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“Exceptions in Search of a Rule: The Source and Taxability of "None of the Above" Income”

Andrew Walker

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Exceptions in Search of a Rule:  
The Source and Taxability of ‘None of the Above’ Income

Andrew Walker∗

∗ Partner, Milbank, Tweed, Hadley & McCloy LLP, New York, New York. An earlier version of the paper was presented to the Tax Club on May 18, 2009.
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The Internal Revenue Code contemplates three categories of income for purposes of the “source of income” rules:  

1. U.S. source income, specific instances of which are enumerated in section 861,  
2. foreign source income, specific instances of which are enumerated in section 862, and  
3. income from sources partly within, and partly without the United States (“mixed source” income), which is allocated and apportioned under section 863(b). Under a delegation of authority in section 863(a), income that is not within one of the statutory categories is to be sourced under Treasury regulations.

Not infrequently, however, one encounters instruments or transactions that produce income of a kind that neither the statutory nor regulatory source rules directly address. The Code and regulations appear to provide no “default” rule or general principle regarding the treatment of income that otherwise is not assigned any source. As a practical reality, one must contend with a fourth category of income, sometimes called “undifferentiated FDAP,” but referred to in this paper as “none of the above” (NOTA) income. Some current, real-world examples of NOTA income are described below.

Courts faced with determining the source of NOTA income have followed one of two general approaches to assign the income a source:  
1. analogizing it to another category of income for which there is an existing statutory source rule or  
2. attempting to determine the source from first principles, based on the income’s economic connections with the United States. Both approaches are more problematic than has been generally acknowledged. From a jurisprudential standpoint, judicial source rules are not easy to reconcile with current law on unexercised delegations of regulatory authority or modern views regarding the appropriate institutional role of courts. Further, as discussed in detail below, allowing judges to create source rules is less than ideal from a policy perspective.

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1 References to “sections,” except where expressly indicated otherwise, are to the Internal Revenue Code of 1986, as amended (the “Code” or “I.R.C”).

This paper examines the NOTA income problem, and discusses how it has been dealt with by courts. Part I of the paper provides an overview of the relevant statutory provisions (and can be skipped by those familiar with the international provisions of the Code). Part II gives a number of contemporary, real world examples of NOTA income problems. Part III surveys the existing cases that have grappled with the problem of NOTA income. Part IV critiques the existing case law, while Part V discusses policy problems with the approach courts have followed and suggests some possible alternatives.

I. An Overview of Source and Other Rules for Cross-border Income

“Source” serves a dual purpose in the United States international tax scheme: First, source determines what income of non-resident alien individuals, foreign corporations, trusts and estates (collectively, “nonresidents”) the United States may tax. Broadly, the United States taxes nonresidents under one of two regimes:

1. If the income is not effectively connected with the conduct of a U.S. trade or business, a non-resident is subject to tax on gross basis tax to the extent the income is fixed, determinable, annual or periodical income (“FDAP”) received from sources within the United States.

2. If the income is effectively connected with the conduct of a U.S. trade or business, the non-resident is subject to tax on gross basis tax to the extent the income is fixed, determinable, annual or periodical income (“FDAP”) received from sources within the United States.

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3. I.R.C. § 2(d) provides that “in the case of a non-resident alien individual, the taxes imposed by sections 1 and 55 shall apply only as provided by section 871 or 877.” Similarly, section 11(d) provides that, in the case of a foreign corporation, tax shall apply “only as provided in section 882.” Section 871(a) provides that “[t]here is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as -- interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income. Section 881 as applicable to foreign corporations is to the same effect.

4. Before 1936, foreign persons were taxed at the same graduated rates as U.S. persons on U.S. source income whether or not they were engaged in a U.S. trade or business. In the Revenue Act of 1936, Congress introduced the bifurcated tax regime for foreign investors: those with a U.S. business or office were taxed on their U.S. source net income at graduated rates and those with neither a U.S. trade or business nor a U.S. office were subject to a flat tax of 10 percent withheld by the payor. See Revenue Act of 1936, ch. 690, 211-19, Pub. L. No. 740, 49 Stat. 1648, 1714-16. Congress also specifically exempted capital gains and provided that trading in the United States in stocks, securities, or commodities through a resident broker, commission agent, or custodian would not generally constitute a U.S. trade or business. See Id. 211(b).

5. Generally, the gross basis tax is collected through withholding by the payor or another intermediary with custody or control over the income. The compliance of withholding agents...
non-resident’s income is effectively connected with the conduct of a trade or business in
the United States, the income is subject to tax on a net basis in the same manner as
income of a U.S. resident. Source may determine whether income is effectively
connected to a non-resident’s U.S. trade or business. Most U.S. source income other than
certain portfolio income automatically is treated as effectively connected, but only
limited categories of foreign source income are treated as effectively connected.\(^6\)

Thus, source rules indentify the categories of income over which the United
States may assert taxing jurisdiction on a basis other than the recipient’s United States
residence or citizenship. Although the “FDAP” concept might appear to be as important
as source in determining the taxability of a nonresident’s portfolio income, as interpreted
by courts and the Treasury, the FDAP concept has been largely denuded of independent
meaning.\(^7\) Source therefore plays the role of primary “gatekeeper” in determining United
States taxability of income in the hands of nonresidents.

The second purpose served by the source rules relates to the manner in which the
United States mitigates double taxation. The United States taxes its citizens and residents
on their worldwide income. To prevent double taxation, subject to a number of
limitations, the United States allows a credit for foreign taxes borne by the income.\(^8\)
Among other limitations, the credit may not exceed the United States tax multiplied by
the ratio of foreign source income to worldwide taxable income.\(^9\) In effect, the United
States asserts primary taxing jurisdiction over United States source income recognized by
U.S. residents, but otherwise cedes primary taxing jurisdiction to the source country.

\(^6\) See I.R.C. §§ 1441 and 1461.
\(^7\) See I.R.C. § 864(c)(4).
\(^8\) FDAP income need not be fixed, determinable or periodic in any ordinary sense of those
terms. See, e.g., Comm'r v. Wodehouse, 337 U.S. 369 (1949). FDAP means any item
included in gross income under section 61, except gains from the sale or exchange of property
and certain other items specifically exempted by regulations or other rules. See Treas. Reg. §
1.1441-2(b).
\(^9\) See I.R.C. §§ 901 and 902.
See I.R.C. § 904(a).
Source rules thus identify income over which the United States may assert primary taxing jurisdiction consistent with international norms.

The general rules for determining source are contained in sections 861 through 865 of the Code (although specific source rules are also found elsewhere). Section 861(a) enumerates certain items of gross income that “shall be treated as income from sources within the United States,” specifically certain interest, dividends, personal services income, rents, royalties, gains from real estate and inventory property, insurance underwriting income and social security benefits. Section 862 enumerates items of income that “shall be treated as income from sources without the United States.” Section 865 provides specific rules sourcing gains from the disposition of personal property. This leaves in statutory “limbo” any class of income not addressed by a specific source rule. However, section 863(a) provides as follows:

863(a) Allocation under regulations. --Items of gross income, expenses, losses, and deductions, other than those specified in sections 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the taxable income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

No obvious unifying principle explains the statutory source rules. Interest, for example, is sourced as a general matter based on the “legal residence of the obligor” rule. Thus a domestic corporation’s interest payments can be U.S. source income even if the corporate earnings that fund interest payments have no actual United States nexus. There is an exception, however, if at least 80% of the U.S. borrower’s gross income is active foreign business income. Another exception applies if the obligor is a bank and the interest is deposit interest related to its offshore branch banking business, presumably

See, e.g. I.R.C. §§ 884(f), 988(a)(3) and 904(h).

I.R.C. §§ 861(a)(1)(A) and 861(c).
because a contrary rule would put U.S. financial institutions at a competitive disadvantage.\textsuperscript{12} Conversely, even if the obligor is a nonresident corporation, interest is U.S. sourced if the interest is functionally related to an active business conducted in the United States (whether or not the borrower’s overall income is predominantly derived from its United States activities), another rule intended to avoid putting U.S. financial institutions at a competitive disadvantage.\textsuperscript{13} The source of interest paid by partnerships turns on where the partnership conducts business and whether the interest is allocable to (i.e., proportionately funded by) effectively connected partnership income.\textsuperscript{14}

Returns to equity capital in the form of dividends from a corporation organized under U.S. law are U.S. sourced, but if realized through a sale or exchange of shares (including a share redemption by the issuer), they are foreign sourced.\textsuperscript{15} The location of leased tangible property determines the source of rental income even if the lessor has full recourse to the lessee,\textsuperscript{16} whereas the location of tangible property securing debt is entirely irrelevant to the source of interest even if the debt is nonrecourse.

The absence of a unified “source” principle is not coincidental. A source assignment is reached only after balancing a complex of conflicting policy and administrative concerns within respect to a particular factual context.\textsuperscript{17} As discussed further below, relevant considerations include: (1) a perceived right to charge for the benefits derived from, and to defray the costs of access by nonresidents to U.S. markets, infrastructure and resources, (2) the need to apportion the international tax base among competing tax jurisdictions consistent with international law, comity and diplomatic considerations, (3) the bargaining leverage in treaty negotiations that base-line source

\begin{itemize}
  \item \textsuperscript{12} I.R.C. § 861(a)(1)(B).
  \item \textsuperscript{13} I.R.C. § 884(f).
  \item \textsuperscript{14} I.R.C. § 861(a)(1)(C).
  \item \textsuperscript{15} Compare I.R.C. § 861(a)(2) with § 865(a).
  \item \textsuperscript{16} I.R.C. § 861(a)(4).
  \item \textsuperscript{17} See American Law Institute, Federal Income Tax Project, International Aspects of United States Income Taxation (1986) 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 geographic source to income. The process seems, however, to require a balancing of the strengths of conflicting claims and considerations as they apply to a particular types of income.”)
\end{itemize}
rules create and (4) general administrability and enforceability constraints. Rarely will these policy considerations all point clearly in the same direction.\textsuperscript{18}

II. **Some Real World Examples of NOTA Income**

Given Treasury’s broad authority to issue source rules, one might think NOTA income would rarely be encountered in practice. In fact, Treasury has exercised its regulatory authority under section 863 to issue source rules sparingly, and NOTA income is fairly common.

**A. Commitment and Similar Financing “Fees”**

One possible example of NOTA income is commitment and similar fees paid in financing transactions. Commitment fees are paid to compensate a lender for agreeing contractually to make a future advance of funds.\textsuperscript{19} Economically, these financing fees compensate for a number of risks incurred as a result of making a financing commitment, including liquidity risk, interest rate risk and credit risk. By committing to a later advance at the borrower’s option, lenders either bear the risk that their cost of funds will have increased at the time the advance is drawn or effectively must protect against the possibility of draws on their book of commitments by reserving an amount of capital in lower yielding, liquid assets.

Commitment fees do not fit neatly into any of the statutory source rule categories. Categories that might conceivably apply are “interest” or “services” income. However, it is settled law that a commitment fee, however denominated, is not interest because it is


\textsuperscript{19} Most often, a periodic “commitment fee” (computed as a specified number of basis points) is payable on the undrawn balance of the aggregate committed amount while interest is paid on the drawn amounts. However, a “facility fee” generally denotes periodic payments of a specified number of basis points on the aggregate committed amount (whether drawn or undrawn) and may be payable in lieu of, or less typically, in addition to commitment fees on the undrawn balance. A lender also may receive specified amounts as “origination” fees, either in cash or as a discount on funds advanced, to compensate them for their early soft commitment during the loan syndication process.
not compensation for the use of money.\textsuperscript{20} “Fee” nomenclature aside, providing a financing commitment bears little resemblance to the performance of personal services. Economically, the fee is a return to capital (more specifically, the availability of capital) not labor, and is a “service” only in the broad sense that performance of any contractual undertaking for the benefit of the other party could be viewed as a “service.”\textsuperscript{21} Indeed, if this is a “service” it is far from clear where “performance” occurs.

The most plausible characterization is probably that the arrangement is an option, in which event source would be determined by the residence of the lender under section 865. The Internal Revenue Service (“IRS”) has ruled that such commitments are economically akin to an option on money, although not in relation to source or withholding provisions of the Code.\textsuperscript{22} A recent case provides further support for treating the commitment arrangement as an option and the fees as option premium.\textsuperscript{23} However, financing commitments do not resemble a classic option. The borrower owns no “property” to be delivered upon exercise (although one can perhaps rationalize the arrangement as a right to put to the lender the borrower’s own “to be issued” debt securities or a call option on the lender’s cash). The periodic payments also are somewhat inconsistent with typical option premiums, which usually involve a lump sum payment, although one could view the commitment arrangement as a series of annual put options.

Reasonable people may differ over which characterization above is substantively more plausible and may even persuade themselves that one particular characterization is compelling. However, there remains a distinct possibility that commitment fees and similar charges are \textit{sui generis} and therefore NOTA income.


\textsuperscript{21} This is distinguishable from situations where the fee, while styled as a commitment fee, is more in the nature of a fee for placement services and compensates not primarily for a capital commitment but for other services such as marketing the loan to potential investors. See, e.g., Chesapeake Financial Corp. v. Comm’r, 78 T.C. 869 (1982).

\textsuperscript{22} Rev. Rul. 81-160, 1981-1 CB 312.

\textsuperscript{23} See Federal Home Loan Mortgage Corp. v. Comm’r, 125 T.C. 248 (2005).
B  Amendment or Consent “Fees”

As common as commitment fees are amendment or “consent” fees paid to lenders for agreeing to amend the terms of outstanding debt. The fee nomenclature might suggest these are payments for “services,” but for the reasons above, that is an unappealing substantive characterization. The same fees are typically payable without regard to the effort the lender has expended in participating in the work-out negotiation.

If the fee is large enough, payment of the fee alone may be sufficient to cause a significant change in yield, and hence a deemed exchange of the debt for new debt under section 1001. In that case, it can be argued that the cash is received as consideration in the deemed exchange and any gain recognized would be sourced based on the residence of the lender under section 865. But that technical argument is unavailing when the fee is too small to trigger a deemed exchange and the nature of the amendment is not otherwise a significant modification. In the latter case, perhaps the additional payment is merely additional yield (i.e. interest), but the fee may instead be NOTA income. Although the significant modification test may be a satisfactory way to distinguish an exchange from a more limited surrender of rights for other purposes, it is intuitively unsatisfying as a lynchpin for the source of income. Allowing a larger fee to escape withholding tax when a smaller fee does not, although both serve as consideration for the same thing, seems counter-intuitive.

C  Synthetic Letter of Credit “Fees”

A recent arrangement that had became quite common in the syndicated loan market -- until tax concerns intervened -- was the synthetic letter of credit facility. Letters of credit typically are issued in connection with revolving credit facilities. Because the borrower is concerned about future performance by the committed lenders,  

\[\text{\footnotesize\textsuperscript{24}} \quad \text{Indeed the characterization as a payment for a service is even less appealing since the amendment process generally will not have the labor-intensive trappings of loan origination.}\]

\[\text{\footnotesize\textsuperscript{25}} \quad \text{Treas. Reg. § 1.1001-3(e)(2)(iii) (changes in yield above specified thresholds, taking into account fees in consideration for an amendment, cause a deemed exchange).}\]
revolving credit tranches of a loan generally are limited to regulated financial institutions with strong credit ratings. To expand the potential lender base to other investors, a financing structure (sometimes referred to as a “synthetic” letter of credit structure) was devised.

