considering business profits as a representative form of income, it follows that one cannot truly know whether a business has made an overall profit and, if so, how much, until the business comes to an end.

On the other hand, if income is to be taxed in any efficient manner governments cannot wait until businesses terminate. Income must be taxed in the meantime. To that end, income must be divided into segments. The only sensible method of segmentation in this context is by reference to time. Thus, for tax purposes we identify segments of income by reference to their starting and ending dates. Invariably, tax systems use a period of twelve months as the appropriate length for these segments, but there is no *a priori* reason why this should be so, particularly where the income in question is not affected by seasonal factors. Segments of six or sixteen months would be just as good, except that people are so used to employing the year to measure almost anything that lasts longer than months and that is quantified by reference to time that to use another duration would be confusing.

[6] *American Thread Co. v. Joyce* (1913) 6 T.C. 163, at 165.
[7] New Zealand Income Tax Act 1994, s.OE2(1)(c).

Dividing income into segments of time is an artificial, formal process that has no necessary connection with the way that gains and profits come about in the natural world. This consideration is further illuminated by an appreciation that the measurement system that we employ to divide income into taxable segments is itself artificial, in that the calendar is an invention of people, not something that (like profit) emerges naturally as soon as two people trade with one another. Nevertheless, this segmenting of income must be done if there is to be an income tax system.

Consequential rules

Ideally, an income tax system would look at individuals or companies over the duration of their existence and assess their total income to tax. That is not practical, so income tax law divides our existence into segments, as described. A consequence is that the rules of income tax law aim at only one segment of a taxpayer's income at a time, that is, income derived between the beginning and end of a particular financial year. It follows that if a taxpayer can defer the recognition of a receipt as income from one year to the next the taxpayer can defer tax on that income. Such deferral may be direct, by not recognising a gain, or indirect, by accelerating the recognition of an expense that must be subtracted from receipts in order to calculate assessable income. If taxpayers can go further, and continue to defer gains indefinitely, or can push gains backwards in time into past financial years, the gains may never be taxable.

Such strategies are fundamental to many tax avoidance techniques (though opportunities for the latter strategy are rare), but they would not work in the ideal tax system described at the beginning of the previous paragraph. Why would they not work? Because if profits throughout all financial years of a taxpayer's existence were assessed together on a single occasion, the taxpayer could not avoid tax by shifting gains from one year into another.

The need for the segmenting of income means that, in their nature, all income tax systems are vulnerable to avoidance strategies that rely on the exploitation of timing differences. The result is that tax laws contain increasing numbers of rules that inhibit the deferral of income or the acceleration of expenses. These rules are essential, but the very reason for their existence means that they are out of sympathy with the legal structure and legal effects of transactions that taxpayers enter: the whole point of the rules is to re-characterise transaction *x* as transaction *y* without changing the legal rights and duties that the parties to transaction *x* owe to each other. An important result is that transactions that the law taxes are not necessarily transactions that exist in the rest of the legal system. Succeeding paragraphs describe examples of this ectopia between the general law (which broadly reflects transactional realities) and income tax law.

Interest

First, take interest. Suppose Lender advances £100 to Borrower for two years at simple interest of eight per cent per annum. Suppose that the parties agree that the total interest, £16, will be due and payable at the end of the two years, when the principal is repaid. Alternatively, suppose that the interest is due on day one. In either case, and in respect of either party, when should the interest be recognised for tax purposes?

If Lender or Borrower were banks or similar financial organisations, in order to compute

their profits they would spread the interest according to a yield to maturity calculation over the two years of the loan. Less sophisticated parties might spread the interest on a straight line basis, attributing an equal fraction to each day of the loan. A third category of parties, people who do not understand the time value of money, might simply account for all the interest when paid or recived.

These different treatments will result in different profits. Income tax law as interpreted by judges in the absence of specific statutory provision, in at least some jurisdictions, would calculate profits in the manner adopted by the third category of people just mentioned. That is, receipts and expenditure would be recognised for tax purposes according to timing of obligations and facts specified in the contracts involved: for parties that are in the business of lending money, interest is ordinarily assessable when it becomes legally due for payment. For parties that are not in the business of lending money, interest may be assessable on a cash receipt basis.

