Ch. 2 – Tax Sourcing Rules
Income & Deductions p.76

IRC §§861 - 865 (& tax common law?).
Multiple objectives of the income sourcing rules:

1) Foreign taxpayers - identify their income within the U.S. income tax sphere.

2) U.S. taxpayers - determine whether the “first right to tax” belongs to the foreign jurisdiction (then, ascertain foreign country income tax & the availability of a U.S. foreign tax credit).
Interest income sourcing
p.78

§§861(a)(1) & 862(a)(1)

1) Source of interest income depends upon the residence of the payor. Residence when?

2) Foreign corp. – its U.S. branch interest as U.S.

3) U.S. corp. foreign branch interest paid is foreign.

4) Previously: Flow through to recipients of foreign source characterization if a U.S. corp had 80 percent of its income derived from a foreign source. Prior §861(c)(1). Proportionate allocation under a related person rule – prior §861(c)(2).
Dividends received from a U.S. corporation has a U.S. source - §861(a)(2).

Dividends received from a foreign corporation is foreign-source income - §862(a)(2).

However, dividends from a foreign corporation are treated as proportionally U.S. sourced if 25 percent or greater of the foreign corp’s gross income was ECI - USTB. §861(a)(2)(B) (on three year base period). Based on “gross” rather than “net” from each source.
Source of rental and royalty income is determined by the place where property is physically located or used – both tangible & intangible property.

§861(a)(4) or §862(a)(4).

See Rev. Rul. 68-443 re trademark licensing income - place of sale of trademarked goods is not relevant for determining the tax sourcing of royalty income – for ultimate use outside the U.S. – i.e., foreign trademarks.

Query: Is all income from sales attributable to the trademark? Yes, to licensor. Is some income attributable to manufacture of physical goods?
Compensation for Personal Services - Income Sourcing

Income is sourced where the services are performed - §§861(a)(3) & 862(a)(3).

Rev. Rul. 60-55 - sales activity generating a commission occurs outside the U.S. & produces foreign source income. Foreign corp. receives commissions for sales/representation services provided in foreign countries - even though shipment of the purchased goods is from the U.S.

Query: Where are the services performed? & not where the sales are legally concluded.
De Minimis Compensation Sourcing Rule p.83

De minimis exception in U.S. - §861(a)(3):
1) Working in U.S. for less than 90 days
2) compensation does not exceed $3,000 (a “cliff provision”), &
3) an expense of a foreign employer.
This sourcing rule effectively provides a tax exemption.
Compensation for foreign vessel’s crew is foreign sourced even if services are performed in the U.S.
Compensation for Personal Services – Allocation Issue

An allocation issue arises when services are performed both within and outside the United States.

What is an appropriate allocation approach?
Stemkowski case - p. 83 (include also training camp time in allocation formula, but not the off-season period when/if conditioning).

Regulations – finalized in 2005 (p. 88); allocate income on basis of time, not facts & circumstances. Special allocation rules for fringe benefits and hardship/hazardous duty pay.
Further Compensation Issues

1) Compensation or royalty income?
   Boulez case – p.89. German resident & French citizen. No ownership participation interest in the copyright for the recording.

2) Signing bonus (payment for what?).

3) Non-compete payment, including exclusive sign-on fee; where does a person not compete?
   Korfund case - p. 95.

4) Sign-on agreement (a NRA with a no future services agreement) - Rev. Rul. 74-108, p.96;
   Allocation to where right to act is forfeited.
Example: Employee earns compensation in the U.S. & a foreign jurisdiction. Employer contributes to a qualified deferred compensation account on behalf of the employee.

What characterization of payments when retirement income distributions occur?

See Rev. Rul. 79-388 (p. 99) re a proportionate allocation. How compute the proportionality when Periodic contributions to retirement plan?
Income realized on sale is geographically sourced where the real property is located.

See §861(a)(5) & §862(a)(5).

What is real property? Land, buildings, oil & gas property? Severed crops?

