

# THE ROLE OF PHYSICAL PRESENCE IN THE TAXATION OF CROSS-BORDER PERSONAL SERVICES

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**Abstract:** This Article addresses the role of physical presence in the taxation of cross-border personal services. For much of the last century, both U.S. internal law and bilateral treaties have used the service provider's physical location as the touchstone for determining international taxing jurisdiction. Modern developments—in particular, the significant advances in global communication technology and the increasing mobility of individuals—raise important questions regarding the continued viability of this physical presence standard. These modern developments have already facilitated the offshoring of numerous types of personal services, such as radiology, accounting, and legal services. As communication technology improves, the range of personal services that can be delivered remotely will follow. In order to address the issues raised by these developments, the Article focuses on the recent introduction of telesurgery, which permits surgeons based in one country to perform real-time procedures on patients located in another country. The Article describes the significant problems that arise in attempting to fit these modern developments into an almost century-old framework of internal tax laws and international treaty principles. It then makes the normative case for de-emphasizing physical presence in determining the international tax consequences of cross-border personal services. Although the arguments for change are strongest in the context of U.S. internal tax law—in particular, in the application of the foreign earned income exclusion—they also impact the principles underlying bilateral tax treaties.

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## INTRODUCTION

Recent technological developments have placed a strain on the jurisdictional rules that the United States and other countries apply to tax income arising in cross-border settings.<sup>1</sup> These rules, reflected in countries' internal tax laws and a vast network of bilateral tax treaties, were developed in the early and mid-20th century, a world "in which you earned income where you were physically present."<sup>2</sup> A fundamental issue facing policymakers is the extent to which long-standing international tax policies and principles remain viable in a globalized economy impacted by the Internet and other communications technologies that facilitate the widespread and instantaneous transfer of goods, services, information, and money across national borders.<sup>3</sup>

In recent years, scholars and government officials from both the United States and other countries have addressed the impact of these technological developments on international tax policy.<sup>4</sup> Much of this

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<sup>1</sup> Simultaneous with these technological developments, traditional international tax policies and principles have been impacted by broader globalization trends, facilitated by modern economic and political developments. See Task Force on Int'l Tax Reform, Am. Bar Ass'n, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 657 (2006) (discussing liberalization of currency exchange policies, increased efficiencies in global capital markets, reductions in barriers to trade and movement of individuals, and improvements in transportation). Of course, it is important to acknowledge that ours is not the first generation to experience technological developments that place pressure on existing tax frameworks. Indeed, one of the first tax cases addressing the sourcing of personal services arose in the early twentieth century as a result of the early use of phonograph technology. See *infra* note 62 and accompanying text (discussing Enrico Caruso's tax case); see also J. Clifton Fleming, Jr., *Electronic Commerce and the State and Federal Tax Bases*, 2000 B.Y.U. L. REV. 1, 1 (stating that "the taxation of electronic commerce can be thought of as a case of *Back to the Future* because it begins almost sixty years ago" in a case involving cross-border radio broadcasts, *Piedras Negras Broadcasting Co. v. Commissioner*, 43 B.T.A. 297 (1941), *aff'd* 127 F.2d 260 (5th Cir. 1942)).

<sup>2</sup> Charles I. Kingson, *Taxing the Future*, 51 TAX L. REV. 641, 642 (1996).

<sup>3</sup> The U.S. Treasury Department recognized this issue relatively early in the Internet era, and attempted to identify the potential impacts of these technological developments on international tax policy. See generally OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE (1996) [hereinafter TREASURY REPORT], available at <http://www.ustreas.gov/offices/tax-policy/library/internet.pdf>.

<sup>4</sup> See generally RICHARD L. DOERNBERG ET AL., ELECTRONIC COMMERCE AND MULTIJURISDICTIONAL TAXATION (2001); OECD TECHNICAL ADVISORY GRP., ARE THE CURRENT TREATY RULES FOR TAXING BUSINESS PROFITS APPROPRIATE FOR E-COMMERCE? (2006) [hereinafter OECD TAG Report], available at <http://www.oecd.org/dataoecd/58/53/35869032.pdf>; Joseph L. Andrus, *Determining the Source of Income in a Changing World*, 75 TAXES 839 (1997); Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507 (1997); Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001); Kingson, *supra* note 2; Steven E. Shay, J. Clifton Fleming, Jr., & Robert J. Peroni, "What's Source Got to Do With It?" *Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81 (2002).

analysis focuses on electronic commerce conducted through the Internet, such as the sale of goods ordered from websites, or the downloading of software or other intangible property. This Article addresses an activity that has received less detailed analysis—the use of technology to perform personal services across borders.<sup>5</sup>

The performance of personal services across borders provides perhaps the most extreme example of how modern developments have undermined the physical location-based assumptions underlying traditional international tax principles. A prominent scholar writing in the early 1960s acknowledged that multinational corporate business developments could be expected to create international tax complications but nonetheless concluded that the taxation of individuals on income from personal services would remain “fairly easy to implement, since the income is earned where the service is performed, [which] is readily determined.”<sup>6</sup> Recent technological developments demonstrate that this inquiry into the place where services are performed is not necessarily “readily determined” in the twenty-first century, and that the focus on the place of the service provider’s physical location may no longer be the appropriate principle for determining taxing jurisdiction.

The physical disconnect between professional service providers and clients has already demonstrated significant growth potential in many areas, including the offshoring of radiology, accounting, and legal services to India and other jurisdictions. Indeed, some scholars have estimated that more than one quarter of U.S. service jobs are potentially offshorable within the next decade or two (although only a portion of these concern professional services).<sup>7</sup> Although the expansion

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<sup>5</sup> Some commentators have addressed the impact of technology on the taxation of services broadly defined. See, e.g., DOERNBERG ET AL., *supra* note 4, at 228–53; Ned Maguire, *Deloitte & Touche Offers Comments on Tax Policy Implications of Global Electronic Commerce*, 15 TAX NOTES INT’L 1483, 1491 (1997) (discussing “electronic commerce services,” including “Internet access, e-mail, supply of online information and Web hosting”); Shay, Fleming & Peroni, *supra* note 4, at 139–43.

<sup>6</sup> PEGGY BREWER RICHMAN, TAXATION OF FOREIGN INVESTMENT INCOME[:] AN ECONOMIC ANALYSIS 26 (1963); see also Fleming, *supra* note 1, at 7 (referring to medical services as “transactions that cannot be moved to the Internet”); Ruth Mason, *Tax Expenditures and Global Labor Mobility*, 84 N.Y.U. L. REV. 1540, 1591 (2009) (“[S]ourcing’ personal services income to the performance state is relatively uncontroversial.”).

<sup>7</sup> See Alan S. Blinder, *How Many U.S. Jobs Might Be Offshorable?* 1 & n.1 (Princeton Univ. Ctr. for Econ. Policy Studies, Working Paper No. 142, 2007), available at [www.princeton.edu/ceps/workingpapers/142blinder.pdf](http://www.princeton.edu/ceps/workingpapers/142blinder.pdf) (ranking 291 occupations by their potential vulnerability to offshoring—i.e., the potential “movement of jobs to other countries, whether or not that movement is within the same firm or to a different firm”); Troy Smith & Jan W. Rivkin, A Replication Study of Alan Blinder’s “How Many U.S. Jobs Might Be Offshorable?” (June 11, 2008) (working paper, on file with author) (confirming much of

of cross-border personal services may be primarily driven by non-tax economic factors,<sup>8</sup> the tax system itself may spur the expansion of cross-border remote professional services to the extent that the system provides tax incentives for performing these activities remotely. Thus, the fundamental tax issues raised by the remote performance of personal services are currently relevant and promise to become increasingly important in the coming years.

To elucidate the international tax issues raised by the remote performance of personal services across borders, this Article focuses on the recent introduction of telesurgery, which perhaps best illustrates the uncomfortable fit between a jurisdictional standard based on the physical location of the service provider and modern technological developments. In the past few years, minimally invasive robotic-assisted surgery, in which the surgeon controls the robotic surgical system in real-time while sitting several feet away from the patient, has become widespread.<sup>9</sup> Telesurgery (sometimes called remote surgery) extends the reach of robotic-assisted surgery by eliminating the need for physical proximity between the surgeon and the patient. Through the use of remote-controlled robotic systems and high-speed communications networks, telesurgery permits a surgeon to perform a real-time operation on a patient who may be hundreds or thousands of miles away. In one of the earliest uses of this technique in 2001, a surgeon located in New York performed a gallbladder operation on a patient in Strasbourg, France, controlling a surgical robot connected through a dedicated transatlantic fiber-optic cable.<sup>10</sup> More recently, a Canadian company announced the successful test of its commercial telesurgery system over a 4000-mile distance.<sup>11</sup> As the technology and communication speed and reliability

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Blinder's research). Blinder's analysis focuses on the economic and political (rather than the tax) implications of this potential offshoring. See, e.g., Alan S. Blinder, *Offshoring: The Next Industrial Revolution?*, FOREIGN AFF., Mar./Apr. 2006, at 113–14 [hereinafter Blinder, *Offshoring*]; Alan S. Blinder, *Free Trade's Great, but Offshoring Rattles Me*, WASH. POST, May 6, 2007, at B04. Blinder's analysis—in particular, his definition of “personal services”—is discussed in more detail *infra* notes 69–78 and accompanying text.

<sup>8</sup> See Blinder, *Offshoring*, *supra* note 7, at 114–16 (discussing role of comparative advantage analysis in future offshoring of personal services).

<sup>9</sup> See Sajeesh Kumar, *Introduction to Telesurgery*, in TELESURGERY 5 (Sajeesh Kumar & Jacques Marescaux eds., 2008).

<sup>10</sup> *Id.* at 4.

<sup>11</sup> See Press Release, Titan Med. Inc., Titan Med. Inc. and Bell Can. Complete Telesurgery Tests Over Unprecedented Distance (Mar. 17, 2009), available at <http://www.titanmedicalinc.com/news.php?news=5>. Another leading maker of robotic surgical systems notes that its “goal is to extend the benefits of minimally invasive [robotic] surgery to the broadest possible base of patients,” and that as part of that goal it is exploring the adaptation of its system to telesurgery. See *Frequently Asked Questions*, INTUITIVE

improve, these types of procedures may increase significantly.<sup>12</sup> Indeed, one company has announced that it expects its telesurgery system will eventually be used between the United States and “proximate offshore locations” on a day-to-day basis.<sup>13</sup>

Telesurgery raises significant legal issues, many of which need further exploration to keep up with the technological developments.<sup>14</sup> This Article focuses on the international tax issues that can be expected to arise with the development of telesurgery. In particular, it considers whether the “source” of the income received by the surgeon is the country where the surgeon is located or the country where the patient is located.<sup>15</sup> Additionally, and, perhaps more fundamentally, does it still make sense for tax law to focus on the physical location of a service provider in a world where technology permits the separation of the ser-

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SURGICAL, <http://www.intuitivesurgical.com/products/faq/index.aspx#4> (last visited Aug. 23, 2010). The company lists almost twenty countries in which the robotic system is currently being used. See *id.* Given that several of the countries listed are sometimes viewed as tax havens, it is not improbable that those countries might someday become the centers for surgeons performing cross-border telesurgery, particularly if international tax principles create incentives for such surgeons to be located there.

<sup>12</sup> See *infra* notes 69–78 and accompanying text (discussing potential growth of telesurgery).

<sup>13</sup> Press Release, Titan Med. Inc., *supra* note 11.

<sup>14</sup> These legal issues include whether the surgeon performing the telesurgery must be licensed in the jurisdiction where the patient is located and admitted to the hospital staff at that location, whether the surgical system must be licensed in that jurisdiction, which jurisdiction’s standard of care will apply for purposes of medical malpractice, and how patient privacy will be ensured in the context of a procedure involving electronic information transfer. See generally Neera Bhatia, *Telesurgery and the Law*, in *TELESURGERY*, *supra* note 9, at 171–77 (discussing the legal and regulatory environment surrounding telesurgery).

<sup>15</sup> For an extensive discussion of the role of source-based taxation in the modern global economy, see Shay, Fleming & Peroni, *supra* note 4, at 154 (concluding that source-based taxation remains a viable jurisdictional basis for taxing in the modern economy, but that “the content of any particular source rule should relate to the rule’s purpose and not to debates over geographical origin”). See DOERNBERG ET AL., *supra* note 4, at 228–36; TREASURY REPORT, *supra* note 3, at 23 (“In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source based taxation could lose its rationale and be rendered obsolete by electronic commerce.”); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1352–53 (1996) (proposing that individuals be taxed only on a residence basis, and that publicly held corporations be taxed only on a source basis, determined via formulary apportionment); Graetz, *supra* note 4, at 317 (“If the source rules are to serve as a way of allocating income equitably among nations and enhancing national economic well-being and/or fairness among taxpayers, they should be overhauled to be better linked to the location of real economic activity, the location of customers, workers, or assets.”); Kingston, *supra* note 2, at 656 (“To the extent commerce becomes electronic rather than physical, and to the extent what is being sold also becomes electronic—information, entertainment, technology—the search for a physical presence . . . takes on a touch of the quixotic.”).

vice provider from the place of the service's impact?<sup>16</sup> After using the telesurgery example to recommend a diminished role for the physical location of the service provider under both internal tax law and tax treaties, the Article considers the implications of its analysis to a broader range of personal services that can be performed remotely across borders.<sup>17</sup> Although the Article focuses on these issues from the perspective of the U.S. tax system, the analysis is generally applicable to other countries attempting to address similar situations.

Part I provides a general overview of the relevant international tax rules and principles under both U.S. internal law and the large network of bilateral income tax treaties. It also discusses the complexities that arise in defining personal services income and provides additional relevant information regarding cross-border telesurgery. Part II applies the current provisions of U.S. internal law and tax treaties to the telesurgery example, illustrating the significant difficulties that arise when the physical location of the service provider is separated from the principal place of the service's impact.

Part III then builds the normative case for departing from the long-standing emphasis on the service provider's physical location. It does so in the context of both the tax liability of a foreign-based surgeon performing telesurgery on a U.S.-based patient, and the foreign tax credit relief available to a U.S.-based surgeon performing telesurgery on a foreign-based patient. In addition, it concludes that a compelling case exists for de-emphasizing the physical location of a U.S.-citizen service provider for purposes of the foreign earned income exclusion.

Part IV considers the broader implications of these recommendations for cross-border personal services beyond the telesurgery example. In particular, it focuses on how both U.S. internal tax law and international tax treaties might adapt to the ongoing progress in technology and communications, which continuously expands the range of personal services that can be performed remotely.

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<sup>16</sup> Given the nascent state of the technology, these tax issues have not yet arisen in the context of telesurgery. The lessons of the past decade—in particular, the significant attention given to tax issues arising from the widespread growth of electronic commerce over the Internet—demonstrate, however, that once a technology-driven, income-producing activity moves from the “gee-whiz” phase to the routine, tax issues are certain to follow.

<sup>17</sup> Analogous tax issues might also arise in a wholly domestic U.S. state taxation context, as telesurgery and other personal services are increasingly performed electronically across U.S. state borders. See *infra* note 99 (briefly discussing state tax cases that de-emphasize the importance of physical presence as a jurisdictional basis for imposing income-based taxes).

## I. THE TRADITIONAL APPROACH TO TAXING PERSONAL SERVICES INCOME

### A. *General Principles of International Taxation*

#### 1. U.S. Internal Law

In an international setting, a country can impose income tax based on two jurisdictional bases: the residence of the taxpayer, or the source of the income.<sup>18</sup> The United States exercises residence-based jurisdiction by taxing the income of its residents,<sup>19</sup> citizens,<sup>20</sup> and domestic corporations<sup>21</sup> regardless of where in the world that income arises (so-called “outbound” taxation).<sup>22</sup> The United States exercises source-based jurisdiction by taxing certain U.S.-connected income of foreign individuals and foreign corporations (so-called “inbound” taxation).<sup>23</sup>

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<sup>18</sup> For a general discussion of residence and source-based taxing nexus, see FED. INCOME TAX PROJECT, AM. LAW INST., INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION: PROPOSALS ON U.S. TAXATION OF FOREIGN PERSONS AND THE FOREIGN INCOME OF UNITED STATES PERSONS 6–7 (1987) [hereinafter ALI INTERNATIONAL TAX PROJECT].

<sup>19</sup> A noncitizen taxpayer’s physical presence in the United States plays an important role in determining whether the taxpayer is a resident alien for tax purposes. See I.R.C. § 7701(b)(1)(A) (2006) (listing “substantial presence test” as one of three potential tests that make a noncitizen a resident alien); see also *id.* § 7701(b)(3), (5), (7) (providing that certain days of physical presence in the United States do not count toward the substantial presence test). This Article focuses on the role of physical presence in determining the source of income from cross-border personal services; it does not address the use of physical presence to determine resident alien status.

<sup>20</sup> Unlike almost all other countries, the United States extends residence-based principles to tax its citizens, even with respect to most income that arises outside the United States. See Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 448–49 (2007).

<sup>21</sup> In general, a corporation organized under the laws of a U.S. state is a “domestic” corporation, whereas a corporation organized under the laws of a foreign country is a “foreign” corporation. I.R.C. § 7701(a)(4), (5). See generally Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475 (2005) (criticizing this exclusive reliance on a place-of-incorporation test).

<sup>22</sup> See I.R.C. § 1; Treas. Reg. § 1.1-1(b) (as amended in 2008); see also I.R.C. § 951 (requiring U.S. shareholders to include a pro rata share of income belonging to controlled foreign corporations). Numerous exceptions apply to this broad exercise of residence-based taxation. See *id.* § 911 (excluding certain foreign income earned by U.S. citizens and residents working abroad).

<sup>23</sup> See generally I.R.C. § 871 (taxation of nonresident alien individuals); *id.* §§ 881, 882 (taxation of foreign corporations).

a. *Inbound Regime—Source-Based Jurisdiction*

Under the Internal Revenue Code (the “Code”), the determination of the “source” of a taxpayer’s income is relevant in both the outbound, residence-based tax regime applicable to U.S. persons, and the inbound, source-based tax regime applicable to foreign persons. The importance of source is most obvious in the latter regime, which explicitly relies on source-based jurisdiction principles. Under that regime, a foreign person engaged in a trade or business within the United States is taxable on the income “effectively connected” to that trade or business.<sup>24</sup> Such income is taxed on a “net” basis (i.e., after allowable deductions), and is subject to the regular progressive marginal rate schedule.<sup>25</sup> Although the Code does not contain a general definition of what level of activity is necessary to constitute a “trade or business within the United States,” it explicitly states that “the performance of personal services within the United States at any time within the taxable year” constitutes such a trade or business.<sup>26</sup>

In determining what income is “effectively connected” to a U.S. trade or business, the Code provides that most U.S.-source income is effectively connected (and therefore subject to tax),<sup>27</sup> and most foreign-source income is not.<sup>28</sup> Thus, the determination of the source of a foreign person’s business-related income plays a significant role in determining whether the income will be subject to U.S. tax. It is particularly relevant that foreign-source personal services income is not subject to U.S. tax under this regime.<sup>29</sup>

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<sup>24</sup> *Id.* § 871(b) (taxation of business income of nonresident alien individual); *id.* § 882 (taxation of business income of foreign corporation).

<sup>25</sup> *See id.* §§ 871(b), 882.

<sup>26</sup> *Id.* § 864(b). The Code contains a de minimis exception with respect to this test. *See infra* note 89.

<sup>27</sup> *See* I.R.C. § 864(c)(2)–(3).

<sup>28</sup> *See id.* § 864(c)(4)(A) (providing that most foreign-source income is not effectively connected).

<sup>29</sup> *See id.* § 864(c)(4)(B)–(D) (providing that certain foreign-source income is effectively connected). None of these exceptions to the general rule applies to personal services income. Source rules are also important in determining the taxation of a foreign person’s passive (non-business) investment income, such as interest and dividends. In general, the United States does not tax a foreign person’s foreign-source investment income (although, under limited circumstances, foreign-source interest, dividends, or royalties might be treated as effectively connected to a U.S. trade or business, and therefore subject to tax). *See id.* § 864(c)(4). In contrast, and subject to several important exceptions, the United States does tax some of a foreign person’s U.S.-source investment income. If applicable, this tax on passive income is imposed on a “gross” basis (no deductions are allowed) at a flat thirty percent rate. *See id.* § 871(a) (nonresident alien individual taxpayers); *id.* § 881(a) (foreign corporation taxpayers).

b. *Outbound Regime—Residence-Based Jurisdiction*

The source of income plays a less direct but very important role in the outbound tax regime applicable to U.S. persons (i.e., U.S. resident aliens, citizens, and domestic corporations). Because the United States generally taxes U.S. persons on their worldwide income regardless of where it arises, the source of a U.S. person's income is not relevant as a threshold matter. The source of income is relevant, however, for purposes of eliminating the potential double taxation of income.

Double taxation exists in an international context when both the taxpayer's country of residence (i.e., the residence country) and the country in which the income arises (i.e., the source country) tax the same item of income. Under internationally accepted practice, and in the absence of a tax treaty, the country exercising residence-based jurisdiction is expected to unilaterally alleviate the double taxation by some reasonable means.<sup>30</sup> When the United States exercises residence-based taxation by taxing the worldwide income of its residents and citizens, it generally mitigates double taxation by allowing a credit for the foreign income taxes paid on foreign source income.<sup>31</sup> The Code and underlying Treasury Regulations contain detailed limitations intended to allow the foreign tax credit only to the extent necessary to offset the U.S. tax imposed on foreign source income and thereby eliminate double taxation.<sup>32</sup>

In the case of a U.S. citizen living abroad,<sup>33</sup> the United States mitigates double taxation by excluding certain foreign-source personal services income from the tax base (as an alternative to the foreign tax credit). This "foreign earned income exclusion" may be elected if the U.S. citizen's tax home is in a foreign country and satisfies certain other requirements related to living abroad.<sup>34</sup>

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<sup>30</sup> ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 6.

<sup>31</sup> See I.R.C. §§ 901–904. See generally CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD C. PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 19–21, 254–57 (3d ed. 2006) (summarizing the alternative methods for the residence country to mitigate double taxation).

<sup>32</sup> See I.R.C. § 904 and Treasury Regulations thereunder. These limitations are subject to manipulation by taxpayers, so that in some circumstances the foreign tax credit is allowed beyond the extent necessary to eliminate double taxation on foreign-source income, permitting the reduction of U.S. tax imposed on U.S. source income. See GUSTAFSON, PERONI & PUGH, *supra* note 31, at 371–75, 385–87 (describing planning opportunities with the foreign tax credit limitations).

<sup>33</sup> In some circumstances, a U.S. resident alien who spends sufficient time in a foreign country can claim the foreign earned income exclusion. See I.R.C. § 911(d)(1)(B).

<sup>34</sup> See *id.* § 911. In 2010, the maximum amount of foreign earned income that can be excluded can exceed \$100,000 (\$91,500, plus certain housing expenses). See *infra* notes

Thus, “the major function of the source rules in the outbound context is to help delineate the proper scope of the unilateral double-taxation relief granted” by the United States.<sup>35</sup> By defining the extent to which the United States, in exercising residence-based (or citizenship-based) jurisdiction, is willing to cede primary taxing rights to the source country, the source rules help to allocate tax revenues between the two countries.<sup>36</sup>

### c. *Source Definitions*

The Internal Revenue Code and related regulations contain detailed rules for determining the source of income.<sup>37</sup> The applicable source rule depends on the type of income at issue. For example, separate source rules apply to interest,<sup>38</sup> dividends,<sup>39</sup> compensation for personal services,<sup>40</sup> rents and royalties,<sup>41</sup> and gains from the sale of property.<sup>42</sup> Accordingly, as a threshold matter it is important to properly characterize the income in question so that the correct source rule can be applied.<sup>43</sup> Moreover, it is important to note that, at least as a general matter, the Code contains a uniform set of source rules that apply for

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135–141 and accompanying text. In addition to meeting the foreign tax home requirement, a U.S. citizen must either have a bona fide residence in a foreign country for a period that includes an entire taxable year, or be present in the foreign country during at least 330 full days during a twelve-month period. *Id.* § 911(d)(1).

<sup>35</sup> Shay, Fleming & Peroni, *supra* note 4, at 147.

<sup>36</sup> *See id.*

<sup>37</sup> See I.R.C. §§ 861–865 and Treasury Regulations thereunder. Related rules apply for determining the source of deductions.

<sup>38</sup> *See* I.R.C. §§ 861(a)(1), 862(a)(1).

<sup>39</sup> *Id.* §§ 861(a)(2), 862(a)(2).

<sup>40</sup> *Id.* §§ 861(a)(3), 862(a)(3).

<sup>41</sup> *Id.* §§ 861(a)(4), 862(a)(4).

<sup>42</sup> *Id.* §§ 861(a)(5), 862(a)(5), 865.

<sup>43</sup> As Professor Reuven Avi-Yonah observed, “the current rules place an immense premium on [how] payments are characterized . . . . These distinctions require constant policing, and much of the complexity of the inbound rules of the Code stems from this problem.” Avi-Yonah, *supra* note 15, at 1331; *see also* Kingson, *supra* note 2, at 642 (asking whether, in the modern global economy, we should “continue to characterize income as royalties, services, sales, interest”). For this and other reasons, Professor Avi-Yonah advocates the revision of the international tax rules to eliminate the need for these item-specific sourcing rules. *See* Avi-Yonah, *supra* note 15, at 1354. *But see* Shay, Fleming & Peroni, *supra* note 4, at 154 (advocating the retention of item-specific source rules, but suggesting that they be more accurately tailored to the underlying substantive tax purposes and enforcement realities). This Article assumes that the current regime, with its different source rules based on the type of income, will remain in place.

purposes of both the inbound tax regime applicable to foreign persons and the outbound tax regime applicable to U.S. persons.<sup>44</sup>

## 2. Income Tax Treaties

The preceding subpart summarized the relevant United States tax law provisions. Of course, other countries have their own internal tax laws that apply in an international setting. Although most countries' tax laws reflect a general convergence regarding broad residence- and source-based taxation principles,<sup>45</sup> the details of each country's tax rules differ to reflect that country's unique needs.<sup>46</sup> As discussed above, the most significant issue arising from the interaction of these independent tax regimes is the potential for double taxation. Although this problem can be mitigated by one of the countries (typically the residence country) ceding taxing jurisdiction through a foreign tax credit or income exclusion, unilateral legislation enacted by one country often cannot resolve many of the theoretical and practical problems that arise when multiple countries have legitimate claims to tax the same item of income in a cross-border setting.<sup>47</sup> Accordingly, countries increasingly rely on income tax treaties to resolve these issues. These treaties benefit taxpayers by easing administrative burdens and mitigating the potential double taxation that might otherwise arise. These treaties also benefit treaty countries' tax authorities by facilitating the sharing of information to limit opportunities for tax evasion.<sup>48</sup>

Income tax treaties are bilateral treaties negotiated directly between two countries.<sup>49</sup> The treaties are not negotiated from scratch, but instead are based on model treaties—most often the model treaty developed by the Organization for Economic Co-operation and Devel-

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<sup>44</sup> In some circumstances, however, Congress has enacted different source rules for the inbound and outbound contexts to achieve a particular tax result. See Shay, Fleming & Peroni, *supra* note 4, at 139 (citing example of certain gain from the sale of personal property attributed to an office or fixed place of business).

<sup>45</sup> See Kirsch, *supra* note 20, at 448.

<sup>46</sup> As Professor Graetz observed, "Tax policy decisions, including decisions regarding a country's tax treatment of international income, should be, and inevitably are, decided based on a nation's capacity, culture, economics, politics, and history." Graetz, *supra* note 4, at 279.

<sup>47</sup> See Michael S. Kirsch, *The Limits of Administrative Guidance in the Interpretation of Tax Treaties*, 87 *TEX. L. REV.* 1063, 1065 (2009).

