Part 3
Source of Income and Deductions

Contents, Part 3 (Ch. 11-15)

Chapter 11: Nature and Function of Source Rules 1
§ 11.01. Function of Source Rules 1
§ 11.02. Nature of Source Rules 4
A Critique of the Source Principle 7
§ 11.03. Source Rules: In the Courts 9
Comm'r v. Piedras Negras Broadcasting Co. 9
Questions 12
Comm'r v. Hawaiian Philippine Co. 12
Case Note 15
Questions 16
Sanchez v. Comm'r 17
Questions 18
§11.04. Source Rule Principles 19
§ 11.04.1. Administrative Simplicity 20
§ 11.04.2. Internal Consistency 21
§ 11.04.3. Economic Nexus 21
§ 11.04.4. Inclination to Tax 23
§ 11.04.5. Sovereign Control of Source 23

Chapter 12: Source of Periodical Income 25
§ 12.01. Interest 25
§ 12.01.1. Residence-of-Obligor Rule 25
§ 12.01.2. The 80-20 Company Exception (Repealed) 26
§ 12.01.3. Some Exceptions to the Obligor Rule 26
§ 12.01.4. Notional Principal Contracts (Interest-Rate Swaps, Etc.) 27
§ 12.01.5. Loan Guarantees 28
§ 12.02. Dividends, Deemed Dividends and Dividend Equivalents 28
§ 12.02.1. General Rule 29
§ 12.02.2. Deemed-Dividend Rule 29
§ 12.2.3. Domestic Corporation Exceptions 29
§ 12.2.4. Foreign Corporation Exceptions 30
§ 12.2.5. Dividend Equivalents 31
§ 12.03. Rents and Royalties 32
SDI Netherlands v. Comm'r 33
Questions 38
§ 12.04. Securities Lending Transactions 39

Chapter 13: Source of Income from Sale of Property 41
§ 13.01. Sale of Real Property 41
§ 13.02. Purchase and Resale of Personal Property 41
§ 13.02.1. General 41
§ 13.02.2. Inventory Property 43
§ 13.02.3. Depreciable Personal Property 44
Example 13.1: Depreciation Recapture Source Rule 45
§ 13.02.4. Intangible Property 46
§ 13.02.5. Corporate Stock 46
§ 13.02.6. Sales Through a U.S. or Foreign Office 47
§ 13.02.7. Special Residency Rules 49
§ 13.03. Sale of Inventory Property Produced by the Seller 50
§ 13.03.1. General Rules 50
Example 13.2: Production and Sale of Inventory Property 53
§ 13.03.2. Apportionment Methods 54
§ 13.03.2.1. The 50/50 Method 54
Example 13.3: 50/50 Method 54
§ 13.03.2.2. Independent Factory Price Method 56
§ 13.03.2.3. Books-of-Account Method 57
§ 13.03.3. Production Assets 57
§ 13.03.3.1. Definition of Production Assets 58
§ 13.03.3.2. Location of Production Assets 58
§ 13.03.3.3. Average Adjusted Basis 59
§ 13.03.3.4. An Example 59
Example 13.4: Production-Assets Method 59
§ 13.04. Natural Resources Income 60
Example 13.5: Source of Natural Resources Income 61

Chapter 14: Additional Source of Income Rules 63
§ 14.01. Personal Services Income 63
Retief Goosen v. Comm'r 66
Favell et al v. U.S. 72
§ 14.02. Income Arising Outside the Geographical Boundaries of Any Country 75
§ 14.03. Transportation Income 78
§ 14.04. International Communications Income 79
§ 14.05. Income Derived from Computer Software 82
§ 14.06. Foreign Exchange Income 84
§ 14.07. Additional Source Rules 85

Chapter 15: Source of Deductions 87
§ 15.01. General Source of Deduction Rules 87
§ 15.01.1. Allocation and Appointment of Deductions 88