These rules of income tax law invite avoidance. For example, for sophisticated taxpayers facing tax bills of dismaying proportions, it is not difficult to contrive loans with large sums of interest that are incurred on day one. Deducting the interest pro tanto eliminates assessable income. But, if carefully arranged, the loan and interest need not affect the true economic circumstances of the taxpayer.

Not surprisingly, law-makers react to this kind of tax planning by promulgating rules that are calculated to frustrate it. One possibility is a rule that requires taxpayers to spread interest deductions over the life of the loan to which they relate. Such a rule may reflect the economic reality of the taxpayer's circumstances but the rule means that tax law departs from the rest of law, and departs from actual transactions. A taxpayer may incur, or even pay, interest, both in fact and pursuant to a binding contract, but tax law treats the taxpayer as though the interest was not incurred, or incurred only in part. That is, there is a gap between tax law and transactions that in fact take place.

Farmers

Consider a farmer who is in business for 10 years. Suppose that over the 10 years taken as a whole the farmer breaks even and makes neither a profit nor a loss. Suppose, however, that the first five years were profitable, and the second five years yielded only losses. The result will be that the farmer will pay tax (albeit only in the first five years) although her farming business did not make a profit. Most tax systems do not permit taxpayers to carry assessable profits forward to set against losses that are incurred in future years. The result is that tax law will treat the farmer as having made a profit even though, over the long haul, she has not. The reverse is not true: if the farmer sustained the losses in the first five years most systems would allow her to carry the losses forward to reduce assessable income in the second five years.

Some tax systems try to mitigate this kind of problem by allowing agriculturalists, and possibly people in other industries where income tends to fluctuate from year to year, to spread their income evenly over several years by an averaging process. That approach is no doubt fair to the taxpayer. But, as with the spreading of interest that is described above, it means that an income tax law that contains averaging rules taxes people as if their transactions were different from what they actually were.

Capital and revenue

The factor of time throws up one problem that dwarfs all others in the income tax field: the distinction between capital and revenue. By definition, income tax law taxes income (or revenue) and not capital gains. Some countries do not tax capital gains, others bring them into the income tax system but at a reduced rate, and others have a separate tax for capital gains. However a jurisdiction deals with capital gains, it is almost inevitable that its income tax law will distinguish between capital items and revenue items.

There are many judicial and legislative attempts to explain the difference between capital and revenue but for present purposes it is sufficient to say that, broadly speaking, for tax purposes capital items are things that last a long time. For example, for a manufacturer, factory and machines are capital items while raw materials, work in progress, and staff remuneration are on revenue account.

In any tax system that purports to distinguish between capital and income the difference is vital. Capital gains are not taxed as income, and capital expenditure is not deductible in calculating assessable income profits. Accordingly, it is in the interests of taxpayers to do their best to characterise receipts as capital and expenditure as on revenue account. These endeavours can be successful. The reason is that, ultimately, gains are fungible; they are gains whether one calls them capital or income. Accordingly, recharacterisation of income as capital can often be achieved. Similar considerations apply to expenses, *mutatis mutandis*. These points may be illustrated by one or two examples of capital items and income items.

Example: business premises

Take business premises. A manufacturer needs a factory but the factory serves the same purpose whether the manufacturer owns it or rents it. However, the tax treatment varies enormously. Rent, being a regular, period-by-period expense, is deductible in calculating the manufacturer's assessable profits. The price of the factory, on the other hand, is not deductible. It is a capital item that relates to many years of occupation and to many years of carrying on business. Therefore, the price of the factory should not be taken into account in calculating annual profits.

Most tax systems mitigate the effect of the distinction between the treatment of rent and the treatment of the price of business premises by allowing taxpayers to subtract from their receipts notional expenses that reflect the depreciation in value of capital assets that are used in a business.

Depreciation or capital allowance regimes soften the economic effect of the difference between renting and buying, but they add to the ectopia of tax law. The reason is that for tax purposes they recognise sums that have not in fact been spent as deductible expenses. As the factory premises example illustrates, the capital/revenue distinction tends to ectopia, in that this fundamental premise of income tax law is not based in commercial reality.

