

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

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Condensed version

Chapter 1 Introduction

The purpose of this paper is, through the comparison between PE taxation on business income and taxation on capital income, studying the concept of source of income (geographic allocation of income) and providing the basis for legislative discussion.

There are many discussions on how to tax on income (especially on international business income) in present and future day when business environments are changing due to the development of information and communication technology. These discussions cover interpretative and legislative discussions. However, this paper does not directly discuss concrete and practical legislative proposals, but only provides the basis for legislative discussion. The reason why I am so restrained is that I have felt that assumptions of legislative discussion are not shared worldwide.

Discussion whether source countries are authorized to tax on some income or not, without common understanding how to find the source of income, provides little. Unfortunately there has been inconsistency in the criterion for source of income. For example, when a person collects the value of certain patent right with different manners, recognition of the source of income is different in some cases. If the person has licensed the patent right and now gets royalty income, then the source of royalty income is defined generally looking at the money obligor. Roughly speaking, the importing country has the source of royalty income. On the other hand, if a person holding certain patent right uses, by himself, the patent right, produces commodities and exports them, the source rule relating with sale will be applied, generally looking at the money creditor (*i.e.* the income earner, the patent holder). Roughly speaking, the exporting country has the source of income (although it depends on the actual situations of transactions).

There is inconsistency. The purpose of this paper is searching (1) how we image the source of income and (2) what is the root of such inconsistency, through examining several cases (including hypothetical examples) theoretically and inductively.

Chapter 2 Significance of the studying source of income

A country has authority to tax on residents' income without considering the source of income (residence tax jurisdiction). On the other hand, in the context of taxation on nonresidents, a country has authority to tax only on domestic source income (source tax jurisdiction).

Even if the source of income is domestic, sometimes a country may not tax on the income. With regard to business income, there are three checkpoints: (1) the source of income is domestic; (2) the nonresident has PE in the taxing country; and (3) taxable income is limited to net income which is attributed to the PE.

On the other hand, with regard to capital income, the requisition of tax is the source of income in many cases: that is to say, there is only one checkpoint. PE is not requisited, and we do not need to consider the allocation of net income because taxation is executed mainly by the manner of withholding (*i.e.* gross taxation); although tax treaties might restrict the source country's taxation on capital income.

Seeing above, the problem whether a certain country has the source of income is not equal to the problem whether the country has authority to tax or not. Source of income is only one of basis when a certain country imposes tax on nonresidents' income¹.

In this paper, in order to concentrate on the problem how we image the source of income in the light of economic substance, administrative problems (that leads to the requisition of PE) and policy concerns (such as equity among countries, attracting foreign capital and etc.) are separated from the economic substance of income. Moreover, when capturing of income in the light of economic substance, there is another point other than source of income (geographic allocation of income): it is income allocation (personal allocation of income). Therefore, allocation of tax jurisdiction has four issues: (1) geographic allocation of income; (2) personal allocation of income; (3) administration; and (4) policy. This paper studies the first.

I wrote the location of studying the concept of the source of income. Next, there are some points to remember when studying source of income.

Income is, by nature, understood as personal attributes, therefore, income is not fit in geographic allocation. However, we hardly say that we don't need the notion of geographic allocation. If we ignore geographic allocation of income, only look at personal allocation of income, and make international tax system in which only residence country has tax jurisdiction, that kind of tax system will not work well².

This paper studies the geographic notion of income. "Source of income" has two meanings: from where and from what. In this paper, the latter meaning of "source of income" is put in other words: "origin of income". I guess that people image the origin of income with three parameters: (1) assets; (2) (earner's own) business; and (3) (business of) customers³. Chapter 4 will study what parameter of the origin of income leads the criterion for source of income (geographic allocation of income).

When studying how we image source of income in the light of economic substance, there are some disrupting factors; administrative and political concerns (which also have effects on allocation of tax jurisdiction as discussed above); realization of income; veil of transaction⁴; and confusion between geographic and personal allocation of income.

The thing not studied by this paper should also be clear. This paper does not discuss allocation of tax burden among taxpayers, and therefore, can not discuss the

¹ Although source of income and allocation of tax jurisdiction is not on the same level, in many actual cases, source of income is discussed, deeply linked with allocation of tax jurisdiction. It is natural because, if source of income is not linked with tax jurisdiction in tax law, source of income will not be discussed in courts after all.