<sup>48</sup> See *id.*

<sup>49</sup> Although the vast majority of income tax treaties worldwide—including all U.S. tax treaties—are bilateral, a small number of multilateral tax treaties exist, most notably among the Nordic countries. See *id.* at 1071 n.29.

opment (the “OECD Model Treaty”).<sup>50</sup> Because of the influence of the OECD Model Treaty, each of the more than sixty U.S. tax treaties in force generally shares a common structure containing many similar or identical provisions. Notwithstanding these similarities, each bilateral treaty also contains unique provisions that “address issues that arise from the specific interaction of the two countries’ tax laws and . . . particular tax policies that might be important to one of the countries.”<sup>51</sup>

Tax treaties allocate taxing rights over various types of income between the residence and the source countries.<sup>52</sup> Unlike unilaterally enacted remedies for double taxation (e.g., the foreign tax credit), that generally give primary taxing rights to the source country, tax treaties generally grant primary taxing rights to the residence country and limit the extent to which the source country can tax. In the case of profits arising from business activities, including personal services performed in an independent capacity,<sup>53</sup> the OECD Model Treaty allows the

<sup>50</sup> Model Tax Convention on Income and Capital (OECD condensed version 2008) [hereinafter OECD Model Treaty]. The OECD Model Treaty contains not only the text of the model treaty, but also specific commentaries on each treaty article [hereinafter OECD Commentary]. The OECD is an international organization of thirty economically developed countries, including the United States, that focuses on economic policy matters. OECD, *THE OECD 7* (2008), available at <http://www.oecd.org/dataoecd/15/33/34011915.pdf>. For purposes of this Article, the OECD Commentary is treated as reflecting the correct interpretation of the OECD Model Treaty. Cf. Kirsch, *supra* note 47, at 1079–81 (discussing interpretive role of OECD commentaries promulgated after underlying OECD Model Treaty provision was adopted).

In addition to utilizing the OECD Model Treaty, United States treaty negotiators rely on a model treaty developed by the U.S. Treasury Department. See United States Model Income Tax Convention of November 15, 2006 (U.S. Dep’t of the Treasury 2006) [hereinafter 2006 U.S. Model Treaty], available at <http://www.ustreas.gov/offices/tax-policy/library/model006.pdf>. The 2006 U.S. Model Treaty is based on the OECD Model Treaty but contains certain variations that reflect the United States’ preferred tax policy approaches. See generally MARTIN B. TITTLE & REUVEN S. AVI-YONAH, *THE INTEGRATED 2006 UNITED STATES MODEL INCOME TAX TREATY* (2008) (detailed comparison of OECD Model Treaty and 2006 U.S. Model Treaty). The United Nations has also developed a model income tax treaty that gives greater preference to source-based taxation than does the OECD Model Treaty and is principally intended for use by developing countries. See Model Double Taxation Convention Between Developed and Developing Countries (United Nations 2001) [hereinafter U.N. Model Treaty].

<sup>51</sup> Kirsch, *supra* note 47, at 1066.

<sup>52</sup> See generally OECD Commentary, *supra* note 50, ¶¶ 19–23 (summarizing the allocation rules).

<sup>53</sup> See OECD Commentary, *supra* note 50, art. 7, ¶ 2.1. Prior to 2000, the OECD Model Treaty contained a separate article (Article 14) for independent services income. See *id.* (discussing former Article 14). Because the threshold standard contained in former Article 14 (i.e., fixed base) was determined to have the same meaning as the threshold standard contained in Article 7 (i.e., permanent establishment), former Article 14 was deleted and independent services were incorporated into the general business profits provision of

source country to tax those business profits only if the taxpayer's business is conducted through a "permanent establishment" in the source country.<sup>54</sup> If the foreign taxpayer has a permanent establishment, then the source country can tax the business profits that are factually attributable to that permanent establishment.<sup>55</sup> If, however, the business activities are not conducted through a permanent establishment, the source country generally cannot tax the business profits.<sup>56</sup> Accordingly, if a resident of the other treaty country conducts significant business activities in the United States but does not do so through a permanent establishment, the treaty between the United States and the taxpayer's country of residence will prevent the United States from taxing that income, even though the income might otherwise have been taxable as effectively connected income under the Code.<sup>57</sup>

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Article 7. *See id.* The treaty now makes this clear by defining the term "business" to include "the performance of professional services and of other activities of an independent character." OECD Model Treaty, *supra* note 50, art. 3(1)(h). Similarly, the U.S. Treasury Department omitted former Article 14 from the 2006 U.S. Model Treaty and incorporated independent personal services income into the general business profits test of Article 7. *See* U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOV. 15, 2006, art. 3 [hereinafter 2006 MODEL TECHNICAL EXPLANATION]; *see also* 2006 U.S. Model Treaty, *supra* note 50, art. 3(e) (definition of "business").

<sup>54</sup> *See* OECD Model Treaty, *supra* note 50, art. 7(1). For income that does not arise from business activities—in particular, most investment interest, dividends, and royalties—tax treaties generally limit the source country's taxing rights by capping (sometimes at zero) the tax rate that the source country can impose. *See generally id.* arts. 10–12.

<sup>55</sup> *Id.* Because both the source and the residence country are entitled to tax under these circumstances, double taxation is avoided by having the residence country cede taxing jurisdiction (either through a foreign tax credit or an exemption). *See id.* arts. 23A (exemption method), 23B (credit method).

<sup>56</sup> Exceptions apply for limited types of income. *See id.* art. 17 (allowing source-country taxation of artists and athletes, even in the absence of a permanent establishment). The analogous provision of the 2006 U.S. Model Treaty permits such taxation only if the artist's or athlete's income in the source country exceeds \$20,000. *See* 2006 U.S. Model Treaty, *supra* note 50, art. 16(1).

<sup>57</sup> In general, a treaty provision that prohibits the United States from imposing tax takes precedence over a Code provision that otherwise would have imposed tax. *See* Kirsch, *supra* note 47, at 1087–90 (discussing the relationship between tax treaties and federal statutes, and the limited circumstances under which the Code might override a treaty benefit).

## B. Defining Personal Services

### I. Broad vs. Narrow Definitions

Before addressing the impact of modern technology on the taxation of cross-border personal services, it is important to clarify the type of personal services that are the focus of this Article. In its broadest sense, the term “services” can include the provision of Internet access and other forms of telecommunications, electronic databases, financial services, online gambling, and many other electronic transactions that involve relatively little, if any, discretionary human input by the provider.<sup>58</sup> Although this broad definition of services raises important tax policy issues, many of which have been addressed by others,<sup>59</sup> this Article focuses on a more narrow set of services income—remuneration for personal services where “at least some significant aspect of the service is provided directly . . . by a *human being*.”<sup>60</sup>

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<sup>58</sup> See DOERNBERG ET AL., *supra* note 4, at 231 (“The tax issues that surround the performance of services can arise in a variety of contexts including electronic access to the internet and on-line service providers . . . , proprietary databases and/or on-line publications, consulting and other services, brokerage and auction functions, and software.”); TREASURY REPORT, *supra* note 3, at 9, 31–35 (discussing the definition of services income); see also *Piedras Negras Broad. Co. v. Comm’r*, 43 B.T.A. 297 (1941), *aff’d* 127 F.2d 260 (5th Cir. 1942) (income from radio broadcast services).

<sup>59</sup> See *supra* note 5; see also David G. Noren, *The U.S. National Interest in International Tax Policy*, 54 TAX L. REV. 337, 345 (2001) (describing difficulty of making distinctions among different types of e-commerce income). The definition of services income is important not only for determining the source of the income, but also for several other purposes under the Code. See, e.g., I.R.C. § 911(d)(2)(B) (2006) (contrasting earned income from personal services with income from return on capital); *id.* § 954(e) (defining “foreign base company services income” for purposes of the Subpart F anti-deferral regime); *id.* § 7701(e) (contrasting services income from lease income).

<sup>60</sup> Peter A. Glicklich et al., *Electronic Services: Suggesting a Man-Machine Distinction*, 87 J. TAX’N 69, 70, 71–72 (1997) (discussing distinction between these human activity-driven personal services and other services). This distinction parallels the definition of services under certain value-added taxes. See Stéphane Buydens et al., *Consumption Taxation of E-Commerce: 10 Years After Ottawa*, 54 TAX NOTES INT’L 61, 67 (2009) (“Factors indicating a service [under Canadian value-added tax] take into account human involvement in making the supply, specific work performed for a specific customer, and the absence of a transfer of rights.”). Professor Larry Lokken, in distinguishing between “personal” services and other services, observed that “if this word [‘personal’] has any significance, it probably is that services are personal if the nature of the service is such that the purchaser of the services expects them to be performed by a particular person (e.g., the person with whom the purchaser contracted).” Lawrence Lokken, *Income Effectively Connected with U.S. Trade or Business: A Survey and Appraisal*, 86 TAXES 57, 60 (2008). Professor Lokken notes that “personal” services can sometimes be performed by entities. See *id.*; see also *infra* notes 335–345 and accompanying text (discussing application of this Article’s conclusions to personal services performed by corporations through their employees).

Even this narrower definition requires some clarification, as it is not always clear whether a payment is made for the personal service performed by the individual or for something else. This difficulty in distinguishing between “pure” personal services income and other types of income predates modern technological developments.<sup>61</sup> For example, an early case involving the tenor Enrico Caruso addressed the distinction between personal services and royalty income in the case of payments from a recording company to an artist.<sup>62</sup> Similar complications arise in modern scenarios when an individual’s personal services create copyrightable or patentable property or other intellectual property rights.<sup>63</sup> In these circumstances, the distinction between personal services and some other characterization “depends on whether the taxpayer has a proprietary interest in” the property created by his services.<sup>64</sup> “If such an interest exists, then the source rules for sales or royalties will apply; if the taxpayer has no such interest, the services rules

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<sup>61</sup> See Avi-Yonah, *supra* note 4, at 543 (“The tax law has struggled for decades to distinguish among royalties, services, and sales.”).

<sup>62</sup> *Ingram v. Bowers*, 47 F.2d 925, 932 (S.D.N.Y. 1931), *aff’d* 57 F.2d 65 (2d Cir. 1932) (explaining which payments from the phonograph company to plaintiff were income from personal services, rather than royalties, because plaintiff held no property interests in the recordings); see also *Karrer v. United States*, 152 F. Supp. 66, 73 (Ct. Cl. 1957) (explaining that payments to a Swiss scientist with respect to synthetic vitamins he discovered were personal services income, not royalties, because the Swiss company that hired the scientist owned the rights in the discovery); *Boulez v. Comm’r*, 83 T.C. 584, 596 (1984) (holding that conductor Pierre Boulez should be taxed on income received pursuant to a contract that did not grant him property rights to his recordings). See generally BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES & GIFTS* ¶ 73.4 (3d ed. 1999) (observing that “the distinction between services income and income subject to other source rules is not always easily drawn,” and citing examples).

The *Ingram v. Bowers* case demonstrates that the pressures of technological developments on tax policy are not just a twenty-first century phenomenon. The case involved Enrico Caruso’s phonograph recordings for the Victor Talking Machine Company, which were among the first blockbuster recordings for the then-new phonograph industry. See ANDRE MILLARD, *AMERICA ON RECORD: A HISTORY OF RECORDED SOUND* 59–64, 69 (1995) (describing Caruso’s influence on the early phonograph industry, including his international impact).

<sup>63</sup> See Treas. Reg. § 1.861-18(d) (as amended in 1998) (discussing difference between computer programs and personal services); see also ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 58–59 (discussing personal services that create property rights); 2006 MODEL TECHNICAL EXPLANATION, *supra* note 53, art. 12 (discussing a professional whose services develop patentable property); Shay, Fleming & Peroni, *supra* note 4, at 143 (discussing software programmers developing software); David R. Tillinghast, *Taxation of Electronic Commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven*, 4 FLA. TAX. REV. 339, 343–44 (1999) (discussing a company delivering software over the Internet). See generally BITTKER & LOKKEN, *supra* note 62, ¶ 73.5.2 (summarizing cases).

<sup>64</sup> See ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 58.

will control.”<sup>65</sup> In some circumstances, however, the taxpayer is treated as having income from personal services, even if tangible property has been created, when the “predominant nature” of the transaction was the performance of personal services.<sup>66</sup>

## 2. The Telesurgery Example

To focus the analysis, the Article concentrates on the cross-border telesurgery example mentioned above, which involves a surgeon in one country controlling a robotic surgical system in the other country to perform real-time surgery on a patient in that other country. In particular, the analysis focuses on the fee received by the surgeon for these services. This fee constitutes income from personal services because it is paid exclusively for the surgeon’s activities, i.e., the remote control of the robotic surgical system, rather than for some other reason, such as the right to use property.<sup>67</sup> Generally, this Article assumes that the surgeon is acting in an independent capacity rather than as an employee.<sup>68</sup>

As perhaps the purest example of cross-border personal services, the telesurgery scenario provides a useful context in which to analyze the core issues raised by the current domestic and treaty laws’ focus on physical presence. In focusing on telesurgery, a future-oriented procedure that is still in its early stages, the Article does not purport to provide a detailed economic analysis of the potential for growth of tele-

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<sup>65</sup> *Id.* In some circumstances, courts have allocated fees for personal services and royalties. See, e.g., *Kramer v. Comm’r*, 80 T.C. 768, 782 (1983) (treating, after detailed factual examination of fees received by professional tennis player, seventy percent as royalties attributable to the use of his name and other intellectual property rights, and thirty percent as income from personal services). Although *Kramer v. Commissioner* involved domestic pension plan issues, the court relied on the definition of “earned income” in Code section 911. See *id.* at 778–79.

<sup>66</sup> For example, an attorney might furnish legal advice in the form of a letter, or a consultant might furnish advice in the form of a memorandum. The income from both situations would generally be classified as income from personal services, as the payment was predominantly for the legal or consulting advice rather than the physical document. See TREASURY REPORT, *supra* note 3, at 31; DOERNBERG ET AL., *supra* note 4, at 236–37. In contrast, a fisherman who sells his catch is treated as having income from the sale of the fish rather than income from fishing services, because the payment is predominantly made by the buyer for the receipt of fish. See OECD Commentary, *supra* note 50, art. 5, ¶ 42.29 (for treaty purposes, income from fishing activities is not services income).

<sup>67</sup> Because of its focus on personal services income, the Article ignores other possible items of income that might be paid by the patient or her insurer, such as payments to the local hospital or surgical center for use of the space or robotic equipment.

<sup>68</sup> Part IV briefly addresses additional issues that arise if the surgeon is acting as an employee. See *infra* notes 335–345 and accompanying text.

surgery or other real-time cross-border personal services.<sup>69</sup> It would not be surprising if, at least initially, the use of cross-border telesurgery flowed in a net outbound direction (i.e., primarily U.S.-based surgeons performing telesurgery on foreign patients, rather than foreign-based surgeons performing telesurgery on U.S. patients). U.S.-based physicians are often early developers and adopters of medical technology. Moreover, given that one of the initial intended uses of telesurgery is to help patients in remote areas who would not otherwise have access to quality medical care, there may be more patient demand outside the United States than inside the United States for cross-border telesurgery.<sup>70</sup> Indeed, less invasive forms of cross-border telemedicine, in-

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<sup>69</sup> See Sharon Kay, *Light Speed*, PBS, [http://www.pbs.org/wnet/innovation/episode7\\_essay1.html](http://www.pbs.org/wnet/innovation/episode7_essay1.html) (last visited Aug. 23, 2010) (describing expected growth in telesurgery over the coming decades). Some remote telesurgery may be driven by social factors, such as the ability to provide medical care to persons in remote areas who otherwise might not have access to care or the ability to allow surgery on battlefields without risk of harm to the surgeon. See, e.g., *National Broadband Plan: Hearing Before the Subcomm. on Commc'ns, Tech. and the Internet of the H. Comm. on Energy and Commerce*, 111th Cong. (2010) (statement of Howie Hodges, Senior Vice President of Government Affairs, One Economy Corporation) (noting importance of expanding broadband coverage in rural areas to facilitate telemedicine); Brett M. Harnett et al., *Evaluation of Unmanned Airborne Vehicles and Mobile Robotic Telesurgery in an Extreme Environment*, 14 *TELEMEDICINE & E-HEALTH* 539, 540–41 (2008) (describing testing of wireless communication system to support wireless telesurgery on battlefields); Press Release, Titan Med. Inc., *supra* note 11 (discussing potential battlefield use); Kay, *supra* (describing a surgeon in Hamilton, Ontario, who has performed numerous telesurgeries on patients in remote parts of Canada); *Mission News*, NASA, [http://www.nasa.gov/mission\\_pages/NEEMO/NEEMO9/index.html](http://www.nasa.gov/mission_pages/NEEMO/NEEMO9/index.html) (last visited Aug. 23, 2010) (describing attempts to adapt telesurgery for use in space).

For a more thorough discussion of the factors that will determine the extent to which personal services may become “offshorable,” see Blinder, *Offshoring*, *supra* note 7, at 118–22. Professor Blinder notes that the “critical divide” between jobs that may be offshorable and those that are not will be “between those types of work that are easily deliverable through a wire (or via wireless connections) with little or no diminution in quality and those that are not.” *Id.* at 118. Professor Blinder acknowledges that certain physician services are suitable for electronic delivery, and that some offshoring of physician services has already begun. See *id.* at 119; see also Frank Levy & Kyoung-Hee Yu, *Offshoring Radiology Services to India* 17–25 (MIT Working Paper Series, Paper No. MIT-IPC-06-005 2006), available at <http://web.mit.edu/ipc/publications/pdf/06-005.pdf> (discussing the development of radiology offshoring from the United States to India).

<sup>70</sup> Although there may be significant demand for telesurgery in remote areas of the United States, those areas, at least in the initial stages of telesurgery, could probably be effectively served by U.S.-based telesurgeons and would not need foreign-based surgeons. See, e.g., Kathleen Burge, *The Robot Will See You Now*, Bos. *GLOBE*, July 3, 2009, at B1 (describing how telemedicine allows critical care physicians to examine patients at remote locations with no on-site specialist).

cluding real-time physical examinations of patients using instruments on portable robots, are already in use in an outbound direction.<sup>71</sup>

In the longer run, however, the net direction of telesurgery personal services might change as it has with respect to other services.<sup>72</sup> For example, in the past few years technological developments have enabled some other medical services for U.S. patients—in particular, diagnostic radiology—to be offshored to other countries.<sup>73</sup> Similarly, U.S.-based businesses have recognized the economic advantage of having other professional services, including certain accounting and legal work as well as non-professional services such as call centers, performed offshore. Indeed, even U.S. patients, in response to the high cost of certain

<sup>71</sup> See *id.* (describing Massachusetts-based vascular specialist remotely examining patients in Bermuda using stethoscopes and cameras attached to a remote-controlled robot).

<sup>72</sup> In an early OECD conference, participants discussed the potential impact of the Internet and global commerce on cross-border health care. The panelists concluded that the “highly competitive nature of health care” would increasingly influence the growth of electronically delivered medical information. OECD DIRECTORATE FOR SCI., TECH. & INDUS., *DISMANTLING THE BARRIERS TO GLOBAL ELECTRONIC COMMERCE* 28 (1998), available at <http://www.oecd.org/dataoecd/37/55/2751237.pdf>.

<sup>73</sup> See *supra* note 69 (discussing Professor Blinder’s studies of offshoring). Professor Blinder concludes that certain medical jobs are less offshorable than others. For example, he suggests that internists might be protected from the pressure of offshoring because they provide a service “where personal presence is either imperative or highly beneficial.” Blinder, *Offshoring*, *supra* note 7, at 125. Though a physical presence is necessary for some examinations conducted by an internist, other aspects of the internist-patient interaction do not necessarily require physical contact. Accordingly, it is possible to envision a scenario where some medical consultations occur with a remote internist via a video link, while those examinations requiring physical contact are performed by an internist or other medical professional on-site. As noted in the Treasury Report on electronic commerce:

As travel and communications have become more efficient and less expensive, the relationship between the service provider’s location and the service consumer’s location has weakened. For example, it is now possible for physicians to remotely diagnose certain diseases through telecommunications links and videoconferencing has eliminated the need for many face-to-face meetings.

TREASURY REPORT, *supra* note 3, at 33; see also Brandon Bailey, *Cisco Says the Doctor Will See You Now, Even from 2,800 Miles Away*, SAN JOSE MERCURY NEWS, Apr. 14, 2010, at 1C (“[S]tudies show most patients become comfortable with [remote] video exams quickly,” said Dr. Javeed Siddiqui, a telemedicine expert at the UC Davis Health System.”); Kay, *supra* note 69 (“Though patients may take comfort from the touch of a surgeon’s hand and a surgeon’s presence, there may be more and more circumstances in the future when they will defer to the long distance touch of an expert.”). Although patients may prefer to have a face-to-face meeting with, and utilize the services of, a long-time local family physician, the economic realities of the current U.S. health system have eliminated this expectation for many patients. At the extreme, this is evidenced by the growth of “medical tourism,” where U.S. patients travel to Mexico or another foreign country to have surgery or another medical treatment at a lower cost than is available in the United States. See Walecia Konrad, *Going Abroad to Find Affordable Healthcare*, N.Y. TIMES, Mar. 21, 2009, at B6.

surgical procedures, have temporarily offshored themselves by engaging in “medical tourism.”<sup>74</sup> Although telesurgery involves more potential complications than other offshored services, such as licensing and insurance issues,<sup>75</sup> it is reasonable to assume that in the coming years<sup>76</sup> surgical services will face the same economic pressures already felt by other professional services,<sup>77</sup> and that further improvements in robot-assisted surgical technology and long-distance communications will facilitate an offshore outlet for these economic pressures.<sup>78</sup>

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<sup>74</sup> See *supra* note 73 (discussing medical tourism).

<sup>75</sup> In the United States, the right to practice medicine is governed at the state level. Once telesurgery moves beyond the experimental stage, significant issues might arise regarding the ability of a foreign-based surgeon to obtain a state medical license to perform telesurgery on a U.S.-based patient. Professor Blinder observes that technological developments make protectionist barriers “vastly harder (read ‘impossible’) [with respect to] electronic trade.” Blinder, *Offshoring*, *supra* note 7, at 124–25. Medical licensing requirements, however, may create significant barriers to offshore surgeons performing telesurgery on U.S.-based patients. For a discussion of the role of licensing requirements in the offshoring of radiology to India, see Bhatia, *supra* note 14, at 171; Levy & Yu, *supra* note 69, at 17–25. Although acknowledging the practical difficulties that might arise, including U.S.-based physicians’ possible opposition to granting state licenses for this purpose, this Article is principally concerned with the theoretical tax policy issues that arise from cross-border telesurgery.

<sup>76</sup> Even if it takes a decade or more for these developments to occur, “decades is precisely the time frame that people should be thinking about” in developing policy responses to offshoring. Blinder, *Offshoring*, *supra* note 7, at 128.

<sup>77</sup> In a domestic context, economic opportunities have already led to the development of telemedicine (although not yet telesurgery) centers to provide cost-effective services to multiple locations. For example, Cisco Systems’ HealthPresence video system is being used by medical groups in Southern California and the Southwest to allow internists to conduct remote, real-time medical examinations. See Bailey, *supra* note 73 (also quoting an insurance company executive as stating that “[t]elemedicine is going to be everywhere. The only question is when”); see also Burge, *supra* note 70 (describing a Massachusetts-based telemedicine center); WORLDCLINIC, <http://www.worldclinic.com> (last visited Aug. 23, 2010) (“[U]nique medical practice . . . providing exceptional . . . telemedical care to an exclusive group of corporate executives, individuals and families whose lifestyle may require immediate access to a personal doctor for any health issue, at any hour, from anywhere in the world.”); cf. Dan Gunderson, *Medicare Will Start Paying for Telemedicine*, MINN. PUB. RADIO (Dec. 12, 2008), <http://minnesota.publicradio.org/display/web/2008/12/11/telemed> (describing medical cost savings to Medicare from telemedicine).

<sup>78</sup> As an extreme (and admittedly hypothetical) example, consider a future surgical center located in a major U.S. city that could accommodate several simultaneous minimally invasive telesurgeries performed by surgeons located outside the United States. Cf. Press Release, Titan Med. Inc., *supra* note 11 (claiming that “[i]n day-to-day applications,” the company’s commercial telesurgery system “will likely be [used from] proximate offshore locations”). Of course, there would have to be some on-site U.S. medical staff (including a backup surgeon in case of complications, and anesthesiology professionals). Such a hypothetical set-up, however, might enable the center to maximize its procedures while minimizing its (presumably high-paid) U.S.-based surgical staff. Although U.S. patients might initially balk at the idea of telesurgery performed by an offshore surgeon, the

### 3. Other Relevant Personal Services

This Article focuses on the telesurgery example in order to clarify the principal issues that arise from cross-border personal services. After reaching conclusions regarding the appropriate scope of source-based taxation in the telesurgery context, the Article briefly considers the implications of these conclusions for other cross-border personal services, many of which are currently being provided. A broad range of personal services can be viewed as “pure” personal services, where the income is primarily attributable to the services provided directly by a human being (rather than for the use of intellectual property or other rights).<sup>79</sup> Although some of these services are closely analogous to telesurgery, others are less so. For example, some forms of telemedicine, such as a real-time teleconference consultation by a foreign-based physician with a U.S.-based patient, are very similar to telesurgery. Although consultation does not involve the same level of physical interaction as telesurgery, it might involve some real-time physical interaction (e.g., the foreign physician checking the patient’s vital signs via a remote monitor).<sup>80</sup> Other sources that lack a real-time telepresence and remote physical interaction, yet still involve a foreign professional who provides services tailored to a particular U.S. person, prove slightly less analogous. For example, radiologists in India currently provide overnight diagnostic services to U.S.-based physicians with respect to U.S.-based patients.<sup>81</sup> Similarly, foreign-based individuals can provide bookkeeping, payroll, and other accounting-type services for U.S.-based companies on an almost real-time basis, and foreign-based attorneys can provide overnight turnaround of document drafts and research services for U.S.-based attorneys.<sup>82</sup>

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current willingness of many U.S. citizens to engage in medical tourism, *see supra* note 73, suggests that economic pressures might cause U.S. patients to adapt, particularly because telesurgery in a U.S.-based surgery center might be more convenient and appear safer than medical tourism. Again, the purpose of this Article is not to address all of the licensing, ethical, medical, technological, business, and legal issues surrounding such a hypothetical scenario. Rather, this example is offered to suggest that inbound telesurgery may play a significant role in the coming years similar to other inbound cross-border professional services.

<sup>79</sup> See Glicklich et al., *supra* note 60, at 70.

<sup>80</sup> See Burge, *supra* note 70 (describing current use of remotely controlled stethoscope, which allows doctor to check patient’s heart and lung functions).

<sup>81</sup> See *supra* note 73 and accompanying text.

<sup>82</sup> See Jonathan M. Ricci, *Electronic Commerce and Non-Resident Aliens: The Internal Revenue Service Versus International Cyberspace Transactions*, 6 RICH. J.L. & TECH. 7, 7 (1999) (providing example of foreign-based attorney performing work for U.S.-based attorneys). Consultants represent another category of service provider that can be located abroad yet provide services targeted and utilized by a particular person in the United States.

Although these cross-border personal services often involve long-term professional-type relationships between a foreign person and a U.S. client, that need not be the case. Perhaps the best example of the diffused nature of modern cross-border personal services is the Amazon Mechanical Turk website, developed by Amazon.com, Inc.<sup>83</sup> The website bills itself as “a marketplace for work” that provides companies or individuals with “a global, on-demand, 24x7 workforce.” The site allows a person to find (and pay) a worker on a one-time basis to perform a task requiring human intelligence—e.g., language translation, audio transcriptions, data research, identification of objects in a photo.<sup>84</sup> The site bills itself as “a service that lets you outsource work to workers around the world,” highlighting the cross-border nature of the services by noting that U.S.-based workers can have their pay transferred to their U.S. bank account, while “[w]orkers in India have the option of receiving bank checks denominated in Indian Rupees.”<sup>85</sup> More than 56,000 tasks are currently listed on the website.<sup>86</sup>

## II. THE PROBLEMATIC APPLICATION OF PHYSICAL PRESENCE PRINCIPLES

### A. U.S. Internal Law

#### 1. Inbound Taxation of Foreign Persons' Business Income

This subpart considers the impact of existing U.S. internal tax law on inbound telesurgery personal services. As discussed above, under the inbound regime, the United States imposes a net-basis tax on a nonresident alien engaged in a trade or business within the United States to the extent the income is effectively connected with the U.S. trade or business.<sup>87</sup> Accordingly, the threshold question for a foreign-based surgeon performing telesurgery on a U.S.-based patient is whether that inbound telesurgery constitutes a “trade or business within the United States.”

