Income & Source

IRC §§861 - 865 (& tax common law?).

Multiple objectives of 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, i.e., before availability of the U.S. foreign tax credit.

Interest income sourcing

§§861(a)(1) & 862(a)(1)

1) Source of interest income depends upon the residence of the payor. Residence when?
2) Flow through to recipients of foreign source characterization if U.S. corp has 80 percent of its income derived from a foreign source. §861(c)(1). Proportionate allocation under a related person rule - §861(c)(2). Related person – 10%+ owner.
3) Foreign corp. - U.S. branch interest as U.S.

Dividends sourcing

Dividend from a U.S. corporation has U.S. source - §861(a)(2).
Dividends from a foreign corporation as 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).
**Rents & Royalties**

**Income sourcing**

Source of rental and royalty income is determined by 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 not relevant for determining sourcing of royalty income – for ultimate use outside the U.S. – i.e., foreign trademarks.

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**Compensation for Personal Services - Income Sourcing**

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

Rev Rul 60-55 - commission sales outside U.S.

Foreign corp. receives commissions for sales/representation services provided in foreign countries even though shipment of goods from the U.S.

Query: Where are the services performed?

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**De Minimis Compensation Sourcing Rule**

De minimis exception in U.S. - §861(a)(3):

i) in U.S. less than 90 days

ii) compensation not exceeding $3,000 (a “cliff provision”) &

iii) expense of a foreign employer.

This sourcing rule effectively provides a tax exemption.
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 hockey player case
Regulations – finalized in 2005; allocate income on basis of time, not facts & circumstances. Special rules for fringe benefits and hardship duty pay.

Further Compensation Issues
1) Compensation or royalty income?
   Boulez case – No participation interest in the copyright.
2) Signing bonus (payment for what?).
3) Non-compete payment, including exclusive sign-on fee; where does a person not compete? Korfund case

Sale of Real Property
Income is sourced where the real property is located.
§ 861(a)(5) & § 862(a)(5)
What is real property?
Whose rules define whether the property is “real property” for this purpose? State law? Federal tax law? Remember the Bosch (estate tax/“proper regard”) case?
Sale of Personal Property
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.
   title passage 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).

Special Personal Property
Sourcing Rules
Depreciation - Code §865(c) - sourced to
   country where depreciation is claimed.
Sale of Intangible Property
Code §865(d)
1) Sale for fixed amount
2) Sale for a contingent payment
   Cf., royalties (not a property sale; i.e.,
   ordinary income).

Sourcing Rules for Special
Entities
Sale of stock in a foreign affiliate corporation
   - Code §865(f).
   Foreign source income? 80% owner.
Personal property sales through a foreign
branch - Code §865(e)(1);
or a U.S. branch - Code §865(e)(2).
Sale of stock of a US. real property holding
corporation - Code §861(a)(5). U.S. source
income.
**Manufacture & Sale of Inventory Property**

Code §863(b) allocation is required when 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?
2) elect independent factory price (IFP)

**Sale of Intangible Property, Royalty or Compensation?**

Sale of intangible property for a royalty - Code §865(d)(1) - sourcing according to royalty rules.

Rev. Rul. 84-78: 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. §862(a)(4).

**Computer Programs**

Sale or license of computer programs when electronically delivering software?
Right to make copies or merely a right to use a computer program?
Reg. §1.861-18.
Further Statutory Sourcing Rules

1) Code §863(c) - vessels and aircraft in international transportation & U.S. contact. 50% US and 50% foreign.
3) Code §863(e) - international communications:
   1) U.S. person - 50-50 split.
   2) Foreign person - all foreign source.

Nonstatutory Sourcing Rules

Scholarships, Prizes and Awards
usually sourced to the jurisdiction of the payor (similar treatment as interest income). Not equivalent to compensation.

Alimony IRC §71 inclusion?
Situs of the payor determines the source.
Estate - Rev. Rul. 69-108: sourced to the estate of the decedent paying the alimony; not to ancillary estate in U.S.

Banking & Financial Services

Bank of America case
1. Acceptance commissions: similar to a loan transaction - credit risk of the foreign bank assumed; source as if an interest payment. Foreign source.
2. Confirmation commissions - credit risk assumed; source as interest.
**Problem 1**

**Interest Characterization**

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

Here: Interest paid by U.S. corporation is 100% foreign source income.

Related person percentage allocation is required if 20% or greater ownership.