Source of income has other functions: it is a basis for limitation of foreign tax credit; and it draws a line of exemption if a residence country adopts exemption method for its residents. In this paper, unless otherwise noted, I focus my mind on the criterion for imposing tax on nonresidents' income.

² Especially, taxation on subsidies but nontaxation on branches will lead objections. There is another possibility that corporations transfer their residence to tax havens.

³ For example, suppose that R leases a real property to S and earns rent income. We can say that the origin of income is the asset; the origin of income is the R's leasing business; and the origin of income is the customer itself or the customer's business.

⁴ For example, suppose that P lends money to R, and R lends money to S. S pays interest to R, and R pays interest to P. In this example, it is difficult to decide how to impose tax on P with looking at S. I call it as veil of transaction. However, in order to examine the source of income in the light of economic substance, we will sometimes need to look also at S through the veil of transaction.

adjustment between residence tax jurisdiction and source tax jurisdiction. Personal allocation of income has significance relations with geographic allocation of income. However, study of personal allocation of income (such as transfer pricing) is the future task.

Chapter 3 History and Comparison

Stepping away from international tax affairs, Germany has a tradition of source income taxation (the meaning of which is, in this paper, “origin”), but, on the other hand, America is under the strong effect of comprehensive income concept. The former is matched with scheduler system that makes classification of income according to the nature of origin of income. On the other hand, the latter is matched with global system that does not subdivide income.

In the field of international taxation on business income, German adopts “attributable income principle”. Under this principle, unless a certain nonresident is considered as having PE in a source country (called as S country: in this case, Germany), there is no taxation on business income of the nonresident. S country’s source income is limited to the business income that is attributed to the PE located in S country.

On the other hand, before 1966, America adopted “entire income principle”. Under this principle, each source of income is decided in transaction-by-transaction base, and nonresident who is considered as doing trade or business within the US is subject to tax on entire domestic source income.

Although an outline above is written in order to make differences between Germany and America conspicuous, there are some similarities: (1) since 1966, America adopted “effectively connected income principle”, and this principle has some similarities with Germany’s “attributed income principle”; (2) comparison above is related with international taxation on business income, however, in the field of international taxation on capital income, both countries usually recognize source of income looking at the customers.

Internationally, since 1920’s League of Nations and other some organizations started to build model tax treaties. Classification and assignment approach, that classifies income according to origin of income and that allocate the class of income between countries, was adopted. Business income was classified as one class, on which other than the residence country cannot impose tax without PE.

Chapter 4 Studying source of income by type of objects of transaction

Chapter 4, looking at three type of origin of income (asset, business, and customer), examines how each notion of origin of income has effects on source of income.

Rent of real property is a typical example of the criterion of asset. Rent of real property has its source doubtlessly in a country where the real property is located. However, sometimes leasing of real property and intermediating lease of real property has similar functions. (Two examples bellow ignore business cost.)

Example 1 (lease): R_1 corporation, which is R country’s resident, buys real property located in S country from S_1 corporation and leases it to S_2 corporation. S_2 pays 100 to R_1 as rent, and R_1 pays 80 to S_1 as purchase price. Readers will wonder why the rent is so high; however, in this example the rent can be interpreted as a lump-sum of several decades.

Example 2 (intermediation): S_3 corporation which owns real property located in S

country, requests corporation intermediation of lease of the real property to R₂, which is R country's resident. S₄ corporation finds the information of lease of intermediation (which can be seen worldwide) marketed by R₂, and rents the real property of S₃. S₄ pays 100 to S₃ as rent, and S₃ pays 20 to R₂ as intermediation fee.

Comparing these examples, R₁ of example 1 can be seen as intermediating between S₁ and S₂. However, according to the existing rule, in example 1, R₁'s rent income, 100, has its source in S country, and in example 2, R₂'s intermediating fee, 20 has its source in R country. In example 1, source rule looks at asset, and in example 2, source rule looks at business. This difference of viewpoints leads inconsistency.

Source rule of movable property is swaying between the criterion of asset and the criterion of business. This swaying has two aspects. The first aspect is as follows: When a certain movable property is sold from R country to S country, the movable property itself transfers, therefore, deciding source of income looking at asset is inappropriate. It is the reason why people image source of income looking at the earner's own business⁵. However, it is difficult to determine the place of sale relying on private law. Therefore, tax law considers the place of location of the property at the time of sale (= title passage) as the place of sale, and considers this place as the source of sales income. Although the criterion of asset is once renounced, it is resurrected for determining source of income.