Whereas under a traditional letter of credit facility the letter of credit participants do not provide funds to the letter of credit issuer unless and until a letter of credit disbursement is made and the borrower fails to reimburse the issuing lender, under a synthetic structure, the participants provide the full amount of their commitment upfront, just as they would if they were making a term loan (and for this reason, this structure is also sometimes called a “pre-funded” letter of credit structure). These amounts are held on deposit by an “issuing lender,” typically the lead bank. Each lender in form acquires a participation in each letter of credit issued by the issuing lender. The deposit with the issuing lender serves as cash collateral for other lenders’ obligations to fund their participation if a letter of credit disbursement is not reimbursed by the borrower. The issuing lender pays interest on the deposits to the other lenders, generally at a rate slightly less than LIBOR, and passes through a proportionate share of the facility fees paid by the borrower. The sum of the interest on each deposit plus the facility fee payable to each lender generally is equal to the amount that such lender would receive for a term loan to the borrower. If a letter of credit disbursement is not reimbursed, the deposit is debited and the lender receives its proportionate share of the borrower’s obligation to the lender to reimburse the letter of credit disbursement and to pay interest on the reimbursement claim until it is paid.

Thus, what the borrower sees as a letter of credit facility, the lenders (other than the issuing lender) see as a term loan facility. While economically the arrangement may be indistinguishable from a term loan from the lenders’ perspective, its proper tax treatment is far less clear. As a matter of form, the portion of the return attributable to the borrower credit spread (the facility fee) generally is styled as direct payment of, or participation in those fees. If treated in accordance with this form, as a financing fee, the income may be NOTA income for reasons discussed above. It is difficult to characterize this arrangement as a loan to the underlying borrower since the borrower has no immediate access to the funds advanced nor control over, or right to the earnings from,
the amounts on deposit. Another possibility is to view the arrangement instead as a contingent (or “credit linked”) loan to the issuing bank.\textsuperscript{26} However, as the putative principal amount is not unconditionally required to be repaid unless the likelihood of default by the underlying borrower is quite remote,\textsuperscript{27} it is not clear this arrangement qualifies as debt for tax purposes. None of these characterizations is entirely satisfactory, leaving open the possibility that the income is \textit{NOTA}.

\textbf{D. Cancellation of Debt Income}

Another unresolved sourcing question involves cancellation of indebtedness (“CODI”) income recognized by a foreign borrower. United States lenders who forgive a foreign borrower’s debt could be viewed as having made an economic transfer to the foreign borrower. Regulations provide that FDAP includes any amount included in gross income under section 61 (other than certain specifically excepted items like capital gains). As CODI is not derived from a sale or exchange of property,\textsuperscript{28} the position that this is not FDAP is unavailing.\textsuperscript{29} The source of the CODI is an open question.

No statutory or regulatory rule addresses the source of cancellation of debt income. Certain cases discussed below have treated cancellation of debt income

\begin{trivlist}
\item \textsuperscript{26} That may not preclude withholding as the “interest” could then be viewed as contingent interest that is not entitled to the portfolio interest exemption. \textit{See} I.R.C. §§ 871(h)(4), and 881(c)(4).
\item \textsuperscript{27} \textit{See} \textit{Gilbert v. Comm’r}, 248 F.2d 399, 402 (2d Cir. 1957) (debt defined as “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor’s income or lack thereof.”)
\item \textsuperscript{28} If the foreign borrower is insolvent, arguably the reference to section 61 could be read to incorporate section 108 insofar as it excludes CODI from gross income. But section 108 does not specifically say that gross income under section 61 excludes such CODI, so this is not clear. Indeed, since the price of CODI exclusion in that situation is reduction in tax attributes and the foreign borrower likely has no US tax attributes, one could argue that section 108 was not even intended to reach foreign borrower not engaged in a U.S. trade or business.
\item \textsuperscript{29} Treas. Reg. § 1.1441-2(b). Withholding regulations do however relieve a U.S. lender of withholding responsibility for CODI if it does not have custody or control over money or other property of the debtor at the time of the cancellation. \textit{See} Treas. Reg. § 1.1441-2(d)(2). This does not, however, eliminate the borrower’s legal liability for any tax owing under sections 871 or 881.
\end{trivlist}
recognized by a foreign borrower as U.S. source income. However the reasons those cases give for treating CODI as U.S. source income are conflicting and opaque.

E. Partnership Guaranteed Payments

Uncertainties also bedevil the source of “guaranteed payments” paid by a partnership to a foreign partner. Guaranteed payments are payments to a partner for services or the use of capital that are not dependent upon the partnership’s income. Section 707(c) states that a guaranteed payment is considered as made to one who is not a member of the partnership, “but only for the purposes of section 61(a) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).” This language implies a guaranteed payment could be treated as a distributive share of partnership income unless this would be inconsistent with treatment of the payment as an item of ordinary income. Regulations under section 707(c) state that guaranteed payments are considered made to a non-partner for purposes of sections 61 and 162, but for the purposes of other provisions, guaranteed payments are regarded as a partner’s distributive share of ordinary income.

Guaranteed payments made to non-residents for the use of capital in abstract could be treated for sourcing purposes in one of three ways: as interest paid by the partnership, as a distributive share of partnership ordinary income, or as an item of ordinary income that is neither interest nor a distributive share of partnership income. Treating the guaranteed payment as interest is hard to justify, because it is paid with respect to an instrument that is not debt under general federal income tax principles.

Some guidance relating to guaranteed payments supports treating the payment as a

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30 See de Ventas, infra note 49; See Big Hong infra note 78.
31 Treas. Reg. § 1.707-1(c).
32 See GCM 36702 (April 12, 1976) (guaranteed payments made by a partnership to a real estate investment trust were characterized as interest income).
34 In extreme cases, of course, the partnership interest might be characterized as debt under general substance over form principles. See TIFD III-E, Inc. v. U.S., 459 F.3d 220 (2nd Cir. C.A. 2006) (“Castle Harbor”).
distributive share of underlying income.\textsuperscript{35} On the other hand, \textit{Miller v. Commissioner}\textsuperscript{36} characterizes a payment as if made to an non-partner (\textit{i.e.}, followed an entity approach to partnerships) in determining the source of a guaranteed payment made to a law firm partner for purposes of applying the foreign source earned income exclusion in section 911.

Even if the distributive share approach were a partial solution, it would necessarily be limited to a payment that does not exceed the underlying partnership income available to be allocated to the partner. Accordingly, this approach cannot be a complete answer. There is also something troubling about the notion that the source of guaranteed payments could change depending on whether the partnership has a more or less successful year.

\textbf{F. Credit Default Swaps, “Footfault” Notional Principal Contracts and Structured Products}

\textit{NOTA} income problems also pop up frequently in the context of innovative financial products and transactions. Until Treasury finally resolved the issue by promulgating Treasury regulation section 1.863-7, one of the most significant areas of uncertainty was the source of swap income. Certain financial derivatives like options and forwards were sourced based on the residence of the counterparty. It was not clear, however, that most swaps could be so characterized. The regulations now generally source income from notional principal contracts to the residence of the recipient unless the income is connected to a U.S. trade or business.\textsuperscript{37}

\begin{itemize}
\item \textsuperscript{35} See PLR 8728033 (April 13, 1987) (guaranteed payments made by a partnership to a real estate investment trust retained the character of the partnership’s underlying income and were therefore rental income in the hands of the recipient) and PLR 8639035 (June 27, 1986) (same); GCM 34141 (June 25, 1969) (guaranteed payments from royalty income eligible for percentage depletion).
\item \textsuperscript{36} 52 T.C. 752 (1969). \textit{See also Carey v. United States}, 427 F.2d 763 (Ct. Cl. 1970).
\item \textsuperscript{37} Treas. Reg. § 1.863-7(b)(1). These source regulations govern income attributable to a notional principal contract, defined as “a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.” Treas. Reg. § 1.863-7(a)(1).
\end{itemize}
Certain instruments, however, do not clearly satisfy the definition of a notional principal contract. For example, it is not entirely clear that credit default swaps qualify. Another example is a swap that perhaps fails certain narrow technical requirements of the definition of notional principal contract in the regulations under section 446 (§ 1.446-3), such as a swap on mortality or casualty risk. The question is whether such an index is objective financial or economic information within the intendment of the regulations. Alternatively, the swap may reference information that could be considered unique to one of the counterparties.

This paper’s purpose is not to resolve whether any one of the competing substantive characterizations in the various examples above should prevail. Rather, the paper is concerned with what follows if one reluctantly concludes (or worries that a court would conclude) that no substantive characterization that could bring the income within a settled source category is compelling and the income is NOTA.

III. Existing Judicial Approaches to NOTA Income

A court’s analysis of potential NOTA income involves three related inquiries. First, the court will evaluate whether there is a supportable substantive characterization that would bring the income within one of the established source categories. Strictly, possibly, the fact that the swap fails to meet the requirements of Treas. Reg. § 1.446-3 is not dispositive because Treas. Reg. § 1.863-7 does not on its face include various of the exceptions in Treas. Reg. § 1.446-3 nor does it directly cross-reference that section. It merely recites the general description of a notional principal contract, but without defining other terms like “specified index” or “notional amount.” On the other hand, it would not be a great stretch for a court to look to Treas. Reg. § 1.446-3 to determine the meaning of “specified index” and thereby incorporate some of those exceptions.

The protocol to be followed in determining the tax treatment of novel financial instruments and arrangements is widely accepted, and requires weighing the features that are similar to, or different than an existing recognized category of financial instrument to determine which recognized financial instrument the instrument most closely resembles. See Rev. Rul. 2003-97, 2003-34 I.R.B. 380 (“In deciding among multiple potential characterizations, the tax law seeks to find the best match between the bundle of rights and obligations and one or more categories of widely recognized instruments.”).
income would not be NOTA if this effort succeeds, so this can be viewed as “step zero” in the analysis. However, announcing a particular substantive characterization of the overall transaction has wider tax ramifications affecting, for example, the timing and character of the income. This constrains how far a court can or should reach to ‘shoehorn’ a novel kind of income into an established source category based on substantive recharacterization. For example, it seems highly unlikely a court would treat a financing fee or credit default swap periodic payment as interest even if it believes there is sufficient economic similarity to justify sourcing such payments in the same way.

If a court concludes the income is NOTA, the court generally will analogize income from the transaction to other categories of income for which settled source rules exist.\(^{41}\) If there is not a sufficiently analogous category of statutory income,\(^{42}\) the court may feel compelled to determine the source of the NOTA income from first principles, based on where the income is produced, how it originates and where the relevant transactions occurred. Often, judicial opinions rationalize the court’s chosen source assignment for NOTA income on both grounds.

### A. Sourcing By Substantive (Re)characterization

Courts have resolved many potential NOTA income problems by characterizing the overall transaction so as to bring the income within a statutory source category, although these decisions often include language intended to show that the court’s conclusion is consistent with the inherent economic “origin” of the income.

One such case is *Hunt v. Commissioner*.\(^{43}\) The Hunts were partners in a partnership (HIPCO), that produced and sold crude oil. HIPCO had an interest in a Libyan oil concession, production from which was jeopardized by threats of production cutbacks and nationalization by the new Libyan regime. In response to these threats, and to coordinate their resistance to the Libyan regime, various oil companies executed an

\(^{41}\) *See Bank of America, infra* note 53.

\(^{42}\) For example, it seems unlikely that cancellation of debt income could be viewed as analogous to income in any existing statutory or regulatory source category.

\(^{43}\) 90 T.C. 1289 (1988) ("Hunt").
agreement to share the burden of any production cutback. Under the agreement, a company that suffered a cutback was entitled to receive substitute Libyan crude from other producers unaffected by the cutback, or if substitute Libyan oil was unavailable, Persian Gulf crude. Back-up crude was to be supplied at tax-paid cost (the cost of production net of government taxes and similar impositions). After HIPCO’s interest in Libyan oil production was nationalized, HIPCO purchased back-up Persian Gulf crude oil pursuant this agreement and resold it to customers, with delivery occurring and title and risk of loss passing, at Persian Gulf ports. At HIPCO’s direction, the crude oil was delivered in each transaction by the producer directly to a tankship provided by HIPCO’s customer and HIPCO never formally took title to the crude.

In calculating the amount of their foreign tax credits, the Hunts elected the “per-country limitation” and sourced the income derived from sales of the back-up Persian Gulf crude to Libya. They argued that the back-up crude was derived indirectly from HIPCO’s ownership of Libyan wells and should be sourced in Libya under Treasury regulation section 1.863-1(b) (which apportioned income from mineral production between the country in which the production occurred and the country in which the sale occurred). However, the Tax Court agreed with the government that income from the sale of the Persian Gulf crude was sourced under the ‘title passage’ rule to the Persian Gulf. Despite the form of the transaction, the court concluded it was in substance a purchase and resale by HIPCO of the crude with title passing at the relevant Persian Gulf port. As HIPCO did not in fact produce the oil, the court held that the apportionment permitted producers under regulations did not apply.

The Tax Court in Hunt approvingly cited statements in Howkins v. Commissioner, that Congress “sought to identify the source of income in terms of the

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44 Prior to the Tax Reform Act of 1976, taxpayers could elect to compute the section 904 limitation on a country-by-country basis (i.e., the amount of the credit in respect of the tax paid to any country could not exceed the same proportion of the U.S. tax that the taxpayer's net income from sources within such country bore to its entire net income).

45 Compare Rev. Rul. 76-154, 1976-1 CB 191 (expropriation damages sourced based on where the expropriated business property was held and business conducted).

46 90 T.C. 1289.

47 49 T.C. 689 (1968).
business activities generating the income or to the place where the income was produced” and that “the sourcing concept is concerned with the “earning point of income or, more specifically, when and where profits are produced.”

However, there was little further discussion in the Hunt opinion about the economic origin of the income from sales of substitute crude oil. Having determined that “purchase and resale” characterization, the title passage rule for sales of personal property resolved the source of the income. The statements in Hunt about the location of business activities that generated the income therefore were not essential to the ultimate holding.

Another case where the court stretched to find a substantive characterization that resolved the source of income was Corporation de Ventas de Salitre Y Yoda de Chile v. Commissioner. There, a Chilean company (not engaged in a trade or business in the United State) had issued bonds under a New York indenture to U.S. investors and later repurchased some of these bonds at a discount to their face amount. Having rejected the taxpayer’s contention that this repurchase did not cause the issuer to recognize income, the court turned to the taxpayer’s fallback position that any such income was not U.S. sourced. The court concluded that the repurchase was a sale of personal property which, under regulatory source rules then in effect, was sourced by the place of sale. Since the repurchase transaction occurred in New York, the court held this was U.S. source gain. While it was a stretch to view the debt security as personal property of the issuer (for whom it was a liability) and the income as gain from a sale (since it was a purchase by the issuer), the court managed to avoid directly confronting whether the income “originated” in the United States and whether, absent regulations, this income could be treated as U.S. sourced. The opinion’s language however is somewhat vague and could also be understood to say that the court thought that personal property sales furnished the best analogy rather than that this was substantively gain from a property sale.

Helvering v. Stein involved a German bank that entered into an arrangement with U.S. banks to allow its German clients who otherwise did not have access to credit

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48 Supra note 43 at 1301.
49 44 B.T.A. 393 (1941) rev’d on other grounds 130 F.2d 141 (2d Cir. 1942) (“deVentas”).
50 115 F.2d 468 (4th Cir. 1940).
in the United States to issue drafts drawn on U.S. banks. Typically, banks accept drafts against the credit of the drawer. Here, contrary to customary arrangements for bankers acceptances, the German bank had arranged with the U.S. banks to itself repay the drawn amounts two days prior to maturity and then recover these amounts from its customers. The German bank profited by charging a higher rate of interest to its customers than the discount on the bankers acceptances. The government argued that this was a purchase of property (in the form of a negotiable instrument) by the German bank in Germany and resale of that property in the United States, but the court disagreed. The court reasoned that, notwithstanding the form of the transaction, in substance the German bank merely borrowed money from the U.S. banks and re-lent it at a higher rate to its German customers. In effect, the court viewed the transaction as a “pledge” by the German bank of customers obligations to support the bank’s own borrowing. This brought the income within an existing source classification because interest derived from German customers was clearly foreign source income.

