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Source-Basis Taxation of Derivative Financial Instruments: Some Unanswered Questions

H. DAVID ROSENBLOOM*

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Derivative financial instruments are, for many persons, shrouded in mystery. Although news of such instruments frequently appears in the financial press, from the Nick Leeson affair[1] to recent disputes involving Bankers Trust[2] and Merrill Lynch,[3] the features of these instruments are rarely described. Usually derivatives are characterized as complex or arcane, the characterization apparently serving to justify the failure to explain. The unfortunate effect, enhanced by oblique financial jargon, has been tall barriers to analysis of these common financial tools.

A derivative financial instrument is a device used to shift risk from one party to another. On this fundamental point, derivatives resemble insurance, a concept familiar to anyone who has purchased a vehicle or home. In an insurance transaction one party pays a fee, or premium, to another. In return, the other party undertakes the risk of paying the first party up to a specified amount in the event of a specified occurrence (such as a theft or fire). If the occurrence comes to pass, the first party has a claim against the second, which gives value to the insurance contract. That value depends on, or derives from, the occurrence, which is typically beyond the influence or control of either party, and the extent of the resulting loss. If the occurrence does not come to pass, the contract expires without having any value to the first party. Yet, such a transaction is sensible because, during the specified period, the insured

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1. *See* Richard Phillips, *Rogue Trader: Barings Bosses Easy to Deceive*, CHI. TRIB., Feb. 12, 1996, at 9.

2. *See* Kenneth N. Gilpin, *$67 Million Settlement by Bankers Trust*, N.Y. TIMES, Jan. 25, 1996, at D8.

3. *See* Leslie Wayne, *Orange County Settlement Sends a Signal from S.E.C.*, N.Y. TIMES, Jan. 25, 1996, at D4.

was relieved of the risk of suffering loss as a result of the specified event by shifting the economic burden of that risk to the insurer.

The principal difference between derivative financial instruments and everyday insurance lies in the word "financial." A derivative usually insures against a financial risk, such as the chance that a particular currency will rise or fall in value, that the price of a commodity such as corn will rise above or fall below a particular level, or that interest rates will move in a particular direction. Such risks are general rather than particular, and their precise economic consequences can be readily calculated. The parties to the derivative instrument do not need to refer to a specified event, require its verification, or provide a mechanism for measuring the consequences of its occurrence. They can enter into a contract whose terms will give it value only if and when the specified event occurs, and then only to the precise extent desired.[4]

The insurance company typically pays the policyholder if the specified event occurs, and if the policyholder makes a demand for payment in the agreed form. The policyholder may choose not to make such a demand, even if the event does occur. This might occur where, for example, the loss was minimal and payment would adversely affect the cost of entering into similar contracts for future time periods. Usually, however, a policyholder has a strong economic incentive to hold the insurer to its bargain and will make the demand contemplated by the insurance contract.

One type of derivative financial instrument, the option, is like the standard insurance contract described above, in calling for a contingent payment. The holder of an option to purchase 100,000 Deutsche marks at 1.3 DM to the dollar is not required to demand payment, and presumably will not do so unless the event insured against—the risk—occurs (for instance, the Deutsche mark rises to 1.1:1). If that occurs, the holder of the option has an economic incentive to require the option writer to sell Deutsche marks at the option price of 1.3 DM to the dollar to the extent specified in the option contract. The holder's gain upon the exercise of the option will precisely mirror the risk that 100,000 Deutsche marks would rise above the designated level.

A second type of derivative calls for unconditional, rather than contingent, payment. This type does not resemble standard insurance so much as another insurance product, the annuity. Under an annuity contract, one party may agree that, in return for a payment of $100,000, the

4. This describes the common use of derivative financial instruments, and is not an inherent characteristic. In theory, derivative instruments can refer to, or "derive" value from, virtually any noncontrolled index, from the batting average of the New York Yankees centerfielder to the average July temperature in Washington, D.C.

other party will pay $1,500 per month for each month from the first party's sixty-fifth birthday until his or her death. A fee is typically paid at the inception of the annuity contract, but an upfront payment is not necessary for the transaction; the parties could agree that the annuity holder, upon reaching age sixty-five, will pay a fee and commence receiving the monthly payment.

The difference between this type of contract and standard insurance is that the annuity binds both parties to make payments, whereas the standard contract of insurance does not require payment unless a specified event occurs and the policyholder makes a claim. If the specified event does not occur, the insurer retains the premium and makes no payment to the policyholder. Similarly, the writer of an option retains the premium and presumably will not be called upon to honor it if the market rate for Deutsche marks stays at 1.3 or more to the dollar.