Conversion of income to capital

The factory premises example illustrates that income tax law draws fundamental distinctions between expenditure (or receipts) that serve the same economic functions. Income tax law goes further. In principle, and in the absence of rules designed to frustrate

the practice, income tax law allows people to change income into capital gains, gains that, depending on the regime in question, may be assessable at a lower rate of tax, or that may be tax free.

Take rent, which, when received by a lessor, is assessable. But suppose that the lessor bargains with his tenant to receive a premium for granting the lease, followed by a reduced rate of rent. Premia are capital, and therefore not taxed as income. Thus, the lessor converts income to capital even though premia and rent are to a large extent substitutable for one another.

Take a shareholder, an ordinary investor, who owns shares that are pregnant with profits. If he derives a dividend from the shares it will ordinarily be subject to income tax. But, alternatively, the shareholder may sell the shares, for a price that reflects both their underlying value and the retained profits that have not yet been distibuted. The price received, including the part of the price that reflects retained profits, is a capital receipt, not assessable for tax as income.

Because of the ease with which some income gains can be converted to capital, most tax systems are replete with rules that frustrate such endeavours with more or less success. For example, one would expect an income tax statute to contain a rule that deems premia to be income, or something to the same effect. There are also likely to be rules about dividend stripping, to frustrate shareholders who sell shares *cum div* and buy them back *ex div*. But these rules do not catch shareholders who simply sell shares to liquidate their investment, as in the example described in the previous paragraph.

The need for the capital/revenue distinction

For all the irrationality of the capital/revenue distinction, and for all the legislative rules that are enacted to maintain a barrier between the two categories, the distinction is essential to the operation of a law that taxes income that is calculated on an annual basis. To understand why this is so, return to a point made earlier in this article: that our method of measuring income, a method which requires dividing income into segments that are delimited by time, is antipathetic to the very concept of income, which is a continuous stream that has no natural or necessary relationship with the calendar.

There is no natural relationship between income and the calendar, but an income tax system cannot operate without artificially creating this relationship. The alternative is to wait for taxpayers to expire and then to measure their lifetime profits, an impractical proposition for a state that wants to collect taxes now. A periodical system is therefore a practical imperative of an income tax regime. The period chosen is always a year, though there is no *a priori* reason why that should be so.

It is the annual nature of income taxation that requires a distinction between capital and revenue. Income is in essence a net concept: taxpayers take receipts and subtract expenses to calculate assessable profits. But take, for example, a manufacturer who buys a new machine that is estimated to last 10 years. The cost of the machine is certainly a cost of doing business but equally certainly, if the manufacturer deducts the total cost in the year of purchase he will under-compute his profits for that year. Only about one tenth of the cost should be attributable to that first year of use. (One tenth is a crude estimate that is sufficient to make the point at issue here. In fact, cost of money calculations would no doubt dictate a much refined fraction in any particular case.)

Many income tax systems have regimes that would allow the manufacturer to take

account of the cost of using the machine for producing assessable income, regimes that ordinarily take the form of schedules of deductible allowances that reflect annual depreciation of machinery. Such regimes are imprecise, in that they are based on estimates and on average costs and usage in different industries, but at least they permit capital costs of long-lasting plant and machinery to be integrated into an annual income tax system.

In contexts other than businesses, capital gains and capital expenditure are more intractable. How is a tax system to deal with the purchase and sale of income-producing investments, or of dwellings and other capital items that are acquired for private use? Again, in an income tax system that dealt with taxpayers one lifetime at a time these transactions would not present problems. But an annual system that brought major investment and private transactions to account in the year they occurred would be prey to unacceptable distortions. In this context, again, a distinction between capital items and revenue items is a practical imperative. To summarise:

- Income tax systems must operate on an annual basis in order to operate at all.
- Annual calculations of a standard income tax system lead inexorably to a distinction between capital and income, even though that distinction is artificial.
- The artificial distinction between capital and income (a) provides opportunities for minimisation of tax by converting income into capital, and (b) is itself responsible for distortions in the calculation of profits.
- In response to (a), law-makers promulgate rules of increasing complexity that are designed to close off tax planning opportunities.
- In response to (b), tax systems adopt regimes that are calculated to mitigate at least some of the distortions that are caused by the income/capital distinction in the first place, depreciation regimes being the example mentioned.