In *British Timkin Ltd. v. Commissioner*, U.K. and U.S. affiliates that manufactured bearings had an agreement allocating particular sales territories in which each could use the company trademark. During the Second World War, the U.K. affiliate became unable to produce adequate quantities of bearings and was prevented by exchange controls from purchasing bearings from its U.S. affiliate for resale to its customers. So the affiliates entered into a revised arrangement whereby orders generated by the U.K. affiliate were forwarded to the U.S. affiliate which fulfilled the orders, making delivery in the United States, and then paying the U.K. affiliate the difference between the wholesale price it would have charged the U.K. affiliate and the price the customer paid. Although it appears the U.K. affiliate had agreed to bear the risk of customer default, the court rejected government arguments that the arrangement was properly characterized as a constructive purchase and sale by the U.K. affiliate in the United States (i.e., it declined to view the U.S. affiliate as a contract manufacturer, agent or partner). Instead, the court characterized the income earned by the U.K. affiliate, in the alternative, as a sales commission or license fee for use of intangible property and

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sourced the income based on where services were performed or the U.K. affiliate’s sales
territory was located (i.e., to foreign sources).

While a number of the decisions above contain language that might appear to
justify judicial sourcing of income based on the location of business activity or the
economic origin of the income, these digressions were unnecessary to the ultimate
holding in these cases and are dictum. The decisions ultimately rest on the substantive
characterization of the transactions the courts adopted, which brought the transactions
within a category of income for which there was a settled statutory or regulatory source
rule.

B. Sourcing By Analogy

The leading case to follow the approach of sourcing income by analogy to other
income addressed by statutory source rules is Bank of America v. United States, which
addressed the source of various banker’s acceptance and letter of credit confirmation
commissions paid to the U.S. bank in connection with commercial letter of credit
transactions involving foreign banks. Citing prior case law, the Court of Claims held that
when neither the Code nor regulations explicitly source an item of income, the income is
to be sourced by analogy to classes of income specified within the statutory framework.

The court ruled that acceptance and confirmation commissions were foreign-source
income by analogy to the interest source rules because the U.S. bank assumed the credit
risk of the foreign banks and assured payment to the holder of the draft. The fact that the
taxpayer received the fees in respect of a risk located abroad also justified sourcing of the

52 See e.g. Stein v C.I.R., 40 BTA 848, 855 (1939) rev’d Stein v Helvering 115 F.2d 468 (4th Cir.
1940) (“[I]t derived no profit from the transactions in the United States. Its profit, if any, was
earned in Germany from the lending of the money on the credit and risk of its clients. It does
not appear that Congress intended to tax that kind of a profit.”); British Timkin Ltd. v.
Comm’r, supra note 51 at 886 (“the situs of the sale and the "source" of the income
attributable to the sale is the place where the seller surrenders all his right, title, and interest to
the buyer.”).

53 680 F.2d 142 (Ct. Cl. 1982).

54 Id. at 147.
fees abroad, by analogy to the insurance premium rules.\textsuperscript{55} However, the court might instead quite reasonably have concluded that a more important economic origin of the fees was Bank of America’s own creditworthiness.\textsuperscript{56}

One earlier case on which \textit{Bank of America} relied, \textit{Howkins v. Commissioner},\textsuperscript{57} considered whether alimony paid by a U.S. resident to his nonresident former spouse was U.S. source income. The \textit{Howkins} decision proclaimed that “for the most part” Congress intended to source income based on where the income was “produced.” However, rather than attempting to discern from first principles where the income was “produced,” the court resorted to an analogy to the statutory source rules for interest. It reasoned that interest was the closest analogy, because like interest, alimony payments are made in satisfaction of a contractual obligation. The court therefore held that alimony payments should be sourced by reference to obligor’s residence.\textsuperscript{58}

While frequently cited as a seminal case, the core holding of \textit{Bank of America} has not to date been followed squarely by other judicial decisions. \textit{Centel Communication Co. v. Commissioner}\textsuperscript{59} recited the holding of \textit{Bank of America} but followed it as to the proper tax characterization of letters of credit, not the determination of source more generally. \textit{Hunt},\textsuperscript{60} discussed above, cited the \textit{Bank of America} approvingly but appears to have resolved the case based on a substantive characterization of the transaction as a sale and repurchase of crude oil. \textit{Clayton v. United States},\textsuperscript{61} cited \textit{Bank of America} as authority for judicial “sourcing by analogy” but held on the facts in \textit{Clayton} that section 402(a) directly determined the source of the income so that there was no need to

\textsuperscript{55} Cf. 861(a)(7). The trial court in the \textit{Bank of America} case relied on the location of the risk rather than on an interest analogy. 81-1 USTC ¶ 9161 at 86,237 (Ct. Cl. 1981).

\textsuperscript{56} See Blessing and Lubkin, 905-2nd T.M., Source of Income Rules at ¶XV.B.1.a.

\textsuperscript{57} Supra note 47.

\textsuperscript{58} The decision may have been influenced by the fact the husband had deducted the alimony payments, which, under section 215, is permissible only to the extent the alimony is includible in gross income by the payee. The court at one point implied the husband was thereby estopped from arguing that the amounts were not gross income to the wife (— they would not have been included in her gross income had they been foreign source income).

\textsuperscript{59} See 920 F.2d 1335, 1343 (7\textsuperscript{th} Cir. 1990).

\textsuperscript{60} 90 T.C. 1289.

\textsuperscript{61} 33 Fed. Cl. 628 (1995).
determine source by analogy. The *Bank of America* approach has, however, been followed in a number of administrative pronouncements.\(^{62}\)

There are also some other cases that can be viewed as employing a variant of analogic reasoning to assign a source. These cases sourced income on the basis that the income was received “in lieu of” or as a “replacement” for other income of specified source.

*Korfund Co. v. Commissioner*,\(^{63}\) for example, addressed the source of payments under a non-compete agreement and held that income received for agreeing not to compete in the United States was U.S. source income.\(^{64}\) The taxpayer argued that a non-compete could be considered the performance of a service in a negative sense (i.e. an agreement not to perform certain acts), and as the exercise of this self-control occurred in Germany where the taxpayers resided, the income was foreign sourced. Alternatively, the right to compete in the United States could represent intangible property, the transfer of which occurs when the taxpayer agrees not to compete. If so, the income would be sourced like royalties based on the territory where the right may be exercised or used. Finally, the noncompete payments could be viewed as replacing business income that otherwise would have been derived from U.S. sources and assigned the corresponding source.\(^{65}\) The latter rationale persuaded the court.\(^{66}\)

A similar “replacement income” rationale justifies the treatment of payments under a guarantee when the primary obligor defaults, which are sourced by reference to


\(^{63}\) 1 T.C. 1180 (1943).

\(^{64}\) See generally Waimon and Surdell, *Money For Nothing*, Taxation of Global Transactions (Fall 2002).

\(^{65}\) The rationale reflects intuitions similar to those underlying the “origin of the claim” doctrine, which generally characterizes judgments or settlements in litigation based on the nature of the underlying loss that is being compensated.

the payments on the underlying obligation that guarantee payments replace.\textsuperscript{67} However, such “replacement income” theories fail to persuade courts as often as they succeed. For example, such an approach in the Hunt case discussed above might well have led a court to conclude that the income from crude sales under the producers’ agreement was a substitute for Libyan source income. Similarly, in Torrington v. United States,\textsuperscript{68} a U.S. corporation’s argument that its ‘war loss’ recognized upon seizure of its German subsidiary was foreign source loss might have prevailed.

C. Sourcing From First Principles

Faced with NOTA income that has no obvious or persuasive statutory analog, certain cases have attempted to resolve the source of the NOTA income by determining the geographic origin of the income from first principles.

One case in which a court grappled openly with the geographic origin of NOTA income is Commissioner v. Piedras Negras Broadcasting Co.\textsuperscript{69} The petitioner in that case operated a radio broadcasting studio in Mexico, just across the United States border. In Mexico, it executed contracts to broadcast advertising programs at flat rates or for a percentage of the sales revenue advertisers generated. The broadcasts were made from the Mexican studio but were directed at listeners in the United States. The dispute centered on whether the broadcaster’s contacts with the United States were sufficient to constitute a trade or business within the United States, which the Court held they were not. However, the court also wrestled with the source of the income and concluded that it was foreign source.

\textsuperscript{67} See Rev. Rul. 70-377, 1970-2 CB 175; Tonopah & Tidewater R.R. Co. v. Comm’r, 39 BTA 1043 (1939) (obligation of guaranty was not an obligation independent of and a substitute for the obligation of the primary obligor, but the payment by the guarantor of interest discharged primary obligation), rev’d by 112 F2d 970 (9th Cir. 1940) (rejecting the substitution concept, although the decision ultimately seems to have turned on the absence of a withholding obligation on the part of the U.S. borrower who did not have custody of the funds used to make payment).

\textsuperscript{68} 149 F.Supp 172 (Ct. Cl. 1957).

\textsuperscript{69} 43 BTA 297 (1941) aff’d by 127 F. 2d 260 (5th Cir. 1942).
The court began by trying to establish a general definition of “source,” citing Webster’s New International Dictionary defining source as “that from which anything comes forth, regarded as its cause or origin, the first cause.” Thereby persuaded that economic income can have a prime cause, the court investigated the factors that allowed the broadcaster to generate the income, arguing that:

Mexico was the situs of the “device” which “produces energy which reaches every part, however small, of the space affected by its power.” [] The initiation of such impulse seems truly the first cause in this matter . . . . We are unable to discern, in the mere fact of broadcasting across the ether over the United States, that capital or labor was employed therein, or that an activity took place therein which can truly be said to be the source of the income here involved. The source, we think, was the studio and power plant or broadcasting station in Mexico and the labor there employed. With and through them, as instrumentalities, the petitioner employed capital and labor, and earned its income. . . . Without them no effect would have been secured upon receiving sets and the advertisers’ customers in the United States. The United States has no power to regulate or control the petitioner’s broadcasting activities, which occur and are exercised in Mexico.70

The court’s dilemma was that the listener base in the United States was the *sine qua non* of the broadcaster’s ability to earn the income. Few Mexican households likely had radio sets to receive the signal, were likely to be customers of U.S. businesses willing to pay for advertising time or, indeed, would have paid attention to the English language broadcasts in any event. Both consumers of and purchasers of the advertising were in the United States. Yet, the broadcaster was able to gain access to that valuable market without needing a physical presence in the United States. The “ethereal” nature of that access meant that, in the court’s view at least, the United States could not block that access as a technological or jurisdictional matter. The jurisdiction of the United States to prescribe or enforce any tax was therefore questionable. The facts presented a stark conflict among competing policies underlying source. On the one hand, the case for taxability based on benefits being derived primarily from access to the U.S. market was

70 43 BTA 297, 312-313 (1941).
very strong. On the other, jurisdictional and enforceability considerations and prevailing international tax norms cut the other way.

*Ferro-Enamel Corporation v. Commissioner*\(^{71}\) involved a domestic corporation that acquired stock in a foreign mining company in connection with a supply agreement intended to secure a source of cobalt for its domestic business. The foreign mining company failed and was liquidated, resulting in a loss from the stock. At the time, no specific statutory or regulatory rule addressed such a loss. The taxpayer treated this as a U.S. source loss enhancing its use of foreign tax credits under section 904. The taxpayer argued that it did not acquire the stock as an investment or to secure dividends (a factual contention not disputed) but to further its U.S. business activities and the loss therefore was U.S. sourced. This argument persuaded the Board of Tax Appeals, but the decision was reversed on appeal by the Sixth Circuit, which held that the purpose for acquiring the stock was irrelevant and that the loss was foreign source loss. The opinion appeared to conclude that the geographic *situs* of the underlying activity determined the source:

> The statute in question undertakes to classify the sources of income within the United States and without the United States by the nature and location of the activities of the taxpayer or his property which produces the income. If the income be from service, the place where the service is performed is decisive. If the income is from capital, the place where the capital is employed is controlling. If the income arises from the sale of a capital asset or a loss from its disposition, the place where the sale occurs, or the loss happens, is decisive.\(^{72}\)

\(^{71}\) 134 F.2d 564 (6th Cir. 1943).

\(^{72}\) *Id.* at 566. The source of foreign stock losses was again before the Tax Court in *Black & Decker Corp. v. Commissioner*, 62 T.C.M. 1204, 91-2736 (1991) (“*Black and Decker*”). By then, Treas. Reg. § 1.861-8(e)(7)(i) had been issued providing that losses from the sale of personal property were to be allocated to the class of gross income to which the property “ordinarily” gave rise. The taxpayer argued that, as it had invested in the relevant foreign subsidiary for strategic reasons rather than to generate dividends and in fact earned no dividends, the property did not “ordinarily” give rise to foreign source income. The Tax Court accepted the government’s position that “ordinarily” was intended to connote generically the kinds of income property of that type would generate and not what was anticipated in a particular case. Although the decision also discussed *Ferro Enamel’s* “geographic situs” test, this was clearly dictum. *See Black and Decker*, at 91-2736 (“The parties also make arguments based on the pre-1977 law relating to the treatment of worthless stock losses. For the sake of completeness, we will address their arguments.”)
Given the diverse and inconsistent statutory source rules the Code actually provides, this attempted synthesis seems as much aspirational as descriptive.\textsuperscript{73}

Other cases that have attempted to discern from first principles the source of NOTA income, offer less thorough, and even less persuasive reasoning.

\textit{Zander & Cia v. Commissioner,}\textsuperscript{74} for example, involved a Brazilian company (not engaged in a U.S. trade or business) that entered into various coffee futures transactions on a New York Exchange through a U.S. broker. The court held that since “all of the transactions involved took place within this country . . . the income therefrom clearly had its origin here.”\textsuperscript{75} The court failed to explain why the place where transactions occurred necessarily determined the inherent economic origin of income, particularly since the transactions actually performed within the United States were not performed by the Brazilian company itself and the broker received separate commissions for the acts performed on the company’s behalf. Indeed, subsequent to the transactions in question but prior to the court’s decision, Congress had amended the statute to exempt such gains derived through independent brokers.\textsuperscript{76} However, the court concluded Congress intended to change rather than clarify prior law (albeit prior law the court had itself “discovered” only after Congress acted).

\textit{Stafford v. Pedrick}\textsuperscript{77} involved the application of the excess profit tax to a domestic corporation. An exemption was available for domestic corporations more than ninety-five percent of whose income was from sources outside the United States. More than five percent of the corporation’s income took the form of cotton export subsidy payments from the U.S. Treasury. The court held that this was U.S. source income as “it strains the meaning of the words to say these payments are not from sources within the United States. They are received from the United States Treasury and every act which the exporter must do to become entitled to the subsidy is done in this country.” At one

\begin{itemize}
\item \textsuperscript{73} See discussion, \textit{supra} text surrounding note 17.
\item \textsuperscript{74} 42 B.T.A. 50 (1940).
\item \textsuperscript{75} \textit{Id.} at 51.
\item \textsuperscript{76} See discussion \textit{supra} note 4.
\item \textsuperscript{77} 171 F.2d 42 (2d Cir. 1948).
\end{itemize}
level, the result is not surprising. The payor was domestic (indeed, it was the United States itself), the recipient was a domestic corporation and the business that benefited from the subsidy was actively conducted in the United States. This may be the unusual case in which almost any sourcing rule would have reached the same result. However, there was at least a plausible argument that, being based on export sales, the subsidy was in some sense an adjustment to the price charged foreign customers for cotton sales (gain from which was foreign source income).