In the world of derivative financial instruments, the annuity resembles the forward contract,[5] where the parties agree to purchase and sell a specified quantity of Deutsche marks at a specified future date at a price of 1.3 to the dollar. The obligation to consummate the transaction is fixed and unrelated to the value of the Deutsche mark on the specified date. However, the financial value of the contract can readily be computed at any time by reference to the market value of the Deutsche mark, and the parties may choose to settle at the specified date with a net payment flowing one way or the other. Although the same could be said with respect to the annuity, such contracts usually are intended to provide a continuing flow of funds, and net settlements for annuities are probably not common.

That derivative financial instruments shift financial risk from one party to another does not mean that the party seeking to shift the risk necessarily bore that risk in the first place. Shifting a risk that the risk-shifter does not bear is a speculation, or a gamble, like a bet on the outcome of the Super Bowl. Shifting is fundamental, whether based on the performance of the Deutsche mark or the Dallas Cowboys.

The two basic types of derivative financial instruments are the option contract and the forward contract. The key difference between them is that the holder of an option has a right, for which it has generally paid a fee or premium, but no obligation. In contrast, the forward creates mutual obligations and mutual rights and, since either party may gain as a result of the contract, it is common that no funds, or premiums, change hands at the inception of the contract. The exchange of value is

5. A standardized form of forward contract traded on an exchange is referred to as a regulated futures contract.

to take place at a specified future date, although it may take place earlier, with reference to the specified date.

Options and forwards may require more than one payment, and they may cover more than one specified future date. A common form of multiple-payment contract is the "swap," which is a series of forward contracts. Another is the "cap," which is essentially a series of options to claim reimbursement for interest in excess of a specified rate.

One last term that requires explanation is the "notional principal contract." This is a derivative financial instrument, either a forward or an option. Its key feature is that the obligations of the parties are referenced to a stated base sum that need not be exchanged—hence the term "notional principal." If one party agrees to make payments to another party for five years to the extent that prevailing interest rates exceed nine percent (a "cap" contract), the parties will need to know what the multiplicand is, so that any required payment can be computed. The figure might be, for example, ten million dollars—notional principal. Alternatively, the parties might agree that, over a three-year period, one will pay interest in Deutsche marks to the other in return for interest in dollars. They will need notional principal bases in dollars and Deutsche marks to make the computations. Essentially, this means that they will pretend to exchange dollars for Deutsche marks at the outset of the transaction, so that they can compute their respective obligations. At the end of the specified period, they will notionally reexchange principal amounts so value changes attributable to currency fluctuations can be computed and paid over. This tends to compensate for the difference in interest rates between the dollar and the Deutsche mark.

There are many other fascinating aspects to derivatives, including their pricing and the multiple uses to which they can be put. In addition, the basic concepts described above may be combined so that, for example, parties may enter into an option contract where the option is to enter into a swap contract. Or derivative elements may be added to more familiar transactions such as loans or equity. Transactions may be deliberately cast "off market," so that compensating payments are needed for the economics to make sense. Payments due at some future date may be "present valued" and paid over earlier. Obligations on one side or the other may be multiplied, or leveraged, so that a swap is not simply dollars-for-Deutsche-marks but dollars-for-Deutsche-marks-times-five.[6]

It is not necessary to understand everything about derivative financial instruments to understand the tax issues that such instruments involve. Nor are derivatives so radically different from other long-

6. This would be similar to five separate, identical swaps.

existing economic transactions as to require a complete set of new tax rules. What does seem true—in a variety of tax areas—is that derivative financial instruments and the many sophisticated ways in which they can be employed place considerable pressure upon established tax definitions and categories. This forces tax policymakers and taxpayers alike to re-examine the bases for long-accepted distinctions.[7] One area that needs such reexamination is international taxation, where derivative transactions cross borders.

I. THE INTERNATIONAL CONSENSUS

The recent forty-ninth Congress of the International Fiscal Association focused upon tax aspects of derivative financial instruments. The General Reporters[8] established guidelines for reports from the twenty-nine countries for which National Reporters undertook to describe their pertinent rules and practices. We then prepared a General Report that synthesized the National Reports and offered observations and recommendations for the development of legal principles in this area.[9]

The subject of derivative financial instruments is international to a limited extent. The most pressing tax issues pertaining to derivatives are basic and thus domestic: What is to be taxed, and when? What character does the resulting income or loss have? These are largely domestic matters, in the sense that they apply to transactions between resident taxpayers in a given jurisdiction. The General Report summarizes the approaches taken in various countries and suggests general lines for countries to pursue in the future. Thus it may be said that the General Report is for the most part "comparative," since it places domestic practices side-by-side for examination, as opposed to "international" in a cross-border sense.

A brief portion of the General Report is, however, devoted to issues of a cross-border nature, and these have been distilled into a single question: How much profit should be reported to a particular jurisdiction?[10] The Report subdivides the question into gross-basis and net-basis taxation at source, and taxation of foreign transactions undertaken by residents.[11] The last of these subjects, foreign transactions by residents, is

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7. *See generally* Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993).

