International Income Taxation

Chapter 2: Source Rules for Income and Deduction

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Whom do you see?

An Old Lady or a Young Lady?

Your Perspective Matters
IRC §§861 – 865

Sourcing objectives:

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.

Question: Why Does Sourcing Matter?
§861(a)(1) & §862(a)(1)

1) General Rule: Source of interest income depends **payor’s residence**.

2) Exception: Interest paid by US branch of foreign corporation treated as US source. See §884(f)(1)(A); Reg. §1.861-2(a)(2)(iv)

3) Exception: Interest paid by foreign branch of US corporation is treated as foreign source. See §861(a)(1)(A)(i).

Question: Why Does Sourcing Matter?
General Rule: Dividends sourced by payor’s residence.

1. Dividend from a U.S. corporation has U.S. source - §861(a)(2).

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

3. Exception: 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). Based on “gross” rather than “net” from each source.
Source of rental and royalty income is determined by **place where property is physically located or used** – both tangible and intangible property.

§861(a)(4) or §862(a)(4).

See Rev. Rul. 68-443 re trademark licensing income – place of initial sale of trademarked goods not relevant for determining sourcing of royalty income. Holding is that royalty is foreign source because the product’s ultimate use outside the U.S. – i.e. foreign trademarks.

License for Foreign-Use

- **X Corporation**
  - US Manufacturer
  - Trademark place on products
  - Product sold to non-US customers in US

Royalty

- **Y Corporation**
Income sourced **where 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 the purchased goods from the U.S. and paid from US.

**Query:** Where are the services performed?

**Answer:** Outside the US because that is where the place of personal services were performed.
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”) and

iii) An expense of a foreign employer.

This sourcing rule effectively provides a tax exemption.

Question: Why Does Sourcing Matter?
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 but not off-season period).

Regulations – p. 88 allocate income on basis of **time**, not facts and circumstances. Special rules for fringe benefits and hardship duty pay. In 2007, proposed regulations provide special source rules for “event basis” situations (professional athletes, musicians, and the like).
Further Compensation Issues

1) Compensation or royalty income? **Boulez** case – p. 89. No participation interest in the copyright. [Beatles variation]

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 (no future services agreement) – **Rev. Rul. 74-108**, p. 96

5) Athletic Endorsement Contracts Personal Services or Royalties? **Garcia v. Commissioner**

6) Retirement Pay for Mixed Sources: Prorate per Rev. Rul. 79-388.
Income is sourced where the real property is located.

§861(a)(5) & §862(a)(5)

What is real property?
1) Inventory - §861(a)(6), §862(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 structured to occur at the destination outside U. S. – clear intent noted.

2) Noninventory personal property is deemed sold at the **residence location**– p. 105. Code §865(a).
   Source rule applicable to both gains & losses.
Depreciation recapture gain (p. 106) **Question: Why Does Sourcing Matter?** is sourced to country where depreciation is claimed. Code §865(c).

Intangible Property Sale (p. 107) §865(d)
1) **Sale for fixed amount** is sourced by **residence** of seller. See §865(d)(1)(A) & §865(a).

2) **Sale for a contingent payment.** Cf. royalties (not a property sale; i.e., ordinary income) is sourced the same as a royalty (**where used**). §865(d)(1)(B).

Note: Goodwill is sourced according to the location where the goodwill was **generated**. See §865(d)(3). But, please consider International Multifoods (p. 107) that goodwill must be separable from listed intangibles to avail oneself of §865(d)(3).
1. Sale of stock of a foreign affiliate is treated as foreign source gain if:
   (i) sale occurs in the foreign country (not US);
   (ii) 50% of foreign affiliate’s income derived in that country from active business, and
   (iii) foreign affiliate is 80% owned, then

   See Code §865(f).

2. Personal property sales will be foreign source if (1) sold through a foreign branch when a 10% foreign tax was paid (see Code §865(e)(1)) or (2) sold for use outside of the US, is sold by a U.S. branch, but a foreign office “materially participated” in the sale (see Code §865(e)(2)).