Example 15.1: Allocation and Apportionment of Deductions 88
§ 15.01.2. One-Taxpayer Rule for Affiliated Companies 90
§ 15.01.3. State and Local Taxes 91
§ 15.01.3.1. Income Taxes 91
§ 15.01.3.2. Property Taxes 93
§ 15.01.3.3. Sales Taxes 94
§ 15.01.4. Losses 94
§ 15.01.5. Miscellaneous Other Deductions 98
§ 15.01.5.1. Supportive Functions 98
§ 15.01.5.2. Stewardship Expenses 98
§ 15.01.5.3. Legal and Accounting Fees 99
§ 15.01.5.4. Charitable Contributions 99
§ 15.01.5.5. Personal Expenses 100
§ 15.02. Interest Payments 101
§ 15.02.1. The Section 1.861-8 Interest Source Rule 101
§ 15.02.1.1. Operation of Asset Method 102
Example 15.2: Asset Method of Apportionment 102
§ 15.02.1.2. Exceptions to Asset Method 106
§ 15.02.1.2.1. CFC Netting Rule 106
Example 15.3: CFC Netting Rule 107
§ 15.02.1.2.2. Qualified Nonrecourse Indebtedness 107
§ 15.02.1.2.3. Integrated Financial Transactions 108
§ 15.02.1.3. Policy Evaluation of Asset Method 109
§ 15.02.2. The Section 1.882-5 Interest Source Rule 112
Example 15.4: Interest Deduction Under Section 1.882-5 116
§ 15.03. Research and Experimental (R&E) Costs 117
§ 15.03.1. Background 118
§ 15.03.2. General Rules 119
§ 15.03.3. Sales Method 120
§ 15.03.4. Optional Gross-to-Gross Methods 123
§ 15.03.5. Policy Notes 125

Chapter 11
Nature and Function of Source Rules

§ 11.01. Function of Source Rules

This part describes the rules employed by the United States for determining the geographical source of taxable income. Most of those rules are found in Code sections 861 to 865 and the accompanying Treasury regulations. Determination of the geographical source of income is essential for the application of most of the tax provisions discussed in this book.

Foreign persons need to know the source of their income in order to determine their exposure to U.S. tax jurisdiction. Under Code sections 871(a) and 881, nonresident alien individuals and foreign corporations are subject to a 30-percent withholding tax on certain categories of gross income, but only if that income is sourced in the United States. Foreign persons are taxable under sections 871(b) and 882 on net income that is effectively connected with a U.S. trade or business. Effectively connected income (ECI) generally is limited to U.S. source taxable income, although there is an exception for foreign source income attributable to an office or other fixed place of business located within the United States. The tax regime applicable to foreign taxpayers is described in part 2.

For U.S. persons, the primary function of the source rule is to determine the limitations on their foreign tax credit. The United States generally asserts tax jurisdiction over the worldwide income of U.S. persons. It moderates that jurisdictional claim, however, by allowing U.S. persons to take a credit for foreign taxes paid with respect to their foreign source income. The credit is subject to a complex set of limitation provisions that depend for their operation on the source rules.[1]

Taxpayers determine the geographical source of their taxable income in two steps. First, they determine the source of their gross income. Detailed source rules are provided, either in the Code or regulations, for substantially all types of gross income subject to tax by the United States. The second step is to reduce each item or class of gross income from a particular source by the deductions properly allocated to that gross income.

In this book, the rules for attributing gross income to geographical areas and the rules for attributing deductions to particular geographical areas are both called source rules. Virtually all commentators follow this usage for the gross income source rules, whereas many commentators do not view the deduction rules as source rules. Instead, they view them as tax accounting rules. The deduction rules often do function as accounting rules, as do the gross income source rules. Their primary function, however, is to determine the right of sovereign governments to tax, and they should be evaluated according to the criteria developed for determining the merits of the gross income source rules. Some of the deduction source rules — the interest deduction rules and the research and experimentation expense rules are examples — use formulas that are functionally similar to the apportionment formulas sometimes used to specify the source of gross income from cross-border activities.

[1] Reg. § 1.861-8(f) (2009) provides a list of 16 operative provisions that require a determination of the source of income. The most important provisions on the list are those that impose tax on foreign persons and those that determine the limitations on the foreign tax credit. Also on the list are provisions determining a taxpayer's foreign base company income under subpart F and provisions granting preferential treatment for income derived from a U.S. possession.

Most source rules serve not only to establish the geographical source of income for the purpose of taxing foreign taxpayers, but also to determine the limitations on the foreign tax credit. Some source rules, however, do not do such double duty. In recent years, Congress has become increasingly willing to adopt source rules that are applicable for one purpose only. Exceptions to the general applicability of source rules are noted throughout this part.