Strained judicial reasoning in *Big Hong Ng v. Commissioner*, 78 may owe something to the strong odor of tax evasion in that case. The petitioner operated multiple companies both inside and outside the United States, with little apparent respect for corporate formalities. One of the foreign companies had borrowed from another to buy a building in the United States. Later petitioner caused the borrower to distribute its sole asset, which, the court held, triggered a constructive discharge of the debt and cancellation of indebtedness income. Among other arguments, the taxpayer asserted that the resulting income was not U.S. source income. The court disagreed, on the basis the debtor’s “only business activity was the rental of [the building] and the indebtedness was related to that activity” and, accordingly “that [the debtor’s] indebtedness was connected with its business in the United States.” While understandable on these facts that the court would strain to reach the result it did, the court’s reasoning was fundamentally flawed. To say that the income was connected (if the court meant by this “effectively connected”) reflected an implicit conclusion the cancellation of debt income was U.S. source but was not an explanation as to why that was the case. The Code treats only specified limited types of foreign source income as effectively connected income even if the nonresident is engaged in business in the United States, and cancellation of debt income is not among them. 79 Sourcing income to the United States because it is effectively connected is inherently circular given this statutory scheme. 80 The court may have intuited that,

78 73 T.C.M. 2900 (1997).
79 See I.R.C. § 864(c)(4).
80 Adopting this rule, all income attributable to an active United States business (other than income specifically enumerated in section 862) would be effectively connected regardless of source. That regime might be perfectly policy, but it is not the regime Congress has enacted.
because the interest on the debt has been allowed as a deduction against the U.S. business income, the cancellation of debt income should be includible. On the other hand, based on that reasoning, the result in de Ventas would have been different.81

*Helvering v. Suffolk*82 addressed whether a New York City tax refund was U.S. source income. The foreign corporation acquired a right to refunds from a defunct U.S. taxpayer in exchange for stock. Much of the court’s opinion focused on rebutting the taxpayer’s contention that the items specified by statute were the exclusive categories of income from U.S. sources, pointing out the authority to promulgate other rules.83 The explanation as to why the income in fact was U.S. sourced was cursory. The court merely asserted that it was “unlikely that Congress intended not to tax income from a transaction of this sort” and noted that the general definition of gross income is very broad.84

*Barba v. Commissioner*85 addressed whether a nonresident’s keno winnings at a U.S. casino were taxable. Among other arguments, the taxpayer argued this was not U.S. source income. The taxpayer’s source argument, however, was somewhat convoluted. The taxpayer argued that on its face, section 863 required that gambling losses be apportioned in order to compute U.S. source income, and since he had no income after his gambling losses were apportioned, there was no U.S. source income under section 863(a), which provides that “where items of gross income are separately allocated to sources within the United States there shall be deducted (for purposes of computing the

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81 Supra, note 49.
82 Helvering v. Suffolk Co., 104 F.2d 505 (4th Cir. 1939).
83 Id at 81
84 This idea that difficult source questions can be resolved based on an implicit presumption in favor of taxability evidenced by the breadth of the gross income definition in section 61 has influenced courts in certain cases. However, the statute expressly limits gross income in the case of a nonresident to U.S. source income, so it is completely circular to suggest that section 61 can inform the source of income analysis. See I.R.C. §§ 872 and 882(b). More fundamentally, international taxation based on source is in the nature of a “schedular” tax and source therefore cannot be resolved based on Haigh-Simons conceptions of economic income. Cf. U.S. Treasury Tax Policy Staff, BLUEPRINT FOR TAX REFORM at 89-90 (2d ed. 1984) (“[T]he concept of income as consumption plus change in net worth implies that distinctions based on the geographic origins of receipts are inappropriate. Income by this definition is an attribute of individuals not places.”).
85 83-1 U.S.T.C ¶ 9404 (Ct. Cl. 1983).
taxable income therefrom) the expenses, losses and deductions properly allocable thereto.

As the court pointed out, when the operative tax provision, in this case section 871, was applicable to gross income, the fact that items were to be deducted for purposes of computing taxable income was beside the point. It appears the petitioner conceded as a general matter the notion that this gambling income originated in the United States. Perhaps for that reason, the court simply took as given that the income was U.S. sourced if the taxpayer’s other argument was unavailing.

D. A Tentative Summary

The cases addressing NOTA income are difficult to reconcile and analytically unsatisfying. A number of the cases adopt very strained substantive characterizations of the transaction at issue to reach the source result the court feels is appropriate.\textsuperscript{86} “Replacement income” theories resolved the source of income in some cases yet fail to persuade the court in others.\textsuperscript{87} In cases that purport to determine source from first principles, no clear authority is offered for the source rules the court expounds, merely conclusory pronouncements that a contrary rule would negate what Congress surely must have intended.

Although some courts purported to find the geographic “source” of income self-evident, “source” is less immutable than they propose. For example, the approach to sourcing income from radio broadcasting in \textit{Piedras Negras} has been superseded by the detailed source rules for international communications income.\textsuperscript{88} Sourcing alimony like interest income, as \textit{Howkins} does, because both are payments pursuant to contractual obligations, is a theory hard to reconcile with current source rules for derivative financial instruments or, indeed, the statutory source rules for rents and royalties. The \textit{Ferro Enamel} court’s intuitions about the geographic situs of stock losses were not ultimately

\textsuperscript{86} Compare \textit{British Timkin}, supra note 51 (not a purchase and resale of property although company assumed risk of default by customers) with \textit{Hunt}, supra note 43 (treated as a purchase and resale of property although company never took title or risk of loss).

\textsuperscript{87} Compare \textit{Korfund}, supra note 63 with \textit{Hunt}, supra note 43.

\textsuperscript{88} I.R.C. § 863(e).
shared by Congress. The “place where transactions occurred” test in Zander was defunct before the case was even decided. Empirically, judicial intuitions about the intrinsic geographic source of income have proven a relatively poor guide to the source of income as ultimately determined by Congress or Treasury.

The few cases that actually determined source by direct analogy to other income, Bank of America and Howkins, also provoke some disquiet. Neither case really explains why it is appropriate to source NOTA income by analogy to other income (i.e., the source rules for interest). The statutory source rules for interest are just that, a set of rules. Those provisions do not on their face purport to be illustrative of some general underlying principle of source. Thus, it is not self-evident why sourcing items that are not interest based on a perceived similarity to interest is appropriate.

Even if one accepts the general proposition that source rules may be appropriately determined by analogy, neither Bank of America nor Howkins successfully explained why the statutory analog they chose was the best analogy. Bank of America failed to explain why the U.S. bank’s own creditworthiness was not a more important contributor to its capacity to earn letter of credit confirmation fees than the credit of foreign banks for which the U.S. taxpayer’s credit was substituted. The “residence of the obligor” is the general source rule for interest, but this is subject to a number of exceptions. For example, the taxpayer in Howkins, argued that the alimony was actually paid out of income he derived from U.K. investments, and there is some suggestion that much of his underlying income may in fact have been U.K. sourced. If so, arguably a better analogy was to the rule for interest paid by a person more than 80% of whose gross income is from foreign sources, which would have resulted in a foreign source assignment. The Howkins court recognized the dilemma, acknowledging the potential application of that exception, but responded that “[i]t is sufficient for our purposes to note in this regard that this exception, like the others, represents a legislative judgment, based upon policy considerations, which Congress has not seen fit to make in the case of alimony.” This was a disingenuous response, given that Congress had not seen fit to make any legislative policy judgment on the source of alimony payments in the first instance.

89 See I.R.C. § 865(j)(1); International Multifoods, infra note 108.
IV. Jurisprudential Problems

The NOTA income cases reflect two underlying premises that they do not explore. Those cases that source income from first principles take for granted that economic income has an intrinsic territorial or jurisdictional “origin” that is judicially discoverable. Without much discussion, the NOTA income cases also take for granted that, in the absence of a regulatory source rule, it is appropriate for the court to supply one. Put differently, the cases presume the statute to be self-executing even though source is integral to the operative rules and the task of assigning a source to NOTA income is clearly delegated by section 863(a) to Treasury not the courts.

A. Source As a ‘Justiciable’ Concept

Presuming income to have an intrinsic economic “source” allows courts to purport to resolve the treatment of NOTA income by embarking on judicial fact-finding expeditions -- where did transactions occur, what factors of production generated the income, where were these located, what legal protections were enjoyed that made it possible to earn the income? Yet one can question whether “income” (as distinct from receipts) has an inherent geographic “source” or origin. Where more than one jurisdiction is involved, which necessarily is true of cross-border income, it will always be possible to identify contributions by multiple countries that allow the taxpayer to earn the income. Source assignments turn on which economic, social and legal protections the international tax system has chosen to emphasize. The determination, for example, that the country in which capital is deployed has provided more important benefits than the country in which the capital originated and was accumulated is a

90 See U.S. Treasury Tax Policy Staff, BLUEPRINT FOR TAX REFORM 89-90 (2d ed. 1984) (“[T]he concept of income as consumption plus change in net worth implies that distinctions based on the geographic origins of receipts are inappropriate. Income by this definition is an attribute of individuals not places.”).
political rather than an economic conclusion.\textsuperscript{91} “Source” is less a meaningful principle that can itself resolve the proper treatment of income than a \textit{post hoc} label. A source assignment is the end result of an analysis that requires balancing a complex of conflicting policy concerns, discussed below, with respect to a particular type of income. To label income as “U.S. source” income is to conclude that, having weighed the relevant but conflicting policies below, this is income that may be taxed by the United States without regard to the non-resident status of the taxpayer.

The core rationale for source-based taxation is that the tax is a charge for granting access to a country’s markets, resources, infrastructure and legal protections.\textsuperscript{92} Source-based taxes can be viewed as “user fees” for benefits the United States provides. Treating income as U.S. source income is a conclusion at some level that the United States has provided such benefits. However, while “benefits” provided by source countries may legitimize source-based taxation in abstract, “benefits theory” cannot explain particular source assignments or rules. The existence of benefits provided by the United States could, taken to its limit, justify taxation of almost any income. For example, \textit{Pax Americana} might rationalize United States taxation of almost any international income to defray the costs of acting as the world’s policeman and primary guardian of world trade. Source based taxation, however, is constrained by international norms which require that the benefits provided by the particular country not be too attenuated. Economic benefits provided by the United States must be weighed against benefits provided by other countries. Source assignments must take into account the possible reaction of trading partners, who could retaliate by treating U.S. residents who do business in their countries in a similar manner.

A further consideration is the practical ability of the United States to enforce collection of any tax. As a matter of public international law, courts of one sovereign

\textsuperscript{91} See generally Graetz & O’Hear, \textit{The “Original Intent” of U.S. International Taxation}, 46 Duke L. J. 1021, 1071 (discussing history of international controversy over taxation at source between net capital exporting and net capital importing nations).

\textsuperscript{92} See Shay, Fleming & Peroni, “What’s Source Got To Do With It?” \textit{Source Rules and U.S. International Taxation}, 56 Tax L. Rev. 93 (2002). A more cynical restatement of the “benefits rationale” is that there is considerable political advantage to imposing these costs to the greatest extent possible on nonresidents, who cannot vote, rather than on residents, who can.
will not enforce the tax judgments of another under the “revenue rule.”  

Countries may depart from the revenue rule by bilateral treaty but the number of countries with which the United States has concluded such agreements is small. With one exception, these agreements provide only limited assistance as to collection of net income tax. Accordingly, the revenue rule represents a significant practical and jurisdictional impediment to the collection of tax from persons who are not within the territorial jurisdiction of the United States and do not have assets the United States can reach.

Domestic law source rules also must take into account that the normal approach to resolving competing claims over the international tax base is through bilateral treaty negotiation. Domestic law source rules serve as a baseline in those treaty negotiations. If United States domestic law source rules were too deferential to claims of competing sovereigns, the United States would unilaterally be forgoing claims that could be a valuable bargaining chip in treaty negotiations. On the other hand, an assertion of taxing jurisdiction perceived as substantially overreaching relative to international norms may be viewed as illegitimate and undercut, rather than enhance, bargaining leverage. Accordingly, although it may not be obvious what source assignment best enhances Treasury’s negotiating leverage, a source assignment must take this into consideration.

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94 The United States has entered into only five income tax treaties under which the contracting parties have agreed to provide general assistance in collecting tax judgments. The relevant treaties are those with Denmark, France, Sweden, the Netherlands and Canada. However, the degree of assistance require to be provided is limited. The United States is a party to the Multilateral Mutual Assistance Convention but has entered reservations with respect to its collection provisions.

95 The most recent broadly drafted collection provision was adopted in the 1995 Protocol to the U.S.-Canada treaty. The mutual collection assistance provision provides broad assistance for a revenue claim that has been certified by the applicant state as “finally determined.”

96 For example, Brazil’s position that the United States should, as many other developed countries do, provide a tax sparing credit (effectively ceding not just primary jurisdiction but exclusive taxing jurisdiction to the source country) has precluded conclusion of a tax treaty between the United States and Brazil.
In particular instances, other policy concerns also may influence the source assignments Congress or Treasury adopt. For example, subjecting income to United States taxing jurisdiction may have implications for the competitiveness of particular U.S. industries or the United States balance of payments and access to international capital. Investment capital may be sufficiently mobile that treating particular income as U.S. sourced would be futile because tax would be too easily avoided by investors and this would merely encourage tax arbitrage.

When Congress or Treasury adopt a particular “source” rule and assign income to a source category, they announce the resolution of these conflicting policy considerations with respect to the particular category of income. For good reason, source assignments for particular categories of income are announced under sections 861 and 862 in the form of flat rules, rather than as elaborations of some more general principle. There is no dominant principle or general standard, and therefore, no general rule subject to exceptions. “U.S. source” is a conclusion rather than a fact. Consequently, endeavoring to assign source to NOTA income by divining the income’s intrinsic geographic source is usually a futile endeavor.

B. The Authoritative Basis for Judicial Source Rules

Although, for reasons above, the justiciability of “source” in all but the easiest cases is doubtful, NOTA income cases generally have taken for granted the authoritative basis for judge-made source rules.98

Bank of America relied, as authority for its approach, on certain earlier cases, which the court claimed had “settled that sections 861 through 863 . . . were not intended

97 See Hufbauer, U.S. TAXATION OF INTERNATIONAL INCOME—A BLUEPRINT FOR REFORM at 98-99 (noting the absence of meaningful bright line distinctions and describing the legal rules assigning source as “scholastic.”)

98 Most NOTA income cases fail to recognize, or at least to acknowledge, that the NOTA income problem is one instance of a more general problem with spurned delegations of regulatory authority. See generally, Gall, Phantom Tax Regulations: The Curse of Spurned Delegations, 56 Tax Law 413 (2003) (“Gall”); Grewel, Substance Over Form? Phantom Regulations and the Internal Revenue Code, 7 Houst. Bus. & Tax L. J. 42 (2006). In fairness, courts began giving explicit attention to the question of statutory self-execution and spurned delegations only beginning in the mid-1980s, well after most NOTA income cases were decided.
to be all inclusive.” However, the cases which the Bank of America cited for this proposition were contested on narrow grounds. The primary contention by the petitioners in those cases appears to have been that only those classes of income described in one of the specific statutory source rules in sections 861, 862 or 863(b) are subject to the operative taxing provisions for international income. The prevalence of this assertion was likely the result of an earlier holding in *NV Koninklijke Hollandische Lloyd v. Commissioner.* In that case, a steamship owned by a foreign corporation (not engaged in business in the United States) was detained unlawfully in New York Harbor. Following suit, the owner was awarded damages based on the lost charter income it could have earned. The Board of Tax Appeal ruled this was not U.S. source income, reasoning it was not among the enumerated statutory classes of U.S. source income. The court’s underlying intuition, however, may have been that the damages originated in a claim for lost charter income, which would not have been U.S. source income, and under the “origin of the claim” doctrine, the damages should be similarly treated. However, the court chose to rationalize its decision by treating the enumerated statutory classes of U.S. sourced income as the only U.S. sourced income.