Whose rules define whether the property is “real property” for this purpose? State law? Federal tax law? Remember the Bosch case (estate tax/“proper regard” for deferring to state law).
Income from Sale of Personal Property  §865  p.99

1) Inventory - §§861(a)(6) & 865(b)
   “passage of title” test
   but,  Reg. §1.861-7(c) re tax avoidance.
   A.P. Green Export Co. - p.100
   title passage was structured to occur at the destination outside U.S. – clear “intent” noted.

2) Noninventory personal property is deemed sold at the residence location.  Code §865(a).
   Source rule is applicable to both gains & losses.
Depreciation - Code §865(c) – income from sale of depreciated property is sourced to the country where the depreciation expense has been claimed. Precluding (1) a deduction claimed in the U.S., & (2) income on disposition derived outside the U.S.

Intangible Property Sale - p.107  §865(d).

1) **Sale** for a fixed amount – sourced at residence.

2) **Sale** for a contingent payment. Cf., royalties (not a property sale), i.e., ordinary income.

**Note:** goodwill (where located) - §865(d)(3).
Sale of stock in a foreign “affiliate” corporation - Code §865(f), foreign country & foreign business.
Foreign corp. as “affiliate” - 80% ownership.
Foreign source income (subject to conditions).

Personal property sales through (1) a foreign branch - §865(e)(1); if a 10% tax rate there is foreign source.

or, (2) a U.S. branch, U.S. source; but, Code §865(e)(2), where participation of a foreign office in the transaction; then income sourcing at the foreign office location.
Code §863(b)(2) allocation required if goods are:

(1) - (a) manufactured outside the U.S. and (b) sold in the U.S., or

(2) - (a) manufactured in the U.S. and (b) sold outside the U.S.

What allocation approach is appropriate?

1) formulary approach? 50-50 method?

2) independent factory price (IFP) (elective); must demonstrate similar sales as made to independent distributors.
Sale of Intangible Property, Royalty or Compensation?

P. 111- Sale of intangible property for a royalty - Code §865(d)(1) – royalty sourcing rules – fixed or contingent payments?

Rev. Rul. 84-78, p.112 - Foreign source income?

Foreign corporation pays royalties for the foreign country live broadcast of a U.S. boxing match. Foreign source **royalty** income is realized. Not income from the **sale** of personal property. See §862(a)(4). Sale is not for the entire life of the property and, therefore, is rent (royalty).
Does a sale or license of computer programs occur when electronically delivering software?

A right to make copies (& sell) or merely a right to use a computer program?

Reg. §1.861-18 situs choices: (1) sale or exchange (property sale?), or (2) lease generating rental income (location), or (3) inventory sale (title passage)?

If leasing/licensing – what is the place where the property is being used?
1) Code §863(c)(2) - vessels and aircraft in international transportation & U.S. contact - 50% US and 50% foreign source income.

2) Code §863(d) - space and ocean activity as U.S. source for U.S. citizen/U.S. corporation; foreign source for the foreign taxpayer.

3) Code §863(e)(1) - international communications:
   1) U.S. person - 50-50 sourcing split.
   2) Foreign person - all foreign source (unless attributable to a U.S. office).
Nonstatutory Sourcing Rules (i.e., “Common Law”)

Scholarships, Prizes and Awards. p.117

is usually sourced to the jurisdiction of the payor (similar treatment as interest income), rather than the status of the recipient. See Reg. §1.863-1(d). Foreign sourced scholarship not U.S.

But, is this not equivalent to compensation?

What if services are to be rendered?

But, if scholarship (1) from a U.S. person to (2) a foreign person to (3) study outside the U.S., then foreign source income, & not sourced to payor.
Nonstatutory Sourcing Rules (i.e., “Common Law”)

Alimony. IRC §71 gross income inclusion? p.118

Situs of the payor determines the source (similar to treatment of an interest payment).

Estate - Rev. Rul. 69-108 (§71 alimony?) p.118

Required continuing periodic payment is being made by an ancillary administrator in the U.S. However, the debt/payment is treated as sourced to the (foreign) estate of the decedent paying the alimony; not to the ancillary U.S. estate.

§71 alimony must end at death of the payee spouse.
1. Acceptance commissions (p.124): similar to a loan transaction - credit risk of the foreign bank is assumed by the U.S. bank; sourced as if an interest payment by foreign bank. Foreign source realized by BofA. See market for “acceptances.”