Some U.S. tax treaties contain source rules.[2] Generally the treaty source rules are compatible with the Code rules or can be made compatible through creative interpretation. In the case of an unresolved conflict, the rule adopted later controls under U.S. constitutional law. Congress sometimes provides, however, that a treaty provision will prevail over a later Code provision.

Taxpayers often seek to manipulate the source rules to minimize their tax liability. Most tax planning, however, involves not only the source rules but also other tax rules that affect tax liability. For a multinational enterprise, made up of a group of corporations, there are four important sets of rules that affect the amount of income on which they are liable for tax.[3] Those rules are the residency rules, the source rules, the tax accounting rules, and the transfer pricing rules. A method of taxation that employs these four sets of rules to determine tax liability has been called an arm's-length/source-rule methodology. The competing methodology, used by some American States, is the combined-reporting/formulary-apportionment methodology.

Under the arm's-length/source-rule methodology, corporations resident in a country typically are treated quite differently from foreign corporations. In general, resident corporations are taxable on their worldwide income, whereas foreign corporations are taxable only on the portion of their income that is attributable to that country. The United States follows this approach. Some counties, however, do not tax their resident corporations on their worldwide income. In those countries, the applicable rules are similar to the rules described below for taxing foreign corporations.

In computing its worldwide taxable income, a resident corporation typically would take the following four steps. Obviously there are some variations in these steps from country to country.

(1) *Books-of-Account Income*. A resident corporation typically uses its worldwide income, as reported on its books of account, as its starting point in computing its domestic source and foreign source taxable income. Many adjustments typically must be made to book income in accordance with the tax jurisdiction's applicable tax accounting rules

(2) *Transfer Pricing Rules*. When a resident corporation has had dealings with a related person, the amount determined in step (1), above, must be adjusted by applying the tax jurisdiction's transfer pricing rules. The OECD transfer pricing guidelines[4] provide for five distinct methods for determining the arm's length price on transfers of tangible property. Other methods must be used to determine the proper transfer price on transfers of intangible property and on the sharing of various corporate resources.

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[2] See U.S./Israel treaty, Art. 4.

[3] The discussion of the rules for computing tax liability under an income tax draws heavily from Michael J. McIntyre, "Contrasting Methodologies: A Systematic Presentation of the Differences Between an Arm's-Length/Source-Rule System and a Combined-Reporting/Formulary-Apportionment System." 1994 *NTA Proceedings* 226-235 (1994). See also Michael J. McIntyre, "The Use of Combined Reporting by Nation States," in chapter 8, Arnold, Sasseville, & Zolt, eds. THE TAXATION OF BUSINESS PROFITS UNDER TAX TREATIES (2003).

[4] OECD Committee on Fiscal Affairs, OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, OECD (2010).

(3) *Source of Gross Income*. After determining its worldwide taxable income in steps (1) and (2), a resident corporation typically must determine the amount of its domestic and foreign source gross income. This calculation, plus the calculation in step (4), is required in order to determine the amount of the taxpayer's allowable foreign tax credit. The function of the credit is to relieve the double taxation otherwise resulting from the taxation of foreign source income by both the residence jurisdiction and the source jurisdiction.

(4) *Allocation of Deductions*. As the final step in determining its domestic and foreign source taxable income, a resident corporation must subtract its allowable deductions either from foreign source gross income or from domestic source gross income. Taxing jurisdictions are not at all uniform in their rules for determining the source of deductions. The general rule is that deductions should be matched with the income they help produce. Deviations from the general rule, however, are commonplace, and application of that general rule is often difficult, especially for expenses that are hard to associate with particular categories of income, such as interest and research and development expenses.

The steps involved in computing the taxable income of a foreign corporation (or a domestic corporation not taxable on its foreign income) differ in some respects from those set forth above for resident corporations. The main differences are summarized below.

Adjustments to Step (1). A foreign corporation engaged in business in a taxing jurisdiction is not required to report its worldwide income. Foreign corporations entitled to the protection of a tax treaty need only report their taxable income that is attributable to a permanent establishment (fixed place of business) located within the taxing jurisdiction. The starting point in determining the amount of such income is the books of account of the permanent establishment. The rules applicable to a foreign corporation that is not entitled to treaty benefits will depend on the domestic laws of the taxing jurisdiction. Some countries utilize the permanent establishment concept unilaterally. Other countries may employ various source rules to determine the taxable income of a foreign corporation.