Code section 864(b) provides that “the performance of personal services *within the United States* at any time within the taxable year” con-

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<sup>83</sup> See AMAZON MECHANICAL TURK, <http://www.mturk.com> (last visited Aug. 23, 2010).

<sup>84</sup> See *id.*

<sup>85</sup> See *Worker Web Site FAQs*, AMAZON MECHANICAL TURK, [https://www.mturk.com/mturk/help?helpPage=worker#tax\\_why\\_tax\\_info](https://www.mturk.com/mturk/help?helpPage=worker#tax_why_tax_info) (last visited Aug. 23, 2010).

<sup>86</sup> See AMAZON MECHANICAL TURK, *supra* note 83.

<sup>87</sup> I.R.C. § 871(b) (2006) (taxation of business income of nonresident alien individual); *id.* § 882 (taxation of business income of foreign corporation); *supra* notes 24–29 and accompanying text.

stitutes a trade or business within the United States.<sup>88</sup> If the word “within” is interpreted as requiring that the service provider must be physically within the country, the foreign-based telesurgeon will not be engaged in a U.S. trade or business. If, however, personal services are treated as performed within the United States by reason of their place of impact, then the real-time robotic cutting at the foreign-based surgeon’s direction might constitute the performance of services within the United States and thus constitute a U.S. trade or business.

Neither the Code nor the Treasury Regulations explicitly define the meaning of “within” in this context.<sup>89</sup> Not surprisingly, several cases and administrative rulings make clear that an individual performing personal services while physically in the United States will be treated as having performed them “within” the United States.<sup>90</sup> Because these

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<sup>88</sup> *Id.* § 864(b) (emphasis added). The Code provides little guidance as to the meaning of a U.S. trade or business outside of this explicit reference to personal services. Similarly, the regulations provide little concrete assistance, apart from detailing certain exceptions, concluding that “[w]hether or not [a foreign] person is engaged in trade or business within the United States shall be determined on the basis of the facts and circumstances in each case.” Treas. Reg. 1.864-2(e) (as amended in 1975). The cases interpreting the term generally conclude that a foreign person is engaged in a U.S. trade or business if the profit-seeking activities are extensive, continuous, and regular. See *InverWorld v. Comm’r*, 71 T.C.M. (CCH) 3231 (1996) (summarizing cases); see also GUSTAFSON, PERONI & PUGH, *supra* note 31, at 131–37 (discussing cases where courts determined whether foreign corporation was “engaged in trade or business within the United States”).

<sup>89</sup> One aspect of this Code section clearly focuses on the physical location of the service provider. The de minimis provision of I.R.C. § 864(b) provides that the performance of personal services does not constitute a trade or business if, inter alia, the nonresident alien individual is paid less than \$3000 and is temporarily present in the United States for no more than 90 days during the taxable year. I.R.C. § 864(b)(1). The fact that this exception applies to someone who is physically present for less than the specified period of time, however, does not necessarily imply that only someone who is physically present in the United States can be subject to the general rule regarding personal services.

The regulations determining the source of income (rather than this threshold question of whether there is a U.S. trade or business) provide additional guidance as to whether personal services are performed “in” the United States. These regulations are discussed *infra* notes 104–109 and accompanying text. The failure of the Code and regulations to address this issue is not surprising, as these rules were “developed when the provision and consumption of services generally took place in the same location.” Avi-Yonah, *supra* note 4, at 543; see also John K. Sweet, Comment, *Formulating International Tax Laws in the Age of Electronic Commerce: The Possible Ascendancy of Residence-Based Taxation in an Era of Eroding Traditional Income Tax Principles*, 146 U. PA. L. REV. 1949, 1968 (1998) (“In earlier times, the performance of services and the utilization of those services most likely took place in the same geographic location.”).

<sup>90</sup> See, e.g., *Johansson v. United States*, 336 F.2d 809, 814 (5th Cir. 1964) (taxpayer participating in boxing match in the United States treated as engaged in a U.S. trade or business); Rev. Rul. 70-543, 1970-2 C.B. 172 (participation in golf tournament in United States, and participation in boxing match in United States, both constituted U.S. trade or business).

situations involved physical presence in the United States, the authorities did not need to consider whether a U.S. trade or business might exist when the personal service provider was physically outside the United States but was impacting the United States.<sup>91</sup>

To the extent that cases discuss where services are performed, they do so in the context of the source rules rather than the threshold trade or business inquiry. One case that can be read as addressing this issue in the context of the trade or business inquiry is the Board of Tax Appeals' 1941 decision in *Piedras Negras Broadcasting Co. v. Commissioner*.<sup>92</sup> In that case, a foreign corporation broadcast radio programs from Mexico into the United States, deriving 95% of its advertising revenue and 90% of its listeners from the United States.<sup>93</sup> The company used independent agents to sell advertising time to U.S. businesses and conducted some physical activities in the United States, including the use of a post office box and hotel room in Texas for collecting and sorting mail. The court, however, viewed these activities as merely "incidental."<sup>94</sup> The court focused instead on the radio transmissions themselves, emphasizing that the station personnel, studio, power station, and other broadcasting equipment was in Mexico.<sup>95</sup> Although the court acknowledged that the radio waves had some physical effect in the United States, it concluded that "[t]he transmission of the impulse through the ether over the United States and the reception at receiving sets therein" was only an "intermediate" and "secondary" step.<sup>96</sup> The primary event generating the income, according to the court, was the transmission equipment and supporting labor in Mexico. Accordingly, the court concluded that the corporation was not engaged in a U.S. trade or business (and also did not have U.S. source income).

Although *Piedras Negras Broadcasting* involved a broader type of service than the personal services that are the focus of this Article, it nonetheless supports a conclusion that a foreign-based surgeon performing

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<sup>91</sup> In *Karrer v. United States*, 152 F. Supp. 66 (Ct. Cl. 1957), the Court of Claims addressed the potential taxation of services performed outside the United States. Because the court's analysis focused on the source of income, rather than the threshold trade or business question, this case is discussed in the context of the source rules. See *infra* notes 110–112 and accompanying text.

<sup>92</sup> 43 B.T.A. 297 (1941), *aff'd* 127 F.2d 260 (5th Cir. 1942). As Professor Doernberg observed, "[t]he court's reasoning mixed together the concepts of being engaged in a U.S. trade or business and whether the income was from U.S. sources." DOERNBERG ET AL., *supra* note 4, at 178.

<sup>93</sup> *Piedras Negras Broad.*, 43 B.T.A. at 303.

<sup>94</sup> *Id.* at 307.

<sup>95</sup> *Id.* at 308.

<sup>96</sup> *Id.* at 313.

a telesurgery procedure on a U.S.-based patient would not be performing services within the United States, and thus would not be engaged in a U.S. trade or business. The court's reasoning might downplay the surgeon's impact on a U.S. patient, just as it downplayed the broadcast's impact on U.S. radio listeners. Moreover, just as the court focused on the location of the broadcast station that initiated the "transmission of the impulse through the ether," it might focus on the location of the surgeon who initiated the transmission of directions to the robotic surgery system through the high-speed communication line.

Several factors, however, might weaken this reading of *Piedras Negras Broadcasting*. Unlike that case, which did not involve the use of any U.S. infrastructure once the radio signals were sent, telesurgery requires extensive use of communications infrastructure in the United States<sup>97</sup> and, perhaps more importantly, utilizes the receiving robot in the United States that is under the control of the surgeon. Moreover, the court placed significant emphasis on a series of old state tax law cases providing a narrow definition of what it means to do business within a state.<sup>98</sup> Given the age of these cases, and subsequent developments in the state tax law area, they might no longer provide the same support.<sup>99</sup> Finally, unlike radio broadcasting from Mexico, over which

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<sup>97</sup> As Professor Doernberg concluded, however, distinguishing *Piedras Negras Broadcasting* from electronic commerce based solely on the use of infrastructure might cause "virtually all nonresidents who make use of the U.S. telephone, postal, or transportation infrastructure" to be considered as engaging in a U.S. trade or business. DOERNBERG ET AL., *supra* note 4, at 183–84.

<sup>98</sup> See *Piedras Negras Broad.*, 43 B.T.A. at 309–13 (citing state law cases from 1895, 1910, 1921, and 1937); see also DOERNBERG ET AL., *supra* note 4, at 179.

<sup>99</sup> See, e.g., *Quill Corp. v. North Dakota*, 504 U.S. 298, 307 (1992) (for purposes of U.S. state sales and use taxation, "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State"). The Massachusetts Supreme Judicial Court, relying on *Quill Corp. v. North Dakota*, recently held that a Delaware bank was subject to a Massachusetts income-based excise tax, despite its lack of physical presence in the state. See *Capital One Bank v. Comm'r*, 899 N.E.2d 76, 86 (Mass. 2009) (holding that *Quill* is not limited to sales and use taxes, and permitting state taxation when there is a "substantial nexus," such as the solicitation and conduct of significant credit card business with Massachusetts customers); see also Robert Willens, *Physical Presence, Substantial Nexus, and the Commerce Clause*, DAILY TAX REP. J-1 (The Bureau of Nat'l Affairs, Inc., Arlington, Va.), May 5, 2009 ("[P]ending a Supreme Court resolution of the matter, it is becoming increasingly clear that the notion of physical presence as the *sine qua non* for the imposition of taxes on out-of-state entities is confined to the sales and use tax arena and the lack of physical presence will not be a bar (on Commerce Clause grounds) to a finding of the type of substantial nexus needed to impose other varieties of taxes."). The Supreme Court of Appeals of West Virginia reached a similar result in 2006 with respect to another out-of-state bank, noting that:

the United States had no control,<sup>100</sup> the performance of telesurgery on a U.S.-based patient would probably require the foreign-based surgeon to hold an appropriate U.S. state medical license.<sup>101</sup>

Even if a foreign surgeon is treated as being engaged in a U.S. trade or business by reason of performing telesurgery on a U.S.-based patient, the surgeon would be taxable only to the extent that the income is “effectively connected” to that trade or business.<sup>102</sup> As discussed above, the “effectively connected” determination depends primarily on the source of the income under the U.S. sourcing rules. In particular, U.S. source personal services income is treated as effectively connected, but foreign source personal services income is treated as not effectively

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[W]e believe that the Bellas Hess physical-presence test, articulated in 1967, makes little sense in today’s world. In the previous almost forty years, business practices have changed dramatically. When Bellas Hess was decided, it was generally necessary that an entity have a physical presence of some sort, such as a warehouse, office, or salesperson, in a state in order to generate substantial business in that state. This is no longer true. The development and proliferation of communication technology exhibited, for example, by the growth of electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there. For this reason, we believe that the mechanical application of a physical-presence standard to franchise and income taxes is a poor measuring stick of an entity’s true nexus with a state.

Tax Comm’r of W. Va. v. MBNA Am. Bank, 640 S.E.2d 226, 234 (W. Va. 2006) (citations omitted).

<sup>100</sup> The court in *Piedras Negras Broadcasting* observed that “[t]he United States has no power to regulate or control the [taxpayer’s] broadcasting activities, which occur and are exercised in Mexico . . . [and] [t]he United States extends no protection to such activities or the petitioner’s property. On the contrary, it licenses interfering broadcasters [in the United States].” 43 B.T.A. at 313.

<sup>101</sup> Professor Nancy Kaufman observed that “[w]hether a foreign corporation qualifies to do business under state law has mixed significance in the case law” with respect to determining whether a foreign taxpayer is engaged in a trade or business within the United States. See Nancy H. Kaufman, *Common Misconceptions: The Function and Framework of “Trade or Business Within the United States,”* 25 VAND. J. TRANSNAT’L L. 729, 783–84 (1993). Professor Kaufman was summarizing cases under the general standard for being engaged in a U.S. trade or business (i.e., outside of the statute’s non-exclusive inclusion of personal services performed within the United States). See *supra* note 88 (discussing general standard). Given that the telesurgeon would be performing a procedure highly regulated by U.S. states and would, presumably, have obtained a license from the state to perform it, a court might be willing to distinguish *Piedras Negras Broadcasting*.

<sup>102</sup> See *supra* notes 24–26 and accompanying text. For purposes of this descriptive analysis, the text considers the possibility that the U.S. trade or business test and the effectively connected test might lead to different results, even though both contain language referring to the place of the taxpayer’s performance. As discussed in Part III, however, as a normative matter, the two tests should be governed by similar, integrated standards. See *infra* note 251 and accompanying text.

connected.<sup>103</sup> The following analysis considers whether income derived from inbound telesurgery is U.S. or foreign source. It concludes that the income is likely to be treated as foreign source under the existing Code, regulations, and case law, and, accordingly, will not be subject to tax even if the foreign surgeon were determined to be engaged in a U.S. trade or business.

As discussed above, the Code provides that “[c]ompensation for labor or personal services *performed in the United States*” is U.S. source income,<sup>104</sup> while “compensation for labor or personal services *performed without the United States*” is foreign source income.<sup>105</sup> In contrast to the reference to personal service in the context of the threshold U.S. trade or business inquiry, which merely includes personal services performed within the United States as a non-exclusive example (without explicitly mentioning the treatment of personal services performed outside the United States),<sup>106</sup> these sourcing provisions juxtapose performances “in” against performances “without” the United States. This binary treatment creates significant hurdles for arguing that a surgeon who is physically outside the United States is, nonetheless, performing services in the United States for purposes of the sourcing rules.

The regulations interpreting this statutory language provide that U.S. source gross income “includes compensation for labor or personal services performed in the United States irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time of payment . . . .”<sup>107</sup> Although this statement does not explicitly rule out the relevance of the place of real-time impact of the telesurgery (i.e., the U.S. location of the telesurgery patient), it does suggest that factors related to the person for whom services are performed, including the residence of the recipient of the services, is not relevant.

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<sup>103</sup> See *supra* notes 27–29 and accompanying text.

<sup>104</sup> I.R.C. § 861(a)(3) (2006) (emphasis added). As with the U.S. trade or business test, an exception applies if, *inter alia*, a nonresident alien individual is paid less than \$3000 and is present in the United States for no more than ninety days in a twelve-month period.

<sup>105</sup> *Id.* § 862(a)(3) (emphasis added).

<sup>106</sup> It is interesting to note a slight variation in language between the two provisions. The trade or business inquiry in section 864(b) refers to “the performance of personal services *within* the United States,” *id.* § 864(b) (emphasis added), while the sourcing inquiry in section 861(a)(3) refers to “personal services performed *in* the United States,” *id.* § 861(a)(3) (emphasis added). The use of “within” rather than “in” appears to have no substantive relevance, particularly because the regulations under section 861 use the two terms interchangeably. See Treas. Reg. § 1.861-4(a)(1) (as amended in 2008) (using both “within” and “in” when referring to relevant personal services).

<sup>107</sup> Treas. Reg. § 1.861-4(a)(1).

Moreover, the regulations reinforce the importance of the geographic location of the service provider by explicitly cross-referencing two other Code sections—638 and 7701(a)(9)—that focus on geographic location.<sup>108</sup> Code section 638 contains detailed geographical rules for determining whether the seabed or subsoil are part of the “United States” or a “foreign country,” and explicitly states that these rules apply in determining the place of performance of services when sourcing the wages and salaries of workers in the oil and gas, mining, and other natural resources fields. Section 7701(a)(9) contains a more generally applicable definition, providing that “[t]he term ‘United States’ when used in a geographical sense includes only the States and the District of Columbia.”<sup>109</sup> The sourcing regulation’s explicit reference to these geographical definitions (and section 638’s explicit cross-reference back to the personal services sourcing provisions) strongly suggests that the distinction between performance of services in the United States and performance outside the United States is based on the geographical location of the service provider.

Case law also supports a focus on the physical location of the service provider rather than the place of service impact. For example, in the 1957 Court of Claims case, *Karrer v. United States*,<sup>110</sup> a Swiss scientist working in Switzerland invented synthetic vitamins while under a contract with an unrelated Swiss company. The Swiss company subsequently sold the vitamins in the United States and the scientist received a significant payment based on a percentage of the sales. Although the case raised significant issues regarding the proper characterization of the income, the court ultimately held that the payment was compensation for the scientist’s personal services to the company (rather than royalties for rights in the invention).<sup>111</sup> Once the court determined that the payments were for personal services, it focused solely on the taxpayer’s physical location when the services were performed, Switzer-

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<sup>108</sup> See *id.* § 1.861-4(a)(5) (“For definition of the term ‘United States,’ when used in a geographical sense, see sections 638 and 7701(a)(9).”); see also BITTKER & LOKKEN, *supra* note 62, ¶ 73.4 n.1 (“[F]or purposes of determining the source of personal services, the ‘United States’ does not include Puerto Rico or a U.S. possession, but it includes continental shelf areas for purpose of sourcing income relating to oil and gas and other natural deposits, including salaries and wages of individuals.”).

<sup>109</sup> I.R.C. § 7701(a)(9).

<sup>110</sup> 152 F. Supp. 66 (Ct. Cl. 1957).

<sup>111</sup> See *id.* at 71–72; see also *supra* notes 61–66 and accompanying text.

land, rather than the place where the product of the labor was eventually sold and used, the United States.<sup>112</sup>

Similarly, the U.S. Court of Appeals for the Fifth Circuit opinion affirming *Piedras Negras Broadcasting* in 1942<sup>113</sup> focused on the physical location of the actor to determine the source of services income.<sup>114</sup> The Fifth Circuit, after comparing the references to “within” and “without” in the sourcing provisions, concluded that “[t]he repeated use of the words *within* and *without* the United States denotes a concept of some physical presence, some tangible and visible activity.”<sup>115</sup> The Fifth Circuit concluded that the relevant physical activity was the transmission of the radio signals in Mexico, rather than their traversing the air in the United States, and therefore held that the income was foreign source.<sup>116</sup> Although some language from the opinion suggests that the telesurgery scenario might be distinguishable from the radio broadcasts,<sup>117</sup> the holding generally provides strong support for a for-

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<sup>112</sup> *Karrer*, 152 F. Supp. at 72 (because the services “were rendered in a foreign country by a nonresident alien,” they were foreign source income under the “clear wording” of the predecessor to § 862 in the 1939 Internal Revenue Code).

<sup>113</sup> 127 F.2d 260 (5th Cir. 1942).

<sup>114</sup> *See id.* at 261. Unlike the Board of Tax Appeals decision discussed *supra* notes 92–101, which had a combined discussion of the U.S. trade or business and the sourcing issues, the Fifth Circuit opinion focused exclusively on the sourcing question.

<sup>115</sup> *Piedras Negras Broad.*, 127 F.2d at 261.

<sup>116</sup> *See id.*

<sup>117</sup> After concluding that the use of the words “within” and “without” denote “some physical presence, some tangible and visible activity,” the court observed:

If income is produced by the transmission of electromagnetic waves that cover a radius of several thousand miles, free of control or regulation by the sender from the moment of generation, the source of that income is the act of transmission. All of respondent’s broadcasting facilities were situated without the United States, and all of the services it rendered in connection with its business were performed in Mexico.

*Id.* Unlike radio transmissions, which are “free of control or regulation by the sender from the moment of generation,” telesurgery involves a tightly controlled series of communications between the surgeon and the robotic system. Indeed, the surgeon not only sends signals to the robotic system via his inputs, but also receives immediate feedback signals from the robotic system and adjusts his movements accordingly. Thus, to the extent that the court viewed the radio transmitter’s lack of post-transmission control as significant, the court might view the telesurgery example as distinguishable. Moreover, unlike the radio broadcasts that were received by U.S.-based radios outside of the taxpayer’s control, the telesurgeon relies on physical equipment (i.e., the robotic system) in the United States that is an integral part of the surgery system. It is not clear from the Fifth Circuit opinion whether the court would view the U.S.-based robotic system as analogous to radio receivers (which the court ignored), or whether it would be viewed as part of the surgeon’s income-producing activity. Even if the court gave some weight to the robotic system, it might not outweigh the fact that the surgeon himself (along with the part of the system that he oper-

eign-based surgeon to argue that personal services income should be sourced where the surgeon is physically located during the surgery.<sup>118</sup>

A case that might support a focus on the impact in the United States, rather than the physician's location abroad, is the Tax Court's 1943 decision in *Korfund Co. v. Commissioner*.<sup>119</sup> In that case, a nonresident alien (Stoessel) agreed not to compete against Korfund in the United States.<sup>120</sup> The taxpayer argued that the payments under the noncompetition agreement were personal services income, and should be sourced in Germany where Stoessel was physically located during the period of the contract. The court, however, agreed with the government and held that the payments were sourced in the United States. This holding does not reflect a willingness to ignore a service provider's physical location in sourcing personal services income, as the court explicitly stated that it considered payments under a noncompetition agreement to be payment for a property right located in the United States rather than income from personal services.<sup>121</sup> Accordingly, *Korfund* does not provide significant support for disregarding a foreign-based surgeon's physical location in sourcing income from inbound telesurgery.

Another relevant consideration is whether the telesurgeon's fee might be allocated as partly U.S. source and partly foreign source. Under the Treasury Regulations:

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ates) is located outside the United States, particularly because the surgeon's income is more directly tied to the performance of "personal services" than was the advertising income in *Piedras Negras Broadcasting*.

<sup>118</sup> See DOERNBERG ET AL., *supra* note 4, at 255–56 (“[I]t seems likely that the place where services are utilized does not, under current U.S. law, determine source.”); Steven R. Lainoff et al., *Attributing the Activities of Corporate Agents Under U.S. Tax Law: A Fresh Look from an Old Perspective*, 38 GA. L. REV. 143, 179 (2003) (citing *Piedras Negras Broadcasting* for the proposition that “[t]he place of performance . . . is generally determined by where that income is actually generated—that is, where value is created—not where the customer is located”).

<sup>119</sup> 1 T.C. 1180 (1943).

<sup>120</sup> See *id.* at 1184–85. Although the case involved the source of Stoessel's (and his related company's) income, the taxpayer was Korfund because the government argued that Korfund should have withheld tax upon the payment of U.S. source income to Stoessel.

<sup>121</sup> *Id.* at 1187 (stating the rights were “interests in property in this country,” and that the income was derived from the use of these valuable property rights in the United States); see also DOERNBERG ET AL., *supra* note 4, at 256 n.275 (“[I]n reaching its decision, the court clarified that it was not treating the income for the covenant not to compete as income from services.”). While noting this limited scope of *Korfund*, Professor Doernberg posits that “[p]erhaps read very broadly, *Korfund* stands for the proposition that when a person is compensated for some action or inaction (i.e., rendering services or refraining from rendering services), it is the location of the effect of the person's action or inaction that determines source for tax purposes.” DOERNBERG ET AL., *supra* note 4, at 256 n.275.

[I]n the case of compensation for labor or personal services performed partly within and partly without the United States by an individual, the part of such compensation that is attributable to the labor or personal services performed within the United States . . . is determined on the basis that most correctly reflects the proper source of that income under the facts and circumstances of the particular case.”<sup>122</sup>

The regulations further provide that “[i]n many cases, the facts and circumstances will be such that an apportionment on a time basis . . . will be acceptable.”<sup>123</sup> In some circumstances, however, the regulations contemplate that other apportionment formulas, such as those that consider the nature of the work and relative value of the services performed in each location, may be used.<sup>124</sup>

The requirement that the allocation “be determined on the basis that most correctly reflects the proper source . . . under the facts and circumstances” might be read as allowing the foreign-based telesurgeon’s income to be allocated partly to U.S. sources and partly to foreign sources.<sup>125</sup> Such an allocation, however, is not supported by the overall structure of the regulation. As quoted above, the introductory clause of the regulation provides that the allocation regulation applies “[i]n the case of compensation for labor or personal services performed partly within and partly without the United States by an individual.”<sup>126</sup> Thus, the regulation contemplates that the general sourcing rules will apply first. As discussed above, those general rules focus on the physical location of the surgeon (i.e., foreign source), and therefore do not satisfy the “partly within and partly without” prerequisite of the regulation. The regulation (as well as its examples) contemplates a situation where the taxpayer receives a lump sum payment for services

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<sup>122</sup> Treas. Reg. § 1.861-4(b)(2) (as amended in 2008). A similar allocation provision applies to personal services income derived by a corporation. *See id.* § 1.864-4(b)(1). The lower court in *Piedras Negras Broadcasting* briefly mentioned the possibility of allocating the income as partly from U.S. sources and partly from foreign sources but did not address it on the merits because neither party had raised the issue. *See Piedras Negras Broad.*, 43 B.T.A. at 313–14.

<sup>123</sup> Treas. Reg. § 1.861-4(b)(2)(i). In the case of an individual working as an employee, the time basis allocation is required, subject to certain exceptions. *Id.* § 1.861-4(b)(2)(ii).

<sup>124</sup> *See id.* § 1.861-4(b)(1)(ii) (providing example of a corporate taxpayer allocating based on relative payroll cost of its different employees performing different services in various locations under a contract).

<sup>125</sup> *See id.* § 1.861-4(b)(2).

<sup>126</sup> *Id.* § 1.861-4(b)(2)(i).

that physically take place partly within and partly without the United States. Under such circumstances, the regulation generally allocates the income based on the amount of time the individual spends performing services within or without the United States.<sup>127</sup> Even the exceptions to the general “time basis” make reference to the physical location of the service provider.<sup>128</sup> Accordingly, this regulation does not provide authority for allocating income between U.S. and foreign sources when, as with the foreign-based telesurgeon, the general place of performance rules allocate all of the income to foreign sources.<sup>129</sup>

A final possible method by which the foreign-based telesurgeon might be treated as having (at least some) U.S. source income would be through an arbitrary allocation. In the case of certain types of income, the Code provides specific sourcing rules that do not rely on the under-

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<sup>127</sup> See *id.* § 1.861-4(b)(2)(ii)(E) (defining the “time basis” for allocation by reference to the number of days of performance of services within and without the United States, and providing an example of an employee who is “transfer[red] during a year from a position in the United States to a foreign posting”). There are numerous cases applying this time-based formula to the salary of professional athletes. See, e.g., *Hanna v. Comm’r*, 763 F.2d 171, 172 (4th Cir. 1985); *Stenkowski v. Comm’r*, 690 F.2d 40, 44, 46 (2d Cir. 1982) (first determining which days were covered by a professional hockey player’s contract, then focusing on how many of those work days were physically performed in the United States and how many were physically performed in Canada). *Hanna* and *Stenkowski* were test cases for forty-one other hockey player cases that were pending in the Tax Court. *Stenkowski*, 690 F.2d at 42 n.1.

<sup>128</sup> See *Treas. Reg.* § 1.861-4(b)(1)(ii) (focusing on the location of the different employees at the time they performed their various services for purposes of making apportionment based on the corporate taxpayer’s payroll).