2. Confirmation commissions (p.126) - credit risk assumed by BofA; foreign sourced (as if interest).

Guaranty Fees

Subsidiary to Parent Corp.

Container Corp., Tax Court (2010)

U.S. subsidiary pays fee to foreign (Mexican) parent corporation for guaranteeing the subsidiary’s debts to unrelated U.S. lenders.

Interest equivalent (sourced to U.S. payor, & withholding at source)) or for services (sourced to foreign country where provided)? Held: Services.

Problem 1
Interest Characterization

U.S. Corp borrows 10 million from foreign bank – 85% of U.S. corp's income is (a) (i) from sources outside the United States and (ii) attributable to the active conduct of business in foreign country, and (b) the remaining 15% is from U.S. sources.

Here: Interest paid by U.S. corp. is U.S. source.


If related person owns all stock - % allocation was then (pre-2010) required if a 20% or greater ownership by payee.
35% of foreign corporation’s US branch income is effectively connected with USTB.

**Dividend** is paid to the sole shareholder of the foreign corp., i.e., a same country (France) foreign corporation holding company.

§861(a)(2)(B) - a portion (35%) of the dividend is treated as U.S. source (since over 25% minimum).

**Withholding ay source** (possible lower France-U.S. tax treaty rate?); but, eliminated when branch profits tax applies. §884(e)(3).
U.S. corporation performed services under a contract with a foreign corporation. Source of corporation’s compensation is where the services are performed. §861(a)(3).

How allocate in this situation? The most favorable calculation to the taxpayer would be based on the value (50/50) of the services income in the two locations. But, see Reg. §861-4(b)(2) concerning a time basis allocation (50/75 of $100,000 as US) as ordinarily being required.
Cosmos (US) (i) manufactures and (ii) leases computers. Cosmos foreign branch office (France) is engaged in marketing. Foreign branch (France) leases a computer to same country (France) foreign branch of third Country (German) company. Source of the rental income? The computer is used in the foreign country and is foreign source income. §862(a)(4). Location of the use controls. Status of Cosmos & the lessee & the marketing not relevant.
Foreign Corp (Panama) owns a U.S. patent. Nonexclusive license is granted to Bermuda corporation & pays 3% royalties to Pan. Corp. What is the source of royalties? U.S. (a U.S. patent). U.S. source: how is the 30% tax withholding at source enforced against Bermuda Corp? Where is manufacturing? Enforce against goods in U.S.? Enforce against Panama’s asset, i.e., U.S. patent? What if a sub-licensing arrangement is implemented by Bermuda Corp. to another foreign corp.? This presents the “cascading royalty” issue.
Problem 6  
§§865(a) & 861(a)(6) & 863(b)  

1) **Purchase** occurs in U.S. and **sale** of inventory **outside** U.S. - §865(b), §862(a)(6) & §1.861-7(c).

2) **Manufacture and sale** of inventory - §863(b)(2) requires an allocation. What allocation method to use - Code §863(b)(2)? 50/50 or IFP method?

3) **Sale of non-inventory item (computer)** by U.S. sub. to foreign parent corporation - §865(a) - **sourced at residence** (US) since not inventory - unless prior depreciation (but, no depreciation here if an immediate resale) - §865(c).
Sale by U.S. corp. of foreign patent rights to foreign corp. for a lump sum amount paid in installments. Sale for fixed price would be U.S. source under the general rule of §865(a), i.e., residence. Except - depreciation override rule (200 of 800 gain) - §865(d)(1)(A). This 200 income is foreign source.

If % payment - royalty sourcing rule is applicable - §865(d)(1)(B) & foreign source (foreign law).

Sale of both trademark & goodwill? Is the trademark separate (& sourced to the seller’s residence)? Goodwill as foreign - §865(d)(3).
Problem 8  
Multiple Foreign Patents

Patent licensing branch in Germany. $800,000 gain from the sale of the German patent to the German purchaser is exempt from German tax.

$200,000 is sourced to Germany under Code §865(c) since reflecting amortization/depreciation deductions against German-source income.