8. Charles Plambeck, Diane Ring, and I.

9. *See* Charles T. Plambeck et al., *General Report* [hereinafter *General Report*] *in* 80b CAHIERS DE DROIT FISCAL INTERNATIONAL [C.D. FISC. INT'L] 653 (1995). Citations hereinafter are to the English language section. The National Reports are published in the same volume of the Cahiers. *Id.* at 615.

10. *General Report*, *supra* note 9, at 684.

11. *Id.* at 684-89.

more concerned with policies relating to general residence taxation than to the specific challenges posed by derivative financial instruments. Many developed countries impose a tax on residents, individual and corporate, on a worldwide basis, and have adopted measures to preclude these taxpayers from avoiding taxation by situating income in related nonresident entities. Such "anti-abuse" regimes address both income shifting, as in the case of transfer pricing, and investment shifting—the placement abroad of income-earning investments.

A principal international question raised by derivatives is whether the anti-abuse rules should apply when income from transactions in derivatives is earned by a foreign corporation owned or controlled by resident shareholders. The question implicates the underlying policy views reflected in each country's anti-abuse regime. In the United States, Subpart F of the Internal Revenue Code[12] and other rules aim at passive forms of income, when earned through a closely held company. In the context of these rules, derivative financial instruments are not very special. To the extent they are used in an active business (other than banking or insurance, which are targeted by Subpart F), there is little reason to impose current tax on the U.S. shareholder. On the other hand, derivative financial instruments are as mobile as other financial instruments, and they may fall within the ambit of the anti-abuse rules if the taxpayer cannot establish a connection with active business transactions.[13]

Similarly, the rules for determining the connection of income from derivatives with a branch are not special rules aimed at these particular transactions, but applications of a general approach. If, as a factual matter, a branch is responsible (however subdefined) for the derivative instrument, then income from the instrument should be viewed, by both the country where the branch is located and the home country, as "attributable" to the branch. Taxation at source would ensue in the host country and the system of avoiding double taxation would be involved in the home country. There is nothing new or unusual here. The rules merely represent the application of general principles in the particular context of derivative financial instruments.

Arguably, the only "pure" international issue raised by such instruments pertains to taxation in the country of source on a gross basis. It is here that close analysis of the special features of derivatives is required, and here, if anywhere, that derivatives place pressure on the international rules. The question posed is whether the country from which pay-

12. I.R.C. §§ 951-964 (1994).

13. *See* I.R.C. § 954(c) (1994) (defining "foreign personal holding company income"); Treas. Reg. § 1.954-2.

ment is made under a derivative financial instrument should have the right to impose tax on that payment.

According to the General Report, the countries surveyed generally do not impose tax at source on payments with respect to derivative financial instruments.[14] The General Report speculates that this result may follow from the mobility of the income that these instruments produce, or the fact that the income does not represent a return on capital—like dividends or interest.[15] However, countries reach the common result of no taxation at source in a variety of ways, ranging from a specific rule applicable to derivatives to a total lack of taxation at source of any type of income in the absence of a fixed presence such as a branch (*i.e.*, a permanent establishment).

The IFA Congress adopted a Resolution[16] which flows from the General Report and which devotes a paragraph to "Clarification of Residence Taxation,"[17] and a more substantial paragraph to "No Taxation at Source."[18] The latter paragraph reads as follows:

> Countries should not impose source basis taxation on income derived by non-residents from derivative instruments in the absence of a branch or permanent establishment to which such income is attributable.
>
> It is the general practice not to impose withholding tax at source on payments made under derivative financial instruments. This is appropriate and should be universally adopted
>
> Apart from withholding tax, profits, gains and losses with respect to derivative instruments should be exempted from tax at source under domestic law or applicable income tax treaties on the ground that they represent:
>
> — business profits, exempt from tax in the absence of a permanent establishment;

14. *General Report*, *supra* note 9, at 684-86.

15. *See* Michael Cosgrove, *IFA Stresses Role of Derivatives, Calls on Nations to Establish New Tax Regimes*, 65 BNA'S BANKING REP. 507 (1995).

16. *Tax Aspects of Derivative Financial Instruments*, 49th IFA Cong. Res. (Cannes 1995).

17. *Id.* at 2.4 This paragraph states:

> In imposing residence taxation on income derived from derivative instruments, the residence principle should be: (a) reinforced by application of a country's anti-deferral regimes, where appropriate; and (b) clarified in the case of global trading, split hedging, and interbranch transactions. In this connection, countries should consider entering into Advance Pricing Agreements in appropriate cases. In computing the taxable income of a branch of a foreign taxpayer, inter-branch or branch/home office transactions in derivative instruments are taken into account in some countries but not in others. The treatment of these transactions should be harmonized and the OECD should be encouraged to continue its work on the subject.

Id.

18. *Id.* at 2.3.