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**Problem 2**

**Foreign Corp branch in U.S.**

35% of foreign corporation branch income is effectively connected with USTB.

Dividend is paid to the sole shareholder, a foreign corporation holding company.

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

Withholding (lower tax treaty rate?) unless the branch profits tax applies. §884(e)(3).

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**Problem 3**

**Compensation from Services**

U.S. corporation performs services under a contract with a foreign corporation.

Source of compensation is where services are performed. §861(a)(3).

How allocate? Most favorable calculation to the taxpayer based on value (50/50) of the services income. But, see Reg. §861-4(b)(2) concerning time basis allocation (50/75 US) being required.
Problem 4
Computer rental income

US Corp. (i) manufactures and (ii) leases computers. Corp foreign branch office is engaged in marketing. Foreign branch leases a computer to same country foreign branch of a Third Country company.

Source of rental income? Computer is used in the foreign country and is foreign source income. Code §862(a)(4).

U.S. status of Corp & lessee not relevant.

Problem 5
U.S. Patent Licensing

Foreign Corp (Panama) owns a U.S. patent. Nonexclusive license is granted to Bermuda corporation & pays royalties to Panama.

What is the source of royalties? U.S. (patent).

U.S. source: how is 30% withholding at source enforced against Foreign Corp?

What if a sub-licensing arrangement is implemented by Bermuda 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. - §862(a)(6).

2) Manufacture and sale of inventory - Code §863(b)(2) requires an allocation.

What method to use - Code §863(b)(2)?

3) Sale of non-inventory item (computer) - Code §865(a) - sourced at residence (US) - unless depreciation (no depreciation if immediate resale) - §865(e).
Problem 7

Foreign Patent Sold

Sale by U.S. corp. of rights to a foreign patent to a foreign corporation for a lump sum amount paid in installments.

Sale for fixed price would be U.S. source under the general rule of Code §865(a), i.e., residence. Depreciation override rule - §865(d)(1)(A). Interest is foreign source. If % payment - royalty rule applicable - §865(d)(1)(B) & foreign source.

Problem 8

Depreciation Deduction

U.S. corp. purchases trucks for 400k used to transport inventory in U.S. Expenses, including 200k depreciation, used to reduce U.S. source income.

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

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

10k from inventory (?) sale - §865(c)(2) - foreign source since a foreign sale.

Problem 9

Sale of Foreign Affiliate Stock

§865(f) - special source rule for the gain on the sale of the stock of a foreign affiliate.

Meets §865(f) test since engaged in the active conduct of a business.

Gain will be foreign source if more than 50 percent of sub’s gross income from the prior three years was derived from the active conduct of business in country of sale. Where to close the deal? §865(f)(3).
**Problem 10**  
**ATM Service fee & BofA Case**

What statutory rule governs determining the source of the service fee?
Service fee? - earned where the service is rendered - foreign source. Or: loan of credit? - then (as interest) sourced back to the New York bank which made the loan?

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**Problem 11**  
**Mfg & Sales Allocation**

Production in the U.S. and some sales through a branch in Europe. What is the division of income between the production and sale of the electronic toys - divided between U.S. and foreign sources?
1) 50-50 approach? or
2) Independent Factory Price
3) Independent sale

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**Problem 12**  
**Computer Program**

Copyright in a computer program. Distributed under a shrink wrap license.
1) 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?
2) Electronic transmission - Use the 50-50 allocation method. Reg. §1.861-18(g)(2). Delivered at the destination computer?
Problem 13
NRA Book Author

Nonresident alien writing book for the U.S. market. What author property interest?
1) Compensation income - where was the book written? §861(a)(3) & 862(a)(3).
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 author’s foreign residence - §865(a) & §865(d)(1)(A).

Sourcing Rules Applicable to Deductions

Code §861(b) & §862(b) require allocation of deductions.
General rules concerning allocation:
1) Allocation based on factual attribution to particular class of income.
2) Apportionment.

Allocation of Interest Expense

Interest expense allocation:
1) money is fungible and interest should be allocated to all assets. Allocation made on basis of assets rather than gross income. Code §864(e)(2).
2) exception for non-recourse debt.
3) exception for integrated financial transactions.
Allocation of Research & Experimental Expense

Tax planning objective - allocate maximum expense against domestic income.
Under Reg. §1.861-17 allocation of R&D cost based on product categories.
Specific allocation of these expenses incurred to satisfy legal requirements.
50% allocated to place of R&D activity.
50% allocated under sales method.