The second aspect is as follows: Source of rent income from lease of movable property is considered to be located in a country where the property is located. This viewpoint is different from that of sales income⁶. However, sometimes lease and sale has similar functions. It is doubtful whether distinction between lease and sale is so significant that the distinction justifies the different tax treatments.

Typical example of the criterion of business is service income. Source of service income is considered to be located in the place of "performance". However, looking at only performance leads sometimes mis-grasping of the substance of business. Suppose a certain lawyer's service. Capital investment before performance (such as training in law school) is also an important activity. The criterion of performance fails to bring this important activity into view. Determining source of service income with considering capital investment⁷ is rare (that seems to me as one type of harm derived from realizational mind).

One good example for examining transactions between two persons living distantly, is broadcasting. The production of broadcasting easily crosses borders, therefore, place of performance is not clear. In theory, both the place of facilities for broadcasting and the place of audience seem significant for business; case law looked at the place of facilities.

From two paragraphs above, we learn that when people image source of income relying on the criterion of business, people tend to ignore capital investment, to pay

⁵ Although people image source of income relying on the criterion of business, there are different treatments between purchasing – selling situations and producing – selling situations. In general, the place of purchase is not recognized as source of income, but on the other hand, the place of production is recognized as source of income. People say that purchase activities have no income producing power (i.e. value added); however this statement is clearly wrong. Unfortunately, some source rules are made with wrong belief.

⁶ Stated above, source rule of sales income shows the first swaying.

⁷ It might be difficult in administration.

heavy attention to conditions at the time of performance, and to pay heavy attention to physical presents of earner's own.

There are some cases in which the criterion of business is hard to apply: fee for covenant not to compete⁸. There is no business activity corresponding to this income. The criterion of performance collapses in such cases.

International taxation on business type income (i.e. PE taxation and service income taxation) seems to presuppose that the result of business activity belongs to a branch or a person that has actually done business activity. However, we can learn from examples of covenant not to compete that the result of business activity does not necessarily belong to a branch or a person that has actually done business activity. We should pay more attention to gap between geographic allocation of income and personal allocation of income.

Income relating with information (such as royalty income) is swaying between the criterion of business and the criterion of customer. As stated in Chapter 1, R-corporation, which is R country's resident, licenses its own patent right in S country to S-corporation, which is S country's resident, and gets royalty income, then source of this royalty income is considered to be located in S country. On the other hand, if R-corporation does production using the patented invention and exports commodities to S country, then source rule of sale will be applied, and in general cases source of income is considered to be located in R country. In the former case source rule looks at customer, and in the latter case source rule looks at business of earner's own. This difference of viewpoints leads inconsistency.

Interest income is also swaying between the criterion of business and the criterion of customer. If a nonresident has PE in S country, then taxation looks at the PE's business. On the other hand, if a nonresident has no PE in S country, source rule looks at customers of loan contracts. However, especially in cases of traditional banking business, a bank, can be seen as supplying services of financial intermediation, irrespective whether the bank has PE in S country or not. Seeing functionally, the bank does business. Different tax administration reflecting existing or nonexisting of PE might be justified; however, can different source rule reflecting existing or nonexisting of PE be justified?

Finally I examine some cases in which the result of business is distributed (or allocated), although this issue hardly has relation with the criterion of asset, business, or customer. Typical case of distribution is the relation between a corporation and its shareholder. However there are double taxation problem. In order to ignore double taxation, the examination focuses on partnership situations. Mr. R, who is a resident of R country, participates in a partnership, which is based on S country's law. Even if Mr. R actually does not step into S country, in other words, Mr. R is hardly be considered as doing business in S country by analogy of source rule of service income, Mr. R is considered as having a PE in S country and is subject to S country's taxation. Moreover this treatment is also applied even if Mr. R owes only limited liabilities. In a

⁸ There are other similar examples. (1) A contractual stand-by agreement: A certain actor is kept for a new film; the actor gets fee for being kept even if the film making has been stopped. (2) Sign-on bonus: An athlete gets fee for not concluding service contracts with other sport teams. This fee is not corresponding to the athlete's service. The latter fee is salary.

partnership situation, the result of business done in S country flows out in a form of income allocation to a foreign partner. If a PE is not considered to be located, the income flows out without taxation; however this nontaxation result is extremely painful for S country's fisc. Therefore S country tries to find a PE in such a partnership situation. This case is also an indication of difference between geographic allocation of income and personal allocation of income⁹.