— capital gains; or
— "other income" exempt under the "other income" article of an applicable treaty.[19]

Participants in the IFA Congress discussion noted that cross-border markets can function efficiently insofar as derivatives are concerned only if the source country does not tax income from derivatives. Such taxation is viewed as potential double taxation or, at the very least, overtaxation. As a consequence, the Resolution recommends that the practice of not imposing a withholding tax "should be universally adopted."[20] It also recommends that taxation at source should be precluded under international tax conventions in the absence of a permanent establishment, on the ground that income from derivative instruments represents "business profits," "capital gains," or "other income."[21]

There is little doubt that the international tax and financial communities disfavor gross basis taxation of derivative financial instruments in the country of source. Nor is there much doubt about the state of the law in most countries. The interesting question, from the point of view of tax policy, is how the result—no gross-basis taxation at source—is reached and justified.

II. Drawing Lines

The General Report speaks of a derivative financial instrument as "one under which the payment rights and obligations of the parties . . . derive from the value of an underlying cash or physical market . . . or from particular financial indices or combinations of indices."[22] Although this definition is accurate, it is also general and abstract, and leaves unclear both (a) why derivatives should be distinguished from other types of financial instruments and (b) which instruments are included within the term and which are not.

As to the first question, it is fair to ask whether and why a typical derivative—a forward sale of Deutsche marks, for example—is relevantly different from a forward sale of a house or a cow. An initial answer may lie in the existence of a market or index for the foreign currency. However, that seems only to displace the inquiry; why should the absence of an established market for the house make a tax policy difference? Perhaps the reason is that the derivative is not designed to transfer property, even though its terms may allow and even contemplate such a transfer. It is designed to transfer only *risk* and thus to be settled

19. *Id.* (paragraph numbers omitted).
20. Cosgrove, *supra* note 15, at 508.
21. *Id.*
22. *General Report*, *supra* note 9, at 661 (emphasis omitted).

on the basis of ascertainable values at the execution date. The contract for sale of the cow may *also* transfer risk, but it is certainly intended, in general, to transfer property. If this distinction contains the germ of a rationale for speaking of derivative financial instruments as a separate subject of tax policy, the crucial word is not "derivative" but "financial." The "derivative" quality of the instrument does not set it apart, because the value of any executory contract changes with a change in the value of the subject of the contract. Most executory contracts are, however, intended to be settled in accordance with their terms and not with a cash payment reflecting net value at the date of consummation.

There is a clear distinction between risk-shifting derivative contracts and other financial instruments reflecting a transfer of capital, such as loans. It is true that interest on a loan may be calculated on the basis of a financial index, and that the value of such an instrument will change according to a change in value of the controlling index. Nevertheless, there is a significant difference between a "pure derivative" and any instrument reflecting a transfer of capital. Tax rules developed to deal with the former instrument may be relevant to treatment of the latter, but the existence of a "hybrid" instrument should not cloud the analysis. Once the appropriate tax policy approach to derivatives is identified, that approach can be blended with the analysis of a capital-transferring transaction, such as a loan.

A general question that emerges from any effort to isolate derivatives for analysis is whether income from those instruments constitutes a coherent subject for such analysis. There are obviously multiple subdivisions of derivative options and forward contracts, notional principal contracts and derivatives that do not involve notional principal. The tax laws of the United States do not define a category of income from derivatives, and it is questionable whether Congress should alter the established rules by creating such a category.

III. LEGITIMACY OF SOURCE BASIS TAXATION

International taxation generally recognizes two grounds for the imposition of tax—residence and source. Taxation on the basis of residence is generally regarded as legitimate because the taxing jurisdiction has, in effect, personal jurisdiction over the taxpayer. Residents enjoy certain benefits in that capacity, and it is appropriate that they help defray the costs of the government that provides those benefits. There are few countries that would contest the legitimacy of residence taxation. Those countries would probably invoke instead a super-residence concept such as citizenship.

Taxation on the basis of source also makes sense, because the juris-

diction imposing the tax has created conditions that permit the income to be earned. The conditions cost money, and it is fair to ask the taxpayer to share the financial burden. Furthermore, the income in question may have supplanted income that otherwise would have been earned by residents. This, arguably, is an additional rationale for taxation by the source country.

Financial market participants often inveigh against source taxation, particularly source taxation on a gross basis, on the ground that such taxation interferes with marketplace efficiency. This would certainly be true when compared to a world where source basis taxation does not exist. In theory, the most efficient markets would be in a tax-free world.

No one claims that taxation in any form, source or residence, is a boon to economic activity. Source taxation on a gross basis is especially cumbersome. The source country sees only a portion of the taxpayer's income, and its tax claim can easily be disproportionate to the taxpayer's profits or true means. Furthermore, where cash flows from one country have no relationship to the taxpayer's net earnings from a transaction—often the case with respect to income from derivative financial instruments—taxation at source on a gross basis can actually deter economic activity. For this reason, it is understandable why the markets oppose source taxation of income from these instruments.