Courts in subsequent cases made short work of this argument given the broad delegation of regulatory authority in section 863(a) to promulgate rules and regulations for NOTA income, which clearly evinces a Congressional understanding that there may be U.S. source income that is not specifically described in section 861. However,

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99 Perhaps, the court was suggesting that the word “source” in operative international tax provisions has a free-standing meaning that can be ascertained using traditional tools of statutory construction. However, although sections 861 and 862 are not inclusive, section 863(a) is a residual “catch-all.” *See Intel Corp. v Comm’r,* 76 F.3d 976 (9th Cir. 1996) (“The statutory structure for determining source uses section 863 to source all items of income, expense, loss, or deduction not enumerated in sections 861 or 862. Thus, section 863 is the catchall or “residual” source determination section.”). Perhaps the court meant merely that U.S. source income is not limited to categories of income for which specific statutory source rules exist under sections 861 and 863(b). That is self-evident from the delegation of authority in section 863(a) to make other rules, but merely begs the question.

100 *Helvering v. Suffolk Co.,* 104 F.2d 505, 507 (4th Cir. 1939); *De Stuers v. Comm’r,* 26 B.T.A. 201, 205 (1932); *Welsh Trust v. Comm’r,* 16 T.C. 1398, 1402 (1951) (“Welsh Trust”).

101 34 B.T.A. 830 (1936).

102 *See Helvering v. Suffolk Co.,* 104 F.2d 505, 507 (4th Cir. 1939) (“[t]he duty is imposed on the Commissioner, with the approval of the Secretary, to regulate the allocation or apportionment of such other income. . . .”); *De Stuers v. Comm’r,* 26 B.T.A. 201, 205 (1932) (citing
because taxpayers in those cases chose to rely on Koninklijke Hollandische, it is unclear whether they even seriously contested that the income’s primary economic nexus was with the United States or questioned more generally a court’s authority to assign source when there is not only no statutory rule but also no regulatory rule.\textsuperscript{103} Those precedents therefore do not answer whether the residual authority to create source rules for other income may appropriately be exercised by courts rather than Treasury.

The cursory attention to the authority issue in early cases (many of which were decided in the 1930s and 1940s) also may reflect then prevailing approaches to statutory interpretation. Courts of that era would have understood the judiciary to enjoy primacy over administrative agencies in matters of statutory interpretation.\textsuperscript{104} However, that traditional approach to statutory interpretation no longer prevails after *Chevron v. Natural Resources Defense Council, Inc.*,\textsuperscript{105} in which the Supreme Court announced that unclear statutory language represents an implicit delegation to the administrative agency with regulatory jurisdiction for that statute to fill in the gaps in the statutory scheme based on regulatory “policy choices.”\textsuperscript{106} Those policy choices, it reasoned, should be left to administrators who are politically accountable rather than to judges who “are not part of either political branch of the Government.”\textsuperscript{107} That concern is all the more pronounced, and courts must be all the more circumspect, when the delegation of authority to an

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\item See, e.g., Welsh Trust, supra note 100 at 1402 (“[n]o serious contention is made that the payments do not have their source within the United States unless section 119(a) has the limiting purpose contended for by petitioner, which, in our opinion, it does not.”).
\item See *Marbury v. Madison*, 5 U.S. 137, 177 (1803) (it is “the province and duty of the judicial department to say what the law is.”)
\item 461 U.S. 956 (1983).
\item The standard of review announced by the Supreme Court in *Chevron* has in later cases and commentary been characterized as the *Chevron* “two step.” At step one, the court decides whether the statute is “clear” and if so must invalidate a contrary regulation. If not, at step two, the court must uphold any reasonable regulatory interpretation.
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agency is an express one. Accordingly, the question of judicial authority to make sources determinations cannot be dismissed merely by invoking cases from the pre-Chevron judicial era.

Two more recent cases, *International Multifoods Corp v. Commissioner* and *Francisco v. Commissioner*, directly discuss the authoritative basis for judicial source rules but address different provisions of the Code than section 863(a). *International Multifoods* addressed the source of losses recognized by a U.S. corporation from the disposition of shares in a foreign affiliate. This was essentially the same issue previously addressed in *Ferro Enamel* and *Black & Decker*. However, the result reached in those cases had been called into question by the enactment of sections 865(a) and 865(j)(1) as part of the Tax Reform Act of 1986. Section 865(a) generally sourced gains from the sale of personal property to the residence of the seller but did not directly address losses. However, section 865(j)(1) authorized the Secretary to issue regulations relating to the treatment of losses from personal property sales. At the time *International Multifoods* was decided, no such regulations had issued, but the general source regulations under sections 861 and 862 for property sales, issued prior to enactment of section 865(j)(1), were still on the books.

The Commissioner argued that, until regulatory authority under section 865(j)(1) was exercised, the pre-existing source regulations remained applicable. These would have treated the taxpayer’s stock loss as foreign sourced, because foreign stock “ordinarily” gives rise to foreign source dividend income. However, the Tax Court held that the pre-1987 regulations were preempted by the 1986 Act changes to section 865. Despite the absence of an express rule for stock losses in section 865, the court concluded that section 865(j)(1)’s delegation of regulatory authority was self-executing. Based on the statute’s legislative history, including the Blue Book, the Tax Court

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110 *Supra*, note 71.
111 *Supra*, note 72.
112 *Id.*
concluded that “Congress intended that regulations promulgated pursuant to section 865(j) would embody a “particular rule”; i.e., residence-based sourcing would generally be used for losses realized on the sale of non-inventory personal property.” On that basis, it held the stock losses to be U.S. source loss, as the taxpayer had asserted.

*Francisco* addressed a delegation of regulatory authority under section 931, which excludes income derived from sources within a “specified possession” from the gross income of an individual who is resident in the specified possession. Section 931(d)(2) provides that the determination as to whether income is so described “shall be made under regulations prescribed by the Secretary.” At the time of the case, no such regulations had been issued. On the other hand, pre-existing Treasury regulations (Treas. Reg. § 1.863-6) stated that, where necessary to determine whether income was from sources within a possession, the principles of the general source regulations were to be applied, substituting the name of the relevant possession for references to the United States.

Francisco was a United States citizen, resident in American Samoa (a “specified possession”), who was employed as chief engineer on a fishing boat that was operated principally in international waters. Francisco claimed an exclusion of his employment income under section 931(a). The IRS disallowed the exclusion, arguing that the source of Francisco’s earnings was governed by section 863(d), which provides specific source rules for income from space and certain ocean activities. Under section 863(d), income from ocean activity not within the territorial waters of a particular country generally is sourced based on the citizenship or residence of the recipient. Because Francisco was a U.S. citizen, on its face, section 863(d) classified his earnings as U.S. source income.

The Tax Court held that the pre-existing possession sourcing regulations remained in effect and were applicable for purposes of section 931 absent specific regulations for ocean activity under section 931(d)(2). The specific source rules for services income governed and, as Francisco’s services were not performed in Samoa, his earnings were not Samoan source income. The court noted that the general source regulation for

113 Specified U.S. possessions include Guam, American Samoa and the Northern Mariana Islands.
possessions (Treas. Reg. § 1.863-6) had not been amended to include a cross-reference to the sourcing regulations for space and ocean activity (Treas. Reg. § 1.863-8) when the latter rules were adopted. The court considered this failure to amend the regulations an implicit decision by Treasury not to apply residence-based sourcing of international shipping income for purposes of sourcing income to possessions.

A dissenting opinion by Judge Foley argued that the statute was inoperative without source regulations under section 931. The dissent noted that the plain language of the statute delegated to the Secretary, not the court, authority to make this determination, stating:

Section 931 cannot reasonably be interpreted because definition of the statute’s most integral terms is relegated to regulations that do not exist. Congress explicitly vested the Secretary with the authority to prescribe legislative regulations delineating the scope of the income exclusion pursuant to section 931(d)(2) . . . Indeed, the determination whether income is “derived from sources within [American Samoa]” or “effectively connected with the conduct of a trade or business within [American Samoa]” is the crux of the statute. Such determination can be accomplished in a variety of ways, and this Court cannot divine what rules the Secretary would promulgate. Moreover, our role is to interpret, not make, the law.\footnote{115}

The dissent distinguished the line of cases cited by the majority, (discussed further below), that have treated regulatory delegations as self-executing when the regulations are intended to be taxpayer-favorable, noting that in those cases “the grant of regulatory authority was not similar to section 931(d)(2)’s mandate, and the statute’s ambit was not as dependent on the promulgation of regulations.”\footnote{116}

The majority opinion offered a number of responses to Judge Foley’s position that section 931 was inoperative. First, the majority pointed out that neither party to the

\footnote{115} Francisco, supra note 109 at 331.

\footnote{116} Id. 370 F3d 1228, 2004-2770 (D.C. Cir. 2004) (stating that “even in the absence of regulations, the court in those cases could arrive at a reasonable conclusion regarding whether the taxpayer met the terms of the statute. . . . Congress, in section 931, did not, however, provide a basis upon which this Court can determine whether petitioner’s income qualifies for exclusion.”)
litigation had raised whether the statute was self-executing absent regulations. Further, the majority noted that the operative rule was in a separate paragraph of section 931 from the delegation of regulatory authority to issue source rules. To the court, this statutory structure suggested section 931 was intended by Congress to be self-executing. Based on the legislative history, the majority concluded that the regulatory authority granted under section 931(d)(2) was narrowly intended to allow Treasury and the IRS to regulate abuse rather than to mandate more comprehensive source regulations for section 931. Accordingly, the tax court felt that section 931(d)(2) did not preempt the general possession sourcing regulations.

The D.C. Circuit upheld the result reached by the Tax Court on appeal. However, the court declined to address the question of judicial authority noting that “neither party in this appeal asserts Judge Foley’s theory, and we have no occasion to pass on the question it raises.” That aside, the appeal court thought the question straightforward. By its plain terms, section 863(d) treated the income as U.S. source income because Francisco was a United States citizen. Until Treasury issued regulations reaching a contrary result, that treatment governed the income’s source.

Francisco and International Multi-foods are somewhat instructive inasmuch as they acknowledge the existence of an issue with judicial authority to make source rules and confirm the relevance of the case law in other contexts addressing when regulatory delegations are self-executing. Ultimately, however, the cases offer limited guidance for most NOTA income problems. The court of appeals in Francisco declined to reach the authority question because it had not been raised by the parties. Further, in the particular context of Francisco, applicable statutory and regulatory provisions on their face

117 Further, Congress had explicitly preconditioned the effectiveness of section 931(a) on the conclusion of an implementation agreement between Samoa and Treasury, but failed expressly to make the issuance of source regulations a precondition.

118 The court was not persuaded by the argument that Samoa’s “mirror tax code” version of section 863(d) would treat the income as possession source income, noting correctly that by that standard no income would be covered. Indeed, it is unclear how section 863(d) principles would have worked under section 931. By definition, a possession resident who was also United States citizen is “dual resident” and a residence based source rule under section 931 analogous to section 863(d) would not have availed the possession resident without a residence “tie breaker” rule similar to those found in income tax treaties.
provided a presumptive source rule for the income at issue. Section 863(d) by its terms treated Francisco’s earnings as U.S. source income. Alternatively, the general possession sourcing regulations for services treated the earnings as non-Samoan source income. However, most NOTA income situations implicate the general delegation of authority to make source rules under section 863(a). The argument that the delegation of authority was merely one to issue anti-abuse rules rather than make comprehensive source assignments also is unavailing as to section 863(a).

*International Multi-foods* evinces a judicial willingness to treat a delegation of authority to make source rules as self-executing. However, the court’s rationale was based on a substantive Congressional intent that personal property losses be sourced based on residence, which the court discerned in the legislative history of section 865. As discussed further below, no colorable Congressional direction or presumptive intent is to be found in the legislative history of section 863(a).

**C. Learning From the General Case Law on Spurned Delegations**

As *Francisco* and *International Multi-foods* acknowledged, relevant to the NOTA income problem, a number of cases in other contexts have explicitly addressed how to deal with spurned delegations of regulatory authority. In many cases, courts have been willing to construct “phantom regulations” to render the statute self-executing even when the plain language of the delegation might have suggested the statute was inoperative without regulations.  

119 It is difficult to distill any clear standard from the cases, but three general rationales or approaches emerge.  

120 Certain cases justify treating as self-executing statutory provisions that might appear literally to require regulatory elaboration, because the statutory provision and

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119 For example, section 108(e)(4)(A) -- stating that “to the extent provided in regulations” a purchase by a related person of an issuer’s debt at a discount is treated as a repurchase by the issuer -- was held by the Tax Court to be self-executing even without regulations. *See Traylor v. Comm’r*, 59 T.C.M. 93 (1990), aff’d 959 F.2d 970 (11th Cir. 1992).

120 *See generally* Gall *supra* note 98 (summarizing and analyzing the case law in detail); Grewal, *supra* note 98 at 92 (arguing that phantom judicial regulations are almost never appropriate and the appropriate remedy under the Administrative Procedure Act is to compel issuance of regulations if their issuance is unreasonably delayed).
associated regulations at issue, clearly were intended by Congress to help the taxpayer. For example *Occidental Petroleum Corp. v. Commissioner*,¹²¹ involved a spurned delegation of regulatory authority under section 58(h) to adjust items of tax preference for purposes of the alternative minimum tax when the tax preference item does not actually reduce tax.¹²² The court stated:

> [T]he failure to promulgate the required regulations can hardly render the new provisions of section 58(h) inoperative . . . . Congress could hardly have intended to give the Treasury the power to defeat the legislatively contemplated operative effect of such provisions merely by failing to discharge the statutorily imposed duty to promulgate the required regulations.¹²³

The rationale in these cases was that it would be inequitable to deny taxpayers the benefit intended by Congress merely because of regulatory delay.¹²⁴ That same reasoning encouraged the *Francisco* court to treat section 931(a) as operative despite the absence of regulations. Yet, there was also a strong suggestion in many of these cases that any regulations that reached a contrary result on the instant facts would have been of questionable validity.¹²⁵ Accordingly, equitable concerns may not entirely explain the results reached by the courts.

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¹²² Section 58(h) provides that “[t]he Secretary shall prescribe regulations under which items of tax preference shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's tax under this subtitle for any taxable years.” The taxpayer had foreign tax credits well in excess of what it needed to eliminate any income tax liability for the year, but also had other tax deductions for depreciation and depletion of the type that would otherwise have been tax preference items. Because the foreign tax credits eliminated any tax otherwise owing, the effect of deducting the depreciation and depletion was merely to increase the credits available to be carried forward. However, the parties stipulated that the resulting foreign tax credit carryforwards had expired unused. Despite a failure by Treasury to issue the mandated regulations, the Tax Court treated the provision as self-executing and reduced the company’s tax preference items by the amounts that were unnecessary to reduce current year tax liability.

¹²³ Supra note 121 at 829.


¹²⁵ See *Occidental Petroleum supra* note 121 at 829 (“In our view, a fair reading of section 58(h) would preclude the imposition of the minimum tax here.”); See also *First Chicago Corporation*, 842 F.2d 180 (1988), aff’g 88 TC 663 (1987) (“[w]ithout such a provision, any regulations promulgated under section 58(h) would be unresponsive to Congress's evident
A second approach-- the “whether versus how” test-- has been applied by the Tax Court in certain cases, to distinguish those delegations of regulatory authority that should be self-executing. This standard was announced in *Estate of Neumann v. Commissioner*,\(^{126}\) in which an estate sought to avoid application of generation skipping transfer tax. Congress had in 1976 amended the generation skipping tax provisions to reach “direct skips” (i.e., outright bequests rather than transfers in trust) and authorized the Secretary to provide any necessary or appropriate regulations, including “regulations (consistent with the principles of chapters 11 and 12) providing for the application of this chapter in the case of transferors who are nonresidents not citizens of the United States.”\(^{127}\) There were no regulations and the estate’s representative argued that section 2663(2) could not apply without them. However, the court disagreed, holding that the nonresident estate was subject to the tax:

In short, the teaching of the decided cases is that issuance of regulations is to be considered a precondition to the imposition of a tax where the applicable provision directing the issuance of such regulations reflects a “whether” characterization, . . . and not where the provision simply reflects a “how” characterization. We follow that path herein. Under these circumstances and applying the teaching of the decided cases, we hold that the regulations contemplated under section 2663(2) reflect a “how” characterization and their issuance is not a necessary precondition to the imposition of the GST tax on the transfers involved herein.\(^{128}\)

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\(^{127}\) Regulations had been promulgated by the time the case came to trial but not prior to the transfer, and the regulations had effective dates after the relevant transfer.