<sup>129</sup> Allocation issues also arise under Code section 954, which, in the case of a controlled foreign corporation, treats certain types of personal services income as “foreign base company services income” if, inter alia, the services “are performed outside the country under the laws of which the controlled foreign corporation is created or organized.” I.R.C. § 954(e)(1) (2006). Under this provision, it is necessary for the corporation to determine where employees perform their services. As with the sourcing allocation regulations, the regulations under section 954 provide that the determination of where services are performed “will depend on the facts and circumstances of each case.” *Treas. Reg.* § 1.954-4(c) (as amended in 2002). They then state that “[a]s a general rule, services will be considered performed where the persons performing services . . . are physically located when they perform their duties . . .” *Id.* (emphasis added). The italicized language focuses on the physical location of the service provider and is thus consistent with the interpretation of the sourcing rules in the above text. The introductory phrase “[a]s a general rule,” however, could imply that, for purposes of section 954, there are circumstances in which an individual will be treated as performing services in a country where he is not physically located. In the context of the rest of the regulation, however, this does not appear to be the import of that language. Instead, the regulation focuses on allocating income received for multiple employees performing various tasks in more than one country. Like the sourcing allocation regulation, this regulation concludes that the time basis generally is the correct method, but that other factors, such as the relative values of the services performed, should also be considered. See *id.*

lying facts. For example, in the case of income for international transportation that either begins or ends in the United States, section 863(c) generally provides that 50% of the transportation income is treated as U.S. source and the other 50% as foreign source.<sup>130</sup> Similarly, section 863(e) provides that international communications income of a U.S. person is sourced using a 50-50 allocation.<sup>131</sup> Although these Code provisions demonstrate that arbitrary allocations can be used to source difficult-to-source income, these specific provisions do not apply to the telesurgery income at issue. Perhaps more importantly, the enactment of these allocation formulas by statute suggests that a court would not be willing to make an arbitrary allocation of telesurgery income in the absence of statutory, or perhaps regulatory,<sup>132</sup> authority.<sup>133</sup>

Based on the foregoing analysis, the hypothetical foreign-based surgeon would have a very strong argument under current law that the surgeon's physical location determines whether the personal services are performed "in the United States" or "without the United States," thereby making the telesurgery fee foreign source.<sup>134</sup> Accordingly, under the inbound tax regime, the income would not be "effectively connected" income and would not be subject to U.S. tax, even if the surgeon were determined to be engaged in a U.S. trade or business.

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<sup>130</sup> I.R.C. § 863(c)(2).

<sup>131</sup> *Id.* § 863(e). See generally BITTKER & LOKKEN, *supra* note 62, ¶ 73.4 (describing transportation services income and international communications income).

<sup>132</sup> For example, in the context of sourcing income from the sale of manufactured goods, Treasury Regulations generally provide for a 50-50 allocation of the gross income between the sales function and the manufacturing function. See Treas. Reg. § 1.863-3(b) (as amended in 2006).

<sup>133</sup> See Andrus, *supra* note 4, at 842-44 (discussing problems with arbitrary 50-50 allocation in international communications sourcing provision).

<sup>134</sup> Other commentators have reached similar conclusions with respect to doctors who perform cross-border telemedicine diagnoses via the Internet (although these sources do not involve the same kind of real-time connection present in telesurgery). For example, Gary D. Sprague and Taylor S. Reid considered a situation where a doctor in one country performed diagnostic services for a patient in another country. They concluded that "it seems straightforward to determine where [the] service provider is located . . . . [I]n the case of a doctor rendering services to a remotely located patient via the Internet, it seems clear that the place where the doctor is physically located is the place where the services are performed." Gary D. Sprague & Taylor S. Reid, *U.S. Taxation of Income from International Electronic Commerce Transactions*, 41 TAX MGMT. MEMO. 503 (2000).

## 2. Outbound Taxation and the Foreign Earned Income Exclusion

### a. *Foreign Tax Credit*

The preceding analysis of the existing sourcing rules has significant implications not only for inbound taxation, but also for outbound taxation. As discussed above, a U.S. person generally is taxable on worldwide income regardless of its source. To eliminate the potential for double taxation, the U.S. person is allowed to claim a credit for foreign income taxes paid.<sup>135</sup> To eliminate the possible abuse of this foreign tax credit, the Code and regulations contain detailed limitations that tie the allowable credit to the percentage of the taxpayer's income that is foreign source. In general, these limitations allow a U.S. person to claim a foreign tax credit only with respect to taxes on foreign source income.<sup>136</sup> In applying these limitations, U.S. sourcing rules (rather than the foreign country's sourcing rules) apply.<sup>137</sup> Accordingly, the sourcing rules are important in determining the amount of foreign tax credit a U.S. person can claim.

### b. *Foreign Earned Income Exclusion*

The sourcing rules discussed above might provide a significant tax benefit for U.S. citizen surgeons who reside abroad (and for those who are willing to move abroad to secure the tax benefit). As noted earlier, the foreign earned income exclusion of Code section 911 allows a U.S. citizen who resides in a foreign country to exclude a certain amount of foreign earned income from gross income.<sup>138</sup> For 2010, the inflation-adjusted cap on the exclusion is \$91,500.<sup>139</sup> In addition to that amount, the individual can exclude another \$12,810 (and possibly much more)<sup>140</sup>

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<sup>135</sup> See *supra* notes 30–36 and accompanying text.

<sup>136</sup> This oversimplified explanation assumes that the taxpayer has no other foreign source income and pays no other foreign taxes (aside from those potentially arising from the telesurgery).

<sup>137</sup> See GUSTAFSON, PERONI & PUGH, *supra* note 31, at 387–88.

<sup>138</sup> See *supra* note 34 and accompanying text. This exclusion is also available, with tighter eligibility requirements, to certain resident alien individuals. See I.R.C. § 911(d)(1) (2006) (defining “qualified individual”).

<sup>139</sup> See I.R.S. Notice 2010–27, 2010–15 I.R.B. 531.

<sup>140</sup> The \$12,810 amount equals the maximum inflation-adjusted housing expense (\$27,450 in 2010), minus a statutorily imposed floor (\$14,640 in 2010). See *id.* The housing expense limit is greater for certain high-cost foreign locales, as defined by the Internal Revenue Service. See I.R.C. § 911(c)(2)(B) (authorizing the IRS to increase the housing cost allowance “on the basis of geographic differences in housing costs relative to housing costs in the United States”); I.R.S. Notice 2010–27, *supra* note 139 (IRS list of 2010 housing expense

with respect to foreign housing costs. Thus, in 2010 a U.S. citizen residing abroad can exclude more than \$100,000 under the foreign earned income exclusion. In recent years, multinational corporations have lobbied Congress to make this exclusion even larger.<sup>141</sup>

Section 911 defines “foreign earned income” as compensation for personal services that is “from sources within a foreign country or countries.”<sup>142</sup> The regulations, in turn, provide that earned income is from sources within a foreign country “if it is attributable to *services performed . . . in a foreign country*.”<sup>143</sup> As with the general sourcing provisions discussed earlier,<sup>144</sup> the section 911 regulations contain geographical details regarding the definitions of “United States” and “foreign country.”<sup>145</sup>

Given that the section 911 regulations use the same relevant language as do the general sourcing rules discussed above<sup>146</sup> (i.e., “services performed . . . in” a country), and that both contain detailed geographical definitions, it is reasonable to assume that both are interpreted consistently and focus on the physical location of the service provider. Applying this standard to an example under section 911, assume that a U.S. citizen surgeon lives in the Cayman Islands and is a “qualified individual” eligible to claim benefits under section 911.<sup>147</sup> If that U.S. citizen, while physically in the Cayman Islands, performs inbound tele-surgery on a U.S.-based patient, that income will be treated as foreign source (because of the surgeon’s physical presence in the Cayman Is-

increases for high-cost jurisdictions). For example, a person living in the Cayman Islands could exclude an additional \$33,360 attributable to housing costs in 2010. *See id.* (applying the \$48,000 maximum housing expense, minus the \$14,640 inflation-adjusted floor).

<sup>141</sup> *See Kirsch, supra* note 20, at 463 (describing lobbying efforts). *See generally* I.R.S. Notice 2010-27, *supra* note 139 (criticizing foreign earned income exclusion).

<sup>142</sup> I.R.C. § 911(b)(1) (defining “foreign earned income”); *see also id.* § 911(d)(2) (defining “earned income”).

<sup>143</sup> Treas. Reg. § 1.911-3(a) (1960) (emphasis added). As with the general sourcing regulations, the section 911 regulations make clear that the place of payment is irrelevant in this inquiry. *See id.* § 1.861-4(a)(1) (sourcing regulation); *id.* § 1.911-3(a) (foreign earned income exclusion regulation).

<sup>144</sup> *See supra* notes 107–108 and accompanying text.

<sup>145</sup> *See* Treas. Reg. § 1.911-2(g) (defining “United States”); *id.* § 1.911-2(h) (defining “foreign country”); *cf. Arnett v. Comm’r*, 473 F.3d 790, 797–99 (7th Cir. 2007) (upholding the validity of Treas. Reg. § 1.911-2(h) and concluding that because Antarctica is not a foreign country under that definition, income from services performed in Antarctica is not excludible under section 911).

<sup>146</sup> *See* I.R.C. § 861(a)(3).

<sup>147</sup> To be a qualified individual, the U.S. citizen must either have a bona fide residence in the Cayman Islands for a period that includes an entire taxable year or be physically present in the Cayman Islands (or other foreign countries) during a period of twelve consecutive months for at least 330 full days. *Id.* § 911(d)(1).

lands). As a result, the U.S. citizen surgeon could exclude more than \$120,000 of such telesurgery income from their U.S. tax base.<sup>148</sup>

### B. *Tax Treaties—The Permanent Establishment Threshold*

Having considered the treatment of telesurgery personal services under existing U.S. internal tax law, this subpart addresses the consequences under tax treaties. This analysis focuses on the OECD Model Treaty because it serves as the underlying basis for most current income tax treaties.<sup>149</sup>

Under Article 7 of the OECD Model Treaty, a country can exercise source-based jurisdiction to tax the business profits of a resident of the other treaty country only to the extent that the profits are attributable to a permanent establishment in the source country.<sup>150</sup> If the foreign taxpayer has no permanent establishment (or if the profits are not attributable to the permanent establishment),<sup>151</sup> then the source country cannot impose tax. Accordingly, the principal question is whether a foreign-based surgeon who performs inbound telesurgeries on U.S.-based patients will be treated as having a permanent establishment in the United States by reason of those activities.<sup>152</sup>

The following analysis considers two possible bases for finding that a U.S. permanent establishment exists with respect to cross-border telesurgery performed by a foreign-based surgeon: (1) the traditional standard, which focuses on whether the taxpayer has a “fixed place of business” in the United States; and (2) a services-based standard re-

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<sup>148</sup> This assumes that the U.S. citizen has significant housing costs in the Cayman Islands. See *supra* notes 138–140 and accompanying text (discussing maximum exclusion amounts).

<sup>149</sup> See *supra* notes 49–51 and accompanying text.

<sup>150</sup> OECD Model Treaty, *supra* note 50, art. 7(1). In this context, “source country” refers to the treaty country in which the taxpayer is not a resident, rather than the country in which the income is sourced under the internal tax laws as previously discussed.

<sup>151</sup> Unlike the Code’s “effectively connected” test that turns on difficult interpretations of the U.S. tax law’s source rules, the “attributable to” standard looks to see if there is a factual connection between the income and the permanent establishment. See OECD Commentary, *supra* note 50, art. 7, ¶ 5. In the telesurgery example, this factual analysis would not raise significant issues with respect to the foreign-based surgeon’s income. If the telesurgery arrangement constituted a permanent establishment in the United States, the surgeon’s income from the telesurgery would be factually connected to that permanent establishment and, therefore, attributable to it.

<sup>152</sup> This analysis assumes that the surgeon is not a U.S. citizen and is instead a resident of a foreign country with which the United States has an income tax treaty based on the OECD Model Treaty.

cently added to the OECD Commentary as an alternative for treaty countries to implement.<sup>153</sup>

### 1. Traditional “Fixed Place of Business” Standard

The permanent establishment threshold was developed in the early twentieth century in an “earthbound” and physical economy.<sup>154</sup> The threshold “connoted a structure of ‘bricks and mortar’ at a geographic point in the territory of the taxing state.”<sup>155</sup> These origins in a physical economy are reflected in the model treaty’s non-exclusive list of items that explicitly constitute permanent establishments: a place of management, branch, office, factory, workshop, mine, and oil and gas wells.<sup>156</sup>

Despite the threshold’s grounding in the early twentieth century, Professor Doernberg and others have observed that “the concept is capable of being adapted.”<sup>157</sup> Indeed, the OECD has spent much of the past decade attempting to clarify how the permanent establishment concept applies in the modern digital age.<sup>158</sup> In doing so, the OECD

<sup>153</sup> A third possible basis for finding a permanent establishment does not require a fixed place of business. Under Article 5(5) of the OECD Model Treaty, a foreign enterprise has a permanent establishment in the source country if a dependent agent, acting on behalf of the enterprise, “has, and habitually exercises [in the source country] an authority to conclude contracts in the name of the enterprise.” OECD Model Treaty, *supra* note 50, art. 5(5). Although the U.S.-based surgical staff might be considered dependent agents to the extent that they are subject to the surgeon’s control during the telesurgery procedures, those staff members presumably will not have, or habitually exercise, authority to enter into contracts binding on the foreign surgeon (even if they help with scheduling telesurgeries). This is particularly likely to be true because, for the reasons discussed herein, this agency analysis would be relevant only if the foreign surgeon does not own the U.S. surgery center or the U.S. robotic surgical system. Moreover, given that a surgeon generally has the final authority to determine whether a surgical procedure will be performed, it is unlikely that any other U.S.-based person, whether a dependent or independent agent, would have or habitually exercise authority to bind the surgeon contractually with respect to the performance of telesurgery activities. Accordingly, it is unlikely that a foreign-based surgeon would have a permanent establishment under this agency-based test.

<sup>154</sup> DOERNBERG ET AL., *supra* note 4, at 349.

<sup>155</sup> *Id.*; see also Avi-Yonah, *supra* note 4, at 534–35 (discussing early development of permanent establishment threshold).

<sup>156</sup> OECD Model Treaty, *supra* note 50, art. 5(2).

<sup>157</sup> DOERNBERG ET AL., *supra* note 4, at 349.

<sup>158</sup> In particular, the OECD added numerous paragraphs to the Article 5 Commentary that specifically address electronic commerce issues. See OECD Commentary, *supra* note 50, ¶¶ 42.1–10; see also DOERNBERG ET AL., *supra* note 4, at 349–54 (describing OECD adaptation); OECD, TAXATION AND ELECTRONIC COMMERCE: IMPLEMENTING THE OTTAWA TAXATION FRAMEWORK CONDITIONS (2001) (describing early OECD efforts to reach an international consensus regarding the taxation of electronic commerce). See generally OECD TAG Report, *supra* note 4.

has made clear that it intends not to scrap the permanent establishment threshold but to adapt it to modern economic and technological developments.<sup>159</sup>

Article 5(1) provides that “the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”<sup>160</sup> Because the term “enterprise” refers to “the carrying on of any business,” the surgeon’s for-profit performance of telesurgery in an independent capacity constitutes an enterprise.<sup>161</sup> Accordingly, the key issue is whether the surgeon’s activities constitute a “fixed place of business” in the United States.<sup>162</sup>

a. *“Place of Business”*

The “fixed place of business” concept incorporates two separate requirements: there must be a “place of business” and it must be “fixed.” The OECD Commentary defines a “place of business” as:

Any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on

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<sup>159</sup> See OECD TAG Report, *supra* note 4, at 72 (“[A]t this stage, e-commerce and other business models resulting from new communication technologies would not, by themselves, justify a dramatic departure from the current rules.”).

<sup>160</sup> OECD Model Treaty, *supra* note 50, art. 5(1).

<sup>161</sup> See *supra* note 53 (explaining that as a result of changes in 2000, Article 7 now applies to “professional services and other activities of an independent character”). In this context, it is assumed that the surgeon is not acting as the employee of another enterprise.

<sup>162</sup> A fixed place of business through which the business of an enterprise is conducted will not constitute a “permanent establishment” if it is used only for activities that are of a “preparatory or auxiliary character.” OECD Model Treaty, *supra* note 50, art. 5, ¶ 4. For example, if a fixed place of business is used solely for “storage, display or delivery of goods or merchandise belonging to the enterprise,” it is not treated as a permanent establishment. *Id.* at ¶ 4(a). In the context of electronic commerce, the commentary makes clear that “[w]here . . . such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment,” the activities would not be considered merely preparatory or auxiliary, “and if the equipment constituted a fixed place of business of the enterprise . . . there would be a permanent establishment.” OECD Commentary, *supra* note 50, art. 5, ¶ 42.8. In the context of telesurgery, the use of the U.S.-situs surgical suite and robotic system constitutes an essential part of the telesurgery, as the robotic system is performing the surgical procedure based on the remote surgeon’s inputs. Thus, if the U.S.-based surgical center or robot constituted a fixed place of business under the following analysis, it would not avoid permanent establishment status based on the preparatory or auxiliary standard.

the business of the enterprise and it simply has a certain amount of space at its disposal.<sup>163</sup>

Based on this definition, the determination of whether the foreign surgeon has a “place of business” in the United States focuses on the tangible, physical nature of the surgeon’s activities. In the context of telesurgery, a surgeon utilizes two relevant physical connections to the United States: the U.S.-based robotic surgical system that physically interacts with the U.S.-based patient in response to the surgeon’s inputs, and the surgical suite in which the patient is located. As the following analysis illustrates, whether either of these constitutes a place of business (and whether it is “fixed”) depends on the precise manner in which the surgeon arranges the activities. Because the precise way in which these future activities might be conducted is not yet clear, this analysis considers several possibilities.

For example, assume that the foreign-based surgeon contracts with an unrelated U.S. surgical center to perform several telesurgeries per day using the center’s robotic surgical system on patients at that center. The robotic surgical system in that suite might constitute a place of business, given that the model commentary includes “machinery or equipment” in the definition of place of business.<sup>164</sup> In addition, the surgical suite in which the U.S.-based patient is located could constitute “premises” or “facilities” under the place of business standard.<sup>165</sup>

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<sup>163</sup> OECD Commentary, *supra* note 50, art. 5, ¶ 4. For a general discussion regarding the relevance of OECD Commentary in interpreting tax treaties based on the OECD Model Treaty, see Kirsch, *supra* note 47, at 1069, 1079–81.

<sup>164</sup> OECD Commentary, *supra* note 50, art. 5, ¶ 2. See generally *infra* notes 174–178 (discussing certain computer servers as places of business). Even a vending machine or other automated device that requires no human input can constitute a place of business. See OECD Commentary, *supra* note 50, art. 5, ¶ 10; see also KLAUS VOGEL, KLAUS VOGEL ON DOUBLE TAXATION CONVENTIONS 290 (1999).

<sup>165</sup> OECD Commentary, *supra* note 50, art. 5, ¶ 2; see also Arvid Aage Skaar, *Erosion of the Concept of Permanent Establishment: Electronic Commerce*, in INTERNATIONAL STUDIES IN TAXATION: LAW AND ECONOMICS 307, 310 (Gustaf Lindencrona et al. eds., 2001) (“[E]ven if [a computer] server is not considered to be a PE-constituting place of business, the *room* or *office* in which the server is located would qualify for this purpose.”) If the center has several surgical suites (or several robotic systems), and the particular suite or robot used remotely by the telesurgeon changes from day-to-day, it nonetheless would be treated as a single place of business. The commentary states that “a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.” OECD Commentary, *supra* note 50, art. 5, ¶ 5.1.

A single surgical center would satisfy this criteria, even if different surgical rooms (or robotic systems) within the center are utilized. The OECD Commentary provides examples

b. *At Taxpayer's Disposal*

Because the foreign-based surgeon would be carrying on the profit-making telesurgery through these “premises, facilities or installations,” the suite and robotic system might appear to meet the general standard for a “fixed place of business.” This conclusion, however, is subject to an important qualification—the OECD Commentary requires that the place of business be “at the disposal” of the taxpayer for it to constitute a permanent establishment.<sup>166</sup> In determining whether it is at the taxpayer’s disposal, “[i]t is immaterial whether the premises, facilities or installations are owned or rented” by the taxpayer, or “whether or not they are used exclusively” for the taxpayer’s business activities.<sup>167</sup> Moreover, “the place of business may be situated in the business facilities of another enterprise.”<sup>168</sup>

The OECD Commentary does not define how extensive the taxpayer’s right to use another person’s facility must be for the facility to be at the taxpayer’s disposal. An example in the commentary states that premises are at the foreign taxpayer’s disposal “where the foreign enterprise has at its *constant* disposal certain premises or a part thereof owned by [another enterprise].”<sup>169</sup> The use of the “constant” qualifier suggests that the threshold is high, and that the mere ability to use the facility periodically is not sufficient. Other examples in the commentary suggest that the premises must be continuously available to the foreign person, at least for a certain amount of time, to be “available,”<sup>170</sup> and that limited access to facilities, even if that brief access re-

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of a consulting firm regularly renting different offices within an office building, and a vendor regularly setting up his stand in different locations within an outdoor market, and concludes that both circumstances represent a single place of business for the taxpayer. *See id.* ¶ 5.3. Assume, instead, that the foreign-based surgeon did not regularly perform telesurgery on patients located at a single U.S.-based site, but instead performed telesurgery on patients located at numerous locations throughout the United States (or even numerous locations within a U.S. city). Under those circumstances, the surgeon’s activities would lack the geographic coherence necessary for a single place of business, making it less likely that there would be a U.S. permanent establishment. The commentary provides an example of a consultant working for a client at different branches in separate locations pursuant to a single project, and concludes that each branch should be considered separately. *See id.* ¶ 5.4

<sup>166</sup> *See id.* ¶ 4.

<sup>167</sup> *Id.*

<sup>168</sup> *Id.*

<sup>169</sup> *Id.* (emphasis added).

<sup>170</sup> The commentary provides that if a person is allowed to use an office in the headquarters of another company on an ongoing basis and for a sufficiently long period of time, a fixed place of business exists. *See id.* ¶ 4.3. Similarly, if a painter physically spends

peats itself daily for several years, is not sufficient.<sup>171</sup> As one prominent commentator observed, “[t]he wording ‘at its disposal’ may be understood as ‘available if and when needed.’”<sup>172</sup>

Consider again a foreign-based surgeon who contracts with an unrelated U.S. surgical center to perform several telesurgeries per day using the center’s robotic surgical system on patients at that center. Under the above analysis, the U.S.-situs center and robot would probably not be treated as being at the surgeon’s disposal. Assuming that other local surgeons (or remote telesurgeons) utilize the U.S. facilities, the foreign surgeon’s (remote) access to the U.S. facilities would be subject to the demands and schedules of other surgeons. Accordingly, the scenario appears to be analogous to the examples in the commentary where the taxpayer did not have a place of business when he had only limited access to facilities, even though that limited access was available daily for several years.<sup>173</sup>

This conclusion is reinforced by the OECD Commentary specifically addressing electronic commerce. The commentary provides that a foreign enterprise’s website, “which is a combination of software and electronic data, does not in itself constitute tangible property [and] [t]herefore does not have a location that can constitute a ‘place of business.’”<sup>174</sup> In contrast, “the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a ‘fixed place of business.’”<sup>175</sup> The commentary then focuses on the foreign enterprise’s relationship to the physical computer server that hosts its website, making a distinction between a server that is owned by an independent person and one that is owned (or leased) by the foreign enterprise itself. In the case of a server owned by an independent person, the commentary concludes that the server will not constitute a fixed place of business of

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three days a week for two years painting a large office building of his main client, that location constitutes a place of business. *See id.* ¶ 4.5.

<sup>171</sup> The commentary provides an example of a salesman who regularly visits a customer to take orders. Although he regularly meets with the customer’s purchasing director in the director’s office, that office is not treated as being at the salesman’s disposal. *See* OECD Commentary, *supra* note 50, ¶ 4.2. Another example involves a road transportation enterprise that uses a customer’s delivery dock every day for several years for the purposes of delivering goods to the customer. The commentary concludes that this presence, even though occurring daily for a number of years, is insufficient to make that place at the enterprise’s disposal. *See id.* ¶ 4.4.

<sup>172</sup> Skaar, *supra* note 165, at 312.

<sup>173</sup> *See supra* note 171.

<sup>174</sup> OECD Commentary, *supra* note 50, art. 5, ¶ 42.2.

<sup>175</sup> *Id.*

the foreign enterprise, even though the foreign enterprise controls the website hosted on the server by remotely changing the software code and data on the server, and even though the foreign enterprise is allowed to specify the particular server and location that hosts the website.<sup>176</sup> If the foreign enterprise owns or leases the computer server itself, however, it is treated as having the server at its disposal and the server is treated as the foreign enterprise's fixed place of business.<sup>177</sup> Thus, the commentary focuses on the foreign enterprise's physical access to the tangible computer server, concluding that the enterprise's lack of physical access in the case of independently owned servers precludes a place of business, even though the enterprise conducts significant business activity through the website that is hosted on the servers.<sup>178</sup>

A strong analogy exists between the foreign enterprise's use of U.S.-based servers for its website and a foreign surgeon's potential use of a U.S.-situs robotic surgical system (and surgical suite) to perform inbound telesurgery on a U.S. patient. The foreign taxpayer is not physically present in either case, and instead relies on equipment in the United States. In the case of the server, the foreign enterprise conducts its U.S. business activity by remotely accessing the server to modify the website code and data; in the case of the telesurgery, the foreign surgeon performs U.S.-related activities by remotely controlling the U.S.-based surgical robot. Although remote surgery is performed via real-time inputs from the foreign surgeon, whereas the remote website updates are performed only periodically, nothing in the commentary's rationale suggests that this difference is relevant.<sup>179</sup> Instead, the focus is on whether the foreign taxpayer has physical access to the tangible property in the United States. As long as the foreign-based surgeon does not own or lease the U.S.-based robot and surgical center and only has remote access to use them at scheduled times, the arrangement is analogous to operating a website through an independent service provider and would not, according to the commentary, constitute a place of business in the United States. Thus, the surgeon would not have a

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<sup>176</sup> See *id.* ¶ 42.3

<sup>177</sup> See *id.*

<sup>178</sup> Indeed, the commentary emphasizes that, in the case of the independently hosted computer server, "the enterprise does not even have a physical presence at the location since the web site is not tangible." *Id.*

<sup>179</sup> In the case of a foreign company whose website provides time-sensitive information, the website might be updated frequently throughout the day, thereby making it even more analogous to the real-time inputs of the remote surgical robot.

permanent establishment under this standard. In contrast, if the surgeon owns<sup>180</sup> or leases the U.S.-based robot or surgical center, the arrangement is similar to a foreign enterprise that owns its own U.S.-based computer servers, thereby creating a place of business at the surgeon's disposal.<sup>181</sup>

As noted above, a place of business constitutes a permanent establishment only if it is a "fixed" place of business.<sup>182</sup> This requires "a link between the place of business and a specific geographical point."<sup>183</sup> If the U.S. surgery center is treated as the place of business under the above analysis—because, for example, the surgeon owns the center—it would clearly satisfy this "fixed" requirement, thereby constituting a permanent establishment. If, instead, the U.S.-based surgical robot is the place of business—because, for example, the surgeon owns the robotic system—the result would depend on whether the robotic system was frequently moved to different locations,<sup>184</sup> or whether it remained at one place for a sufficient period. If, for example, the robot was regularly moved among various surgical centers, it might not constitute a "fixed" place of business.<sup>185</sup> If, instead, it remained in a particular center for a sufficient period,<sup>186</sup> it would be a fixed place of business.

<sup>180</sup> This Article does not address the potential legal restrictions on a physician having an ownership interest in the robotic system or surgical center. Cf. Ice Miller LLP, *Survey of Recent Developments in Health Law*, 41 IND. L. REV. 1081, 1081–1114 (2008) (summarizing recent developments under the federal Stark Law).

<sup>181</sup> Even if the surgeon does not actually enter the United States, the mere fact that he owns the center or robotic equipment and could therefore exercise physical dominion over it if desired appears sufficient to put it at his physical disposal. Cf. VOGEL, *supra* note 164, at 286 (citing a German case for the proposition that "[i]t is sufficient if the entrepreneur has the power of disposition through an employee; even if he himself is forbidden to enter the State in question this does not preclude the existence of a permanent establishment in that State").

<sup>182</sup> OECD Model Treaty, *supra* note 50, art. 5(1).

<sup>183</sup> OECD Commentary, *supra* note 50, art. 5, ¶ 5.

<sup>184</sup> In this context, merely moving the robot among rooms within a particular surgical center or hospital would not constitute different locations. See *id.* art. 5, ¶ 5 ("It is enough that the equipment remains on a particular site.")