When these considerations are taken into account an income tax system can be viewed as a set of rules that can never exactly come to grips with assessable income, which is the subject matter of its attentions. Perceiving a problem, legislators respond by enacting a sub-set of rules, rules that give rise to another problem, which requires a further sub-set of rules, and so on. This pattern of tax legislation is familiar enough. People often describe tax reform as a never-ending process of closing one loophole only to reveal, or even to create, another. There is some truth in this description, but it tells less than the full story. It omits to mention that even as a theoretical hypothesis it is not possible to postulate the existence of a perfect income tax system, because one of the conceptual foundations of income tax, the distinction between capital and income, is fundamentally flawed.

Essence of ectopia

Starting from its introduction, this article has attempted to show how income tax law differs from most other areas of law. Ordinarily, there is a symbiotic relationship between law and its subject matter. That relationship can never properly exist between income tax law and taxable income for reasons that have been explained.

This quality of income tax law is not a result of income tax law's concern with taxation. Most other tax laws can be, and are, as closely related to their several subject matters as are laws that deal with things other than taxation. This assertion may be tested by considering first sales taxes, operating either directly or as value added taxes, and secondly wealth taxes.

A sales tax attaches to transactions, simply taking a fraction of transaction prices by way of tax. That is so whether the original price is quoted as including or as excluding tax. Unlike income, a transaction is something that exists as an observable fact. Accordingly, the primary task of sales tax law is well able to be specified: to define the kinds of human action that are to be considered to be transactions for the purposes of attracting tax.

Similarly, a wealth tax attaches to something that exists as a fact, either tangible property or intangible rights to property (tangible or intellectual) or rights to money. The property in question is defined independently of the wealth tax itself. Physical property defines itself. Intangible property, for example, patent rights or rights under a debenture, is defined by law or by contract. Either way, the subject matter of a wealth tax exists independently, and the rules of a wealth tax simply prescribe that a fraction of the value of the property in question must be paid by way of tax at prescribed intervals. For this reason, litigation about wealth taxes tends to be conceptually simpler than litigation about income taxes.

These examples help to explain why some parts of income tax laws operate more readily than others. Take, for example, an income tax law that taxes wages and that allows no deduction in calculating the assessable component of wages. That is, wages are taxable in gross. In this event, the subject matter of the income tax law, gross wages, is identical to the same observable fact, again, gross wages. Accordingly, there is neither conceptual nor practical difficulty in assessing and collecting the tax, especially if it is exacted at source, collected from the employer. The contrast with a tax on business profits is extreme. For tax purposes, business profits must be defined by tax law itself, and, for the sorts of reasons that have been discussed in this article, tax law must establish rules and categories that exist only for its own purposes.

Consequences of ectopia

The ectopia of income tax law is all pervasive. It is the cause of most, if not all, of the characteristics of income tax law that are generally considered to be unsatisfactory. The author has considered some of these characteristics and their links with ectopia in other articles. An example is the excessive *formalism* of tax law: because income tax legislation cannot come directly to grips with income, it is typically the most formalistic of laws and, although it is above all an economic law, income tax cases frequently turn on form rather than on economic substance.[8] For similar reasons, income tax law is more often than most laws not readily *comprehensible*. It is often misleading to look for the substance or policy of an income tax rule in order to work out its meaning because the substance or policy may be separated from the rule by arbitrary demands of practicality.[9]

A third example comes about because of general anti-avoidance rules. Ectopia itself, the rigid formalism of income tax law that ectopia dictates, and the lacunae and avoidance possibilities that are one result, present difficulties for any tax system. One response, from both parliaments and courts, is to invent over-arching substance-over-form rules. At the cost of some *erosion of the rule of law*, such anti-avoidance rules may frustrate taxpayers' ability to exploit formalistic rules so as to avoid paying tax on economic gains.[10]

[8] John Prebble, "Ectopia, Formalism, and Anti-avoidance Rules", *supra* n. 4, pp. 380–383.
[9] John Prebble, "Why is Tax Law Incomprehensible?" *supra* n. 4, especially at 385–388.
[10] John Prebble, "Ectopia, Formalism, and Anti-avoidance Rules", *supra* n. 4, pp. 370–373.