Remainder (600) is U.S. source, i.e., appears to be foreign source income under §865(e)(1)(A), but, §865(e)(1)(B) applies – the foreign source rule does not apply if the income is not subject to at least a 10 percent foreign tax.  
continued
Multiple Foreign Patents

If the patent were inventory property: the “title passage” rule would apply; all the gain would be foreign source income. §865(b).

Sale for a “royalty-like price”? Source is determined by the royalty source rules. §865(d)(1)(B).

Therefore: German patent rights and foreign source income realized. §862(a)(4).
Problem 9  p.130
Depreciation Deduction

U.S. corp. purchases trucks for 400x used to transport inventory in U.S. expenses, including 200x depreciation; previously used to reduce U.S. source income (& tax basis for trucks).

Sale of trucks for 410x (producing profit of 210x), with title passing in the foreign country (Peru).

200x as U.S. source - §865(c)(1) - U.S. depreciation.

10x from foreign country inventory (?) sale - §865(c)(2) - foreign source since a foreign based sale. §862(a)(6).
§865(f) – a special source rule for the gain on the sale of the stock of a foreign (German) affiliate. Meets the §865(f) test - engaged in the active conduct of a business. Gain as foreign source? But, more than 50% of sub’s gross income from the prior three years was derived from active conduct of business in another foreign country (France). Tax advice: Close (& negotiate) the deal in France? §865(f)(3).
Problem 11
ATM Service Fee & BofA Case


What statutory rule governs determining the source of the service fee? None. See BofA case?

Service fee?- earned where the service is rendered – i.e., foreign source.

Or: is this a loan of credit? - then (as interest) sourced back to the NY bank making the loan?

No statutory sourcing rule? But, impact of §861(a)(9) – re the status of a guarantee fee?
Production in the U.S. and some sales through a branch in Europe. What is the division of the $200 income between the production and sale of the electronic toys - divided between the U.S. and foreign sources?

1) 50-50 approach ($100 of $200 profit)? or

2) IFP ($250 base less $100 cost; $150 U.S. source - for manufacturing; $50 foreign)? Avoid this?

3) Independent sale for $150; only $50 U.S. mfg. income (and $150 foreign sales income). IFP-yes.
Copyright in a computer program. Distributed under a “shrink wrap license.”

1) Really a “sale” of a copyrighted article?
Reg. §1.861-18(h), Example 1. 50-50 method applies - Divide between the mfg. & the sales functions. Title passage where (re sales income)?

2) Electronic transmission - Use the 50-50 allocation method. Reg. §1.861-18(g)(2). Manufacturing income 50% in the U.S. Foreign source sale income since delivered at the destination computer? Reg. §1.861-18(g)(2). Where actually delivered?
Nonresident alien writing a book for the U.S. market. What is author’s “property interest”?


2) U.S. source royalty income - §865(d)(1)(B) & §861(a)(4).

3) Fixed price - sale of the intangible for a fixed price - source to the NRA’s author’s foreign residence - §865(a) & §865(d)(1)(A).
Code §861(b) & §862(b) require allocation of deductions (expenses, interest, R&D, stewardship expense, etc.).

General rules concerning allocation of deductions:

1) Allocation based on factual attribution to the particular class of income.
2) Apportionment where not “definitely related to gross income.”

See Reg. §1.861-8.
Interest expense allocation:

1) money is fungible and interest should be allocated to all assets. Allocation made on basis of asset value rather than on gross income. Code §864(e)(2). To preclude allocating borrowing to particular entity in a related group.

2) exception is made for non-recourse debt.

3) additional exception for integrated financial transactions.
Interest expense allocation formula (to U.S.):

1) Relative asset values:
   \[ \frac{6}{10} \times 200,000 = 120,000 \text{ U.S. source expense.} \]

2) Tax book values:
   \[ \frac{4}{5} \times 200,000 = 160,000 \text{ U.S. source expense.} \]
Problem 2 Interest Expense Allocation

[to come]
Tax planning objective - allocate maximum expense against domestic income.

Under Reg. §1.861-17 allocation of R&D cost is based on product categories.

Specific allocation of these expenses incurred to satisfy local country legal requirements.

50% allocated to place of R&D activity.

50% allocated under “sales method” (comparing foreign sales to total sales in product category).

Optional gross income rather than sales method.