<sup>185</sup> In the context of a computer server, the OECD Commentary notes that "what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed . . ." OECD Commentary, *supra* note 50, art. 5, ¶ 42.4.

<sup>186</sup> The OECD Commentary mentions that countries often use a six-month standard for determining the requisite permanence. *Id.* at ¶ 6. If, however, the activities are of a recurrent nature (e.g., repeated use of the robot for telesurgery at several locations), "each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used." *Id.*; see also *id.* ¶ 6.1 ("[W]here a particular place of business is used for only a very short period of time but

In summary, if a foreign-based surgeon performs inbound telesurgery on a U.S.-based patient utilizing a U.S. surgical center and robotic surgical system that the surgeon does not own or lease, the surgeon likely will not have a permanent establishment and, accordingly, the telesurgery income will not be taxable by the United States under the OECD Model Treaty. In contrast, if the surgeon utilizes a U.S. surgical center or robotic system that the surgeon owns, leases, or otherwise is treated as having at the surgeon's disposal, the arrangement will create a permanent establishment provided that the place of business remains fixed, and the treaty will allow the United States to tax the telesurgery attributable to that permanent establishment. Thus, as with computer servers, the current OECD Model Treaty and OECD Commentary provide strong incentives to conduct remote operations electronically through physical equipment owned by an independent enterprise.

## 2. Alternative "Services" Permanent Establishment

A recent development presents a second way in which a foreign person might have a permanent establishment in the United States, even without a fixed place of business or an agency arrangement. In 2008, a so-called "services permanent establishment" provision was added to the OECD Commentary.<sup>187</sup> This provision is not a part of the OECD Model Treaty itself. Rather, it is an alternative provision that countries might agree to incorporate into an actual bilateral treaty to expand the scope of arrangements that constitute a permanent establishment.<sup>188</sup>

Under this "services permanent establishment" alternative provision, an enterprise that is a resident of one of the treaty countries is deemed to have a permanent establishment in the source country if the enterprise performs services in the source country:

- (a) through an individual who is present in [the source country] for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived

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such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.").

<sup>187</sup> See *id.*, art. 5, ¶ 42.23.

<sup>188</sup> See *id.* ("States are free to agree bilaterally to include such a provision in their tax treaties.").

from the services performed in [the source state] through that individual, or

(b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in [the source country].<sup>189</sup>

Neither of these subparagraphs requires the foreign enterprise to have a fixed place of business in the source country. Instead, the first subparagraph focuses on the number of days an individual is present in the source country performing services (as well as the percentage of total business income derived from the activity). It deals primarily with situations in which an enterprise is carried on by a single individual.<sup>190</sup> For example, it could apply “where a consultant provides services over a long period in a country but at different locations that do not meet the conditions of [a fixed place of business].”<sup>191</sup>

The second subparagraph, in contrast, focuses on the duration of the activities performed by the individual or individuals (rather than the amount of time any particular individual is present).<sup>192</sup> For example, this provision could apply if four different employees of the enterprise each spent fifty different days in the source country working on a single project (even though no single employee was present for 183 days).<sup>193</sup>

The alternative provision reflects an attempt to adapt the permanent establishment threshold to modern global business developments. In particular, it acknowledges that some service-related enterprises can conduct a significant amount of cross-border activity and derive significant revenues from the source country even without having a permanent establishment under the “fixed place of business” or agency-based tests. More importantly, it reflects the reluctance of some countries to surrender source-based taxing rights under these circumstances.<sup>194</sup>

Although this alternative provision strengthens source-country taxing rights in response to modern developments, it does not apply to the telesurgery example. In one important respect—the elimination of the

<sup>189</sup> *Id.*

<sup>190</sup> *Id.* ¶ 42.34. The subparagraph also applies if, for example, the individual is working for a company in which the individual owns all of the shares. *Id.*

<sup>191</sup> OECD Commentary, *supra* note 50, ¶ 42.25.

<sup>192</sup> *See id.* ¶ 42.33.

<sup>193</sup> If more than one employee is present on a particular day, that day is counted as only one day toward the 183-day threshold. *Id.* ¶ 42.39.

<sup>194</sup> *See id.* ¶ 42.16.

fixed place of business requirement—it relaxes the traditional focus on physical presence. It replaces that standard, however, with another standard that also relies on physical presence. In particular, both subparagraph (a) and subparagraph (b) depend on an individual (or individuals) being “present” in the source country for a specified number of days while performing services. The commentary makes clear that this reference means physical presence.<sup>195</sup> Thus, even if a foreign-based surgeon performed inbound telesurgery on a U.S.-based patient on a daily basis, he would not have any days of “presence” in the United States and would not be treated as having a permanent establishment in the United States under the alternative provision.

### III. THE CASE FOR DE-EMPHASIZING PHYSICAL PRESENCE

#### A. Possible Rules for Sourcing Personal Services Income

The prior Part concluded that, under both existing internal law and tax treaties, the heavy focus on the physical location of the service provider is likely to preclude taxation in the country where the telesurgery patient is located. This Part considers the normative implications of this conclusion. Three possible rules have been identified for determining the source of income from services: the place where the services are performed, the place “where the benefit of the services is received,” and the place “where the benefit of the services is utilized.”<sup>196</sup> As discussed above, the Internal Revenue Code adopts the place of performance standard.<sup>197</sup> The justification often given for this rule is that it best reflects the location “where the economic activities creating the

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<sup>195</sup> See *id.* ¶ 42.28 (describing the application of the provision to individuals who are “present in a country for a sufficiently long period of time notwithstanding the fact that their presence at any particular location in that country is not sufficiently long to make that location a fixed place of business”) (emphasis added); *id.* ¶ 42.36 (“The first condition refers to the days of presence of an individual.”); *id.* ¶ 42.38 (providing examples based on the days that the individuals are present in a country); *id.* ¶ 42.39 (explaining that the individual must be performing services while “present in the State”).

<sup>196</sup> DOERNBERG ET AL., *supra* note 4, at 234. The ALI International Tax Project identifies two possible source rules—the place where the services are performed, and the place where the services are utilized. ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 57.

<sup>197</sup> See I.R.C. §§ 861(a)(3), 862(a)(3) (2006); see also DOERNBERG ET AL., *supra* note 4, at 256 n.270 (noting that *Piedras Negras Broadcasting Co. v. Comm’r*, 43 B.T.A. 297 (1941), *aff’d* 127 F.2d 260 (5th Cir. 1942) held that place where consumers heard advertisements was not relevant).

income occur.”<sup>198</sup> Although place of performance is the majority rule, some countries look to the place where the recipient resides.<sup>199</sup>

Traditionally, in the case of personal services, all three of these rules would yield the same result. For example, in the case of a U.S.-based surgeon performing routine surgery on a patient at a U.S. hospital, the procedure is performed in the United States, the patient receives the benefits of the surgery in the U.S. hospital, and the benefits are utilized in the United States.

In the case of telesurgery, however, this unity no longer exists.<sup>200</sup> For example, with inbound telesurgery the benefits are received and utilized by the patient in the United States (because of this coincidence between receipt and utilization, the remainder of this discussion will refer to only the utilization by the patient). In contrast, as discussed extensively in the following Section, the place where the services are performed is not clear and depends on the identification of the relevant performance. If the relevant performance is the surgeon manipulating the control device, the performance would be in the foreign country.<sup>201</sup> If the relevant performance is the physical interaction of the surgical instruments with the patient’s body, the performance would be in the United States. Reliance on the general “where value is created” justification underlying the place of performance rule does not necessarily resolve this question, as an argument can be made that both aspects of the telesurgery performance create value.

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<sup>198</sup> TREASURY REPORT, *supra* note 3, at 22; *see also* Sprague & Reid, *supra* note 134 (referring to the place “where value is created”). The Board of Tax Appeals in *Piedras Negras Broadcasting v. Commissioner* noted that the “source” of income refers not to a place, but to an activity. 43 B.T.A. at 309. It then concluded that the principal activity creating income was the generation of radio signals in Mexico, and that the transmission of the broadcast and receipt of the signal in the United States were merely “intermediate steps in the process, and not the source.” *Id.* at 312–13.

<sup>199</sup> *See* Glicklich et al., *supra* note 60, at 73–74 (Brazil using place of recipient’s residence); ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 57 (Germany finding domestic source services income if either performance or utilization in Germany); *cf.* Glicklich et al., *supra* note 60, at 73–74 (noting that, for value added tax purposes, most countries focus on the jurisdiction in which the service recipient resides).

<sup>200</sup> *Cf.* DOERNBERG ET AL., *supra* note 4, at 234–36 (applying these three rules to income from electronic commerce). The ALI International Tax Project demonstrates that this lack of unity often existed with respect to other types of income even before the recent growth of electronic commerce. *See* ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 19 (discussing source of interest from cross-border loan).

<sup>201</sup> Part of the surgeon’s performance also involves the exercise of “brain power” in the foreign country. *See* Glicklich et al., *supra* note 60, at 73 (noting that a majority of the value of an architect’s service is attributable to the use of “brain power”).

To determine the appropriate rule for sourcing personal services income, it is necessary to consider other relevant principles. The following subpart considers the general principles underlying source-based taxation and their impact on these determinations.

### B. *Justifications for Source-Based Taxation of Personal Services Income*

In the past decade, numerous scholars have questioned the normative validity of source-based taxation in a global economy.<sup>202</sup> For example, Professors Reuven Avi-Yonah<sup>203</sup> and Michael Graetz,<sup>204</sup> writing separately and with different emphases, have suggested that source-based taxation should be limited to active business income. More recently, Professors Steven Shay, Cliff Fleming, and Bob Peroni<sup>205</sup> have defended broader source-based taxation, concluding that it has a “robust normative foundation,”<sup>206</sup> but observing that many of the existing U.S. source rules “lack a strong theoretical or prescriptive content.”<sup>207</sup> This Article does not address this foundational question regarding the general validity of source-based taxation, and it assumes that source-based jurisdictional principles will continue to apply to income from personal services. Instead, this Part considers whether the existing source rule’s focus on the teleurgeon’s physical location is the preferable sourcing standard, or whether a different approach would be better.

A threshold problem in determining the source of a particular item of income is that the economic concepts underpinning the income tax do not depend on the source of income.<sup>208</sup> At most, generally

<sup>202</sup> For a summary of scholarship in this area, see Noren, *supra* note 59, at 343–47; Shay, Fleming & Peroni, *supra* note 4, at 88 nn.18–19.

<sup>203</sup> See Avi-Yonah, *supra* note 15, at 1352–53 (proposing that individuals be taxed only on a residence-basis and that publicly held corporations be taxed only on a source-basis, determined via formulary apportionment); Avi-Yonah, *supra* note 4, at 520–21 (“In the case of multinational corporations, source-based taxation seems generally preferable.”).

<sup>204</sup> See Graetz, *supra* note 4, at 323, 328, 333 (arguing that active business income should be taxed at source principally because of problems with defining corporate residence, but that portfolio income should be taxed principally at residence due to national welfare and fairness concerns).

<sup>205</sup> See Shay, Fleming & Peroni, *supra* note 4, at 88–106.

<sup>206</sup> *Id.* at 154.

<sup>207</sup> *Id.*

<sup>208</sup> Hugh Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in *TAXATION IN THE GLOBAL ECONOMY* 30 (Assaf Razin & Joel Slemrod eds., 1990); see also Shay, Fleming & Peroni, *supra* note 4, at 137 (citing Ault & Bradford, *supra*, for the proposition that “the Schanz-Haig-Simons net income concept can describe only a taxpayer’s worldwide income. It cannot allocate that worldwide income among the various countries whose legal and economic infrastructures may have contributed to the production of the income”); ALI INTERNATIONAL TAX PROJECT, *supra* note 18,

articulated principles exist that might allow a country to claim source-based tax jurisdiction even though they do not necessarily determine whether the country should exercise such taxation rights.<sup>209</sup>

For example, a common justification for imposing source-based taxation is the benefits principle—“if [a] country’s governmental services and protections are (or may fairly be deemed to be) utilized in deriving the income,” then the country should be able to tax that income.<sup>210</sup> Under this principle, both the country where the surgeon is located and the country where the patient is located could claim taxing rights, as both countries provide important telecommunications infrastructure. Another frequent justification for source-based taxation is that the foreign person is exploiting the local market, and therefore that country should be able to impose a tax.<sup>211</sup> The country in which

at 18 (“A comprehensive rationale has never been presented for the source rules that now exist, either in the U.S. or elsewhere; and it is difficult, if not impossible, to articulate generally valid and neutral principles for assigning a geographical source to income.”).

<sup>209</sup> For an application of these principles to source-based taxation generally, see Shay, Fleming & Peroni, *supra* note 4, at 90–106. The following analysis does not address one of the most fundamental explanations offered for source taxation, namely, that countries exercise source-based taxation merely because they have the power to do so. See Ault & Bradford, *supra* note 208, at 32; Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 31 (1993). This *force majeure* explanation, although perhaps grounded in political reality, is not a normative argument. See Shay, Fleming & Peroni, *supra* note 4, at 89.

<sup>210</sup> ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 18; see also Michael J. Graetz & Michael M. O’Hear, *The “Original Intent” of U.S. International Taxation*, 35 DUKE L.J. 1022, 1036–37 (1997) (describing importance of benefits principle to T.S. Adams, the key Treasury Department tax advisor in the early development of U.S. international tax policy); Shay, Fleming & Peroni, *supra* note 4, at 90 (listing various benefits that a nonresident derives from business activities in the United States). Commentators have disagreed on the strength of the benefits justification for source-based taxation. Compare Green, *supra* note 209, at 29–30 (arguing against the benefits justification because “[t]here is no definite relationship between a corporation’s taxable income and the costs that the corporation imposes on the public sector”), with Shay, Fleming & Peroni, *supra* note 4, at 90–91 (listing benefits that a nonresident derives from business activities in the United States, concluding that “the benefits provided by the U.S. government to nonresident earners of U.S. source income are quite similar to government benefits received by U.S. residents, thus justifying a substantial source tax”).

<sup>211</sup> See ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 18 (“The country that provides the market for property or services from which income is realized has a claim to be the source of that income.”). Although this market exploitation rationale is similar to the benefits rationale in that the market consists of the local “physical, legal, and economic infrastructure,” the market exploitation rationale “relieves the [source country] from the necessity of quantifying the cost of government benefits conferred on nonresidents,” and instead treats the source tax as a market pricing question. See Shay, Fleming & Peroni, *supra* note 4, at 91–92; see also Charles E. McLure Jr., *Source-Based Taxation and Alternatives to the Concept of Permanent Establishment*, 2000 WORLD TAX CONF. REP’T 6:1, 6:4, available at

the patient is located could claim additional justification under this rationale, as the foreign surgeon is exploiting that country's market for medical care.

Although these principles might justify the United States treating the inbound telesurgery income derived by foreign-based surgeons as U.S.-source income, they do not necessarily preclude treating the income as foreign source. Moreover, even if the income can be considered U.S.-source income, these principles do not indicate whether the United States should impose tax. The indeterminacy of this quest to determine the source of income reflects a more general observation of Professors Fleming and Peroni:

Rules for determining the geographic source of a taxpayer's income and deductions are essentially legal concepts that have no independent economic significance. Instead, they work with other rules in the tax code to define the scope of the U.S. taxing jurisdiction over foreign persons with respect to their activities within the United States and over U.S. persons with respect to their activities outside the United States.<sup>212</sup>

Accordingly, to determine the appropriate source rule for personal services (and telesurgery in particular), it is necessary to focus on the policies underlying the substantive tax provisions for which the source rules are relevant. As explained, the source rules applicable to telesurgery implicate three substantive tax provisions: (1) the determination of a foreign surgeon's income that is taxable as effectively connected to a U.S. business; (2) the determination of a U.S. surgeon's foreign tax credit; and (3) the availability of the foreign earned income exclusion to a U.S. citizen surgeon living abroad. The following analysis summarizes the general tax policy objectives that are relevant to all tax provisions. It then applies these general objectives, as well as relevant

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<http://mail.ctf.ca/publications/reports.asp> (describing market exploitation theory as an example of "entitlement" theory).

<sup>212</sup> J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and its International Dimension*, 27 VA. TAX REV. 437, 553 (2008); see also Shay, Fleming & Peroni, *supra* note 4, at 154 ("Source rules are simply devices to [implement the relevant taxing provisions]. Thus, the content of any particular source rule should relate to the rule's purpose and not to debates over geographical origin."); ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 19 ("The correctness of [the source rules] depends in part on the rules adopted for the imposition of tax on the U.S. source income of foreign taxpayers."); Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 S.M.U. L. REV. 391, 396 (2003) ("In the context of the foreign tax credit limitation, the source rules of current law need to be revised to reflect the purpose for which they are being applied.").

specific policy objectives, to each of the three previously mentioned provisions. Applying this “purposive” approach to determining the appropriate source rules,<sup>213</sup> it concludes that different source provisions might be necessary to achieve the different policy objectives underlying these three provisions.<sup>214</sup>

In adopting different source rules for different purposes, the analysis is sensitive to the potential problems that variations in sourcing rules might create. In particular, when two countries have inconsistent jurisdictional standards, double taxation or nontaxation often arises.<sup>215</sup> These inconsistencies might be more common when a country departs from a widely utilized sourcing rule (such as the focus on the physical presence of the service provider), leading one commentator to suggest that double taxation might be minimized if each country bases its own rules “on reasonable expectations about the tax rules likely to be applied in other countries.”<sup>216</sup>

Thus, to the extent that the following analysis recommends changes to the traditional focus on the physical location of the service provider, it does so only after considering how those changes would interact with other countries’ sourcing rules that might continue to focus on the location of the service provider. Ultimately, however, modern developments may justify a country changing those source rules if “consider[s] inadequate” if, in the absence of rule changes, those developments would “result[] in an unacceptable division of tax revenues between residence and source countries, in significant tax revenue

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<sup>213</sup> See Shay, Fleming & Peroni, *supra* note 4, at 150–51 (discussing purposive approach to determining source for purposes of foreign tax credit and source-based taxation).

<sup>214</sup> *Cf. id.* at 139, 155 (“[S]ource rules for double taxation relief need not be symmetrical with source rules for source taxation purposes if the differences reflect the different objectives of the foreign tax credit and source taxation.”). The American Law Institute’s study on international taxation cautioned against countries adopting different source rules for inbound and outbound purposes: “If the U.S. would tax the income in the case of a foreign taxpayer, it should logically respect a foreign country’s assertion of its source-based jurisdiction over income in the reciprocal situation.” ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 349. Nonetheless, the American Law Institute’s study acknowledged that in some circumstances a country may be justified in adopting different source rules for inbound and outbound purposes. *See id.*

<sup>215</sup> *See id.* (describing double-taxation potential arising from U.S. communications income sourcing rules). This problem is also reflected in the inconsistent entity classification positions that taxpayers take between the United States and other countries utilizing the check-the-box regulations.

<sup>216</sup> Andrus, *supra* note 4, at 843.

losses,”<sup>217</sup> or in the violation of other important policy objectives. Moreover, treaties can sometimes resolve problems arising from two countries’ inconsistent source rules, such as when neither country is willing to give a foreign tax credit to income it considers domestic.<sup>218</sup>

### C. Relevant Tax Policy Objectives

The following analysis considers the appropriate sourcing rules in the context of the three general policy goals against which tax provisions are often judged: fairness, efficiency, and administrability.<sup>219</sup> The fairness principle is often subdivided into horizontal equity and vertical equity.<sup>220</sup> Horizontal equity requires that similarly situated taxpayers be taxed in a similar manner.<sup>221</sup> Vertical equity compares the taxation of high-income taxpayers and low-income taxpayers, focusing on whether their relative taxation reflects the society’s views of the proper relationship. In the United States and elsewhere, vertical equity is generally reflected in a progressive marginal income tax rate structure, based on ability-to-pay concerns.<sup>222</sup> Vertical equity concerns could arise if a high-

<sup>217</sup> OECD TAG Report, *supra* note 4, at 26–27, ¶¶ 108–109 (noting circumstances in which countries might feel that the risks of double taxation “are the price to pay to change rules that they consider inadequate”).

<sup>218</sup> See 2006 U.S. Model Treaty, *supra* note 50, art. 23(3) (requiring residence country, for purposes of foreign tax credit limitation, to treat certain income as foreign source despite internal law sourcing rules).

<sup>219</sup> See Graetz, *supra* note 4, at 294 (“[S]ince Adam Smith, it has been commonplace to say that a tax system should be fair, economically efficient, and reasonably easy to administer and comply with.”); Section of Taxation, Am. Bar Ass’n, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 659 (2006) [hereinafter *ABA Task Force Report*]. For purposes of this Article, it is sufficient to focus on these general criteria. Other commentators sometimes subdivide or reclassify these considerations into different groupings or incorporate additional considerations. See, e.g., DOERNBERG ET AL., *supra* note 4, at 67–71 (adding inter-nation equity, nondiscrimination considerations, and flexibility); U.S. TREAS. DEP’T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 13–20 (1984) [hereinafter *TREASURY TAX REFORM*] (subdividing three principle criteria).

<sup>220</sup> Professor Doernberg suggests that “[i]n an international context . . . there is also an issue of inter-nation equity—each country receives a fair share of revenue from cross-border transactions.” DOERNBERG ET AL., *supra* note 4, at 68–69.

<sup>221</sup> “Conversely, [horizontal] fairness, and a concern for a foreign country’s adverse taxation of U.S. residents, [also] supports a view that the United States should not discriminate against nonresidents and foreign-owned business.” Section of Taxation, Am. Bar Ass’n, *Statement of Policy Regarding U.S. International Taxation*, reprinted in TAX NOTES TODAY, June 11, 2009, 2009 TNT 110-31, at 4 (LEXIS) [hereinafter *ABA Statement*]; see also Graetz, *supra* note 4, at 299–300 (discussing nondiscrimination and reciprocity as fairness-based norms in international context).

<sup>222</sup> See *TREASURY TAX REFORM*, *supra* note 219, at 14 (“Most Americans probably agree that those with high incomes should pay a greater percentage of their income in tax than those with intermediate levels of income.”). See generally *ABA Task Force Report*, *supra* note

income U.S. person were to earn a significant foreign income that was excluded from taxation and thereby generate a lighter tax burden than a low-income U.S. person who earned solely domestic income that was subject to tax.<sup>223</sup>

Violations of the fairness criterion can have a secondary impact on compliance norms. In particular, the perceived fairness of the tax—with respect to both its legal requirements and the perception of compliance with those requirements—might have important implications on taxpayers' willingness to comply with tax obligations.<sup>224</sup> This aspect of fairness can have different implications for source-based taxation, depending on the circumstances in which it arises. For example, the OECD technical advisory group report on the taxation of electronic commerce notes that a country should not purport to impose a tax on foreigners with no physical connection to the country if, as a practical matter, the taxes will never be collected.<sup>225</sup> The report explains that as a result of lack of enforcement, "the taxpaying public will perceive that the system of tax is unfair and discriminatory" and will therefore have less desire to comply.<sup>226</sup> A contrary argument, however, might suggest that the failure to impose the tax (regardless of enforcement difficulties) might in itself undermine the public's confidence in the tax system. If the United States fails to impose a tax on foreign persons earning income in the United States but does tax U.S. persons on similar income, U.S. taxpayers might conclude that the foreign person is "getting away with something."<sup>227</sup> Indeed, compliance norms might be undermined to a greater degree in the latter situation, as U.S. persons

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219, at 678 n.27 (discussing literature on ability-to-pay theories); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 301 (2001) (utilizing ability-to-pay principles to justify worldwide taxation of U.S. residents).

<sup>223</sup> See *ABA Task Force Report*, *supra* note 219, at 692–702. This example could also be viewed as violating horizontal equity to the extent the high-income U.S. person with significant foreign income has a lower tax liability than a high-income U.S. person with exclusively domestic income.

<sup>224</sup> See Kirsch, *supra* note 20, at 501–03 (discussing this phenomenon in the international tax context and citing authorities); see also Shay, Fleming & Peroni, *supra* note 4, at 112 (“[T]o induce compliance, residents must see an income tax as treating similarly situated nonresident taxpayers in a comparable manner.”).

<sup>225</sup> See OECD TAG Report, *supra* note 4, at 29, ¶ 73.

<sup>226</sup> *Id.*

<sup>227</sup> For similar arguments in the context of residence-based taxation, see Kirsch, *supra* note 20, at 502–03 (discussing possible contradictory effects of this phenomenon in the context of taxation of U.S. citizens abroad).

might have more information about what the law is than how well the law is enforced.<sup>228</sup>

The efficiency criterion (sometimes referred to as economic neutrality) posits that tax laws should “distort pre-tax economic decisions as little as possible.”<sup>229</sup> Although efficiency considerations in the international context usually focus on the efficient allocation of capital investments,<sup>230</sup> they also arise with respect to individuals’ decisions of where to live and where to work.<sup>231</sup> In the case of a residency decision, a neutral tax policy is important not only because of economic efficiency concerns, but also because of the significant personal aspects of the decision.<sup>232</sup>

In the early twentieth century, commentators dismissed concerns over tax-motivated changes in residence<sup>233</sup> because of the difficulties and complications of cross-border relocation. In 1975 a commentator made a similar observation, noting that tax-motivated changes in residence “would require a mobility of population which probably does not exist.”<sup>234</sup> More recently, Professor Avi-Yonah observed that “labor is less mobile than capital and wage earners typically do not have the ability to transform their domestic wages into foreign source income.”<sup>235</sup>

Although labor remains significantly less mobile than capital, labor mobility is much higher than it was several decades ago.<sup>236</sup> This may be

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<sup>228</sup> See *id.* (discussing this issue in the context of the tax imposed on U.S. citizens abroad).

<sup>229</sup> ABA *Task Force Report*, *supra* note 219, at 680. This principle is based on the assumption “that the value of society’s goods and services can be maximized through the free market. Thus, laws and regulations, when utilized, optimally would distort pre-tax economic decisions as little as possible.” ABA *Statement*, *supra* note 221, at 4.

<sup>230</sup> There are two competing methods for determining whether a tax is “neutral” with respect to capital investment: capital export neutrality and capital import neutrality. See Kirsch, *supra* note 20, at 488 n.196 (summarizing competing views).

<sup>231</sup> See *id.* at 489 (discussing the application of neutrality principles to a person’s decision where to live); see also Shay, Fleming & Peroni, *supra* note 4, at 107 (“In the cross-border context . . . economic efficiency usually refers to the effect of taxation on the decision where to locate a taxpayer’s residence or investment. The efficiency objective is locational neutrality.”). See generally Mason, *supra* note 6 (discussing competing approaches for determining whether a tax is neutral with respect to the taxation of labor).

<sup>232</sup> See Kirsch, *supra* note 20, at 489 (“Because of the personal nature [of the choice of residence] . . . this analysis assumes that a neutral tax policy—one that neither encourages nor discourages decisions regarding place of residence or nationality—is preferable to a policy that actively attempts to influence these decisions.”).

<sup>233</sup> 67 CONG. REC. 3782 (1926) (statement of Richard P. Momsen, president of the American Chamber of Commerce for Brazil) (expressing “[i]n]o fear” of tax-motivated changes in residence).

<sup>234</sup> Brainard L. Patton, Jr., *United States Individual Income Tax Policy as It Applies to Americans Resident Overseas*, 1975 DUKE L.J. 691, 733.

<sup>235</sup> Avi-Yonah, *supra* note 4, at 519.