Ectopia and trans-national aspects of income tax law

Formalism, incomprehensibility, and erosion of the rule of law may manifest themselves in many aspects of an income tax system, both domestic and international, but ectopia has special and marked effects on tax law as it applies to international trade and investment. That is not surprising, considering that space, or geography, is one of the two major factors that lead to the ectopia of income tax law. The remainder of this article examines several features of international taxation that are sometimes or always brought about by ectopia.

Double taxation

The most pervasive tax-related problem of international trade and investment is double taxation, to the extent that the incidence of double taxation and measures to relieve it constitute the largest part of many university courses in international taxation. "Double taxation" is the term used when a single item or stream of income is taxed twice, once in each of two countries. The taxpayer may suffer because it is not fundamental to the computation of assessable income to make allowance for income tax that income has borne in another jurisdiction, subject to what is said in the next section of this article. In this respect, income tax may be contrasted with other taxes. For instance, most tax systems allow taxpayers who are computing their profits to deduct the expense of property taxes or sales taxes, along with other expenses of running a business, as part of the cost of deriving income.

The reason for the disallowance of a deduction for income tax is that income tax is held to be incurred after income has been derived: it is not a cost of earning income.[11]

The most common case of double taxation occurs where income with a source in one jurisdiction is derived by a taxpayer who is resident in another, and both jurisdictions assess the income. This example of double taxation is not in fact caused by ectopia. Rather, it is a result of jurisdictions using more than one connecting factor (here, both source and residence) to determine liability for tax. However, where double taxation comes about because two states both treat the taxpayer as resident for fiscal purposes, or where two states both say that certain income has a source within their respective jurisdictions, ectopia is at work.

As explained earlier in this article, there is a lack of logic in ascribing a geographical source to income at all. It is not surprising, therefore, that states' source rules sometimes overlap, and deem income to arise in more than one jurisdiction. There is a similar lack of logic in ascribing a geographical residence to a company, which in turn may lead to companies having more than one residence. The position is not so conceptually problematic in the case of individuals, who, logically, *can* have a geographical residence and, indeed, can have more than one.

Alleviation of double taxation

Double taxation is so clear a problem for international trade and investment that states commonly enact unilateral measures to relieve it. By statute, states may exempt all or certain kinds of foreign-source income from tax, or jurisdictions of residence may allow a

[11] *Ashton Gas Co. v. Attorney-General* [1906] A.C. 10, H.L.; *Inland Revenue Commissioners v. Dowdall O'Mahoney & Co. Ltd* [1952] A.C. 401; 33 T.C. 259, H.L.

credit for tax exacted at source, to be subtracted from tax payable in the jurisdiction of residence. Such unilateral measures are very helpful to international business, but they may not exist in a particular state, or, even if they do exist, they are seldom a complete solution.

One problem is that unilateral measures usually give credit only for tax deducted at source, with "source" defined according to the law of the jurisdiction of residence. Tax levied by a state that has a wider definition of "source" than the taxpayer's state of residence may remain unrelieved, because the state of residence does not recognise the income as having a source in the country that has taxed it. That will be especially likely to be so when the state of residence claims also that it is the state of source.

For these reasons, among others, it has become customary, particularly since about 1950, for states to conclude treaties for the relief of double taxation, usually on a bilateral basis, but occasionally multilaterally. Ordinarily, such treaties contain tie-breaker provisions that come into play when taxpayers are held to be resident in the jurisdictions of both treaty partners, or when the domestic law of each jurisdiction claims its state as the source of certain income.

Most of the world's double tax treaties follow models promulgated by the Organisation of Economic Co-operation and Development, the most recent being a loose-leaf version first published in 1992 that is subject to periodical updating.[12]

Credits for foreign tax

Whether a jurisdiction allows credits for foreign tax unilaterally or pursuant to a tax treaty there is one rule that is invariable in the author's experience: there is credit only in respect of foreign income that is the same income that is derived by the domestic taxpayer. However, such a rule can, in most circumstances, operate only imperfectly. The reason is that it is rare for any two income tax systems to treat the same economic profit in precisely the same manner. To say this another way, what one tax system means by "income" is not the same as what another tax system means by "income".