Adjustments to Step (2). Transfer pricing rules do not apply to transactions between parts of a single corporation (that is, between branches). Some countries apply rules analogous to transfer pricing rules, however, in determining the income of a branch of a foreign corporation. Other countries use formulas or other apportionment methods.

Adjustments to Step (3). As noted above, some taxing jurisdictions use source rules to determine the income of a domestic branch of a foreign corporation. The source rules applicable to foreign persons, however, may not be the same as the rules applicable to domestic persons. In some cases, a foreign corporation may be allowed under the source rules to exclude from domestic taxable income certain book income of the branch that does not have a domestic source.

Adjustment to Step (4). If a foreign corporation engaged in business in a taxing jurisdiction is taxable there, it is taxable on its net business income attributed to that jurisdiction. Thus it must determine the amount of its allowable deductions that are attributable to its business operations in the taxing jurisdiction. The rules for attributing deductions to a branch of a foreign corporation may differ in some respects from the rules used to attribute deductions to the domestic source income of domestic corporations. For example, the United States has different interest allocation and apportionment rules for foreign and domestic corporations.

Although each of the four sets of rules offer opportunities for tax avoidance, it is the operation of these rules in concert that allows many multinational companies to pay tax at low effective tax rates. Residency

rules are simple, but they are also easily manipulated. Many countries, including the United States, determine residence status by the place of incorporation. Place of incorporation is an historical fact, so it cannot be changed, at least formally. In practice, however, a corporation can change its residence by organizing a new corporation wherever it wants to be resident and then merging itself into the new corporation. The other common residency rule is place of management. In principle, that rule might have some substance. In practice however, the place of management is determined by easily-manipulated ceremonial events, such as place where the board of directors meet.

Source rules are sometimes simple and sometimes quite complex. Some are difficult to manipulate, whereas others invite manipulation. The U.S. rule that determine the source of income from the sale of goods by reference to the place where title to the goods passes is a well-known example of a source rule that is easily manipulated. Some source rules depend on the taxpayer's residence. Because the residence of a corporation is easily manipulated, those source rules for corporations also are easily manipulated.

Accounting rules are not really rules, in the legal sense. In many important situations, they are no more than loose guidelines, subject to substantial manipulation by the taxpayer. The recent scandals involving Arthur Anderson and Enron have rocked the international accounting fraternity. The Enron case and the many other scandals that have followed in its wake have made clear to just about everyone that accounting rules are subject to manipulation and almost certainly will be manipulated in at least some cases when the stakes are high.

Transfer pricing rules are extremely complex, to the point, perhaps, of being incapable of fair administration. They are also easy to manipulate, for their operation depends on factual matters typically under the control of the taxpayer. In addition, the rules are not uniform. Many different arm's length pricing methods are arguably applicable to the same set of transactions. The transfer pricing rules also are flawed conceptually because they assume, implicitly, that a multinational enterprise earns the same income as a group of unrelated corporations would earn from engaging in the same activities. In fact, multinational companies have come to dominate international commerce because they earn more money that their unrelated rivals.

§ 11.02. Nature of Source Rules

As discussed above, a source rule assigns items of taxable income to a particular geographical area in order to give the government of that area the sovereign right to tax that income. The usual pattern is to find some link between an item of gross income and a geographical area. In computing taxable income attributed to that area, the deductible costs of producing that gross income are subtracted out.

Contrary to popular belief, the assignment of income to a particular geographic area does not involve an inquiry into the geographical location of income. The reason is that income, by its very nature, has no geographical place. It is a number, calculated by adding and subtracting other numbers. In Henry Simons' famous formulation, income is defined as the sum of consumption and net change in savings over some period.[5] Income so defined cannot have a physical location, for it is merely a number.[6] A number is a quantity that has shed its accidental properties of time, place, color, and so forth. This abstraction from all

[5] Henry C. Simons, Personal Income Taxation 50 (1938).

[6] Income is "merely an arithmetic answer and exists only as the end result of appropriate calculations." Id. at 51. Simons also criticizes the "folly" of "describing income as a flow and, more emphatically, of regarding it as a quantity of goods, services, receipts, fruits, etc." Id.

accidental properties other than quantity is a prerequisite to mathematical manipulation. As the U.S. Supreme Court has noted, dividing up income according to its geographical attributes is like "slicing a shadow."[7]

In Simons' formulation of the income concept, the sum of a taxpayer's sources of income derived over a measurement period equals the sum of the taxpayer's personal consumption and savings over that period. Although personal income so computed has no geographical source, the various sources of income that are added together to determine the taxpayer's income may have links to particular geographical areas. In some cases, those links can provide a basis for assigning jurisdiction to tax to a particular sovereign government.