3. Sale of stock of a U.S. real property holding corporation is US source (see Code §861(a)(5)). See (later) FIRPTA rules.
Outbound Case: Code §863(b) allocation is required when goods are manufactured in the U.S. and sold outside the U.S.

What allocation approach is appropriate?
1) Formulary approach? 50-50 method?
2) Independent factory price (IFP) (elective)

Inbound Case: if manufactured outside and sold inside, then §863(b)/§865(e)(2) interplay.
Sale of intangible property for a royalty –

Code §865(d)(1) – sourcing according royal rules.

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 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: (1) sale or exchange or (2) lease generating rental income?

If licensing – what is the place where the property is used?
1) Code §863(c) – vessels and aircraft in international transportation and U.S. contact. 50% U.S. and 50% foreign.


3) Code §863(e) – international communications:
   a) U.S. person – 50-50 split.
   b) Foreign person – all foreign source.
Scholarships, Prizes and Awards  p. 117
Usually sourced to the jurisdiction of the payor (similar treatment as interest income). Not equivalent to compensation.

Alimony. IRC §71 inclusion? p. 118
Situs of the payor determines the source.

Sourced to the estate of the decedent paying the alimony; not to ancillary estate in U.S.
Bank of America Case  p. 120

1) Acceptance commissions (p. 112): Similar to a loan transaction – credit risk of the foreign bank assumed; sourced as if an interest payment. Foreign source to B of A.

2) Confirmation commissions (p. 114): Credit risk assumed; foreign sourced (as interest).


4) Container Corp. (p. 128) was contra to Bank of America. In response, Congress enacted §861(a)(9) and §862(a)(9) (guarantee fee is US source if underlying debt is issued by a US person or US ToB). Congress thus endorsed Bank of America case.

Question: Why Does Sourcing Matter?
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.
35% of foreign corporation’s U.S. branch income is effectively connected with USTB.

Dividend is paid to the sole shareholder, a foreign corporation holding company.
Problem 3
Compensation from Services

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

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

How allocate?

Galaxy Corporation

- 25 days in Canada for $50,000
- 50 days in US for $50,000
Cosmos (U.S.) (i) manufactures and (ii) leases computers. Cosmos 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?
Foreign Corp (Panama) owns a U.S. patent.

Nonexclusive license is granted to Bermuda corporation and it pays royalties to Panama.

What is the source of royalties?

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 (U.S.) – unless depreciation (but, no depreciation if an immediate resale) - §865(c).
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 (200 of 800 gain) - §865(d)(1)(A). Interest is foreign source. If % paid – **royalty rule** applicable - §865(d)(1)(B) and foreign source.
Patent licensing branch in Germany. Gain from the sale of the German patent to the German purchaser is exempt from German tax.

a. $200,000 sourced to Germany under code §865(c) since reflecting depreciation deductions against German-source income.

b. 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.

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

d. Sale for “royalty-like price”? Source is determined by royalty source rules. §865(d)(1)(B). Therefore: German patent rights and foreign source income. §862(a)(2).
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 (and tax basis).
§865(f) – special source rule for the gain on the sale of the stock of a foreign affiliate.

Meets §865(f) test – engaged in the active conduct of a business. Gain as foreign source?

But, more than 50% of a sub’s gross income from the prior three years was derived from active conduct of business in France. Close the deal in France? §865(f) (3).
ATM Service Fee & B of A 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?
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 ($100 of $200 profit)? Or

2) IFP ($250 base less $100 cost; $150 U.S. source; $50 foreign)? No preferable.

3) Independent sale for $150 and $50 U.S. manufacturing income (and no other income to taxpayer).
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 manufacturing and 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?
Nonresident alien writing book for the U.S. market. What author property interest?

1) Compensation income – Where was the book written? §861(a)(3) and 862(a)(3).

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

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

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 asset value rather than on gross income. Code §864(e)(2).

2) Exception for non-recourse debt.

3) 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

\[
\frac{4}{5} \times 200,000 = 160,000 \text{ U.S. source expense.}
\]
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”.