Chapter 5 Discussion

At first, I discuss the relationship between net income and gross income.

It is a common knowledge that income taxation should basically be net-basis taxation; gross-basis taxation in a form of withholding is only admitted in administratively difficult situations and is alternative necessary evil.

However, from examining tax treatments of partners and shareholders, I have become to think that net-basis taxation and gross-basis taxation impose tax on similar tax base.

Suppose that S₁-partnership does business in S country and its gain is allocated to nonresident R₁-partner, and S₂-corporation does business in S country and it pays dividend to nonresident R₂-shareholder.

With regard to R₁-partner, S₁-partnership's office is recognized as a PE of R₁-partner and S country imposes tax on R₁-partenr's gain which is allocated from S₁-partnership's business income. This taxation is net-basis taxation: in calculating business income, costs are deductible. Although actually R₁-partner has never stepped into S country (*e.g.* R₁-partner has never done business activity in physical sense), R₁-partner is considered as doing business through S₁-partnership in legal sense and is subject to S country's taxation. Even if R₁-partner is a limited partner, S country will impose tax; although, in usual, a limited partner behaves not as a business person (or an entrepreneur) but as an investor.

A shareholder is one typical example of an investor. When R₂-shareholder gets dividend from S₂-corporation, R₂-shareholder cannot deduct costs, therefore taxation on R₂-shareholder is considered as gross-basis taxation. However, the dividend is derived from S₂-corporation's business income which is calculated in net-basis.

In both taxation on S₁-partner and taxation on S₂-shareholder, so-called "the result of business" of S₁-partnership or of S₂-corporation in S country seems to be understood as S country's source income.

What is "the resul of business"? Next, I state the line drawing of "the result of business".

The figure bellow shows the image of "the result of business" in S country.

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

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

When S1-partner or S1-corporation makes a payment to a certain resident of S

⁹ In many actual cases, PEs are recognized. Therefore this kind of difference is not considered to be exposed.

country (which includes a payment attributable to a certain nonresident's PE) ((1) in the figure), deduction is required in order to preclude double taxation (= accumulation of taxation). When a payment is made to a certain nonresident (which excludes a payment not attributable to the nonresident's PE) ((2) in the figure), the problem is what is deductible and what is not. Under existing rules, payments subject to taxation on capital income (such as dividends, interests, royalties, rents, etc.) ((3) in the figure) is not deducted in calculating S country's source income, and such payments does not make erosion of S country's tax base (unless otherwise a tax treaty provides). On the other hand, payments subject to taxation on business income (such as sales income, service fee, etc.) ((4) in the figure) make erosion of S country's tax base.

Gross basis taxation on nonresident's (3) type income (capital income) means that S country imposes tax on the amount, showed as follows: <earnings of S1-partnership or S2-corporation> minus <(1) type payments> minus <(4) type payments>. Although nominally it is gross basis taxation on a nonresident, it can be considered as an alternative of net basis taxation on resident's business, because parts of (1) and (4) are deducted from the tax base. Part of (3) in the figure is an image of "the result of business" in S country.

Let's make clear the width of S country's source income. Part of (3) is considered as S country's source income. Also large part of (1) can be said as S country's source income, because the payee is subject to S country's taxation, except the part which is paid to nonresidents in the form of (4). Part of (3) and large part of (3) is S country's income. Part of (4) erodes S country's tax base, and is not considered as S country's source income.

What criterion the line limiting "the result of business" in S country (i.e. the line between (3) and (4)) is relied on? Understanding this line drawing involves difficulties. In usual, an equity payment from a business entity in S country is not deducted when calculating the entit's taxable income; on the other hand, a debt payment is deductible. However, in the context of determining source, also a debt payment does not lose the nature of S country's source income. The line of debt/equity has no meaning in the line between (3) and (4). How about the criterion of added value, because one typical example of debt payment, interest, is not an item reducing the added value of the payor? This explanation is fitted to the source of interest income. However there are some examples of payments for real transactions, not for financial transactions, that reduce the added value of the payors but do not lose the nature of S country's source income, such as rents and royalties. Also the criterion of added value does not explain the line between (3) and (4).