\(^{128}\) Under the plain language of the broader statute (leaving aside the spurned delegation), the transfer was subject to the tax. As then in effect, section 2601 provided that “a tax is hereby imposed on every generation-skipping transfer (within the meaning of subchapter B).” The term ”generation-skipping transfer” was defined under section 2611(a)(3) to include a “direct skip,” in turn defined as a transfer subject to a tax imposed by chapter 11 or 12 [the estate and gift taxes] of an interest in property to a “skip person.” Any testamentary transfer to a grandchild was therefore subject to the GST by the plain terms of the statute. The difficulty requiring regulatory elaboration was that in the case of nonresident aliens, only U.S. situs property was subject to estate and gift tax.
The Tax Court also applied this “whether versus how” standard in *Hillman v. Commissioner.* One commentator has usefully restated the “whether versus how” test as intended to distinguish delegations to make core decisions about taxability on policy grounds from authority merely to issue regulations elaborating the statutory scheme. Most cases, however, have eschewed black-letter standards like the “whether versus how” test and preferred a more case-specific analysis that takes into account the text of the delegation and broader statutory structure and legislative history. Even the Tax Court has not followed the “whether versus how” standard in more recent cases. In cases in which courts have been willing to treat the statute as self-executing, it appears they did so when the court believed that was what Congress intended and the court felt it could clearly discern a presumptive Congressional preference for a particular substantive rule from the statutory structure or legislative history.

*H Enterprises International Inc. v Commissioner,* for example, involved a consolidated group, one member of which borrowed money (granting security over its real estate management services to various partnerships involved in rental real estate activities in which the taxpayer also owned an interest. The taxpayer did not participate in the activities of the partnerships but did materially participate in the S Corporation’s real estate management activity. Management fees from the partnerships were deducted by each of the partnerships, resulting in ordinary losses (that were potentially passive activity losses to the taxpayer-partner). Because the passive deductions could not offset the non-passive income of the S corporation, it resulted in a mismatch. Section 469(l) provides that the IRS shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of Section 469, including regulations that provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income). The Tax Court held that where regulations have been necessary to implement a statutory scheme providing favorable taxpayer rules, the statute’s effectiveness is not conditioned upon the issuance of regulations. On appeal, however, the Fourth Circuit reversed. It held that section 469(a) prohibited the Hillmans from deducting their passive management fee expenses from their related nonpassive management fee income because nothing in the plain language provided an exception to section 469(a)’s general prohibition against a taxpayer's deducting passive activity losses from nonpassive activity gains.

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129 114 TC 103 (2000). The taxpayer in *Hillman* owned an S corporation that provided real estate management services to various partnerships involved in rental real estate activities in which the taxpayer also owned an interest. The taxpayer did not participate in the activities of the partnerships but did materially participate in the S Corporation’s real estate management activity. Management fees from the partnerships were deducted by each of the partnerships, resulting in ordinary losses (that were potentially passive activity losses to the taxpayer-partner). Because the passive deductions could not offset the non-passive income of the S corporation, it resulted in a mismatch. Section 469(l) provides that the IRS shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of Section 469, including regulations that provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income). The Tax Court held that where regulations have been necessary to implement a statutory scheme providing favorable taxpayer rules, the statute’s effectiveness is not conditioned upon the issuance of regulations. On appeal, however, the Fourth Circuit reversed. It held that section 469(a) prohibited the Hillmans from deducting their passive management fee expenses from their related nonpassive management fee income because nothing in the plain language provided an exception to section 469(a)’s general prohibition against a taxpayer's deducting passive activity losses from nonpassive activity gains.

130 See Gall, *supra* note 98 at 430.

131 For example, in *International Multifoods*, discussed above, rather than applying the “whether versus how” test, the Tax Court discerned from the legislative history and statutory structure a presumptive Congressional preference for residence-based sourcing of losses from personal property.

132 105 TC 71, aff’d 183 F.3d 907 (1999).
assets) and distributed the proceeds to its parent, which in turn used the proceeds to make a portfolio stock investment. At issue was whether the parent’s claim to a dividends-received deduction for dividends on the portfolio stock was limited by the rules for debt financed portfolio stock under section 246A. The taxpayer argued that because two delegations authorized regulations to apply section 246A(a) to related-party transactions, and no regulations had been issued, section 246A was inapplicable. The Commissioner responded that the stock purchased by the taxpayer was in fact “debt-financed”—in other words, because the proceeds used to purchase the stock were traceable to a borrowing, the terms of the statute were met. The Tax Court agreed, noting:

[I]t is clear that [§ 7701(f)] does not state or imply that where one member of an affiliated group of corporations borrows money and another member of that group has that money transferred to it and uses the funds to purchase portfolio stock and tax-exempt securities, the provisions of section […] 246A [applies] only to the extent prescribed by regulations. We, therefore, conclude that the fact that regulations have not been issued under sections 246A(f) and 7701(f) does not resolve the issue in this case of whether the borrowing by one member of an affiliated group and the purchase of the portfolio stock and tax-exempt securities by another comes within the [statutory] provisions . . . .”

It was possible to interpret the plain language of the statute (ignoring the delegation) to reach a result the court felt was appropriate. Equally, however, it was clear that any regulations likely to be issued under section 264A(f) would have treated the transactions engaged in by H Enterprises as a related borrowing that limited the dividends-received deduction.

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Section 7701(f)(1) authorized the Treasury to “prescribe such regulations as may be necessary or appropriate to prevent the avoidance of those provisions of this title which deal with the linking of borrowing to investment . . . through the use of related persons.” Section 246A(f) provided that “[t]he regulations prescribed for purposes of this section under section 7701(f) shall include regulations providing for the disallowance of interest deductions or other appropriate treatment (in lieu of reducing the dividend received deduction) where the obligor of the indebtedness is a person other than the person receiving the dividend.”
In *Traylor v. Commissioner*, at the debtor’s instigation, creditors assigned debts to the debtor’s children at a discount to their face amount. The IRS argued that under section 108(e)(4), the debtor recognized cancellation of debt income. The statute provides as follows:

(4) Acquisition of indebtedness by person related to debtor.

   (A) Treated as acquisition by debtor.-- For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. * * *

   (B) Members of family.-- For purposes of this paragraph, sections 267(b) and 707(b)(1) shall be applied as if section 267(c)(4) provided that the family of an individual consists of the individual’s spouse, the individual’s children, grandchildren, and parents, and any spouse of the individual’s children or grandchildren.

The literal language of the narrow delegation may suggest a delegation of discretion to apply the rule or not. Yet, the court determined that the provision was self executing, and it appears the taxpayer did not even question this on brief. Perhaps, Congress provided for regulations merely because it could envisage circumstances in which a relationship to the borrower technically described in sections 267 or 707 could be sufficiently attenuated that a repurchase by the related party would not be tantamount to a repurchase by the borrower. Nevertheless, particularly in the face of statutory language specifically treating family members as related persons for this purpose, it would have been hard to imagine any regulations exempting the specific transaction engaged by *Traylor*.

*Pittaway Corp. v. United States* involved a corporation that contracted with other companies to assemble and package their consumer products. Many of the aerosol products required isobutene, which was inserted into the customers’ trademark containers, and the corporation purchased and used its own supply of the chemical. Section 4661(a)

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134 59 T.C.M. 93 (1990), aff’d 959 F.2d 970 (11th Cir. 1992).
135 102 F.3d 932 (7th Cir. 1996) (“Pittaway”).
imposes tax on any “taxable chemical sold by the manufacturer, producer, or importer thereof.” Section 4662(b) provided that “[u]nder regulations prescribed by the Secretary, methane or butane shall be treated as a taxable chemical only if it is used otherwise than as a fuel or in the manufacture or production of any motor fuel, diesel fuel, aviation fuel, or jet fuel (and, for purposes of section 4661(a), the person so using it shall be treated as the manufacturer thereof).” Fifteen years after enactment of section 4662(b) there were no regulations. As the court noted, “what may be Pittway’s best argument it makes only in passing: that the IRS dropped the ball by never issuing regulations interpreting section 4662(b) even though the statute explicitly stated that such regulations were to be forthcoming. Nevertheless, the court held for the government because it found the statutory language to be clear regarding the intended substance of the regulations:

In this case, the language directs us to a single conclusion: that Pittway, as the user of the butane, is the manufacturer responsible for the excise tax imposed on the butane. Even if there were regulations, we would have to question them if they suggested a different result.

As a general matter, the “spurned delegation” cases have struggled to reconcile two distinct, but potentially conflicting Congressional intentions. Congress has a procedural intention regarding who, as between regulatory agencies and courts, will elaborate the statutory scheme. Congress may also have a substantive intent that the statutory provision will operate in a particular way, at least a presumptive intent. Either intent may be more or less clear from the structure, purpose and legislative history of a particular statutory provision. The more obvious the substantive intent as to the factual situation before the court, the less important the procedural intent; if the court is fairly confident it will reach the same result that Treasury would (or validly could) via the regulatory process, respecting Congress’s choice of interpretive agent is less important. Conversely, the more unclear it is what substantive outcome Congress would want, and what rule Treasury would likely have adopted, the more likely is a court to defer to Congressional intent that this be resolved through the administrative process by politically accountable actors.
While it is difficult to distill any clear standard from the cases, as a general matter in those cases that have treated delegations of authority as self-executing, it was fairly obvious what result would have been reached with respect to the factual situation at hand under reasonably foreseeable regulations. To say that regulations reaching a contrary result would have been invalid may be overstatement, particularly given the deferential mode of review that obtains under *Chevron*, but such regulations certainly would have tested the outer bounds of “reasonableness.” \(^\text{136}\)

The IRS itself appears to have distilled much the same conclusion from this case law, announcing its current position in a recent technical advice memorandum: \(^\text{137}\)

It is the position of the IRS that a statute is not self-executing with respect to a reference to regulations unless the statute itself or the legislative history gives some specific guidance as to what the content of the regulations should be. Where such guidance is missing, the statute is not self-executing. Similarly, in a case such as the one at hand, where the statute not only specifically prescribes a method of allocation but also states that regulations can provide for a different method, but where neither the statute

\(^{136}\) See Pittway, supra note 135 at 936 (“Even if there were regulations, we would have to question them if they suggested a different result.”); Occidental, supra note 121 at 829 (“In our view, a fair reading of section 58(h) would preclude the imposition of the minimum tax here.”); First Chicago, supra note 125 at 184 (“[w]ithout such a provision, any regulations promulgated under section 58(h) would be unresponsive to Congress's evident desire, however clumsily expressed, to avoid the anomaly of taxing people on benefits they don't actually receive. . . . The government's interpretation would decapitate section 58(h).”) Estate of Maddox, supra note 124 at 235 (“Certainly, had the Secretary promulgated regulations that in effect merely lifted the corporate veil in this situation, they would plainly have had to be sustained.”) Hillman, supra note 129 at 115 (“Respondent’s position . . . is not only contrary to the legislative history and intent of Congress but does not appear to be based on any tax policy or reason other than the failure to promulgate a regulation.”) But see Estate of Hoover, 102 T.C. 777, 784 (conceding that “different regulations might also be considered valid,” although the outcome in Hoover was then reversed on appeal).

\(^{137}\) TAM. 2004-47-037. The TAM considered whether a reference to regulations in section 384(c)(3) had any effect in the absence of action by the Secretary. Section 384(c)(3) defines the term “preacquisition loss” for purposes of section 384’s loss limitations. The flush language to section 384(c)(3)(A) provides, “Except as provided in regulations, the net operating loss shall [for purposes of calculating preacquisition losses] be allocated ratably to each day in the year.” Despite the lack of regulations, the taxpayer argued that a method other than “ratable allocation” could be used to allocate the taxpayer’s net operating loss. The IRS concluded that the legislative history should be examined whenever a statute references regulations, and that if the legislative history is sufficiently enlightening, a statutory delegation may be self-executing even in the absence of regulations. After examining the statute’s legislative history, the IRS concluded that the statute was not self-executing.
nor the legislative history provide any guidance as to what that other method might be, the statute is not self-executing with respect to regulations concerning such other method. 138

This may be a somewhat “strong” formulation of the approach followed by the cases, which have been willing to infer Congress’ substantive intent from the statutory structure or legislative history even without “specific” direction, but it is a fair summary.

D. Is Section 863(a) Self-Executing?

The judicial willingness to treat operative Code provisions that depend on the source of income as self-executing, with respect to income that is not sourced by any statutory or regulatory source rule, in part may reflect the precedential effect of early cases from a pre-Chevron era in which a more activist judicial role in statutory interpretation and lawmaking was the norm. However, that conclusion also is encouraged by the statutory structure. Section 871, for example, imposes tax on FDAP from source within the United States without any qualification as to the meaning of source or cross-reference to the statutory definitions of source in sections 861 ff.

Nor does the operative provision itself include a delegation of rulemaking authority to define source. Generally, the operative Code provisions appear to presuppose a binary world in which all income is allocated or apportioned either to the U.S. source or foreign source class, and these provisions do not seem to countenance the possibility that income could exist in tax “limbo,” neither subject to taxation under the operative rules nor exempt. That intuition, and the Code’s organization-- placing source rules in a separate, free-standing set of sections-- may explain the suggestion, for example in Bank of America, that sections 861 ff are not the exclusive determinant of source.

On the other hand, interpreting the operative provisions in isolation, as if they were not modified by the source provisions, is contrary to the plain language of the

138 The IRS went on to suggest that such a delegation could be rendered self-executing through rules issued in informal agency guidance (such as Revenue Procedures or Announcements). See also PLR 9714002 (Dec. 6, 1996) (“When Congress states what the rule is to provide, but leaves the mechanics to the Secretary, the regulation is self-executing. Otherwise, it is not.”)
source provisions. Section 861 states flatly that the following categories of income “shall be treated” as from sources within the United States, section 862 that the categories of income it lists are from sources outside the United States, and section 863(a) that remaining items are to be sourced under regulations. The language of the statute does not suggest that the source rules of sections 861 and 862 are merely illustrative, and the Code suggests no general principle of source or default presumption that a court can apply.139

Moreover, the structure of the Code on which the argument for self-execution relies, may be no more than an accident of statutory reorganization. As originally enacted, the source rules incorporated the delegation of regulatory authority to source NOTA income within the same statutory provision as the operative rule that is now found in section 871. The Revenue Act of 1921 taxed all individuals (foreign or domestic) on their net income, but provided in section 213(c) that in the case of a non-resident individual, gross income “means only the gross income from sources within the United States determined under the provisions of section 217.” Section 217, in turn enumerated specified categories of U.S. source and foreign source income and, then, in section 217(e), included substantially the same provision now found in Code section 863(a), delegating to the Commissioner with the approval of the Secretary authority to determine the source of any other income under rules and regulations. Accordingly, it was clearer on the face of the statute that the meaning of source for purposes of the operative provision was defined by source provisions contained in the predecessor source rules in section 217 (including section 217(e)). There is nothing in the legislative history indicating that subsequent reorganization of these provisions in later statutes reflects any substantive intent to change the meaning of “source” in the operative provisions of the Code.

Treating section 871(a) as a self-executing rule also presupposes that “sources within the United States” has a judicially discoverable meaning. For the reasons discussed above, however, attempting to determine the intrinsic geographic source of income from first principles will be a futile endeavor in most cases. Courts attempting to

139 The failure to provide a general governing source principle is likely not an oversight. Cf. Graetz & O’Hear, The “Original Intent” of U.S. International Taxation, 46 Duke L. J. at 1071 (discussing general U.S. hostility to systematic ex ante allocation of all types of income to the residence or source country and preference for specific rules for concrete instances.)
construe “source” to render the statute operative have been forced to resort either to conclusory pronouncements (the “I know it when I see it” school of judicial reasoning) or unpersuasive attempts to discern some deep structure or underlying general theory of source from the existing rules. A judicial source assignment on that basis, however, merely announces one court’s idiosyncratic view of a transaction’s “United States-iness.”