<sup>236</sup> See Kirsch, *supra* note 20, at 490–91 (discussing increased labor mobility).

particularly true of a high-income professional (rather than a low-income wage earner), especially if relocation makes significant tax savings available. Consequently, telesurgery raises the prospect of neutrality issues regarding not only the place of residence but also the place of work. Although a person's place of residence and place of work are often the same, in telesurgery the two concepts can be separated. For example, a U.S. surgeon might have the opportunity to perform more "normal" surgeries on U.S.-based patients or more telesurgeries on foreign-based patients. To the extent that one of these choices grants the surgeon more favorable tax treatment, neutrality will be violated even though the tax law did not influence the surgeon's place of residence.<sup>237</sup>

The third tax policy criteria—administrability—focuses on two broad concerns: (1) the ability of taxpayers to understand and comply with their obligations under the law (and the costs of doing so), and (2) the ability of the tax authorities to enforce the law (and the costs of doing so). As Professor Doernberg observed, "[w]hatever the merits of tax proposals, if they cannot be implemented and administered in a reasonable manner then they will fail."<sup>238</sup>

Although administrability concerns can arise in a wholly domestic setting, they are particularly problematic in the international context. For a country to enforce its tax laws, the tax administrators need information on the taxpayer's income-producing activities and the ability to compel compliance once the taxpayer's proper tax liability is determined.<sup>239</sup> A country can sometimes enforce inbound source-based taxation by requiring local firms and financial intermediaries to report information and withhold taxes on payments to foreign persons.<sup>240</sup> In other circumstances, however, the source country might lack both the information and ability to ensure compliance. Administrability problems also arise for the IRS in outbound circumstances. Although the IRS might have greater ability to collect known tax liabilities from a U.S. person, it can still face difficulty in obtaining information regard-

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<sup>237</sup> Countries sometimes intentionally violate the efficiency/neutrality norm to encourage a particular behavior. For example, a developing country in need of health services might intentionally forego the taxation of inbound telesurgery to encourage surgeons from more economically developed countries to perform telesurgery on patients located in that country. Such an approach, however, might not have the intended incentive effect if the surgeon's country of residence nonetheless taxes the surgeon under residence-based principles.

<sup>238</sup> DOERNBERG ET AL., *supra* note 4, at 363.

<sup>239</sup> See Shay, Fleming & Peroni, *supra* note 4, at 116.

<sup>240</sup> See Green, *supra* note 209, at 31.

ing the U.S. person's overseas activities.<sup>241</sup> Both the inbound and the outbound problems are exacerbated if the taxpayer intentionally utilizes a country that will not share tax information.<sup>242</sup> Administrative concerns for taxpayers arise when they have difficulties understanding and complying with the law of a foreign country (or countries). Differences in language and legal systems, as well as other barriers, often add significant costs to taxpayer compliance and thereby undermine efficiency concerns as well.

These administrative problems for both governments and taxpayers have also been magnified in the context of electronic commerce. In the traditional paradigm, a nonresident might have a physical presence in the United States, such as a store, that gives the IRS jurisdiction to obtain information and the ability to enforce a failure to pay by encumbering or seizing the taxpayer's U.S. assets.<sup>243</sup> If, instead, the nonresident makes significant sales to U.S. customers via its website, the IRS may have difficulty obtaining information about the sales and there may be no U.S.-situs assets for the IRS to encumber or seize.<sup>244</sup>

Electronic commerce makes compliance more difficult for taxpayers. For example, if a taxpayer maintains a website through which it sells (and electronically distributes) music, software, or some other intangible item, the website might be viewed, and purchases made, by residents around the world in dozens of countries. If each of those countries purported to impose source-based tax on those sales, the taxpayer might incur tremendous logistical difficulties and administrative costs in attempting to comply—this situation may also implicate efficiency, and possibly fairness, concerns.<sup>245</sup>

Tax treaties mitigate and sometimes eliminate these administrative concerns. Indeed, administrative benefits are often viewed as the principal justification for tax treaties.<sup>246</sup> For example, the permanent estab-

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<sup>241</sup> See *id.* at 31–32.

<sup>242</sup> Shay, Fleming & Peroni, *supra* note 4, at 128 n.178.

<sup>243</sup> DOERNBERG ET AL., *supra* note 4, at 174.

<sup>244</sup> See *id.* at 174–75; Shay, Fleming & Peroni, *supra* note 4, at 128 (even when “there is sufficient jurisdiction to tax the income,” there is increasingly no “in personam or in rem jurisdiction to compel production of requested information that is not provided voluntarily,” and “there is little practical ability to enforce the rule”).

<sup>245</sup> See OECD TAG Report, *supra* note 4, at 68, ¶ 334 (“[E]nterprises would be faced with the increased compliance burden of satisfying tax obligations in all the countries where customers access their websites to conclude contracts.”); see also DOERNBERG ET AL., *supra* note 4, at 235 (expressing concern about nonresident enterprise having source-based income when a customer in source country clicks on a web page hyperlink).

<sup>246</sup> See OECD TAG Report, *supra* note 4, at 16, ¶ 52 & n.22 (suggesting that the permanent establishment threshold “primarily addresses the issue of whether there is enough

ishment threshold eliminates the need for a taxpayer to comply with some countries' source-based tax regimes by precluding source-based taxation of business income when the taxpayer's activities do not exceed a specified threshold. Similarly, it eliminates the need for the source country's tax administrators to enforce the law in those circumstances. Treaties also aid enforcement by facilitating the sharing of information between the countries' tax authorities<sup>247</sup> and, in limited circumstances, by providing assistance in the collection of taxes.<sup>248</sup>

#### D. *De-Emphasizing Physical Presence Under U.S. Internal Law*

This subpart considers the tax policy criteria's effect on the substantive provisions of U.S. tax law that depend on the source of income. In particular, it considers the extent to which U.S. law should continue to focus exclusively on the physical location of the personal services provider in three areas: (1) the determination of a foreign surgeon's income that is taxable as effectively connected to a U.S. business; (2) the determination of a U.S. surgeon's foreign tax credit; and (3) the availability of the foreign earned income exclusion to a U.S. citizen surgeon living abroad. The analysis illustrates the tradeoffs that arise among tax policy goals in these areas and makes recommendations as to the resolution of these tradeoffs. The analysis first examines each

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business profits to justify the administrative burden of source taxation," and observing that the exchange of information and assistance in collection of taxes pursuant to treaties is becoming more important).

<sup>247</sup> See OECD Model Treaty, *supra* note 50, art. 26. The actual U.S. tax treaties in force differ in the extent to which, and circumstances under which, the United States and the other country will exchange information. In addition, the United States has some tax information exchange agreements (in lieu of a full tax treaty) with certain countries. See Kirsch, *supra* note 20, at 499–501 (discussing recent increase in tax information exchange agreements); see also Kristen A. Parillo, *Tax Information Exchange Agreements: A Worthy Endeavor*, 53 TAX NOTES INT'L 859 (2009) (describing operation of tax information exchange agreements and expansion of agreement network).

<sup>248</sup> In the absence of a collection assistance provision in a treaty, the common law "revenue rule" holds that one country will not provide assistance to another country in collection of the other country's final revenue claim." Shay, Fleming & Peroni, *supra* note 4, at 119. In 2003, the OECD added a collection assistance article to its model treaty. See OECD Model Treaty, *supra* note 50, art. 27. Very few U.S. treaties in force, however, actually have a collection assistance provision. See Shay, Fleming & Peroni, *supra* note 4, at 135–36 (describing five U.S. income tax treaties that provide for collection assistance); see also William L. Burke, *Tax Information Reporting and Compliance in the Cross-Border Context*, 27 VA. TAX REV. 399, 428–29 n.57 (2007) (describing the multilateral OECD Convention on Mutual Assistance in Tax Matters, and noting that "the United States Senate entered a reservation with respect to the provisions for mutual assistance in the collection of taxes assessed").

substantive provision in the context of telesurgery, and then in Part IV considers the broader implications for other personal services.

### 1. Taxation of Foreign Person's Business Income

As discussed previously, the United States taxes the business income of a nonresident alien individual only if that income is "effectively connected" to a trade or business in the United States.<sup>249</sup> The earlier analysis concluded that, under the existing Code, regulations, and case law, the income derived by a foreign-based surgeon performing inbound telesurgery on a U.S.-based patient would probably be treated as foreign source because the surgeon is physically outside the United States.<sup>250</sup> Accordingly, the income would not be effectively connected and would not be subject to tax. The following analysis reconsiders this focus on the physician's physical location as the principal determinant of source and, thus, taxability. Although not explicitly addressed below, this analysis is also relevant to the threshold question of whether the foreign surgeon is treated as engaged in a U.S. trade or business by reason of the telesurgery. Given the purposive nature of the sourcing question, the same factors in this analysis that support (or undermine) treating the income as U.S. source would also support (or undermine) treating the surgeon as engaged in a trade or business in the United States, as both issues are components of the substantive question of whether the income should be taxed.<sup>251</sup>

Horizontal equity considerations suggest that a foreign-based surgeon performing telesurgery on a U.S.-based patient should be taxed in the same manner as a U.S.-based surgeon performing "normal" surgery on a U.S.-based patient. Although one could argue that the U.S. and foreign surgeons are not similarly situated given their different locations, the relevant focus for U.S. tax policy purposes should be their similarity with respect to the income in question.<sup>252</sup> Given the potentially high-profile nature of inbound telesurgery, U.S.-based surgeons will likely be aware of the activity and, eventually, will learn of the non-taxation of the foreign-based surgeons. The perceived unfairness of this

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<sup>249</sup> See *supra* notes 24–29 and accompanying text.

<sup>250</sup> See *supra* notes 87–134 and accompanying text.

<sup>251</sup> Cf. Kaufman, *supra* note 101, at 788–89 (“[T]he term ‘trade or business within the United States’ may be, and should be, interpreted in light of the functions the term performs in the international context.”).

<sup>252</sup> As Professor Doernberg observed, a resident and nonresident who “earn[] the same amount of profit from the same business activities in [a country] should be taxed the same” with respect to that income. DOERNBERG ET AL., *supra* note 4, at 69.

disparate tax treatment might undermine U.S. taxpayers' faith in the tax system, thereby undermining the compliance norm.<sup>253</sup>

Efficiency considerations also suggest that a foreign-based surgeon should be taxed on inbound telesurgery income. A failure to tax inbound telesurgery income might enable foreign-based surgeons to charge lower fees than U.S.-based surgeons, thus providing a tax-induced advantage in the U.S. market for telesurgery performed by offshore surgeons. This outcome would be particularly acute if the foreign surgeon's country of residence taxed the income at a lower rate than the rate imposed by the United States on U.S.-based surgeons.<sup>254</sup> This disparate tax treatment could influence the future development of cross-border telesurgery and encourage offshore tax havens to promote themselves intentionally as potential low (or no) tax residence bases for cross-border service providers.

Although this efficiency concern supports treating the foreign surgeon's inbound telesurgery fee as taxable U.S. source income, the potential for double taxation must be addressed. Ordinarily, the taxpayer's country of residence would be expected to mitigate double taxation when the United States is exercising source-based jurisdiction.<sup>255</sup> The residence country could mitigate double taxation by exempting the income or providing the taxpayer with a foreign tax credit. In the telesurgery example, however, the foreign country might not be willing to provide relief. The residence country is expected to provide relief from double taxation only with respect to income that it considers foreign source.<sup>256</sup> Given the traditional focus on the service provider's physical location to determine the source of services income,<sup>257</sup> the foreign country would likely consider its telesurgeon's income domestic source and therefore would not provide relief for its resident.<sup>258</sup>

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<sup>253</sup> See *supra* notes 224–228 and accompanying text; see also Shay, Fleming & Peroni, *supra* note 4, at 111 (citing T.S. Adams, the key Treasury Department tax advisor in the early development of U.S. international tax policy, for the proposition that “a country's taxation of its own residents will lose legitimacy and efficacy if residents perceive that nonresidents with equal amounts of residence-country income pay less tax”).

<sup>254</sup> If the foreign jurisdiction imposed a higher rate, the foreign surgeon would not have an advantage over the U.S.-based surgeons regarding tax costs.

<sup>255</sup> See *supra* note 30 and accompanying text.

<sup>256</sup> See *supra* note 32 and accompanying text (describing how the United States, when it is the residence country, applies foreign tax credit limitations to ensure that it allows a foreign tax credit only to offset U.S. tax on foreign source income).

<sup>257</sup> See *supra* note 199 and accompanying text (describing place of performance test as the majority rule).

<sup>258</sup> The foreign country might also insist on treating the income as domestic (from its perspective) under some other theory. See Shay, Fleming & Peroni, *supra* note 4, at 140

Although this concern might suggest that the United States should refrain from taxing inbound telesurgery activity (at least until there is a broader international consensus regarding this approach to sourcing), as a practical matter this double taxation would arise in only limited circumstances. First, the potential problem might be relieved through a tax treaty.<sup>259</sup> It might also be moot for many taxpayers if the de minimis threshold for finding a trade or business is expanded.<sup>260</sup> The most significant potential concern, then, relates to foreign surgeons in non-treaty countries who derive significant income from telesurgery into the United States. As noted above, however, many of these non-treaty countries might be low (or no) tax jurisdictions, thereby mitigating the potential double taxation. To the extent this is the case, it might not be necessary for the United States to take any further steps to address the potential double taxation arising from its expansion of source-based taxation (other than being willing to consider expanding its treaty network). With respect to surgeons in other jurisdictions (i.e., high tax jurisdictions with which the United States does not have a tax treaty), arguments can be made that the United States should consider unilateral relief, perhaps for a limited period after departing from its traditional focus on the service provider's location, even though any such relief would add significant complexity.<sup>261</sup> Ultimately, given the policy

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("[If] extensive human capital [is] required to perform the services, then the country where the . . . human capital was developed also would seem to have a claim on some portion of the income.").

<sup>259</sup> See *id.* at 142 (suggesting broader imposition of tax at source, coupled with relief via tax treaty); cf. 2006 U.S. Model Treaty, *supra* note 50, art. 23(3) (re-sourcing provision for purposes of U.S. granting foreign tax credit relief to U.S. residents).

<sup>260</sup> See *infra* note 273–278 and accompanying text.

<sup>261</sup> It is unusual for the source country (i.e., the United States) to provide unilateral relief from double taxation. See *supra* note 30 and accompanying text (noting that the residence country generally is expected to provide relief). An argument can be made that this is a rare circumstance where the source country should grant unilateral relief because the United States, by moving beyond the more traditional focus on the service provider's physical location, would be departing from the source rule that most countries apply. Although such a departure is justified by the policy considerations discussed above, the United States could acknowledge the double-taxation potential that it creates and be willing to provide relief at least during a transition period during which other countries might be expected to adopt the broader sourcing rule. The most straightforward relief would exempt such income from U.S. taxation if the foreign surgeon establishes that his telesurgery income on U.S.-based patients was subject to some minimum level of residence-country tax.

If the United States grants relief under this scenario, foreign countries, for tactical reasons, might never adopt a sourcing rule that treats this income as foreign source for purposes of granting their foreign tax credit or exclusion relief. After all, if the foreign country continues to consider it domestic source and not grant relief, the United States

justifications for the United States to tax the income, relief in these circumstances might best be achieved by expanding the U.S. treaty network to cover the affected countries.<sup>262</sup>

A final consideration involves administrative concerns. Given that most recent scholarship on administrative issues (under both internal law and treaties) focuses on the enforcement and compliance problems raised by electronic commerce, it is useful to address the relationship between the telesurgery personal services example and the general electronic commerce scenario. Although electronic commerce shares some characteristics with the telesurgery example—most notably, the reliance on modern high-speed communication to facilitate remote activity—there are several relevant differences.

Regarding government enforcement, the IRS is better positioned to enforce tax laws with respect to a foreign-based telesurgeon than with respect to a foreign person conducting other business activities over the Internet. For example, a foreign-based telesurgeon will be interacting with a U.S.-based business, such as the U.S. surgical center or a U.S. insurance company. That U.S.-based business, as a participant in the U.S. health system, is already subject to significant government non-tax regulation, and might be used to collect information and withhold payments

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would provide relief and the foreign country could retain all of the tax revenue. Once the foreign country considers the income foreign source, that country would be expected to provide relief, thereby surrendering tax revenue. There are at least two potential ways the United States could address this concern. First, it could set a time limit on its willingness to grant relief on the theory that after a certain number of years the international consensus on sourcing telesurgery and similar personal services should change. Alternatively, it could grant the relief only to the extent that the taxpayer demonstrates that his residence country also sources inbound telesurgery based on the physical location of the surgeon. Such an approach would ensure that the residence country did not attempt to adopt an inconsistent sourcing rule solely to take advantage of the United States' willingness to provide relief. *Cf.* Treas. Reg. § 1.901-2(a)(3)(ii) (1960) (anti-“soak up” provision denying foreign tax credit when foreign tax is conditioned on availability of U.S. foreign tax credit). These provisions, however, would add significant complexity to the Code. Because they would be relevant for only limited circumstances (as described in the text), the theoretical relief they provide might not justify this added complexity.

Another possible approach would be an arbitrary source rule (e.g. 50-50) that results in the United States taxing only an arbitrary portion of the income. *Cf. supra* notes 130–133 and accompanying text (discussing the 50-50 sourcing rule for international communications and transportation income). Such an approach, however, is not grounded in firm principles and still leaves potential double taxation for the 50% subject to U.S. taxation. *See generally* BITTKER & LOKKEN, *supra* note 62, ¶ 73.4 (describing transportation services income and international communications income); Andrus, *supra* note 4, at 842–44 (discussing problems with arbitrary 50-50 allocation in international communications sourcing provision).

<sup>262</sup> *See* Shay, Fleming & Peroni, *supra* note 4, at 105 (“[C]urtailment of source taxation by the United States should occur only in the context of carefully negotiated bilateral or multilateral tax treaties.”).

to a foreign-based surgeon.<sup>263</sup> This arrangement contrasts with electronic commerce generally, where a foreign enterprise might be making sales to a broad range of U.S. customers who might not be reliable withholding agents.<sup>264</sup> Moreover, the telesurgery scenario involves relatively large payments for discrete activities. In contrast, electronic commerce sales often involve a more significant number of small purchases.

Professor Larry Lokken notes that the basic function of the “trade or business within the United States [threshold] is to limit the effectively connected income tax to foreign persons having physical connections with the United States that make collection of the tax on a self-assessment basis feasible and reasonable.”<sup>265</sup> He concludes that “[i]n the case of services, this physical connection exists only if human beings located in the United States are primary actors in the performance of the services.”<sup>266</sup> Although the service provider’s physical presence in the United States might make enforcement easier, particularly if the service provider spends significant time in the United States and has property in the United States, the telesurgeon’s physical absence does not necessarily preclude enforcement. Rather, if enforcement depends primarily on withholding at source (as suggested above), the critical factor is the withholding agent’s, not the service provider’s, presence in the United States.<sup>267</sup>

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<sup>263</sup> The existing Code and regulation provisions generally require thirty percent withholding on personal services income paid to a nonresident alien individual. See I.R.C. § 1441(a) (2006). Although income effectively connected to a U.S. trade or business generally is exempted from these withholding requirements, this exception does not apply to an individual working as an independent contractor (unless the individual is a resident of Mexico or Canada or is eligible for treaty benefits). See *id.* § 1441(c)(1) (denying effectively connected income exception to personal services income); Treas. Reg. § 1.1441-4(b) (as amended in 2000) (listing inapplicable withholding exceptions).

<sup>264</sup> See OECD TAG Report, *supra* note 4, at 53, ¶ 262 (“Experience with consumption taxes has shown that private consumers are not a practical collection point. Thus, the option must, for practical reasons, be restricted to payments made between enterprises.”); Shay, Fleming & Peroni, *supra* note 4, at 87 (“[E]nforcement of net-basis taxation at source on a remote seller (of goods, intangibles, or services) without a direct physical presence is extremely difficult in the absence of a treaty.”).

<sup>265</sup> Lokken, *supra* note 60, at 61.

<sup>266</sup> *Id.*

<sup>267</sup> Cf. OECD Model Treaty, *supra* note 50, art. 16 (allowing a country to tax directors’ fees paid by a resident corporation, even if the recipient director did not physically perform any services in that country). But see 2006 MODEL TECHNICAL EXPLANATION, *supra* note 53, art. 15 (noting that the United States entered a reservation with respect to this provision of the OECD Model, and that the U.S. Model Treaty only allows source-country taxation of directors’ fees to the extent the director performed services in that country).

The use of withholding to enforce a net-basis tax sometimes raises additional practical concerns.<sup>268</sup> For example, withholding is typically done based on the gross amount of the payment because the withholding agent generally does not have information about the taxpayer's deductions. Given that business income (including telesurgeons' fees) are taxed on a net basis, this gross-basis withholding might result in too much being withheld. Although this concern is particularly troublesome for businesses that have significant expenses and operate on thin profit margins, it might be of less concern for a foreign-based telesurgeon who has limited deductions attributable to the services fee from the inbound telesurgery. Alternatively, gross-basis withholding sometimes results in too little tax being withheld. Although a foreign taxpayer often has little incentive to file a return and pay the extra tax not covered by withholding, the unique aspects of telesurgery will aid enforcement. A foreign-based surgeon, to the extent he is subject to U.S.-based licensing requirements,<sup>269</sup> might have a strong incentive to comply with tax requirements, particularly if tax compliance is relevant to maintaining those licenses.<sup>270</sup>

A significant difference also exists between electronic commerce and telesurgery services with respect to taxpayers' compliance concerns. As discussed above, an important concern with electronic commerce is that a nonresident enterprise might be involuntarily pulled into dozens of taxing jurisdictions by reason of customers using its website.<sup>271</sup> In contrast, in the case of the foreign-based telesurgeon, there is purposeful availment of the U.S. market.<sup>272</sup> The surgeon voluntarily and knowingly

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<sup>268</sup> See OECD TAG Report, *supra* note 4, at 68–69, ¶ 336 (noting administrative and compliance problems with non-final withholding tax).

<sup>269</sup> See *supra* note 75 and accompanying text.

<sup>270</sup> See generally U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-569, TAX COMPLIANCE: OPPORTUNITIES EXIST TO IMPROVE TAX COMPLIANCE OF APPLICANTS FOR STATE BUSINESS LICENSES 19-20 (2009) (suggesting that tax compliance might be improved by conditioning state business licenses on proof of compliance with federal tax obligations).

<sup>271</sup> See *supra* note 245 and accompanying text. This concern is implicit in the OECD Commentary, which makes clear that the mere availability of a website in a country does not create a permanent establishment. See OECD Commentary, *supra* note 50, art. 5, ¶¶ 42.2–3. See generally *supra* notes 174–178 (explaining that the computer server itself, if owned or leased by the foreign enterprise, can constitute a permanent establishment).

<sup>272</sup> Cf. *Quill Corp. v. North Dakota*, 504 U.S. 298, 307 (1992) (for purposes of U.S. state taxation, “if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State’s *in personam* jurisdiction even if it has no physical presence in the State”). The use of the “purposefully avails” language in the text is not meant to imply that such a standard is constitutionally necessary to establish U.S. taxing jurisdiction over a foreign person who does not satisfy this standard (e.g., a foreign person conducting sales over the Internet), an issue that this Article does

chooses to perform the telesurgery on a U.S.-based patient; indeed, the surgeon might have had to exert significant effort to obtain a U.S. license and otherwise facilitate the procedure. Thus, although U.S. taxation of the foreign-based surgeon might create some compliance burdens for the taxpayer, they are of a significantly lesser magnitude than those underlying many electronic commerce discussions.

Thus, administrative concerns, though important, do not necessarily preclude the taxation of inbound telesurgery income. Moreover, many of these concerns could be mitigated by significantly expanding the current, ineffective de minimis rules that apply to income from personal services.<sup>273</sup> Numerous other commentators have advocated an increase in the de minimis threshold above the existing \$3000 threshold, which dates back to 1936.<sup>274</sup> As Professor Christopher Hanna observed, if that original \$3000 had been adjusted for inflation, the threshold would be dramatically higher today.<sup>275</sup> Professor Hanna recommended that the threshold be increased to \$25,000.<sup>276</sup> Professor Lokken has suggested increasing the threshold to \$20,000, and thereafter adjusting it for inflation.<sup>277</sup> Regardless of the precise increased threshold that is adopted, the IRS and taxpayers could focus enforcement and compliance on situations that warrant such efforts by treating a foreign person as engaged in a U.S. trade or business only if a relatively significant amount of personal services income is earned.<sup>278</sup>

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not address. See Anthony P. Polito, *Trade or Business Within the United States as an Interpretive Problem Under the Internal Revenue Code: Five Propositions*, 4 HASTINGS BUS. L.J. 251, 268 n.101 (2008) (discussing “purposefully avails itself” standard in context of international taxation). The standard is mentioned here, in contrast, to illustrate the difference between the telesurgery scenario and electronic commerce generally.

<sup>273</sup> See *supra* note 89 (describing limited usefulness of existing de minimis rule).

<sup>274</sup> See Christopher H. Hanna, *Some Modest Simplification Proposals for Inbound Transactions*, 56 S.M.U. L. REV. 377, 378–81 (2003).

<sup>275</sup> Professor Hanna, writing in 2003, calculated that \$3000 indexed for inflation from 1936 to 2002 would equal approximately \$39,000 in 2002. *Id.* at 380–81. That amount would have increased to over \$47,000 in 2010. See Bureau of Labor Stats., *Inflation Calculator*, U.S. DEPARTMENT OF LAB., <http://data.bls.gov/cgi-bin/cpicalc.pl> (last visited Aug. 21, 2010).

<sup>276</sup> See Hanna, *supra* note 274, at 380–81; see also ALI INTERNATIONAL TAX PROJECT, *supra* note 18, at 99–100 (recommending that the de minimis threshold for personal services income be increased to \$50,000 if the service provider is physically present for fewer than 90 days during a twelve-month period, or \$5000 if the provider is physically present for such a period); Shay, Fleming & Peroni, *supra* note 4, at 140–41 (suggesting a possible \$25,000 de minimis rule in the substantive tax provisions).

<sup>277</sup> See Lokken, *supra* note 60, at 72.

<sup>278</sup> This discussion has focused on the threshold test in I.R.C. § 864(b) for being engaged in a U.S. trade or business. Cf. Shay, Fleming & Peroni, *supra* note 4, at 141 (“The de minimis rule is a self-imposed limitation on the jurisdiction to tax and should not be part of the source rules.”). Professor Lokken notes that a corresponding increase in the

## 2. Foreign Tax Credit

As discussed previously, the United States generally taxes its citizens and residents on their worldwide income, regardless of its source.<sup>279</sup> The United States, consistent with international norms applicable to the country exercising residence-based jurisdiction, generally mitigates double taxation by allowing a foreign tax credit. This relief is subject to certain limitations intended to ensure that the credit is allowed only to the extent necessary to offset the U.S. tax imposed on foreign source income.<sup>280</sup> Accordingly, the source of income plays a significant role in the outbound context.

The earlier analysis identified a potential taxpayer concern with the existing sourcing rules in the context of outbound telesurgery performed by a U.S.-based surgeon on a foreign-based patient.<sup>281</sup> Because those rules focus on the physical location of the surgeon, the United States currently would consider this income to be from U.S. sources, thereby preventing the U.S. surgeon from claiming a foreign tax credit and potentially subjecting the income to double taxation.<sup>282</sup> Given the prior subpart's suggestion that the inbound sourcing rules should be changed to focus on the patient's location, it might be tempting to conclude that the outbound sourcing rules should likewise be changed to focus on the patient's location. It is important to consider, however, how such a change would impact the policy goals underlying the outbound taxation regime. As noted above, this purposive approach to the sourcing rules might justify different rules in the inbound and outbound contexts.<sup>283</sup> In particular, as Professors Shay, Fleming, and Peroni observed, "the source rules in the outbound context should treat a U.S. person's income items as derived from a foreign source only in situations where double taxation relief with respect to such income items is appropriate."<sup>284</sup>

Under currently prevailing source rules, it is unlikely that double taxation would occur when a U.S.-based surgeon performs telesurgery

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threshold amount under the I.R.C. § 861(a)(3) source rules would extend the exemption to the withholding-at-source provisions. See Lokken, *supra* note 60, at 72.

<sup>279</sup> See *supra* notes 19–22 and accompanying text.

<sup>280</sup> See *supra* notes 30–36 and accompanying text.

<sup>281</sup> See *supra* notes 133–135 and accompanying text.

<sup>282</sup> This example assumes that the surgeon has no other potentially foreign sourced income. The possibility that he has other foreign income is addressed *infra* notes 286–290 and accompanying text.

<sup>283</sup> See *supra* notes 212–214 and accompanying text.