Historically, the line between (3) and (4) is explained by passive/active dichotomy. Dividends, interest, royalties, and rents are passive income; on the other hand, sales income and service fees are active income. The former's origins are passive activities and are not business; the latter's origins are business. Source of income derived from passive activities is imaged looking at (the business of) a customer; source of income derived from active business is imaged looking at the business of an earner's own, and if the business is not conducted at a PE in S country, then it is not S country's source income.

However this explanation does not match the functional understanding of business. For example, when a bank makes a loan contract and gets interest income, then the bank certainly does business regardless whether the bank has a branch in S country or not. For another example, the explanation that lease and sale are different therefore rent maintains the nature of S country's source income and sales income lose the nature of S country's source income, has little rationality in the light of the continuity between lease and sale.

From the functional analysis of several types of transactions, I conclude that there is no uniform criterion for the line between (3) and (4).

Before trying to unify the criterion for the line between (3) and (4), I desert one candidate of the criterion of asset, business, and customer: the criterion of asset. I think that the criterion of asset can be altered to the other two criterions.

Dividend and interest income is derived from non-real or incorporeal asset. There might be a possibility of explanation that the location of such non-real asset is the residence of the customer (*i.e.* the money obligor) and that it is the source of income. However, next explanation is simpler: people images source of dividend or interest income looking at (the business of) the customer.

About real or corporeal asset, it can be altered to the business of the earner's own or the business of the customer. For example, suppose that R-corporation owns real asset, such as machines, and leases it in S country. In this situation, a traditional explanation of the source of rent income looks at the location of the asset. However we can explain this situation as follows: the machine is one type of branch of R-corporation and the business of the earner's own is conducted at the place of the machine. Another explanation is as follows: the borrower conducts his business at the place of the machine and pays rent to R-corporation from the business, therefore the business of the customer is an origin of the rent income and the source of income is recognized at the place of the business of the customer.

Consequently, I can desert the criterion of asset and it is altered to income producing activity (*i.e.* business).

Let's try to unify the criterion of source of income.

Among several examples, sometimes people image source of income looking at the business of the earner's own and at the other time looking at the business of the customer. The difference of viewpoints leads inconsistency of source of income. In order to resolve this inconsistency, as thought experiment, we come up with ways to unify either two criterions. Of course, there are two possibilities.

First possibility is looking at the business of the earner's own thoroughly. However this thinking cannot function in the example of income of an investor, who does not conduct his own business¹⁰. In order to fulfill the first possibility, I do two tasks: the first task is restructuring the concept of business; the second task is making difference between the case when a person does his own business and gets gain and the case when the gain is distributed or allocated in wide meaning.

The first task is, in order to restructure the concept of business, to image the business looking at the real things such as human bodies or machines. This has two meaning: the positive meaning is looking at only real things; the negative meaning is that we should not image the business as legal assessment. The former has already been discussed at the place of deserting the criterion of asset¹¹. With regard to the

¹⁰ Also in the example of covenant not to compete, source rule looking at the business of the earner's own cannot function.

¹¹ Historically, differentiating between lease and sale leads inconsistency of source of income. If real things themselves are considered as business, the inconsistency is resolved. When R-corporation leases a machine to S-corporation who is a resident of S-country, then the machine itself is considered as a PE of R-corporation, and R-corporation's business is conducted in S-country where the machine is located. When R-corporation sells the machine to S-corporation who is a resident of S-country, then the buyer's business is conducted in S-country. The difference between

latter, suppose that a nonresident, Mr. R, participates in a partnership of S country as a partner. Historically people think that R-partner does business in S country in legal sense even if R-partner has never stepped into S country actually. However, factually (*sachlich* in German word) speaking, R-partner does not business in S country. About R-partner's receipt of business profit from the partnership of S country, I consider it as distributing or allocating business profit in wide meaning.

The second task is as follows: For example, when a bank gets interest income, there are two elements; one of which is a consideration for business of financial intermediating service, and another of which is a receipt of distribution of business profit in wide meaning from the borrower¹². The former part has its source at the place the bank conducts business (in usual, it is the location of offices)¹³. The latter part is not the considerations for producing added value, therefore there is little meaning in asking source of income for the latter part and the nature that source of income is located at the place where the monetary obligor does business is not changed¹⁴. We can consider the source of income of investors in a same way as the bank's latter part.