Take a relatively simple example. There are at least three ways of dealing with wages and salaries. A tax system may allow employees to deduct all income-related expenses, following a system-wide rule that applies to all kinds of income; or there may be a limited category of allowable deductions for employment-related income; or the system may allow no deductions. These three options mean that what is "income" varies according to which option jurisdictions adopt. But the author is reasonably confident that no state or treaty that provides for credit in respect of tax on foreign source employment income would deny a credit on the basis that the foreign state employs a different option from the state of residence.

This answer is practical and sensible, but where the issue relates to something other than employee deductions states' definitions of income may be so far apart that it is simply not possible to establish that what was taxed as "income" in state A is even recognised as a juridical concept by the tax laws of state B.

Credit for tax on underlying corporate profits

Dividends throw up a particular problem in the area of credits for foreign tax. Where a

[12] O.E.C.D., *Model Tax Convention on Income and Capital, Report of the Committee on Fiscal Affairs* (O.E.C.D., 1992, updated 1994, Paris).

foreign dividend has suffered withholding tax in the state of source (ordinarily a flat rate tax imposed on the gross dividend with no allowance for deductions) the state of residence will have no difficulty in identifying the withholding tax with the dividend income that it wishes to assess. A credit for the withholding tax can be readily calculated and granted. But suppose that the state of residence also desires to allow credits for tax that was charged on the underlying corporate profits from which the dividend was paid. If the profits of the dividend-distributing company were derived from a range of sources, in a range of income years, and have borne a range of taxes, how is the crediting country to decide what foreign tax can be treated as relating to any particular dividend? There is no answer that can be wholly justified by principle or logic, which means that the rules that countries adopt to answer these questions must be arbitrary and ectopic to varying degrees.

Withholding taxes

Even the apparently conceptually simple institution of withholding taxes that countries levy at source on people who pay dividends, interest and royalties that flow out of the jurisdiction to foreign recipients illustrate the effect of ectopia, though in an unusual way. In one sense, these taxes are the least ectopic of income taxes. The reason is that flat-rate withholding taxes are levied on observable phenomena, namely payments of interest, dividends, and royalties. That is, there is no gap between the tax and the factual object that is taxed.

On the other hand, flat rate withholding taxes are a surrogate for ordinary income tax, which is a tax on net income. There are two reasons why countries employ such taxes to inflict tax on passive income that flows to non-residents. First, the recipients of the income are foreign. Therefore, to collect tax it is necessary to levy it at source, on the person who pays the tax. Secondly, because the recipient is foreign, it is not feasible to calculate the recipient's net profit from his or her gross receipts. The response by governments, to collect a flat rate of tax on gross payments, is understandable, but except in rare cases the result must be that a foreign taxpayer suffers a different rate of tax from a domestic taxpayer, sometimes more, sometimes less. Also, different foreigners suffer different rates of tax, being tax on net income, depending on the levels of expenses that they incur in order to earn the income in question.

Some of these variations are smoothed out by market forces: perhaps tax benefits are capitalised into the value of investments; perhaps foreigners increase the price that they charge for capital when investing in a jurisdiction that charges withholding taxes, thereby transferring the incidence of the tax to the domestic taxpayer (this transfer is particularly likely to happen in the case of withholding tax on interest); perhaps foreigners will organise their investments to avoid withholding taxes in one way or another. However, even when one takes factors such as these into account, the fact remains that withholding tax is a crude, pragmatic, arbitrary response to a realisation that income tax proper cannot be made to work in respect of outward flowing passive income. The public policy question becomes not, "How can the tax system be improved so that all forms of income and all taxpayers are taxed equally?" but, "How much withholding tax can the government impose without choking off inwards investment?"

Apportionment of profits

Some domestic tax laws and most double tax treaties recognise that certain business profits

may be attributable to more than one source, and provide for apportionment of such profits to the jurisdictions involved. An example is the profit on the manufacture and sale of an article that a taxpayer makes in one country and sells in another. Article 7 of the OECD model treaty, a version of which is customarily adopted in most bilateral treaties, resolves many such cases by providing that commercial and industrial profits are assessable only in the taxpayer's country of residence, unless the taxpayer carries on business in the other state through a "permanent establishment". Where there is a permanent establishment, Article 7 provides that it must be treated as if it were independent, and the taxpayer's assessable profit is split between the two jurisdictions as if the taxpayer were two persons.