<sup>284</sup> Shay, Fleming & Peroni, *supra* note 4, at 147.

on a foreign-based patient, regardless of the U.S. source rules. Because most countries currently source personal services income based on the location of the service provider, the foreign country probably would view this income as foreign source (from its perspective) because the surgeon is located in the United States. As a result, the foreign country would be unlikely to exercise source-based taxation on the U.S. surgeon's income even though the patient is in that country.

In contrast, double taxation might arise if the foreign country applied a source rule that focused on the location of the patient and therefore imposed source-based tax on the telesurgery income. Under such circumstances, the willingness of the United States to allow a foreign tax credit (by treating the income as foreign source) may depend on the perceived legitimacy of the foreign country's exercise of source-based taxation. If the United States retains its current focus on the location of the service provider in the inbound context, then the foreign country's exercise of source-based taxation would be inappropriate from the United States' perspective, and the United States should not be expected to unilaterally provide relief. Instead, problems arising from the countries' inconsistent source rules might be alleviated by treaty.<sup>285</sup> If, however, the United States adopts the inbound source rule suggested above and treats a foreign surgeon's inbound telesurgery income as taxable U.S. source income, the United States should respect the foreign country's exercise of similar source-based jurisdiction in the outbound scenario.

The preceding paragraphs considered the foreign country's treatment of the income in isolation. In actual practice, though, the U.S. foreign tax credit limitation is not applied on a transaction-by-transaction (or a country-by-country) basis.<sup>286</sup> Instead, foreign tax credit limitations apply in the aggregate to two broad categories of income.<sup>287</sup> Even if a foreign country does not tax the U.S. surgeon's telesurgery income (thereby eliminating the need for double taxation relief with respect to that particular income), the U.S. source rules will be relevant if the surgeon also paid foreign taxes on other business in-

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<sup>285</sup> See *supra* note 218.

<sup>286</sup> Shay, Fleming & Peroni, *supra* note 4, at 150 (“[I]t is theoretically possible to analyze double taxation relief on a transaction-by-transaction basis, . . . [but] the item-by-item approach to applying the foreign tax credit limitation has been rejected as impractical.”).

<sup>287</sup> See I.R.C. § 904(d)(1) (2006) (applying limitations separately with respect to “passive category income” and “general category income”). Income from personal services, including the telesurgery fee, would be general category income, the same classification that applies to most business income. See *id.* § 904(d)(2).

come, as they may affect the taxpayer's foreign tax credit limitation for those other foreign taxes. In particular, if the telesurgery income is treated as foreign source it might allow the U.S. surgeon to claim a higher foreign tax credit than he otherwise would have received.<sup>288</sup> In other contexts,<sup>289</sup> commentators have advocated the use of a minimum-level-of-tax requirement to prevent manipulation of the foreign tax credit limitation.<sup>290</sup> As a practical matter, it is doubtful that outbound telesurgery would be a useful method for manipulating the foreign tax credit limitation to increase the creditability of foreign taxes paid on other foreign business income. Thus, the use of a minimum-level-of-tax requirement in this context is less important.

Accordingly, outbound telesurgery income should be treated as foreign source for purposes of the foreign tax credit only if the United States has changed the inbound source rules to focus on the location of the patient, rather than the location of the surgeon, to legitimize (from a U.S. perspective) the foreign country's imposition of source-based taxation in the reciprocal outbound scenario.<sup>291</sup> Until that happens, income from outbound telesurgery will continue to be treated as U.S. source income (due to the current law's focus on the location of the surgeon), thereby limiting the availability of a foreign tax credit. As a practical matter, it is unlikely that the United States would make these changes in its sourcing rules until inbound telesurgery (or similar cross-border personal services) becomes significant relative to outbound transactions.<sup>292</sup> In the meantime, taxpayers could obtain partial relief

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<sup>288</sup> More specifically, if the telesurgery income were treated as foreign source, it would increase the numerator of the limitation ratio in the "general category income" basket. *See id.* § 904(a), (d). If the other foreign business income were subject to a rate of tax that was higher than the U.S. rate, this foreign source treatment of the telesurgery income might provide an unwarranted tax benefit for the surgeon—i.e., allowing a foreign tax credit in excess of the amount necessary to alleviate the double taxation on the other foreign business income.

<sup>289</sup> These concerns regarding "cross crediting" of untaxed foreign source income typically arise in the context of income other than an individual's personal services income, such as income from investments or inventory property sales.

<sup>290</sup> *See* Shay, Fleming & Peroni, *supra* note 4, at 150 (noting that the subject-to-tax condition for providing double tax relief is not novel under either foreign countries' laws or the Code itself, and recommending a minimum foreign tax greater than ten percent as a condition for treating any type of income as foreign source for purposes of the foreign tax credit).

<sup>291</sup> If, after a change in the U.S. sourcing rules, there is credible concern that outbound telesurgery is used to manipulate the foreign tax credit limitations, a subject-to-minimum-tax condition could be added.

<sup>292</sup> *See supra* notes 69–78 (hypothesizing about the possible short-term and long-term development of cross-border telesurgery services).

from double taxation by claiming the foreign tax as a deduction,<sup>293</sup> rather than as a credit.

A final scenario involves a U.S. citizen surgeon living abroad who performs telesurgery on a U.S.-based patient.<sup>294</sup> The United States generally taxes the worldwide income of its citizens abroad, subject to the foreign earned income exclusion discussed below. Additionally, the foreign country could exercise residence-based taxation over the U.S. citizen living there. In this situation, an issue arises as to which country should grant relief from double taxation through a foreign tax credit.<sup>295</sup> Under the existing source rules which focus on the location of the service provider, both the United States and the foreign country would treat the income as sourced in the foreign country. This result, which would increase the availability of a U.S. foreign tax credit, appears appropriate.<sup>296</sup> Double taxation is likely to exist and, in the reciprocal case of a U.S.-based surgeon performing telesurgery on a foreign-based patient, current law would treat that income as U.S. source, thereby hampering the availability of a U.S. foreign tax credit.

The earlier analysis recommended that, once the United States changes its inbound tax regime to tax a foreign-based surgeon's inbound telesurgery income as U.S. source, it should make a corresponding change to the outbound sourcing rules. Specifically, for purposes of a U.S. surgeon's foreign tax credit limitation, the United States should source income based on the location of the patient (at least in the absence of evidence of foreign tax credit limit manipulation). In the case of a U.S. citizen surgeon living abroad and performing telesurgery on a U.S.-based patient, such a change might create a double-taxation prob-

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<sup>293</sup> See I.R.C. § 164(a)(3) (allowing a deduction for foreign income taxes if the foreign tax credit is not claimed). Whereas a credit provides a dollar-for-dollar benefit, a deduction only provides a benefit equal to the amount of the deduction multiplied by the taxpayer's marginal tax rate.

<sup>294</sup> As discussed below, a U.S. citizen living abroad might elect the foreign earned income exclusion for telesurgery income arising from U.S.-situated patients. The analysis below, however, recommends changes to the foreign earned income exclusion that would preclude its use in these circumstances. Such changes would place additional importance on the foreign tax credit provisions for U.S. citizen surgeons abroad.

<sup>295</sup> This is similar to the issue that arises in the inbound context, *see supra* notes 255–262 and accompanying text, with the added complication that the United States is exercising residence- or citizenship-based jurisdiction rather than merely potential source-based jurisdiction.

<sup>296</sup> Indeed, most countries would consider the United States to be the country that is overextending its taxing jurisdiction by imposing citizenship-based tax. *See Kirsch, supra* note 20, at 448–49, 469 (discussing United States' unique status in exercising citizenship-based taxation).

lem similar to the one noted in the inbound tax regime analysis.<sup>297</sup> In particular, the United States would not provide foreign tax credit relief because, under this new approach, the surgeon would have U.S. source income. If the foreign country retained the traditional focus on the location of the service provider, it also would not provide relief because it would consider the income to be sourced in that country.<sup>298</sup>

As noted in the discussion of the inbound tax regime, an argument can be made that the United States should grant unilateral relief in these circumstances.<sup>299</sup> By moving beyond the more traditional focus on the service provider's physical location, the United States would be departing from the source rule that most countries currently apply. Accordingly, it could consider providing relief, at least for a limited time,<sup>300</sup> to U.S. citizen surgeons who reside in countries that apply a place-of-the-service-provider standard for determining source.<sup>301</sup> To prevent abuse, the re-sourcing should apply only if the taxpayer establishes that the foreign country actually imposed tax on that income. Otherwise, the possibility exists that the taxpayer would double-dip, attempting to claim a U.S. foreign tax credit under this re-sourcing rule even if the other country gave the taxpayer a foreign tax credit because, for example, it considered the income to be sourced at the location of the (U.S.) patient.<sup>302</sup> The argument for such relief is weaker in this context than in the inbound context, however, because the taxpayer is

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<sup>297</sup> See *supra* note 261.

<sup>298</sup> If the foreign country adopted the patient-location approach to sourcing, it would treat the income as foreign source and presumably provide relief.

<sup>299</sup> See *supra* note 261 (making this same argument in the context of a foreign person performing telesurgery on a U.S.-based patient).

<sup>300</sup> See *supra* note 261 (suggesting the possibility of a time limit for relief to give other countries the opportunity to modify their sourcing rules to address technological developments, such as telesurgery).

<sup>301</sup> As noted above, to prevent the other country from taking advantage of the United States' willingness to provide relief, this relief should be conditioned on the foreign country not applying a "location of the patient" source standard in its inbound regime.

<sup>302</sup> In the more typical foreign tax credit scenario discussed previously, where the U.S. citizen surgeon resides in the United States, a failure to apply an item-by-item approach to the foreign tax credit limitation would only risk the possibility that outbound telesurgery income that is untaxed by the foreign country might provide benefits with respect to other foreign income of the taxpayer. See *supra* notes 286–290 and accompanying text (suggesting that potential abuse in that context is limited). In the present scenario, however, the U.S. citizen, because he lives abroad, is likely to have significant other foreign tax liabilities.

a U.S. citizen subject to residence-like jurisdiction in addition to source-based jurisdiction.<sup>303</sup>

Given these considerations, and the administrative complexities that would be added by a special re-sourcing rule for foreign based U.S.-citizen surgeons who perform telesurgery on U.S.-based patients, such a targeted provision does not seem justified. Although the potential double taxation could be addressed by treaty, this scenario would not fit within the standard re-sourcing provision of the U.S. Model Treaty.<sup>304</sup>

### 3. Foreign Earned Income Exclusion

As the foregoing analysis demonstrates, the taxation of a foreign person's business income and the availability of a foreign tax credit for a U.S. person implicate important tax policy goals. Determining the appropriate sourcing rules in each area requires a detailed consideration and balancing of these goals. In contrast, a purposive analysis of the appropriate sourcing rules for the foreign earned income exclusion involves significantly fewer tradeoffs and points to a very restrictive definition of foreign earned income. In the context of telesurgery, a purposive analysis strongly suggests that a U.S. citizen surgeon living abroad should not be able to treat income from telesurgery performed on a U.S.-based patient as foreign earned income that is eligible for the exclusion, despite the surgeon's physical location in the foreign country.

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<sup>303</sup> Even so, a reasonable argument can be made that the United States should provide relief, given that residence-based jurisdiction exercised by the actual country of residence might have a stronger claim than residence-like jurisdiction exercised based on citizenship.

<sup>304</sup> Under Article 23(3) of the 2006 U.S. Model Treaty, the United States agrees to re-source (as foreign) the income of a U.S. resident that the treaty permits the foreign country to tax. 2006 U.S. Model Treaty, *supra* note 50, art. 23(3). This provision would not apply to a U.S. citizen living abroad, as he would not be a U.S. resident under the treaty. If a reciprocal provision applied to the foreign country, it would require the foreign source country to re-source (and thereby provide relief) to the extent the treaty permits the United States to tax the income. Consider a situation where the substantive provisions of the treaty did not permit the United States to tax the income (because, for example, the income was not attributable to a permanent establishment), but the United States nonetheless was allowed to tax the surgeon under the saving clause, which allows the United States to tax its citizens as if the treaty did not exist. *See id.* art. 1(4). It is highly unlikely that the foreign country would re-source the income for purposes of its foreign tax credit based on U.S. taxation under the saving clause, rather than under a substantive provision of the treaty that gave the U.S. source-based taxing rights. *See* 2006 MODEL TECHNICAL EXPLANATION, *supra* note 53, art. 23 (stating that the residence country is required to re-source when the treaty "assigns to the other Contracting State primary taxing rights over an item of gross income").

It is important to note that the foreign earned income exclusion is not necessary to relieve double taxation. Indeed, the imposition (or nonimposition) of tax by the foreign country in which the U.S. citizen resides is not relevant to the citizen's eligibility for the exclusion.<sup>305</sup> The provision allows a U.S. citizen living abroad to exclude a significant amount of foreign earned income from U.S. tax,<sup>306</sup> even if that income is not subject to any foreign tax.<sup>307</sup> As a practical matter, the foreign earned income exclusion is most important for U.S. citizens living in foreign jurisdictions that do not impose income tax, as it enables those citizens to earn income free of any income tax.<sup>308</sup> It is significantly less important for citizens living in foreign jurisdictions that impose an income tax, as the foreign tax credit generally is available to alleviate any double taxation that such individuals would otherwise experience.<sup>309</sup> Supporters of the foreign earned income exclusion offer numerous other reasons for the provision, including efficiency arguments concerning the competitiveness of U.S. businesses operating abroad, equity arguments associated with the cost of living abroad, and administrative arguments related to the complexity of the foreign tax credit provisions.<sup>310</sup>

For the purposes of this Article, however, the critical question is whether the income of a U.S. citizen surgeon residing abroad and performing telesurgery on a U.S.-based patient should be treated as foreign source, thereby enabling the surgeon to claim the foreign earned income exclusion. As explained above, under current law the surgeon has a strong argument for entitlement to the exclusion because that

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<sup>305</sup> A minor caveat is that if the taxpayer avoids tax in the foreign country by submitting a statement to the foreign tax authorities that he is not a resident of that country, he cannot qualify for the foreign earned income exclusion using the "bona fide resident" test. See I.R.C. § 911(d)(5) (2006). Nonetheless, he can still qualify for the exclusion under a physical presence test.

<sup>306</sup> See *supra* note 138 accompanying text.

<sup>307</sup> For example, if a U.S. citizen residing in Saudi Arabia earns \$150,000 from his job there, he can exclude approximately \$110,000 of that from his U.S. tax base. See *id.*

<sup>308</sup> See Kirsch, *supra* note 20, at 503–04.

<sup>309</sup> See *id.* at 462 n.90 ("Those citizens living in high-tax jurisdictions, such as much of Europe, do not rely as heavily on the foreign earned income exclusion because the U.S. foreign tax credit eliminates much or all of their U.S. tax liability."); see also *id.* at 504–05. The foreign earned income exclusion can provide some ancillary benefits to the individuals compared to the foreign tax credit. For example, it can simplify compliance by eliminating the need to calculate foreign tax credit limitations, and can provide relief when inconsistencies in countries' source rules might limit the foreign tax credit. See *id.* at 481 n.159.

<sup>310</sup> The author has criticized these arguments in other scholarship. See *id.* at 503–29.

income is “foreign earned income” based on the surgeon’s physical location.<sup>311</sup>

This result cannot be justified, even assuming the legitimacy of the arguments frequently made in support of the foreign earned income exclusion. Supporters of the exclusion claim that the provision, by mitigating the tax burden imposed on citizens abroad, helps those citizens (and the U.S. multinational corporations that employ them) compete abroad and thereby provides indirect benefits to the U.S. economy. Regardless of whether this argument is valid in the typical scenario when the citizen abroad is performing activities that directly compete against foreign persons in the foreign country, it is not valid when, as here, the U.S. citizen surgeon is performing inbound telesurgery services that directly impact the U.S. health market. By providing a tax advantage, the exclusion is merely helping that foreign-based U.S. surgeon compete against U.S.-based surgeons. There is no legitimate reason for the tax code to subsidize this activity because such a subsidy undermines workers in the United States (the exact opposite of the purported purpose for the foreign earned income exclusion).<sup>312</sup> Indeed, the current law’s focus on the service provider’s physical location creates a strong incentive for U.S. citizen surgeons to relocate and operate from offshore, particularly if proponents of the foreign earned income exclusion are successful in expanding the excludable amount.<sup>313</sup> Once technology permits, it would not be surprising if a significant number of U.S. citizens relocate offshore to earn tax-free telesurgery income, especially if they already have U.S. state medical licenses that permit such activity.

In addition to violating the efficiency criterion, this disparate treatment raises significant fairness concerns. The U.S. surgeon living in the United States and the U.S. citizen surgeon living abroad are similarly situated to the extent each is earning income from surgery (or

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<sup>311</sup> See *supra* notes 142–148 and accompanying text.

<sup>312</sup> Cf. Kirsch, *supra* note 20, at 518 (noting that the foreign earned income exclusion might promote foreign manufacturing activities that displace U.S. manufacturing activities).

<sup>313</sup> See *id.* at 490–91, 509 (discussing the impact of tax incentives on a U.S. citizen’s decision to move abroad, and observing that the foreign earned income exclusion might encourage such a move “only if [the] taxpayer is able to work effectively outside the United States”); Cf. Press Release, Titan Med. Inc., *supra* note 11 (claiming that “[i]n day-to-day applications,” the company’s commercial telesurgery system “will likely be [used from] proximate offshore locations”).

telesurgery) on U.S. patients.<sup>314</sup> Yet the foreign earned income exclusion, to the extent it focuses on the physical location of the surgeon, would treat the foreign-based surgeon much more favorably than the U.S.-based surgeon.<sup>315</sup> This fairness disparity might also have significant secondary effects on U.S.-based taxpayers' willingness to comply with the tax law.<sup>316</sup>

Finally, administrative-based arguments do not support the foreign earned income exclusion in this context. Although the exclusion might be a simpler way to prevent double taxation in circumstances where the foreign tax credit would otherwise be used, the foreign earned income exclusion frequently applies when no foreign tax credit is necessary or appropriate (because the foreign country might not impose tax).<sup>317</sup> Moreover, even in those circumstances where the foreign country imposes tax on a foreign-based U.S. citizen performing telesurgery on a U.S.-based patient, the prior subpart illustrates that significant complications arise in determining the proper extent to which the United States should relieve double taxation through a foreign tax credit.<sup>318</sup> Given the complex balancing of competing concerns arising in that foreign tax credit analysis, it is hardly an answer to conclude that, because of these difficulties, all of the underlying income should be excluded, particularly when that income might not be subject to any foreign income tax. Doing so would focus on administrative simplicity to the complete exclusion of efficiency and fairness concerns.

In summary, the rules for determining the source of personal services income for purposes of the foreign earned income exclusion should be changed. In particular, in circumstances like inbound telesurgery, where the services have an immediate and direct impact on the United States, those services should not be considered "foreign," even if the taxpayer-surgeon is physically located in a foreign country. This recommendation further reflects the importance of a purposive interpretation of sourcing rules so that they further the policy goals underlying the relevant substantive tax provision.

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<sup>314</sup> See *supra* note 252 and accompanying text (discussing similar circumstances of U.S.-based surgeon and foreign-based surgeon performing inbound telesurgery).

<sup>315</sup> This could also violate vertical equity, to the extent that the exclusion causes a high economic income foreign-based U.S. citizen surgeon to have a lower gross income than a low economic income U.S.-based taxpayer. See Kirsch, *supra* note 20, at 480–84 (arguing that U.S. citizens abroad and in the United States are part of the same community for purposes of vertical equity ability-to-pay analysis).

<sup>316</sup> See *supra* notes 224–228 and accompanying text.

<sup>317</sup> See *supra* notes 305–309 and accompanying text.

<sup>318</sup> See *supra* notes 294–304 and accompanying text.

This change in the sourcing rules might be effected by amending the section 911 regulations rather than by modifying the Code. As discussed previously, the Code defines “foreign earned income” as compensation for personal services that is “from sources within a foreign country or countries.”<sup>319</sup> The Code itself does not define the source in this context. Rather, the regulations refer to income “attributable to *services performed . . . in a foreign country*,”<sup>320</sup> thereby invoking language similar to the general personal services sourcing rules that apply for purposes of inbound and outbound taxation. It is this regulation language, along with other geographically focused language in the regulations,<sup>321</sup> that led to the earlier conclusion that the current section 911 rules look to the physical location of the service provider to determine whether earned income is “foreign.”<sup>322</sup> These regulations should be amended to change that result in the case of inbound telesurgery (and similar inbound services, as discussed in more detail in Part IV).

#### IV. BROADER IMPLICATIONS

##### A. *U.S. Internal Law—Beyond the Telesurgery Example*

The preceding Part used the telesurgery example to suggest changes to the traditional place of performance rule for sourcing income from the performance of personal services. In particular, it questioned the exclusive focus on the physical location of the service provider in three substantive tax areas where the source of personal services income is critical to determining tax consequences. As mentioned initially, the telesurgery example provides perhaps the purest example of cross-border personal services, and therefore provides a useful context in which to analyze the core issues raised by the current law’s focus on physical presence.<sup>323</sup>

This Part briefly considers the implications of these suggestions in situations beyond the telesurgery example. As summarized earlier,<sup>324</sup> these other services range from activities that are closely analogous to telesurgery, such as diagnostic telemedicine, to those that are less so, most notably the Amazon Mechanical Turk global services market-

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<sup>319</sup> I.R.C. § 911(b)(1), (d)(2) (2006).

<sup>320</sup> Treas. Reg. § 1.911-3(a) (1960) (emphasis added).

<sup>321</sup> See Treas. Reg. § 1.911-2(g) (defining United States), 1.911-2(h) (defining foreign country); see also *supra* note 143.

<sup>322</sup> See *supra* notes 142–148 and accompanying text.

<sup>323</sup> See *supra* note 69 and accompanying text.

<sup>324</sup> See *supra* notes 79–86 and accompanying text.

place.<sup>325</sup> Rather than examine the specific application of the foregoing criteria to each scenario, the analysis focuses on the relevant similarities and differences from the telesurgery example and draws general conclusions regarding their effect on the proposed changes to U.S. internal tax regimes. Part IV.B does the same regarding the OECD Model Treaty.

As discussed above, the foreign earned income exclusion provides the strongest context for modifying the source rules for personal services income. The foreign earned income exclusion is not necessary to mitigate double taxation, and, as illustrated in the telesurgery example, it would provide an unwarranted subsidy to foreign-based U.S. citizens who compete directly against U.S.-based citizens in the U.S. market. In addition to undermining the purported purpose of the foreign earned income exclusion, this result raises efficiency and fairness concerns that significantly outweigh any purported administrative benefits.<sup>326</sup>

Beyond telesurgery, these same arguments apply in any situation where the foreign-based U.S. citizen performs services that purposefully and directly impact the relevant U.S. market. Pertinent examples include a foreign-based U.S. citizen physician who diagnoses or otherwise treats a U.S.-based patient, a foreign-based U.S. citizen attorney who provides legal services for a U.S.-based client, or a U.S. citizen consultant who provides advice to a U.S.-based company. In each of these scenarios, the exclusion for U.S.-directed services of a foreign-based citizen would fail to advance the purported policy goals of the foreign earned income exclusion and, instead, would generate significant efficiency and fairness problems.<sup>327</sup>

Accordingly, the foreign earned income exclusion should be modified so that no exclusion is permitted if the foreign-based U.S. citizen is

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<sup>325</sup> The Amazon Mechanical Turk website provides information for workers regarding their potential tax liability from their income. See *AMAZON MECHANICAL TURK*, *supra* note 85. The site focuses on the U.S. tax liability of U.S.-based workers, treating U.S.-based workers as independent contractors for the person who requested the work performance. According to the site, Amazon furnishes the U.S. worker's social security number (or other relevant identification number) to the person who requested the performance once the worker's annual compensation from that requester reaches \$600, thereby enabling the requester to furnish the U.S. worker with a Form 1099. The website makes clear that no information reporting is done for foreign-based workers and implies that foreign-based workers have no U.S. tax obligations, presumably on the theory that the foreign workers are not engaged in a U.S. trade or business when they are matched with, and perform services for, a U.S. requester. Instead, the website recommends that foreign-based workers check with their own country's tax authorities.

<sup>326</sup> These arguments are discussed *supra* notes 312–318 and accompanying text.

<sup>327</sup> See *supra* notes 310–318 and accompanying text (discussing purported policy goals of the foreign earned income exclusion).

providing services that have a direct and purposeful impact on the United States. Admittedly, there might be some administrative line-drawing issues in determining how direct the impact need be before it is no longer considered foreign source earned income. For example, a U.S.-citizen consultant located in London and providing advice to a British company regarding a potential expansion by the company into the United States could be viewed as impacting the U.S. market for consulting advice (and potentially displacing a U.S.-based consultant who otherwise might have given the advice). On the other hand, the client itself is a foreign corporation that has not yet entered the U.S. market.

Regardless of the precise factors that are adopted to draw this line, the purpose of this discussion is to demonstrate that the foreign earned income exclusion's current focus on the physical location of the service provider is inappropriate. The Treasury Regulations must be modified to ensure that foreign-based citizens are not able to exclude income earned from services (including many activities that, unlike telesurgery, are currently in widespread practice) that have a direct and purposeful impact on the United States.

The recommendations arising from the telesurgery example also have broader implications for the inbound taxation of nonresident aliens. As discussed above, a strong normative case exists for treating a foreign-based nonresident alien surgeon's fee from inbound telesurgery as U.S. source, and therefore taxing it as income effectively connected to a U.S. trade or business. Given the current nascent state of this technology, there is no immediate need to change U.S. tax law to address the taxation of cross-border telesurgery. Nevertheless, the telesurgery analysis, by demonstrating the importance of de-emphasizing the service provider's physical location, has significant relevance for personal services taking place today.

In general, the same fairness and efficiency-based arguments that justified taxing the foreign-based telesurgeon would apply to other foreign-based nonresident alien service providers who perform personal services for clients or other persons located in the United States. This would be most obvious in the case of foreign-based radiologists and other physicians, whose services clearly displace services that otherwise would be performed in the U.S. market by U.S.-based physicians.<sup>328</sup>

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<sup>328</sup> This argument is strongest to the extent that the foreign-based provider is required to have a U.S.-based license for his activities. A slightly less direct, but nonetheless relatively objective, standard could focus on foreign service providers performing work at the direction of, or for ultimate review by, a U.S.-based person whose activities require a U.S. license (e.g., foreign-based attorneys preparing drafts for a U.S.-based attorney).

Like telesurgery, these services would have their most detrimental efficiency impact in the case of foreign service providers based in low (or no) tax jurisdictions. A less obvious case would involve, for example, a U.S.-licensed attorney<sup>329</sup> located in London and providing advice to a British company regarding the U.S. legal implications of a potential expansion into the United States. Although an argument can be made that this attorney would impact the U.S. market for legal advice (and potentially displace a U.S.-based attorney who traditionally would have given the advice), this situation appears more tenuous than the earlier example because the client is located outside the United States and has not yet entered the U.S. market.<sup>330</sup> The Amazon Mechanical Turk service marketplace example illustrates an even more extreme circumstance because the impact on the United States of a particular task solicited via the marketplace might be even more diffused.<sup>331</sup>

Given the lack of physical presence (or any other significant U.S. connections) of the nonresident alien taxpayer, enforcement concerns may be significant. For some remote personal services, the enforcement issues are similar to those in the telesurgery example and therefore do not necessarily preclude the application of source-based taxation. In particular, if the remote personal services are performed directly for, or under the direction, of a person located in the United States, that person may facilitate information reporting and, perhaps more importantly, withholding. Examples include a U.S. hospital or insurance company paying offshore radiologists, or a U.S. law firm paying an offshore attorney for drafting or other services. In some situations, however, such as in the London-based attorney example mentioned above, a foreign-based person's personal services might impact the U.S. market even though the client is not located in the United States. In those situations, there is very little chance that the United

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<sup>329</sup> To focus on the inbound tax regime, this example assumes that the U.S.-licensed attorney is not a U.S. citizen or resident alien.