Second possibility is looking at customers thoroughly. Traditionally, source rule which looks at customers is mainly related with the place of customers' business. When customers are consumers, the second possibility is hard to work. Therefore, in order to be consistent, new source rule looks at, not customers' business, but demand.

This thought does not match with existing thought of personal allocation of income. Although traditionally net income is not allocated to non-PE countries, if new source rule looks at demand, there will be some oddness: on the one hand, a certain country is the place of demand and that country has source of income, on the other hand, if there is no PE in that country, net income is not allocated in the light of personal allocation of income. However, from the beginning, source of income (geographic allocation of income) and personal allocation of income are different. For example, suppose that country-A's resident, named B, has land in country-C and gets rent. The rent income is geographically allocated to country-C and personally allocated to B. Personal allocation of income is one requisition for tax equity in residence tax jurisdiction, and adjustment between source tax jurisdiction and residence tax jurisdiction is not discussed in this paper¹⁵.

If we make new source rule looking at demand, tax system might resemble destination principle of VAT. However this paper does not discuss the problem which is better, income tax or VAT.

Chapter 6 Implications of this paper

two cases above is the owner of the business. In both cases, the machine itself is considered as business, and the income which is derived from the production factor, *i.e.* the machine, has its source in S-country.

¹² In usual, interest is not considered as distribution, differentiated from dividend. However, functionally analyzing, debt/equity dichotomy has little meaning. Moreover, some part of interest is time value of money; and it is derived from the borrower's business profit.

¹³ Scooping up the former part from the interest income is administratively difficult, although it is able in theory.

¹⁴ This paper only discusses source of income. The problems how to adjust source tax jurisdiction and residence tax jurisdiction and how to treat the possible double taxation are future works.

¹⁵ Traditionally residence tax jurisdiction should make final adjustment; therefore, adjustment of the inconsistency between geographic allocation of income and personal allocation of income is the task of residence tax jurisdiction if we follow the traditions.

In the standard textbooks, tax jurisdiction has two types: residence tax jurisdiction and source tax jurisdiction. However I think that tax system is divided in three manners. Source tax jurisdiction has two types: PE taxation (which resembles resident taxation) and non-PE taxation.

Although PE is treated as quasi-resident, it will be difficult to treat a PE perfectly same as a resident. On the one hand, in the relation between person and person, such as a parent company and a subsidiary, personal allocation of income is strongly affected by the legal contract between two persons; therefore correspondence between the place of business activity and personal allocation of income often collapses. On the other hand, in the relation between parts of one person, such as a branch and a head office, there is no legal contract; therefore, correspondence between the branch's business activity and the personal allocation of income of the branch is strong.

There have already been some legislative propositions. This paper discusses only source of income, therefore, my comment is based only in the light of source of income.

U.S. Treasury, *Selected Tax Policy Implications of Global Electronic Commerce* (1996) disrespects taxing right of source countries. However, U.S. Treasury's paper does not deny the concept of source of income, because the paper looks at the business of earners' own.

Doernberg, *Electronic Commerce and International Tax Sharing*, 16 *Tax Notes Int'l* 1013 (1998) protects taxing right of source countries. However, Doernberg's paper looks at whether source country's tax base is eroded or not and only looks at the relationship between person and person. Therefore, the paper denies the concept of source of income.

Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 *Harvard Law Review* 1573 (2000) protects taxing right of source countries and does not deny the concept of source of income because Avi-Yonah's paper looks at the place of demand. However, looking at demand needs big jump from the traditional international tax system.

Chapter 7 Conclusions

This paper makes clear that existing source rule has unreasonable dichotomy: passive and active, for example, rent income is not business income and sales income is business income. In order to solve this dichotomy, the possible solution is that source rule looks at only one thing. The first possibility is looking at business; however even if we follow the first in order to solve the dichotomy, we need another line drawing between the part of consideration for business activities and the other part. The second possibility is looking at demand. This resembles destination principle of VAT and is hard to be matched with traditional system of income taxation. This paper only offers the basis for legislative discussions and discusses source of income. In concrete and pragmatic legislative discussions, we need to pay attention to other things, such as administration and policy.