A provision like Article 7 is quintessentially ectopic. That is, it requires taxpayers and tax authorities to calculate income, and therefore to assess tax, on the basis of the assumed fiction that one person is in fact two. The default rule in Article 7 (no tax without a permanent establishment) is also ectopic. Article 7, like all relevant articles in double tax treaties, assumes that business profits can sensibly be said to have a geographical source. *In fact* a manufacturing exporter derives profits that are related both to the state of manufacture and to the state of sale. But by Article 7 one of the sources is disregarded.

These are arbitrary rules that are necessary if tax systems are to operate with any sort of practical efficiency. But the income of an international business that these rules compute and tax is a measure of income that is different from the true measure of income in each of the two countries.

Transfer pricing

The problem just discussed, of apportioning business profits between two jurisdictions, is similar to the problem of dealing with transfer pricing. "Transfer pricing" refers to the practice of trading in goods or services between related persons (perhaps parent and subsidiary companies, perhaps sibling subsidiaries of the same parent company). Such business forms a large fraction of all world trade, as multinational groups export goods and services to their subsidiaries around the world.

Prices in such trade are by definition not set by parties who deal at arm's length. From the point of view of a multinational group that is wholly owned through a parent company, prices for goods that are bought and sold within the group have no economic importance. If a manufacturing company in the group charges too much to a sales subsidiary in another country the sales subsidiary's excessive expenditure and consequent loss will be balanced by the manufacturer's excessive receipts and consequent profit. From the point of view of tax, however, the situation is different. Other things being equal, it makes sense for the group to manipulate intra-group transfer prices, and thus to contrive to derive lower profits in higher-tax countries and higher profits in lower-tax countries.

Many jurisdictions legislate to try to frustrate such profit shifting, but the resulting rules are always difficult to apply and usually conceptually questionable. The most common approach is to deem goods and services that are transferred between related parties to have been sold at an arm's length price. That is, the solution is similar to certain apportionment of business profits rules that apply in the absence of a double tax agreement.

The problem of the arm's length rule is that it is fictional in several respects. First, the contracts that it attacks are not in fact arm's length contracts. Among other things, they

may contain enforceable and unenforceable terms that would not be found in an arm's length contract. Secondly, anti-transfer pricing rules take an entity that is essentially monolithic from the point of view of economics, and purport to divide it into separate, purportedly independent units. Thirdly, a rule that says that deemed intra-group prices should be calculated on an arm's length basis assumes that evidence of comparable uncontrolled prices exists. That is often not so, especially where the multinational group in question produces and sells a product for which there is no comparable counterpart.

For reasons such as these, transfer pricing regimes often have alternative tests, such as reference to the standard rate of profit in the industry in question. But whatever test is employed, the fact remains that it entails attributing profits to a company that are different from the profits that the company makes as a matter of non-tax law, and that are different from economic profits.

Economic double taxation

A by-product of the application of transfer pricing rules may be economic double taxation, which is to be distinguished from juridical double taxation. The latter, which has already been discussed, occurs when two jurisdictions expressly tax the same income.

Economic double taxation occurs in situations such as these: a parent company in country A sells widgets to a subsidiary in country B, at a price high enough to prevent the subsidiary from making a profit on the resale of the widgets. The tax authorities in country B recalculate the subsidiary's profits on the basis that the purchases were made at a cheaper, arm's length, price, and charge income tax on the result of this computation. Meantime, however, the authorities in country A have already taxed the parent company on the basis of the actual prices that the parent charged to its subsidiary. The group winds up paying tax twice on the same economic profit. However, there is no scope for mitigation of double taxation because, juridically, what is taxed is the separate incomes of the parent and the subsidiary. Only a few, relatively modern, double tax agreements provide for relief in these circumstances.

Controlled foreign companies

Income tax systems tend to have a love-hate relationship with companies. On the one hand, they generally recognise companies as taxable entities. On the other hand, they often provide for the corporate veil to be disregarded, in order to tax the economic reality that lies behind. One of the more dramatic examples of this kind of legislation is found in controlled foreign company regimes.