However, if the “source” of income is not susceptible of common law discovery, section 871(a) effectively contains two conflicting rules of taxability: (1) this income is taxable by the United States and (2) this income is not taxable by the United States and an implicit delegation to Treasury or the IRS to decide on policy grounds which of those rules applies. Unless the meaning of “source” is independently ascertainable using traditional tools of statutory interpretation, section 871(a) really says that gross basis tax applies to FDAP income described in section 861 and any other income which, under regulations or other rules, Treasury determines to be U.S. source income.

The legislative history also undermines the view that “source” was intended to be determined through judicial common law elaboration. Specific statutory source rules were enacted, beginning in 1921, precisely because leaving source assignments to common law development had proven unsatisfactory to Treasury and Congress. Source determinations arrived at by the Department of Justice in opinion letters of the Attorney General differed from the views of Treasury as to the appropriate source rule for cross-border business income and interest income. At the instigation of Dr. T. S. Adams of the Treasury, Congress enacted specific statutory source rules and transferred discretion to

140 With apologies to Stephen Colbert.

141 It is intriguing that Chevron itself, albeit involving a completely different statute, turned on the meaning of “source.” See Chevron, supra note 105 (“The basic legal error of the Court of Appeals was to adopt a static judicial definition of the term ”stationary source” when it had decided that Congress itself had not commanded that definition” and later, the statutory language “simply does not compel any given interpretation of the term ”source.”) The case addressed requirements enacted under the Clean Air Act Amendments of 1977 directing States that had not achieved the national air quality standards to establish a permit program regulating “new or modified major stationary sources” of air pollution. EPA regulations allowed States to adopt a plantwide definition of the term “stationary source.”
source other income to the Commissioner of Internal Revenue. The Committee reports for the predecessor of section 871 state as follows:

This section [section 217 of the 1921 Act, predecessor of current provisions] explicitly allocates certain important sources of income to the United States or to foreign countries, as the case may be, and with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States) authorizes the Commissioner, with the approval of the Secretary, to determine the income derived from sources within the United States either by rules of separate allocation or by processes or formulas of general apportionment. (emphasis added)

Applicable regulations directly repeat this legislative history, stating that “[t]he gross income from sources within the United States shall consist of the items specified in section 861(a), plus the items allocated or apportioned to such sources in accordance with section 863(a). In making source assignments, a court therefore cannot convincingly claim to be construing the term “source” in operative Code provisions like section 871(a). Judicial source rules are issued under the auspices of section 863(a), which on its face contemplates administrative rather than judicial resolution.

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142 See Graetz and O’Hear, supra note 139 at 1056-58; See also Internal Revenue Hearings at 7 (in response to a question from Senator La Follette about the “principles” that would govern how other income would be allocated or apportioned, Dr. Adams responded that this “has largely been left to administrative discretion, as will be see in subdivision (e) of section 217.”)


144 See Treas. Reg. §§ 1. 861-1(a)(1) and (b).

145 Section 863(a) clearly is a delegation of authority to make “legislative” rather than “interpretive” rules. It is an express delegation of regulatory authority. It grants authority to make rules that have the force of law. Further, the broad, open-ended authority to decide the appropriate rules on policy grounds rather than interpolate a statutory standard functionally resembles a grant of lawmaking rather than interpretive authority. See generally Pierce, Distinguishing Legislative Rules From Interpretive Rules, 52 Admin. L. J. 547 (2000); Merrill and Watts, Agency Rules With the Force of Law: The Original Convention, 116 HARV. L. REV. 467, 571 (2002); ABA, Report of the Task Force on Judicial Deference, reprinted in 104 TAX NOTES 1231 (Sep. 13, 2004).
The relevant case law on “phantom regulations” offers little support for the proposition that section 863(a) is self-executing as a general matter. Given a lack of any statutory or Congressional direction in the Code or legislative history on the substantive content of source rules to be issued under section 863(a), read in conjunction with the applicable operative provisions of the Code, section 863(a) in substance is a delegation of legislative authority to decide “whether” on policy grounds gross basis tax applies to a particular kind of income, not “how” it applies. Because the legislative history provides no “specific guidance,” and indeed is entirely agnostic about what substantive rules Congress expects source regulations under section 863(a) to adopt, the statute also is not self-executing either under the approach adopted by those cases which have focused on Congressional intent or the IRS’s own restatement of the applicable standard for self-executing of delegations of regulatory authority.

There may be instances where the treatment of NOTA income under any regulations that might conceivably issue is so self-evident (for example, the state tax refunds or Treasury cotton subsidies addressed respectively in Stafford v. Pedrick and Helvering v. Suffolk) that Congressional intent can fairly be presumed. But that is not true of most NOTA income, including the kinds of income in the examples at the beginning of the paper. For example, it is hardly self evident that Congress intends to, or Treasury would, treat cancellation of debt income as U.S. source income or how they would choose to source partnership guaranteed payments. Despite the long line of NOTA income cases implicitly treating operative Code provisions that turn on source as self-executing, with respect to most NOTA income, the better argument would seem to be that they are not.

V. Policy Concerns with Judicial Source Rules: Possible Alternatives

Not only is the propensity of courts to treat “source” as a self-executing concept not well supported by general authority, but it is also dubious on policy grounds.
A. Institutional (In)Competence

The fundamental problem with developing judicial source rules from first principles is that doing so requires a determination based entirely on policy considerations—a lawmaking rather than interpretive function. Although courts necessarily interpret statutory provisions taking into account underlying policy considerations, the problem is particularly acute when it comes to source rules. As discussed above, there is no justiciable principle underlying the source concept or the existing rules.\textsuperscript{146} The creation of judicial source rules therefore requires policy-based rulemaking largely unmoored from the statutory text\textsuperscript{147}. Indeed, given that section 863(a) authorizes either allocation or “mixed source” apportionment, there is no statutory provision to which the court can point to explain why the court has chosen to allocate the income entirely to one source or another rather than dividing it between them (and the latter may be more sensible in the absence of a coherent source principle).\textsuperscript{148}

A court is less institutionally competent than Treasury to engage in rulemaking required for source determinations, not merely because the decision involves overt policy choices rather than traditional statutory interpretation, but because much of the basic information necessary to those choices will not even be before a court.\textsuperscript{149} For example, a court will not have before it any economic analysis based on which it can estimate

\begin{footnotesize}
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\item This can be contrasted, for example, to judicial attempts to interpret what constitutes “income” where Haigh-Simons definitions of economic income at least provide a normative baseline for a court to apply.
\item See \textit{Comm’r v. Beck’s Estate}, 129 F.2d 243, 245-6 (2\textsuperscript{nd} Cir. 1942) (“Judicial legislation is one of the facts of life, an inescapable and necessary one. But courts may not, as legislatures may, roam at large, confined only by the Constitution; their function, when dealing with legislation, does not go beyond that of filling in small gaps left by the legislature--and to closing those gaps in accordance with what appears to have been the legislative purpose.”) \textit{Int’l Trading Co. v. Comm’r}, 57 T.C. 455 (1971) (“Also, there are occasions when we cannot ascertain the intention of the legislation, and on such occasions, we must leave the problem to Congress to resolve.”)
\item But see Treas. Reg 1.863-1 (“Items of gross income other than those specified in section 861(a) and section 862(a) will generally be separately allocated to sources within or without the United States.”)
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benefits the United States has provided in allowing access to its markets or its legal protections relative to those provided by other countries, the likely response of taxpayers and how they will adjust behavior to the rule adopted by the court or the revenue impact of a particular source rule. A court also lacks information on administrative hurdles to collecting the tax, information about how trading partners of the United States treat similar income, insight into the diplomatic and international comity considerations that may be implicated and how a particular rule may affect Treasury’s negotiating leverage in treaty discussions. Were a court to take the exercise seriously, the proceeding would resemble transfer pricing litigation with economists reports and dueling expert testimony regarding foreign tax law, trade and international relations. This could be done, if the IRS were disposed to plead its case in this manner, but a court seems an inefficient forum for an exercise of this kind.

Analogizing to income for which Congress has provided a source rule might appear to overcome this difficulty. If Congress treats a category of income as U.S. sourced and the particular NOTA income is “like” income in that category, sourcing it consistently may at least approximate what Congress intends. In any event, it may seem more likely to approximate what Congress intends than if the court simply invents its own source rule.

However, at bottom, sourcing by analogy is not fundamentally different than sourcing from first principles. To the extent the instrument or arrangement in fact is substantively indistinguishable as an economic matter from one addressed directly by the statute (i.e., the court was able to conclude its analysis at step zero), a judicially-created source rule is unnecessary. Once the substantive differences are too pronounced to support such a characterization, however, there is, at best, inherent circularity in sourcing by analogy.

Most NOTA income will resemble more than one class of income. For example, credit default swaps somewhat resemble insurance, which would suggest the income be sourced where underlying risks are located (wherever that might be in the case of credit risk). On the other hand, if a credit default swap narrowly fails to qualify as a notional principal contract, it would seem just as sensible to use the source of notional principal
contract income as the appropriate proxy. Alternatively, imagine a court required to rule *de novo* on the source of substitute dividend payments under a stock loan before the specific regulations that apply a look-through approach to sourcing such payments were promulgated. Informed by the outcome for notional principal contracts, the court could quite legitimately conclude that, by analogy to income from equity swaps, they are properly sourced based on the residence of the counterparty. Or, the court could conclude that regular corporate dividends furnish the best analogy (which, in turn, might justify a source rule based on the swap payor’s residence or the “look-through” approach that Treasury actually has adopted). Interest certainly seems an appropriate analogy for the income derived from synthetic letter of credit facilities, but is the appropriate analogy interest paid by the deposit bank or interest paid by the underlying borrower if they are in different jurisdictions? A court’s intuitions about which analogy is better cannot be divorced from the examination of the same complex of underlying policies that is required to determine source from first principles.

Finally, even if sourcing by analogy could overcome the above objections, source rules only partly capture legislative intentions about taxability. For example, *Bank of America* concluded that, since the closest analogy was interest, it should source letter of credit fees like interest (implicitly concluding that Congress would intend them be sourced consistently). However, Congress has decided to exclude many kinds of interest from withholding. Treaties may have carefully crafted rules for interest and other income designed to balance the competing policies above. There is no reason to suppose that sourcing letter of credit fees “like” interest but not applying the other statutory exclusions for interest will approximate overall Congressional intent regarding the taxability of *NOTA* income.

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150 The *Bank of America* authorities suggest that analogy be drawn only to a statutory source rule. However, it is far from clear why analogy should be so limited. Because Congress has delegated legislative regulatory authority to make source rules to Treasury, it would seem preferable to approximate what Treasury intends in a closely comparable situations than to approximate what Congress intends in less comparable circumstances. One can worry that Treasury has crafted specific rules that, by negative inference, suggest a different treatment if the precise regulatory requirements are not met, but that is equally true of the statutory rules.

B. Legal Uncertainty

For the same reasons courts are ill-equipped to develop source rules, it is very difficult for taxpayers and their advisors faced with NOTA income to meaningfully predict how any court will rule. This uncertainty is inefficient and results in some transactions being restructured in ways they otherwise would not have been absent tax considerations. The lack of predictability also violates equitable and due process concepts and undermines the legitimacy of any court decision.

An effect of the substantial legal uncertainty that results is that NOTA income, for practical purposes, is U.S. source income in the hands of nonresident portfolio investors. Faced with NOTA income, a rational withholding agent (potentially liable for the tax but not entitled to the economic income) is likely to withhold. In theory, foreign investors can apply for a refund if they are willing to file a U.S. tax return, but for obvious reasons (including hesitation about becoming embroiled with the U.S. taxing authorities), most are reluctant to do so. If the NOTA income risk is identified, nonresidents are likely to demand restructuring of the transaction to take a more favorable form or not to invest at all. Accordingly, the income is treated by commercial actors as if it were U.S. source income.

For a U.S. tax resident, there is limited downside to taking the position NOTA income is foreign source other than potential deficiency interest. It is hard to imagine that understatement penalties could be sustained for failing to analogize to the right statutory income class when there is more than one plausible analogy.\(^{152}\) Hazards of litigation may allow negotiation of a favorable settlement. Of course a taxpayer with net deductions or losses related to an investment that would have generated NOTA income, can take the opposite position and argue that NOTA income is U.S. source.

\(^{152}\) See Donlon Development Corp. v. Commissioner, 66 T.C.M. 441 (1993); Gall, supra note 98 at 442-44 (discussing reluctance to apply penalties for disregarding “phantom” regulations); [XILINX 9TH CIRCUIT DECISION].
C. Revenue Considerations - Protecting the Fisc

Judicial sourcing of NOTA income may seem unfortunate, but necessary to prevent revenue escaping the United States tax net. Assigning U.S. source to NOTA income in a particular case might protect the fisc. For reasons above, however, it is far less clear that judicial willingness to invent source rules by analogy or from first principles protects the fisc from a systemic perspective. Judicial willingness to engage in open-ended source assignment (and the resulting lack of predictability) fosters the situation, discussed above, in which NOTA income would be (if paid) effectively subject to withholding as U.S. source income, but may be treated by U.S. residents as foreign source income for foreign tax credit limitation purposes. Given the mobility of investment capital, it is questionable how much withholding tax revenue is actually raised under section 871. Conversely, legal uncertainty about source for tax credit limitation purposes is most likely detrimental to the fisc.

If the Treasury and the IRS are concerned that NOTA income revenue is escaping taxation, they are free to issue regulations and address the problem. Indeed, if need be, Treasury could likely issue such regulations with retroactive effect. Consequently, protection of the fisc is a poor rationale for judicial sourcing (at least, judicial sourcing as it has so far been implemented).

A more subtle revenue concern is that an openly announced policy against judicial source rules would invite abuse. Taxpayers could structure transactions to differ just enough from categories recognized by the existing source rules so as to put themselves in a position to argue that they have earned NOTA income. However, there is already substantial electivity in the treatment of cross-border portfolio income. Whether judicial source rules improves matters really depends on whether one believes it is easier to

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153 For example, once the tax concern with synthetic letter of credit transactions was identified and understood by market participants, these transactions largely disappeared. They did not continue subject to withholding tax.

154 Section 7805(b), which imposes specific statutory limits on retroactive regulations, is effective only for regulations relating to statutory provisions enacted on or after July 30, 1996. I.R.C. §§ 7805(b)(2), (3) and (8). There are equitable limits on the exercise of discretion to apply regulations retroactively, but the standard applied by courts has been very deferential to the government. See Snap-Drape v. Commissioner, 98 F.3d 194 (5th Cir. 1996).
confidently plan out of all existing recognized source categories (i.e., into NOTA income treatment) than it is to plan into treatment a class of income that is already exempt. “Substance over form” doctrines already police such arbitrage at the margin. Cases that are clearly abusive will be relatively easy for courts to resolve at “step zero” of the analysis. If the income is too different as a substantive matter to be attacked in this manner, it is questionable why considering it NOTA income is even “abusive.”

D. “Harmless Error” — A Possible Rejoinder

There is a possible answer to the above concerns. Although Congress may purport to prefer that the necessary source rules be developed through regulations, its willingness to delegate legislative authority to administrative agencies exceeds its willingness to provide the funding needed to comply fully with those mandates.155 Delay in issuing source regulations may simply reflect a decision by Treasury to expend its limited regulatory resources on matters it considers more important. Insisting on regulations as a precondition to enforcing the operative international provisions of the Code would merely divert regulatory resources from other, perhaps more important problems.