Nevertheless, source taxation is a legitimate form of taxation, and complaints about such taxation with respect to income from derivatives are not confined to that type of income. It is generally accepted that tax claims of countries that give rise to income are not only legitimate but superior to claims of countries where taxpayers reside. For this reason, the residence jurisdiction generally is asked to give a credit or exemption with respect to income earned in the source jurisdiction. To the extent that arguments on behalf of the markets extend beyond derivative financial instruments—to interest on loans, dividends on equities, and other forms of source taxation—the arguments prove too much. Moreover, derivative financial instruments originate in a relative handful of countries, and the arguments therefore have a quasi-political nuance. Countries not in the select group may not have the same reverence for markets as the United States, the United Kingdom, and Japan. Any foregoing of source basis taxation with respect to derivatives would not be done solely for reasons of market efficiency.

IV. Building Blocks of Taxation at Source

United States tax rules are so highly and carefully articulated that it is possible to isolate policy choices for particularized analysis. The choices in the United States are surely not different, in principle, from

those faced by other jurisdictions. However, the U.S. analytical methodology is extraordinarily clear.

The United States approaches source basis taxation in three distinct steps. First, the Code identifies types and items of income over which the United States asserts a legitimate claim as the country of source.[23] Such identification is made in a series of so-called source rules, which are neither obvious, immutable, nor internally consistent. They involve hard, case-by-case judgments, based on criteria that are not always articulated. The process is complicated by the need for source rules in the U.S. system for avoiding double taxation of income taxed on the basis of residence. In the United States, source rules commonly do "double duty" in that one rule may control both taxation at source and the foreign tax credit. Since the policies at work in these areas differ, there are various exceptions to such "double duty," where a source rule operates only to control taxation of foreign persons or only for purposes of the credit.

As a general proposition, U.S. source rules are, or should be, "neutral" in the sense of not being distorted by considerations of favor or disfavor with respect to particular kinds of income. The source rules applicable to foreign persons making investments in the United States thus represent an honest effort to identify income that is "ours" to tax. In making this identification Congress generally looks for an economic nexus with the income in question, as well as international acceptance of the particular rule being considered. Congress also considers the administrability and simplicity of the rule, and its resistance to manipulation. Legislators may ask whether we would find the rule objectionable if it was adopted by another country with respect to U.S. residents. These factors do not necessarily all point in the same direction, and the process of developing source rules requires considerable judgment and discretion. The concept of using source jurisdiction to tax is widely accepted, but its implementation in the form of specific and concrete rules is not universally agreed.

Having weighed the factors, Congress reaches a judgment for each income type, and then implement it in the form of a specific rule.[24] Of course, it is not practical to specify a source rule for all income types, and the process is supplemented by a judicial doctrine called the rule of analogy. This is the common sense notion that when a separate source rule is lacking for a particular type of income, the proper approach is to

23. *See, e.g.*, I.R.C. §§ 861-865 (1994).

24. U.S. source rules are set forth primarily in §§ 861-65 of the Internal Revenue Code. I.R.C. §§ 861-63, 865 (1994). Section 988(a)(3) is also an important source rule for determining how to treat certain currency transactions. I.R.C. § 988(a)(3) (1994).

reason by analogy from the closest available income type for which a specific source rule exists.[25]

The U.S. practice of taxing each income type follows the method adopted by most other tax systems, as well as the international network of double tax conventions. This "classification and assignment" system depends upon the ability of the tax laws to distinguish among different kinds of income. This is not always an easy task. Income from services often resembles income from intangible property. Leases merge into sales. The "pigeon holes" used by the United States to classify income for source purposes sometimes do not contain the pigeons.

The most important point is that a source rule is *not* a rule of taxation. It is more in the nature of a national declaration of what might be taxed on the ground that the United States has, in its unilateral view, a legitimate right to do so. In this respect, the source rule is a building block in the overall scheme of international taxation adopted by the United States.

The next step in approaching source-based taxation is to identify those items of income that the United States *will* tax at source. The rules of taxation represent an overlay on the source rules. Types and items of income that will be subject to tax are separated from those whose U.S. source has no further implications insofar as source-basis taxation is concerned.

For reasons that are partly historical, partly political, and, in small part, responsive to tax policy concerns, this second step is itself broken down into separate "substeps." First, the Code broadly identifies those items of U.S. source income that Congress intends to tax. Then, a host of exceptions and exemptions serve to pare back, temporarily or permanently, the field of potential taxation to the actual.