At the cost of some generalisation, controlled foreign company regimes may be described as sets of rules that are designed to frustrate people who try to divert part of their income to tax havens. There are many ways in which taxpayers may use controlled foreign companies. One example will suffice: reinvoicing by an importer. Suppose an importer establishes a wholly-owned subsidiary in a tax haven. Instead of buying from its foreign suppliers in the ordinary way, the importer causes the tax haven subsidiary to buy, and then to re-sell, to the importer. The subsidiary makes a profit on the transaction, perhaps large enough to eliminate the importer's profit in its own country, which is the object of the exercise.

Faced with this kind of international tax planning, controlled foreign company rules

take the profit of the foreign subsidiary and attribute it to the importer as if the profit were the importer's own income. Described simply like this, controlled foreign company rules may be seen as being calculated to reduce the ectopia of a taxation system. Without the rules, profit that belongs economically to the importer escapes the tax net. With the rules, the profit is caught and assessed to the taxpayer (the importer) who derives the economic benefit, albeit that the benefit is squirrelled away in a tax haven.

In complex cases analysis is more difficult. What does one do about foreign companies where the ownership changes during a tax year? Should controlled foreign company regimes apply to artificial, tax avoidance arrangements only, or should they apply in respect of all foreign companies that are owned by domestic taxpayers? Should they apply to tax haven companies only, or to companies resident in any foreign jurisdiction? These are only a sample of the questions that law-makers must answer before enacting a controlled foreign company regime and, at the margin, many of the answers must be formalistic and arbitrary, leaving an element of ectopia between the rules and the facts to which the rules relate.

Conclusion

The use of the concept of net income as a base for taxation is flawed. The flaws are much less obvious in some areas than in others. For example, in the context of a regime that collects tax on wages on a pay-as-you-earn basis there is very little gap between the law and the facts to which the law applies. For the wage worker who does not incur expenses in earning her income the wages that she receives are the same as the income on which she is taxed. The taxation occurs by withholding of tax from wages that she earns at the moment at which the employer pays the wages. Consequently, in respect of both computation and collection the tax regime is closely integrated with the observable, physical fact of the payment of wages.

The position is very different in respect of business profits, which are not physical facts that can be observed and reflected in a tax system in the same way that a payment of wages can be observed and reflected. This article uses the label "ectopia" to refer to the displacement between income tax law and the facts to which income tax law applies. As has been observed, ectopia varies in degree between one aspect of an income tax system and another.

The theme of this article is that where there is tax on income that arises from international transactions or investments the ectopia between the law and the subject matter of the tax system is apt to be very pronounced. A consequence of this pronounced ectopia is that it is probably impossible to construct an income tax system that is all at once principled, administratively efficient, comprehensible, and inexpensive to comply with. As a result, the income tax system is apt to distort the economic results of investment and trading decisions and may even distort judgment as to whether and how those decisions are made.

In modern times, and particularly since the mid-1980s, legislators have become increasingly aware of the desirability of neutrality in tax systems. This awareness has been reflected in at least some jurisdictions by such major measures as the repeal of fiscal preferences for one industry over another and by efforts to ensure that the form of a business does not dictate its tax status.

People have made similar efforts in the international area. For example, for domestic

taxpayers, controlled foreign company regimes may at least partly neutralise differences between investing at home and investing abroad; and for foreign-based taxpayers, transfer pricing rules help to neutralise tax planning advantages that they might enjoy over domestic enterprises. But there is no thoroughgoing solution. Income tax law must depend on concepts of time and place that are conceptually flawed in their application. The result is rules that mete out different treatment to taxpayers whose economic position is similar. Such discrepant treatment is particularly apt to occur if there is an international element involved.

It is hard, perhaps impossible, to measure the effects of states' income tax policies on international trade and investment. On the one hand, most large companies say their investment decisions are driven by commercial, not tax reasons.[13] On the other hand, one comes across cases where whole industries have shut down or begun as a result of tax changes. All that can be said for certain is that as long as governments continue to use income taxation as their major tool for raising revenue there will be distortions to international trade and investment and consequent efficiency costs.

[13] See, *e.g.*, John Prebble, "Costs of Compliance with the New Zealand Controlled Foreign Company Regime", in C. Sandford (ed.), *Tax Compliance Costs: Measurement and Policy* (Fiscal Publications in association with the Institute for Fiscal Studies, 1995, Bath and London) p. 321 at p. 340.