Even if the risk of judicial error in making source determinations is high, if a court gets it seriously wrong, Treasury and the IRS can always fix the error. A particular taxpayer may, with the benefit on hindsight, have received a windfall or another been unfairly handled, but such outcomes are equally possible if the court declines to make any source assignment and treats the statute as inoperative. Provided the court does not claim that the source assignment it announces is the only reasonable interpretation of the statute, under National Cable & Telecommunications Association v. Brand X Internet Services,156 subsequent regulations may reverse any result the court reaches. Indeed, as

155 See e.g. Occidental Petroleum, supra note 119 at footnote 6; Pierce, supra note 149 at 65-66 (describing factors that make the formal regulatory process under the APA long and costly for administrative agencies); Alden F. Abbott, The Case Against Federal Statutory and Judicial Deadlines, 39 Admin. L. Rev. 171, 175-6 (1987) (describing causes of regulatory delay).

156 545 U.S. 967, 981 (2005). Brand X holds that only judicial decisions based on a conclusion that the statute is “clear” (i.e., at step one of Chevron) cannot be reversed by subsequent
section 863(a) predates 2004, the only legal limit on issuance of retroactive regulations is that there be a “rational basis” for retroactive application,\textsuperscript{157} although as a prudential matter Treasury may employ such authority sparingly.

This rejoinder is far from satisfactory, however. Although judicial error may be reparable, it is not costless. Significant legal uncertainty generally is inefficient. Courts seeking to rationalize their authority to make a source determination also may be tempted to suggest that the rule they announce is “clearly” what Congress intended. This may at least raise questions about the legitimacy of regulations that seek to overrule the result. A judicial decision in favor of foreign source treatment adversely affects treaty negotiating leverage. Although the Treasury can overrule the court through regulations, the existence of an earlier contrary judicial pronouncement may undercut the perceived legitimacy of the rule and its value as a bargaining chip. Unless significant time has passed, the regulations may appear self-serving, particularly if the treaty partner’s legal system is less sanguine than \textit{Brand X} about the power of agencies to reverse judicial decisions through regulation. Conversely, a U.S. source determination that is not perceived as consistent with international norms may create discord with treaty partners.

Even if judicial sourcing errors are reparable, a judicial willingness to create source rules also systematically discourages the issuance of regulations. Open ended authority to issue legislative source regulations, combined with the \textit{Brand X} permission to overrule court decisions (retroactively if need be), creates a free option for Treasury and the IRS. If they do nothing, they may get the rule they like without the bother of doing the work Congress intended and without the political headaches.\textsuperscript{158} If they really don’t like the result, they can change it by regulations, retroactively if need be. It is probably no accident that some 80 plus years after the predecessor of section 863(a) was

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\textsuperscript{157} See \textit{United States v. Carlton}, 512 U.S. 26 (1996), and discussion at note 154, supra.

\textsuperscript{158} Melnick, \textit{Administrative Law and Bureaucratic Reality}, 44 Admin. L. Rev. 245, 251 (1992) (discussing bureaucratic proclivity to avoid politically controversial decisions).
enacted, the only source regulations on the books under section 863(a) are those for notional principal contracts, natural resources, scholarships and REMIC residual interests.

Judicial source rules also have a tendency to divert the administrative process in more subtle, but pernicious ways. For example, Revenue Ruling 2004-75\textsuperscript{159} addressing the source of insurance payouts relies on the source rule announced in \textit{Bank of America} to justify its conclusion that these payouts should be sourced based on the residence of the insurer. When one steps back, this is somewhat startling state of affairs. Because the agency failed to promulgate legislative regulations as the statute clearly intends, a court was forced as a “third best” solution to make up its own rule to render the statute operative, which the agency then relies on in a different context as a substitute for independent policy consideration.

If you believe that the regulatory process required by the Administrative Procedure Act, including public notice and comment,\textsuperscript{160} is best able to appropriately reconcile the varied, conflicting policy concerns that bear upon a source determination, these are troubling results.

\textbf{E. In Search of a Default Rule}

Because the statute is agnostic as to the substantive content of the source rules Treasury is to issue, the “right” outcome is by definition whatever Treasury may decide. From the standpoint of reducing uncertainty and judicial error, arguably a better approach than the current judicial confusion would simply be to adopt a rule that the government always wins. Even if you think courts sometimes get it right, given the paucity of

\textsuperscript{159} 2004-31 IRB 109.

\textsuperscript{160} The Administrative Procedure Act of 1946, 5 U.S.C. §§ 500ff (the “APA”) governs the procedures by which administrative agencies of the federal government issue regulations and other rules. Section 553 of the APA requires that, with certain exceptions, before an administrative agency promulgates a “legislative” rules, notice of a proposed rulemaking must be published in the Federal Register and interested parties must be given the opportunity to participate in the rulemaking by presenting their views (“notice and comment rulemaking”). \textit{See generally} Asimow, \textit{Public Participation in the Adoption of Temporary Tax Regulations}, 44 \textit{TAX LAWYER} No. 2, 343 (1991); Pierce, \textit{Distinguishing Legislative Rules From Interpretive Rules}, 52 Admin. L. J. 547, 550 (2000) (discussing the benefits of notice and comment rulemaking).
statutory guidance on the content of source rules for NOTA income, it is hard to argue they will get it right more often than the government (albeit, for this purpose the “government” may be litigators of the Department of Justice rather than the Treasury personnel who would draft regulations). However, such a default rule would be of questionable legitimacy as it has no plausible basis in the statute and runs counter to due process norms. It may be even worse than current law from the perspective of enhancing the regulatory process. By effectively outsourcing regulatory authority to government litigators, such an approach is likely to emphasize revenue raising over other policy considerations underlying source, and to promote the adoption of inconsistent, result-oriented theories in similar cases, increasing legal uncertainty.

Leaving aside for a moment questions of statutory authority, it would be preferable instead to adopt a substantive default source rule for NOTA income, acknowledging openly that this is merely a default rule that Treasury can change by issuing other specific regulations or rules for a particular class of income.

Treating all NOTA income as presumptively U.S. sourced would generally maximize revenue, at least if income and gains exceed losses and deductions from cross-border transactions in the aggregate. It would maximize the prescriptive taxing jurisdiction of the United States and its treaty negotiating leverage. The difficulty is that such a default presumption could violate international tax norms and be very hard to administer and enforce consistently. Treasury can never issue regulations to address specifically each possible kind of income. Since the gross basis tax on nonresidents necessarily can apply to anyone anywhere in the world, and FDAP as a concept has been denuded by Treasury and courts of any separate limiting content, under this default rule there could be any amount of income technically subject to U.S. tax under section 871 or 881, which the IRS could not practically enforce or collect. This would call into question the legitimacy of the rules. Perhaps more to the point, there is no clear statutory basis for such a default presumption. As discussed below, if any implicit default presumption may be discerned from the statutory structure and legislative history, it is that income is not U.S. sourced until Treasury determines that it is.
In addition, adopting such a default presumption would give Treasury little incentive to follow the formal regulatory process intended by section 863(a) and mandated by the APA. To the extent the NOTA income in question is a significant source of revenue for U.S. taxpayers, this problem may take care of itself. U.S. multinationals are certainly capable of lobbying Treasury and otherwise bringing political pressure to bear to precipitate regulations that preserve the creditability of foreign taxes on their NOTA income. However, affected nonresidents are less likely to have the political leverage needed to set the regulatory process in motion.

A default presumption that NOTA income is foreign source income would avoid the above jurisdictional problems. It is questionable how much section 871 tax revenue would be lost given the ease with which gross basis tax can be avoided under current rules for most portfolio income. The approach marginally undercuts treaty negotiating leverage, but if it is openly admitted to be merely a default presumption, which applies only in the absence of regulations, Treasury can engage in self-help by issuing regulations as the statute intends. On the other hand, the implications for the foreign tax credit limitation under section 904 make a default rule favoring foreign source treatment seem less attractive. Such a default source rule under section 904 could result in substantial revenue losses unless Treasury could promptly issue regulations as every new class of income arises and commercial arrangements evolve (which is of course highly unlikely). As political access of the affected U.S. taxpayers generally would have allowed them to instigate regulations under the alternative “U.S. source” default rule, adopting the “foreign source” default rule also does not clearly improve the prospect of regulations actually issuing. Indeed, in the face of such a default presumption, political access enjoyed by U.S. multi-nationals could be employed more perniciously to divert regulatory attention to other areas so that the favorable default presumption is not disturbed even when this is inappropriate as a policy matter.

In abstract, the most appropriate default rule would seem to be one that treats NOTA income as foreign source income for purposes of sections 871 and 881 and as U.S. source income for purposes of section 904. This would encourage Treasury to regulate as Congress intends with respect to non-residents (who may otherwise lack the political access to instigate regulatory relief) if Treasury feels the United States should tax the
class of income, while U.S. multi-nationals could lobby for regulations if they feel foreign taxes on the income should be creditable. Revenue losses, jurisdictional and international comity concerns would be minimized.

F. Implementing a Default Rule or Presumption

Even if one is persuaded in abstract that a set of default source rules for NOTA income would be preferable to the confusion and incoherence of current law, there remains the problem of how to implement the preferable default source rules in a manner consistent with the existing statute.

For reasons above, despite the long standing case law that has implicitly treated operative Code provisions that employ source as self-executing with respect to NOTA income, there are some compelling arguments that the cases are wrongly decided (at least, with the benefit of hindsight, taking into account more modern understandings of the proper institutional role of courts in the realm of statutory interpretation). Were a court today minded to put an end to the confusion, there are a couple of possible paths.

One way for courts to give effect to default presumptions is by employing appropriate interpretive maxims or canons. Following this approach may have the advantage of allowing a court to assign the appropriate source in easy cases (such as the state tax refunds or federal cotton subsidies discussed above) while admitting the uncertainty of the assignment the court makes in less easy cases. The difficulty in this context is the dual purpose the source rules serve and binary nature of such interpretive canons. For example, a presumption that, absent regulations, income will be presumed to be foreign sourced, to avoid a court’s trespassing in matters implicating international relations, would reach the appropriate default result in a case involving liability for tax

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161 See generally Einer Elhauge, STATUTORY DEFAULT RULES: HOW TO INTERPRET UNCLEAR LEGISLATION (2008); Elhauge, Preference-Eliciting Statutory Default Rules, 102 Colum. L. Rev. 2162, 2615 (2002) (arguing that if in doubt because the words of a statute are not clear, the court should reject the statutory interpretation that favors the most politically powerful group with ready access to the legislative agenda).

under section 871 but may reach less desirable results in a case involving the foreign tax credit limitation under section 904. Conversely, a presumption that Congress intended to tax cross-border income to the limits of its prescriptive and enforcement jurisdiction\textsuperscript{163} might achieve the appropriate default result in a case involving the creditability of foreign taxes under section 904 but not with respect to the liability of a nonresident for gross basis tax under section 871. Whatever source assignment is selected in a particular case (addressing the section 904 limitation, for example) may then be the precedent that governs the source of income for other purposes (for example, section 871). This could engender dueling interpretive canons as results reached in one context offends courts in another.\textsuperscript{164} That result would be unlikely to foster greater certainty and efficiency.

Alternatively, with a little creativity, a court could read the statute literally to reach the default position this paper argues is preferable, if the court is simply willing to admit that NOTA income is what it actually is, “none of the above.”

Section 2(d) of the Code provides that “in the case of a non-resident alien individual, the taxes imposed by sections 1 and 55 shall apply only as provided by section 871 or 877.” Similarly, section 11(d) provides that, in the case of a foreign corporation, tax shall apply “only as provided in section 882.” It is also clear that, as to non-residents, only U.S. source income is included in gross income as FDAP. Under those sections, unless the nonresident’s income is one of the narrow classes of foreign income that can be effectively connected to the conduct of a trade or business, it is taxable only if it is from United States sources. Unless section 863(a) is self-executing, which for reasons above it should not be, only those categories of income specifically listed in section 861 or allocated or apportioned to U.S. sources by the Treasury or IRS rules pursuant to section 863(a) are United States source income. Any transaction that generates a category of income whose source is unspecified under the statute and that has not been addressed by Treasury (i.e., which is “none of the above”) is not United States source


income and therefore is not subject to tax under section 871 or 881 pending regulations. This is also consistent with the legislative history explaining that section 863(a) authorizes the Treasury “to determine the income derived from sources within the United States either by rules of separate allocation or by processes or formulas of general apportionment,” which would suggest that income of (as yet) undetermined source is not U.S. source income.

Conversely, section 904 limits foreign tax credits based on the ratio of foreign source to worldwide taxable income. Arguably, for so long as Treasury has failed to exercise its authority to treat NOTA income as either U.S. or foreign source, pending regulations, arguably it is neither, and is included in the denominator but not the numerator of the section 904 limitation.165

Realistically, however, the wide acceptance of Bank of America and its legal forebears, and general judicial reluctance to reverse long standing precedent, makes it unlikely that any court will grasp the nettle. Any solution probably depends on Treasury exercising its broad authority under section 863(a) to issue guidance enacting the preferable default rules for NOTA income. This guidance could take the form of regulations, providing that, in the absence of a specific source rule, income will be considered foreign source for purposes of sections 871 and 881, and U.S. source for purposes of section 904. Regulations could perhaps include an anti-abuse rule to prevent transactions substantively identical to those covered by section 861 or source regulations being structured with a principal purpose of qualifying as NOTA income. Alternatively,

165 One technical difficulty must be admitted. One can read section 871 to say that it applies only to income that is U.S. sourced (under the statute or regulations) and section 904 to take into account in the limitation numerator only income that is foreign sourced. Rendering the section 864 provisions for effectively connected income operative on that basis is more difficult. NOTA income would then be excluded from treatment as effectively connected under both the rules for U.S. sourced and foreign sourced income and NOTA income might be better treated than it would have been if it were either U.S. sourced or foreign sourced income. That seems an absurd result. Arguably, the policy considerations above favor treating the income as foreign sourced. On the other hand, the substantive reasons for subjecting income with actual nexus to U.S. business activity as taxable without regard to source are fairly compelling. See American Law Institute, supra note 17 at 78. Fortunately, even U.S. sourced FDAP is treated as effectively connected only in limited circumstances. See Treas. Reg. § 1.864-4(c). The problem is limited to NOTA income that satisfies the “business activities” or “asset use” test and may not arise that often in practice.
guidance could be couched as an exercise of prosecutorial discretion, for example through a Revenue Procedure, providing that in the case of NOTA income, the IRS will not challenge the position that it is foreign source income for purposes of sections 871 and 881 if there is a reasonable basis for that position.

VI. **Conclusion**

Faced with income that is not assigned a source by any statutory or regulatory source, it is black-letter law that source is to be determined by analogy to the statutory source of income category it most closely resembles under *Bank of America*. Failing that, source must be determined from first principles based on the economic origin of the income. Despite the general acceptance of this approach, the underlying case law is unsatisfying and incoherent. That confusion is perhaps unsurprising, as the statutory structure effectively enacts a series of exceptional source assignments without announcing any general rule of source.

The origin of the *NOTA* income confusion is twofold. First, courts have mistaken a tax law term of art (“source”), which identifies income that should be subject to U.S. taxing jurisdiction based on a complex of conflicting policy concerns, for an economic incident of income. Second, the case law has not recognized (or at least acknowledged clearly) that the *NOTA* income dilemma is an instance of the more general problem of spurned delegations of regulatory authority. The result has been a court intrusion into the lawmaking sphere that properly belongs to more politically accountable agencies like Treasury and the IRS, which have far greater relevant expertise. Judicial willingness to legislate source assignments may even have compounded the problem by systemically discouraging the issuance of source regulations.

Respect for precedent will probably prevent any court from acknowledging long-standing error. Consequently, it will require action by Treasury to regulate a general rule that finally reconciles the statutory and regulatory exceptions, even if this is no more than a presumptive default rule of source.

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