The first "substep" is taken through the concept of "fixed or determinable annual or periodical"[26] gains, profits, and income—a statutory concept that, as interpreted by U.S. courts, has come to confound analysis.[27] The U.S. Supreme Court has held that a single lump-sum royalty payment is "periodical,"[28] and the U.S. Claims Court—the tribunal gen-

25. An example of the analogy approach in a foreign tax credit context can be found in Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982). An example pertaining to the income of foreign persons is Revenue Ruling 89-67, 1989-1 C.B. 233, where the IRS, forced to choose between analogizing scholarship income to compensation for personal services and likening it to capital income, chose (incredibly) the latter path.

26. The phrase appears in the tax imposition sections, §§ 871 and 881, of the Internal Revenue Code, as well as in § 1441, which governs withholding. I.R.C. §§ 871(a)(1), 881(a)(1), 1441(b) (1994). Its roots trace back to the first U.S. income tax law, in 1913.

27. *See* sources cited *infra* notes 28-31.

28. Commissioner v. Wodehouse, 337 U.S. 369, 393-94 (1949).

erally available for litigation against the government in tax matters—has found that gambling winnings from the game of keno are "fixed or determinable."[29] More generally, the statutory language has been so drained of precise or ascertainable meaning that attempting to match words against the characteristics of particular income types can be hazardous.[30] It makes more sense to approach the "fixed or determinable annual or periodical" issue on the assumption that *all* income falls under this rubric, unless a controlling rule declares to the contrary with respect to a particular income type. Such rules exist for sales of real and personal property[31] and for insurance premiums.[32] On the basis of these rules, the IRS regards the specified types of income as not fixed or determinable annual or periodical, and therefore not subject to U.S. taxation at source, irrespective of whether the income in a particular case has a source in the United States.

Income that does not fall within a declared exemption is inherently problematic. When, for example, a taxpayer argued that his gambling winnings were too uncertain to be fixed or determinable annual or periodical, the Claims Court responded with the observation from *Wodehouse* that:

> the words "annual" and "periodical" do not mean actually recurring but are merely generally descriptive of the character of the gains, profits and income which arise out of such relationships as those which produce readily withholdable interest, rents, royalties and salaries, consisting wholly of income, especially in contrast to gains, profits and income in the nature of capital gains from profitable sales of real or personal property.[33]

This does not offer much guidance. Given the shapes into which courts

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29. Barba v. United States, 2 Cl. Ct. 674 (1983).

30. One regulation offers the following explanation:

> Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. The fact that a payment is not made annually or periodically does not, however, necessarily prevent its being fixed or determinable annual or periodical income. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical.

Treas. Reg. § 1.1441-2(a)(2) (as amended in 1984). Since the statute itself contains no conjunction between the words "determinable" and "annual," I.R.C. § 1441(b) (1994), it is difficult to characterize keno winnings and lump sum royalties (which may be fixed and determinable when paid but seemingly are not annual or periodical) as well as contingent royalties (which may be annual or periodical but not fixed or determinable).

31. Treas. Reg. § 1.1441-2(a)(3) (as amended in 1984).

32. Rev. Rul. 80-222, 1980-2 C.B. 211.

33. *Barba*, 2 Cl. Ct. at 678 (quoting *Wodehouse*, 337 U.S. at 393-94).

have stretched the statutory language, it is difficult to declare with certainty that *any* type of income outside the specific rules recited above escapes taxation at source on the ground that it is not fixed or determinable annual or periodical.

Even income that has a U.S. source *and* is fixed or determinable annual or periodical may escape taxation at source in the United States. This is because of the last building block of source basis taxation—a series of specific exemptions and exceptions that Congress has attached to particular transactions and income types as incentives. The greatest number of these pertain to various kinds of interest.[34] Other exceptions apply to certain dividends and other forms of U.S. source fixed or determinable annual or periodical income.

Arguably, many of these exceptions reflect the relative mobility of different income types. The justification for source-basis taxation is strongest when the income in question would be earned even if the foreign investor was to depart. Income from real property in the source country is the most compelling example, but the rationale also underlies the familiar international concept of a permanent establishment. The justification is weakest when income is mobile, and would be likely to go elsewhere if taxed too heavily or, arguably, at all. The best example is interest—income from liquid capital where the investor seeks a fixed return.

V. APPLICATION OF THE BUILDING BLOCKS TO INCOME FROM DERIVATIVE FINANCIAL INSTRUMENTS

The first question in analyzing a particular type of income pertains to source. Does the income have a source in the United States? If not, it cannot be taxable on a gross basis because U.S. law does not include the concept of foreign source fixed or determinable annual or periodical income. Obviously, foreign source income does not require analysis of the various exceptions and exemptions, because if the income does not have a U.S. source there is no need to exempt or except it. It is simply not subject to source-basis taxation.[35]

Although source comes first, it is instructive to begin with the latter two questions. Under current law the inquiry with respect to income from derivatives proceeds no further than the question of source.

34. *See, e.g.*, I.R.C. §§ 871(h), 881(c) (1994) (providing exemption for "portfolio interest").