<sup>330</sup> The argument for taxation might be strengthened by the fact that the service provider is utilizing a license to practice U.S. law. In contrast, it might be weakened if the example instead involved a consultant giving advice on business conditions in the United States, as the service provider would not be subject to licensing requirements in the United States.

<sup>331</sup> To the extent that Mechanical Turk involves a large number of individuals performing relatively small, low-paying tasks requested by U.S. persons, the impact (at least with respect to each individual foreign-based worker) would be relatively small. Moreover, because of the diverse nature and relatively low pay associated with each individual task, it is unlikely that U.S.-based taxpayers would express fairness concerns, thereby limiting any potential secondary effect on compliance norms.

States could reasonably enforce or even obtain information about the transaction.

Taxpayer compliance concerns (in particular, the typical Internet-related concern about involuntarily being pulled into dozens of jurisdictions pursuant to customers using a website) are not as compelling in the case of personal services, particularly if the United States were to raise the de minimis rule to a more reasonable amount. Like telesurgery, many of the personal services discussed above involve a foreign-based service provider voluntarily and knowingly engaging with a U.S.-based patient or client, and thus there is purposeful availment of the U.S. market. Nonetheless, in some limited types of personal services, such as in the Amazon Mechanical Turk example, a service provider located outside the United States might unintentionally impact the U.S. market. A foreign-based worker might respond to a requested task without knowledge or concern as to whether the person making the request is located in the United States.<sup>332</sup> Accordingly, this situation might be more analogous to that raised by a foreign business's use of a website that is viewable by U.S. customers, and might justify an exception based on compliance concerns.<sup>333</sup>

Ultimately, in the inbound taxation of foreign-based nonresident aliens, the broad range of personal services that can exploit U.S. markets without the provider's physical presence necessitates difficult line drawing.<sup>334</sup> These lines must be drawn based on two different considerations: first, the purposefulness and immediacy of the services' impact on the U.S. market, and second, the enforceability and level of compliance that can be expected. As the foregoing analysis demonstrates, both of these considerations are strongest when the person for

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<sup>332</sup> The fact that Amazon.com, the company facilitating the matching of the worker and the requester, is a U.S.-based corporation is not relevant to the underlying equity- and efficiency-based arguments that might otherwise justify the U.S. taxation of a foreign-based worker performing services for a requester located in the United States.

<sup>333</sup> As a practical matter, a significant percentage of the amounts earned by foreign-based workers through this online services marketplace could probably be excluded from U.S. taxation if the United States enacted a more meaningful de minimis exclusion. See *supra* notes 273–278 and accompanying text. As noted earlier, Amazon.com currently facilitates reporting and compliance by U.S.-based workers. See *supra* note 325. Thus, Amazon.com might be enlisted to perform information reporting, and possibly withholding, with respect to payments (in excess of de minimis amounts) to foreign workers. Such a requirement, however, might merely create an incentive for foreign-based workers to use similar online services marketplaces run by non-U.S. companies over which the United States would not have enforcement powers.

<sup>334</sup> Of course, this line drawing creates its own enforcement and compliance problems. See Shay, Fleming & Peroni, *supra* note 4, at 131 (describing administrative difficulties regarding exceptions to withholding).

whom the services are performed is physically located in the United States. At a minimum, these considerations suggest that a foreign person performing professional-type services for a U.S.-based client should be treated as being engaged in a U.S. trade or business (if beyond an expanded de minimis amount), and the resulting income should be treated as U.S. source, despite the service provider's physical absence from the United States.

A final observation concerns personal services performed by foreign corporations. Although the focus of this Article is on "pure" personal services performed by individuals, a significant amount of cross-border personal services are performed by individuals working for corporations.<sup>335</sup> Under current law, a corporation can render personal services pursuant to the activities of its officers or employees.<sup>336</sup> More importantly, the corporation's personal services income is sourced based on where the services are physically performed, just as with the individual's income.<sup>337</sup> Thus, under current law, if a foreign corporation sends its employees to the United States to perform services for the corporation's U.S.-based clients, both the foreign employees and the foreign corporation have U.S. source personal services income arising from that physical performance in the United States.

The fairness and efficiency-based arguments that justified taxing the foreign-based individual would also apply if the services were conducted by foreign-based individuals working for a foreign corporation. Just as the above analysis justified an expanded source-based taxation of an independent India-based radiologist performing diagnostic services with respect to a U.S.-based patient, it would also apply to an India-based company that employed India-based radiologists performing these services. Thus, the arguments in the telesurgery example justify the United States taxing (on a net basis) both the foreign corporation

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<sup>335</sup> A significant amount of these services involves not only a payment for the performance of the corporation's workers, but also for the use of or access to information or other intangible property rights. *See id.* at 142 (providing example of a foreign corporation employing computer programmers in India and then selling the software to customers in the United States). *See generally supra* notes 58–66 and accompanying text (discussing both broad and narrow definitions of personal services).

<sup>336</sup> *See* Glicklich et al., *supra* note 60, at 71 (citing cases); *cf.* OECD Model Commentary, *supra* note 50, art. 5, ¶ 10 ("The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise.").

<sup>337</sup> *See* David R. Tillinghast, *The Source of E-Commerce Income Characterized as Services Income: An Every-Day Problem with No Clear Solution*, 33 TAX MGMT. INT'L J. 429, 429 (2004).

and its foreign-based employee with respect to the employee's services that have a direct and purposeful impact in the U.S. market.<sup>338</sup>

From an administrative perspective, the addition of the foreign corporation to the scenario adds another layer of enforcement and compliance complexity. Under existing law, if nonresident alien employees of a foreign corporation perform services while physically present in the United States, no withholding is required on the payment to the foreign corporation with respect to those services.<sup>339</sup> The foreign corporation, however, is required to withhold tax from the salary or wages it pays to the nonresident alien employees attributable to the personal services performed while in the United States.<sup>340</sup> Thus, the current regime primarily relies on compliance by the foreign corporation. Professors Shay, Fleming, and Peroni observe that in practice, “[w]here the U.S. contact is minimal, these requirements simply are not observed and there is no meaningful prospect of enforcement.”<sup>341</sup> For this reason, they suggest a significant expansion of the current, impractical *de minimis* provisions of the Code.<sup>342</sup>

Given the enforcement problems that currently exist when personal services taxation is limited to services performed by the foreign corporation's employees who are physically present in the United States, the enforcement problems may be even greater with respect to taxing services performed by employees who are not physically present but whose services purposefully and directly impact the United States. Consider the example of a foreign corporation providing inbound remote radiology services through its foreign-based employees. As a theoretical matter, the foreign-based employees should be taxed on com-

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<sup>338</sup> See Shay, Fleming & Peroni, *supra* note 4, at 142 (suggesting that the United States should tax a foreign corporation whose foreign-based employees perform services that create intellectual property that is sold in the United States).

<sup>339</sup> See I.R.C. § 1442(b) (2006) (no withholding required on payments to foreign corporations engaged in a U.S. trade or business); see also Treas. Reg. § 1.1441-4(a) (same). Instead, the foreign corporation is expected to file its own tax return and pay any required tax on its net income effectively connected with the U.S. trade or business. See *id.* § 1.6012-2(g).

<sup>340</sup> In general, compensation paid to the employees for personal services performed in the United States is exempt from withholding under I.R.C. § 1441. See Treas. Reg. § 1.1441-4(b)(1)(i) (as amended in 2000). Instead, the compensation is subject to withholding under the general rules applicable to employees. See *id.* § 31.3401(a)(6)-1(a) (as amended in 1999). The nonresident alien individual is expected to file a return at the end of the year that may show a tax liability less than the withheld amount (in which case a refund would be made) or more than the withheld amount (in which case the individual would be expected to pay the additional amount). See *id.* § 1.6012-1(b).

<sup>341</sup> Shay, Fleming & Peroni, *supra* note 4, at 140–41.

<sup>342</sup> See *id.* at 141 (suggesting a \$25,000 *de minimis* amount); see also *supra* note 89 and accompanying text.

pensation received from the corporation for their U.S.-directed services.<sup>343</sup> Similarly, the foreign corporation should be taxed on its net income (after a deduction for the radiologists' compensation) from these activities. If the existing enforcement regime were merely extended to this scenario, however, there might be little possibility of the foreign corporation withholding U.S. tax on its overseas payment to its foreign-based employees, and there might also be little chance of either the foreign corporation or the foreign-based employees filing U.S. tax returns and paying their U.S. tax liability.

Accordingly, the only practical method for collecting the tax would be through withholding when the U.S.-based hospital, physician or other U.S.-based person utilizing the services pays the foreign corporation. One complication of this approach would be ensuring that the United States collects only one level of tax. As a practical matter, this might best be done by focusing exclusively on the corporation, requiring only the foreign corporation (not its employees) to file a return, and allowing the corporation a deduction for relevant expenses other than the compensation paid to the foreign-based employees for their U.S.-directed services. By denying a deduction for the compensation paid to the foreign-based employees, the initial withholding by the U.S.-based payor will serve, in part, as a substitute for withholding on the compensation paid by the foreign corporation to its foreign-based employees.<sup>344</sup>

The other complication relates to the sometimes arbitrary nature of a flat-rate, gross-basis withholding regime to enforce a net-basis tax. Despite this difficulty, the United States currently imposes such a regime with respect to the disposition of a foreign person's U.S. real property interests. The United States generally requires that the buyer withhold ten percent of the sales price and that the seller subsequently file a tax return to determine the correct amount of tax.<sup>345</sup> Accordingly, some flat-rate withholding (perhaps less than thirty percent) imposed on the initial payment by the U.S. client to the foreign corporation may

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<sup>343</sup> Although the employee's compensation would be taxable on a net basis, as a practical matter employees generally have few, if any, deductions. See I.R.C. §§ 62(a)(1), 67 (treating employee expenses as a miscellaneous itemized deduction, and disallowing such deductions except to the extent that they exceed two percent of adjusted gross income).

<sup>344</sup> To prevent significant overtaxation of the foreign-based employees' income (but at the expense of added complexity), the foreign employees might be allowed to file a return and seek a refund of any overpayment of their share of the withheld tax.

<sup>345</sup> See I.R.C. § 1445. Professors Shay, Fleming, and Peroni consider the possibility of this type of withholding regime for Internet-based retail sales but dismiss it due to the impracticality of enforcement for Internet sales. See Shay, Fleming & Peroni, *supra* note 4, at 130-31.

be justifiable, particularly given the enforcement problems that would arise in the absence of withholding.

In summary, the purpose of this analysis is not to define the exact parameters by which personal services performed by foreign-based persons should be subject to U.S. source-based taxation. Rather, its point is to highlight that many such services are analogous to telesurgery, and therefore should be taxed by the United States even if the individual performing the services is not physically present in the United States. Regardless of where the line is ultimately drawn, the current standard of U.S. tax law—which focuses solely on the service provider’s physical location—will become increasingly untenable in an ever-evolving modern economy. Given the Code’s use of the terms “within” and “without” to define the source of personal services, any change to U.S. tax law in the inbound tax area would likely have to be accomplished by statute.<sup>346</sup> Because the United States’ approach to these issues might influence other countries’ treatment of cross-border personal services, the timing of any change in U.S. law might, as a practical matter, partially depend on whether Congress views the United States as a net importer or a net exporter of such services.

### B. *Tax Treaties*

The principal focus of this Article is the appropriate U.S. internal tax law treatment of cross-border personal services performed by persons who are not physically present in the United States. The preceding analysis suggested that the United States expand its source-based provisions to this cross-border personal services income in certain circumstances. Because the United States often surrenders source-based taxing jurisdiction reciprocally pursuant to tax treaties, the above recommendations would primarily affect individuals residing in non-treaty countries.

This Section briefly considers possible arguments for changing the treatment of these cross-border personal services under the OECD

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<sup>346</sup> This statutory change might make clear that income from personal services performed by a nonresident alien outside the United States that has a direct and purposeful impact on the United States generally is treated as U.S. source income (and constitutes a U.S. trade or business, subject to expanded de minimis rules). It could then provide for regulations to delineate services that have a direct and purposeful impact, with particular attention given to enforcement and compliance concerns. Cf. *supra* notes 319–322 and accompanying text (concluding that, for purposes of the foreign earned income exclusion rather than the inbound tax regime, the recommended sourcing changes might be effected by regulation).

Model Treaty, upon which most tax treaties of the United States and other countries are based. The analysis in Part II, *supra*, concluded that under the existing OECD Model Treaty, the United States can tax the inbound telesurgery income of a surgeon resident in the other treaty country only if the foreign surgeon owns or leases the U.S.-based robotic surgical system or U.S. surgery center.<sup>347</sup> Otherwise, the surgeon will not be considered to have a permanent establishment in the United States, and the United States will be unable to impose source-based tax.<sup>348</sup> More importantly, this conclusion suggests that the model treaty would preclude the United States from taxing income derived from a broad range of inbound personal services that can be conducted without the physical presence of the service provider, including radiologists reading scans, attorneys drafting documents, and accountants preparing records. In each of these circumstances, it is highly unlikely that the foreign service providers would own or lease any physical equipment or structure in the United States related to the services, and therefore they would not have permanent establishments.<sup>349</sup>

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<sup>347</sup> See *supra* notes 179–181 and accompanying text.

<sup>348</sup> This conclusion does not affect the earlier recommendation to deny the foreign earned income exclusion to U.S. citizens abroad who perform inbound personal services that directly and purposefully impact the U.S. market. Under the saving clause of U.S. tax treaties, the treaty generally does not affect the United States' ability to tax its citizens under its internal tax law. See 2006 U.S. Model Treaty, *supra* note 50, art. 1(4).

<sup>349</sup> In addition to the taxpayer not having a permanent establishment under the traditional test, the remote services would not constitute a permanent establishment under the new alternative "services permanent establishment" test in the OECD Model Commentary, which requires physical presence by the service provider. See *supra* notes 187–195 and accompanying text.

If the foreign individual performing remote services from abroad is doing so as an employee of a foreign corporation, Article 15 will prevent the United States from taxing the employee. That article provides that if an employee is a resident of a treaty country, the other country can exercise source-based taxation of the employee's income only if "the employment is exercised in" that latter country (and only to the extent derived from the exercise of employment therein). OECD Model Treaty, *supra* note 50, art. 15(1). Thus, the principal focus is whether the foreign person exercises employment "in" the source country. The OECD Commentary states that "[e]mployment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid." OECD Commentary, *supra* note 50, art. 15, ¶ 1. Accordingly, under this general rule, the United States could not tax the employment income of a service provider who is not physically present in the United States. Moreover, even in circumstances when the employee is physically present in the United States, Article 15 prohibits the United States from imposing source-based taxation if the individual's employer is a resident of the treaty country, the services are not attributable to the employer's permanent establishment in the United States, and the individual is present in the country for no more than 183 days in any twelve-month period beginning or ending within the relevant fiscal year. For this purpose, an employee is considered to be present in the source country for a day if he is physically present for any portion of the day. See *id.* ¶ 5; see also 2006 MODEL TECHNICAL

In general, the same normative arguments addressed in the context of inbound taxation under internal law suggest that the United States, in the case of inbound telesurgery (or analogous personal services), should be allowed to impose source-based tax under the treaty. As discussed above, both fairness and efficiency concerns support the ability of the United States to tax the income of a foreign person whose personal services have a direct and purposeful impact in the U.S. market even though the person is physically located outside the United States.<sup>350</sup> For other policy-related reasons, however, the country in which the taxpayer resides might be unwilling to surrender taxing rights under a treaty.<sup>351</sup> In particular, the residence country (in which the service provider is physically located) might be unwilling to abandon the long-standing traditional rule for sourcing personal services income that focuses on the physical location of the service provider.<sup>352</sup>

Administrative concerns also play an important role in determining how a tax treaty divides the tax base between countries and often serve as the principal justification for limiting source-based taxation. The earlier analysis concedes that an expansion of source-based taxation over cross-border personal services would raise significant administrative concerns, particularly with respect to complexities necessary to mitigate double taxation if each country uses a different internal law source rule.<sup>353</sup> The principal role of a tax treaty in this context is to determine the threshold at which the administrative concerns are significant enough to warrant the source country abandoning its imposition of tax that might otherwise be justified under tax policy principles.<sup>354</sup>

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EXPLANATION, *supra* note 53, art. 14 (“[D]ays that are counted include any day in which a part of the day is spent in the host country.”). Thus, this prohibition would provide further protection to the employee.

<sup>350</sup> See *supra* notes 252–262 and accompanying text.

<sup>351</sup> As noted previously, if a treaty allows source-country taxation, the residence country generally provides relief from double taxation through either a foreign tax credit or an exemption. This often requires the residence country to treat the income as foreign source for treaty purposes, even though its internal laws would have treated it as domestic source. See 2006 U.S. Model Treaty, *supra* note 50, art. 23(3).

<sup>352</sup> The residence country might also argue that it has a strong claim under other theories. See Shay, Fleming & Peroni, *supra* note 4, at 140 (“[I]f extensive human capital [is] required to perform the services, then the country where the . . . human capital was developed also would seem to have a claim on some portion of the income.”).

<sup>353</sup> See *supra* notes 255–272 and accompanying text. Additional complexities arise when the personal services are performed by foreign-based employees of a foreign corporation, rather than by a foreign-based person operating as an independent contractor. See *supra* notes 339–345 and accompanying text.

<sup>354</sup> The recently added OECD Model Commentary regarding the alternative services permanent establishment squarely addresses this tradeoff. It notes that countries that favor

In some ways, the administrative issues raised by cross-border tele-surgery (and analogous remotely performed services) are less significant than those arising in other contexts. For example, as discussed in detail previously, many of the enforcement and compliance concerns that arise under electronic commerce do not apply (or are less important) in the case of cross-border personal services.<sup>355</sup> In particular, enforcement via withholding might be more feasible with cross-border personal services due to the existence of more reliable withholding agents. Additionally, the purposeful nature of personal services minimizes the prevalent concern in electronic commerce regarding a taxpayer involuntarily being brought within a country's taxing jurisdiction. Nonetheless, the allowance of source-country taxation (and the corresponding residence-country tax relief via a foreign tax credit or otherwise) would entail greater enforcement and compliance difficulties than would exclusive residence taxation of the income.

It should also be noted that the OECD Model Treaty already contemplates source-based taxation of certain services even though the taxpayer is not physically present in the source country. Under Article 16, a country can tax directors' fees paid by a resident corporation to a director who is a resident of the other treaty country, even if the recipient director did not physically perform any services in that first-mentioned country.<sup>356</sup> The OECD Commentary notes that "it might sometimes be difficult to ascertain where the [directors'] services are performed,"<sup>357</sup> so instead of focusing on the physical location of the director, "the provision treats the services as performed in the State of residence of the company."<sup>358</sup>

Ultimately, source-based taxation of remote cross-border personal services would be justified in a treaty only if governed by an objective

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the alternative provision "consider that profits from services performed in a given state should be taxable on the basis of . . . generally accepted policy principles" for determining the source of income, regardless of the absence of a traditional permanent establishment, and even if this taxation "raises certain compliance and administrative difficulties, these difficulties do not justify exempting from tax the profits from all services performed on their territory by such enterprises." OECD Model Commentary, *supra* note 50, art. 5, ¶¶ 42.15, .17.

<sup>355</sup> See *supra* notes 314–321 and accompanying text.

<sup>356</sup> OECD Model Treaty, *supra* note 50, art. 16. The United States, however, has placed a reservation on this article of the OECD Model Treaty, and the 2006 U.S. Model Treaty permits the corporation's country of residence to tax directors' fees only to the extent the director performed services in that country. See 2006 MODEL TECHNICAL EXPLANATION, *supra* note 53, art. 15.

<sup>357</sup> OECD Commentary, *supra* note 50, art. 16, ¶ 1.

<sup>358</sup> *Id.*

standard that allowed source country taxation if there is a relatively strong normative case for source-based taxation and relatively low administrative costs. Such circumstances might exist if the remotely performed services have a direct and immediate impact on the source country due to readily identifiable transactions that surpass a de minimis threshold.<sup>359</sup> The source country's taxing rights might be particularly strong if the transactions involve professional services, such as medical or legal services, for which the provider (or the person for whom the services are performed) is required to have a license in the source country.<sup>360</sup> Rather than expanding the definition of permanent establishment to include such circumstances, taxation might be allowed in a manner analogous to existing Article 16 of the 2006 U.S. Model Treaty (corresponding to Article 17 of the OECD Model Treaty).<sup>361</sup> Article 16 permits source-based taxation of artists and athletes regardless of the permanent establishment requirement, provided the amount exceeds a de minimis threshold.<sup>362</sup> Of course, this expansion of source-based taxation for certain professional services income would go beyond Article 16 in one significant way—unlike Article 16, it would allow

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<sup>359</sup> This approach is generally consistent with Professor Avi-Yonah's suggestion that income from electronic commerce transactions be taxable under treaties at the place of consumption, provided that the seller's gross income from the transactions exceeds a relatively high threshold. See Avi-Yonah, *supra* note 4, at 536–37. Although Professor Avi-Yonah's comments focus primarily on Internet-facilitated sales of goods, it also mentions services. See *id.*; see also Noren, *supra* note 59, at 345–46 (favorably citing Professor Avi-Yonah's proposal). Other commentators have advocated the extension of Article 17-like taxation rights for personal services income in excess of a monetary threshold, although such proposals contemplate situations where the services were physically performed in the source country. See, e.g., Graetz, *supra* note 4, at 319–20 (“It is also worth exploring whether a threshold amount of sales, assets, labor, or research and development within a nation could better serve to establish both the source of business income and a threshold for the imposition of tax.”).

<sup>360</sup> This definition of “professional services” is narrower than that in the U.N. Model Treaty. See U.N. Model Treaty, *supra* note 50, art. 14(2) (term includes “independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants”). One problem with the proposed standard is that different countries might have different views as to what “professions” require licensing.

<sup>361</sup> Unlike the 2006 U.S. Model Treaty, the OECD Model Treaty does not contain a monetary threshold below which the source country cannot impose tax.

<sup>362</sup> Professor Doernberg posits the possibility of including “income from the electronic exercise of independent professions” in Article 17 of the OECD Model Treaty. DOERNBERG ET AL., *supra* note 4, at 348. As the OECD TAG Report summarized, “the argument for change is not . . . that the activity produces large amounts of income. Instead, it is the fact that the income-producing functions take place in the host jurisdiction that justifies a change [in the treaty] to allow the country to tax that income.” OECD TAG Report, *supra* note 4, at 49, ¶ 241.

taxation even when the taxpayer was not physically present in the source country.

As a practical matter, a new international consensus to adopt this approach is unlikely in the near future.<sup>363</sup> The OECD's focus on the service provider's physical location is well-entrenched, as evidenced by the recent addition of the "services permanent establishment" alternative in the OECD Commentary.<sup>364</sup> In one regard, that addition reflects a departure from a physical focus because it permits the finding of a permanent establishment based on the extended performance of services, notwithstanding the absence of a fixed place of business. More importantly, however, the commentary makes clear that the only personal services that count toward the creation of a services permanent establishment are those that physically occur within the source country; it explicitly states that "all member States agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State." Even those OECD member and non-member countries that have expressed official reservations or positions regarding the traditional fixed place of business threshold for taxing independent personal services have not gone so far as to advocate source-based taxation of service providers who were not physically present when the services were performed.<sup>365</sup>

The United States is not likely to support broader source-based taxation of cross-border personal services income under the OECD

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<sup>363</sup> Cf. Michael F. Mundaca, *How Much Should Borders Matter?: Tax Jurisdiction in the New Economy*, Testimony Before the Senate Comm. on Finance, Subcomm. on Int'l Trade, July 25, 2006, at 7, available at <http://finance.senate.gov/hearings/testimony/2005test/072506mmtest.pdf> ("[G]aining a global consensus around a new standard [beyond the permanent establishment physical presence standard] would be difficult, if not impossible.").

<sup>364</sup> See OECD Model Commentary, *supra* note 50, art. 5, ¶¶ 42.11–48. See generally *supra* notes 187–195 and accompanying text (discussing alternative provision).

<sup>365</sup> Instead, these countries generally focus on taxing certain independent personal services if the service provider is physically present for a threshold amount of time (typically 183 days), despite the absence of a fixed place of business. See, e.g., OECD Model Commentary, *supra* note 50, art. 5, ¶ 77 (reservation of Korea and Portugal); OECD, *Non-Member Countries Positions on the OECD Model Tax Convention*, Positions on Article 7, ¶¶ 14–14.3 [hereinafter OECD Non-Member Positions] (positions of more than one dozen non-member countries). The U.N. Model Treaty, despite its greater permissibility regarding source-based taxation, allows taxation of independent personal services in the absence of a fixed base only if the service provider is physically present in the source country for at least 183 days. See U.N. Model Treaty, *supra* note 50, art. 14(1)(b). The position of Chile regarding the OECD model is vague; it reserves the right to tax a person who "performs professional services and other activities of independent character, including planning, supervisory or consultancy activities, with a certain degree of continuity." See OECD Non-Member Positions, *supra*, at ¶ 14.7 This standard makes no mention of the requisite connection of those services to Chile. See *id.*

Model Treaty. As a traditional net exporter of services,<sup>366</sup> the United States generally prefers narrower criteria for allowing source-based taxation, including a physically focused fixed place of business threshold for a permanent establishment.<sup>367</sup> In the long run, however, given potential economic pressures and the tax incentives discussed above, the flows of telesurgery and analogous technologically enabled cross-border personal services might change.

## CONCLUSION

This Article illustrates the significant international tax policy problems that arise as modern technological developments facilitate the cross-border delivery of personal services. These problems can be expected to expand as an increasingly broad range of services are delivered remotely, thereby diminishing the practical importance of a service provider's physical presence. Accordingly, it is important that both U.S. internal tax law and bilateral tax treaties be reconsidered to the extent necessary to keep pace with these developments. As a prominent commentator observed more than a century ago, a "system of taxation . . . which may have been perfectly just under . . . older and simpler conditions, may now be entirely inadequate because of the failure of government to take account of . . . new complications . . ."<sup>368</sup>

The Article focuses on the recent development of cross-border telesurgery. Although cross-border telesurgery might not, by itself, be a significant enough phenomenon to justify changing the current internal law and treaty provisions for taxing personal services, the telesurgery example is merely illustrative of the problems that can arise by focusing exclusively on the service provider's physical location as the touchstone for taxation. As discussed in Part IV, the same problems identified in the telesurgery example can also arise with other electronically delivered cross-border personal services, many of which are in use today.

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<sup>366</sup> As discussed earlier, *supra* notes 69–78 and accompanying text, the United States is also likely to be a net exporter of telesurgery services, at least in the initial stages of the phenomenon.

<sup>367</sup> See Joann Weiner, *Conversations: Michael Mundaca*, reprinted in TAX NOTES TODAY, Sept. 10, 2008, 2008 TNT 176-8 (LEXIS) (Treasury Department Deputy Assistant Secretary for International Affairs emphasizing importance of "economic and administrative certainty" provided by the physical fixed place of business standard).

<sup>368</sup> EDWIN R.A. SELIGMAN, *ESSAYS IN TAXATION* 99 (1895); see also Kirsch, *supra* note 20, at 530.

To address the tax policy problems arising from the expanded cross-border delivery of personal services, this Article suggests changes that de-emphasize the role of physical presence. Most importantly, it recommends a significant curtailment of the foreign earned income exclusion, denying the benefit to foreign-based U.S. citizens whose personal services purposefully and directly impact the United States. In addition, it proposes changes to both the source rules that apply to the inbound taxation of foreign persons and the foreign tax credit limitation applicable to U.S. persons. Finally, the Article suggests possible changes to the OECD Model Treaty but acknowledges that such changes are not likely to be adopted, at least in the short term. Given the ongoing progress in technology and communications, which continuously expands the range of personal services that can be performed remotely, as well as the significant time lag that can occur in modifying norms reflected in the OECD Model Treaty and OECD Commentary, it is important to continuously reexamine standards, such as a service provider's physical location, that might lose their continued viability in an ever-changing world.