35. U.S. taxes do reach certain foreign source income on a net basis. However, effectively connected foreign source income may be best analyzed as a refinement of the source rules rather than an exceptional application of source-basis taxation to income that the United States considers to have a foreign source.

Approaching the subject in reverse order allows for discussion of issues that current law does not address.

No legislation withdraws income from derivatives from U.S. taxation at source. If such income *was* U.S. source fixed or determinable annual or periodical income, however, the case for an exemption might be made. This type of income exhibits all the mobility of income from debt capital, and it is conceivable that Congress could be persuaded to equate it with income from portfolio debt. On the other hand, each exception must stand on its own, partly political footing. The exemption for portfolio debt was established to give U.S. companies access to the Eurobond market, as a substitute for cumbersome and artificial parent-guaranteed debt issues by Netherlands Antilles affiliates. To gain a specific exception or exemption for income from derivatives, a taxpayer would have to persuade Congress and, conceivably, the IRS (a harder sell), that interests of national policy justify foregoing collection of taxes to which the United States has a legitimate claim.

On the other hand, classification of income as fixed or determinable annual or periodical is an elastic process. It might be difficult to conclude that payments under derivative financial instruments invariably fall outside this classification, while lump-sum royalties and keno winnings fall within. It is true that the IRS has declared insurance premiums not fixed or determinable annual or periodical, and that derivatives are similar risk-shifting transactions. The IRS has noted that "Congress, in enacting the withholding provisions, intended to require withholding on only those kinds of gross income items having a high content of net income, but insurance premiums do not have this high content of net income and often yield a loss. . . ."[36] In other words, the source country has little basis for determining the amount of net income from the gross amount that flows outside its borders. This observation would certainly apply to income from many derivative financial instruments. Of course, the observation also applies to interest earned by banks and many forms of royalties. However, these items remain subject to U.S. taxation at source.

Furthermore, not all payments under derivative financial instruments resemble insurance premiums. In the case of a forward contract, for example, one risk is exchanged for another, so that typically there is no fee analogous to an insurance premium. If there is such a fee, it is generally paid because the contract does not reflect a current market price, and thus contains an embedded loan element. In the case of an option, there is an initial fee analogous to an insurance premium, but

36. Rev. Rul. 80-222, at 211.

pursuing the analogy would leave options with a different tax treatment than unconditional payment derivatives.

Moreover, the insurance analogy does not deal with eventual payment to the option holder. The analogous insurance proceeds are in some cases specifically exempted from taxation,[37] while in others they are taxed as proceeds from a disposition of the underlying property whose potential loss was the risk insured against.[38] This analysis is difficult to square with a cap contract or similar derivative financial instrument.

It is also true that income from property sales is not fixed or determinable annual or periodical. The difficulty here is that many common forms of derivative financial instruments are surely not sales. For example, a swap contract covering interest rates does not produce income from a sale in any normal sense of those terms.

Although one cannot exclude the possibility of defeating U.S. taxation at source on the ground that income from derivative financial instruments is not fixed or determinable annual or periodical, there is no solid basis for concluding that all payments under all such instruments fall outside the statutory class. On the contrary, especially with respect to multi-year contracts in which cash flows move one way or the other with regularity, there may be a strong inclination to find that the statute properly applies.

Thus, we return to the question of source, the logical first question and the last alternative basis for concluding that U.S. taxation at source should not apply to income from derivative financial instruments. The question posed is this: What is the source of a payment made by a U.S. person to a foreign person, with no trade or business in the United States, pursuant to a forward or futures contract, or an option? The payment may be at the outset of the transaction, as is typically found in the case of an option contract. Or it may be at the consummation of a contract, gross or net, as in the case of a forward contract.

The United States has responded to date with a partial answer: Source with respect to income from a "section 988 transaction" or a "notional principal contract" is generally determined according to the residence of the recipient, or, in certain cases, a business unit of the recipient.[39] Under this approach, cross-border payments to nonresidents can never have a U.S. source and therefore can never be subject to U.S.

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37. *See* I.R.C. §§ 101, 104, 105 (1994).

38. I.R.C. § 1033 (1994); *see also* Rev. Rul. 82-74, 1982-1 C.B. 110.

39. I.R.C. § 988(a)(3) (1994); Treas. Reg. § 1.863-7 (1991). Section 988 transactions include forward contracts, futures contracts, options, or similar financial instruments where the amount to be paid or received is either denominated in, or determined by reference to, a foreign currency. I.R.C. § 988(c)(1) (1994).

taxation at source.[40]

This position is curious. "Notional principal contracts" are one subcategory of derivative financial instruments. Forward and futures contracts, also derivative financial instruments, are not notional principal contracts. The source rules adopted by the United States do not apply explicitly to them unless they involve foreign currency and thus are governed by the statutory rules adopted in 1986.

More broadly, the rationale for ascribing the source of income from either a currency transaction or a notional principal contract to the country of the recipient's residence is unclear. The general source rule for income from capital, such as dividends and interest, follows the residence of the *payor*, at least in the United States and probably internationally as well. On the other hand, the statutory source rule for insurance premiums looks to the situs of the risk,[41] which admittedly is difficult to identify when the risk in question is financial in nature. The *only* statutory U.S. source rule that looks to residence as a controlling factor, apart from the above-described rule for currency transactions, is the statutory rule, also enacted in 1986, which applies to sales of property.[42]

The question whether income from derivatives is relevantly similar to income from currency transactions and sales of property forces a closer examination of the justification for source basis taxation. If such taxation is founded on the need to protect the host country from fiscal sacrifice when it opens its productive processes to foreign participants, the key question becomes whether such productive processes are involved in the earning of income from these instruments. If, on the other hand, source taxation depends on whether the laws of the host country set ground rules for an income-producing transaction and thus contribute to the earning of income, the investigation must proceed in a different direction. Conceivably, the precise nature of the underlying risk may be significant.

Residence basis taxation, of course, requires no such justification. It rests on an "accretion" concept, so that additions to wealth, regardless of their nature, are subject to imposition. Thus, windfalls are clearly taxable in the country of the recipient's residence, even when a payor in another country can be identified. Such gains and losses, the outcome of pure risk, are arguably "sourceless." In a classification and assignment

40. Because source also plays a major role in U.S. taxation of the foreign income of U.S. residents, the decision to source income from notional principal contracts according to the residence of the recipient has substantial consequences apart from U.S. taxation at source.

41. The statute speaks of liability arising out of "an activity in, or in connection with the lives or health of residents of, the United States . . . ." I.R.C. § 861(a)(7) (1994).

42. I.R.C. § 865 (1994).

system this is tantamount to ascribing source to the country of residence. This, in turn, equates with exclusive taxation in the home country.

Such a rationale arguably applies to income from some derivative financial instruments. The fact that the payor is a resident may not furnish a sufficient nexus to justify imposition at source when the underlying index is worldwide oil prices or foreign exchange fluctuations between a third country and a fourth. The link of the transaction to productive processes in the country of the payor's residence (not to mention the third or fourth country) may just be too weak. The claims of any and all potential source countries are fully recognized when persons having permanent establishments in those countries earn fees and commissions taxable under normal rules relating to the taxation of service income.

On the other hand, this analysis does not cover the universe of income from derivative financial instruments. Where the underlying index is rooted in productive processes of the country from which payment is made, one could reasonably argue that the label accorded the transaction should not distinguish it from other transactions linked with economic activity in that country. The case can become compelling when the transaction is integral to local activities carried on by the payor. Although no capital was transferred, the transaction may nevertheless be essential to the raising of capital.

Such inquiries highlight the lack of coherence of any such category as income from derivative financial instruments. United States law draws a line—a line that seems to lack any justification—between notional principal contracts and other derivatives. Why, after all, should a tax rule of significance turn on whether a particular derivative involves notional principal? Nor is it clear why derivative instruments involving foreign currency should be subject to an independent set of rules. Other candidates for categorization according to the nature of the underlying element, from which the value of the derivative financial contract will derive, present obvious problems of administration. A line reflecting the degree of linkage between the transaction at issue and economic activity in the country of source seems justifiable in terms of traditional source concepts. However, the rule could be manipulable and, again, would give rise to numerous definitional problems.

The source rules are supposed to represent neutral identifications of the U.S. claim to tax. Although U.S. practice has hardly been consistent, the 1986 Tax Reform Act took substantial strides toward limiting source rules to this function while shepherding all incentive-type considerations

into exceptions and exemptions from the normative taxing scheme.[43] If incentives, market views, and other noncentral considerations are set aside as not germane to the determination of source, it is unclear why a source rule tracking the residence of the recipient for all income from all derivative financial instruments is appropriate.

VI. Conclusion

This Article is not intended to make the case that income from derivative financial instruments should be taxed at source, either in the United States or elsewhere. The point is rather to scrutinize the decisionmaking on that question in the larger context afforded by prior U.S. law, concerns expressed by the financial markets, and the treatment of other types and items of income. The result that has been reached in the United States may well be correct, if only because derivatives give rise to a unique type of income whose attachments to jurisdictions other than the one where the recipient resides are too fleeting for legitimacy. If that is the case, however, the emphasis should properly shift back to the matter of definitions, so that it can be made clear what types of income are to be singled out for this extraordinary treatment and how they are relevantly different from everything else.

43. *See, e.g.*, I.R.C. § 871(i)(2)(A) (1995) (exempting interest on bank deposits) and I.R.C. § 871(i)(2)(B) (1994) (exempting dividends from so-called "80-20 companies"). Both exceptions are adopted for corporate recipients in I.R.C. § 881(d) (1994). These exceptions were reflected in the source rules prior to 1987.