Assume, for example, the a taxpayer earns a salary of $10,000 from teaching school in a rural community. The taxpayer does all of her teaching in that community and has no meaningful economic ties to any other community. Under these circumstances, the association of her employment income with the location of her employment is strong. In addition, it does not appear from these facts that the income has significant links with any other geographical area. Under these facts, it seems entirely appropriate to assign jurisdiction to tax that employment income to the government of the country where the teacher carries on her teaching activities.[8]

In some cases, the place where the activities occurred that generated income is not always a good indicator of the source of that income. Consider, for example, a taxpayer who engages in whaling operations on the high seas. He hunts the whale, boils down its blubber on a factory ship, and sells the whale oil without entering the territorial waters of any country.[9] Under these facts, all of the income-producing activities occurred on the high seas. It would be inconsistent with the function of source rules, however, to assign the source of the income to the high seas because no government has sovereignty over the high seas. In addition, the whaling activities on the high seas merely contributed to the earning of the income. Much of the production activities relating to the outfitting of the boats occurred in one or more sovereign states, and the marketing of the whale oil also occurred in one or more sovereign states.

The most important issues in determining the source of income arise when an enterprise earns income that has some important links with more than one country. Consider, for example, the source of the income of an enterprise that produces goods in one country and sells those goods in another country. In this example, both the country of production and the country of sale are likely to make a claim to tax at least some portion of the income of the enterprise based on the source of the income. Both countries can rightly claim that significant economic activities took place within their borders and that those activities were necessary for the enterprise to earn income. Although it may seem obvious that not all of the income has its source in one or the other country, it is not at all obvious how the source of the income in this example should be determined.

In practice, the source of income is determined under the tax laws of particular countries. Because the source of income is not obvious in many cases, the source rules adopted by various countries sometimes conflict. When source rules conflict, a taxpayer may find itself subject to tax in more than one country. Or it may find it is not taxable on its income in any country. Well designed source rules would mitigate the risks of overlapping and underlapping claims to tax jurisdiction over particular items of income. Principles that ought to govern the design of source rules are address in § 11.04, below.

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[7] Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 192, 103 S. Ct. 2983, 2954 (1983).

[8] That assignment of the right to tax may not be an exclusive right because source is only one possible basis for assigning the right to tax. If the teacher is resident is some other country, for example, then the country of residence may also claim the right to tax.

[9] The example is drawn in part from Spermacet Whaling & Shipping Co. v. Comm'r, 30 T.C. 618 (1958), 281 F.2d 646 (6th Cir. 1960).

The term “income” has a different meaning when used to describe what is taxed and when used to describe how such income is linked to particular geographical areas. As noted above, the income of an enterprise, for purposes of imposed an income tax, is determined by abstracting from the factual details of earning the income, including facts tending to indicate its source. In that context, the term “income” means the sum of certain receipts obtained by a taxpayer over some period, minus certain allowable deductions.

Source-of-income rules, in contrast, do not abstract from the characteristics of particular income items. They do abstract, however, from the taxpayer earning the income and from the period over which the income is measured. That is, a source rule states that the source of income falling within a particular category is to be determined by reference to certain characteristics of that income but without reference to the person earning the income or the year or other period during which the income arose. For example, U.S. source rules provide, in general, that dividends are sourced in the country of the payor and that income from services is sourced in the country where the services are performed.

It should be clear from this difference in meaning that the source rules do not identifying the true source of a taxpayer’s taxable income because the taxable income of a person computed with respect to the taxable period has no true source. The function of source rules is to assign a source to a taxpayer’s income by reference to the characteristics of the various receipts that were taken into account in determining the taxpayer’s income. In some tax systems, the identification of income with a particular source may be done through an apportionment formula. Most of the American states, for example, use a formula based on the taxpayer’s property, payroll and sales.

A tax system using source rules typically assigns taxable income of a taxpayer to a particular geographical area based on the geographical location assigned under the source rules to the receipts that went into the calculation of the taxpayer’s income. In some cases, the source rules may employ a formula to make that assignment. For example, income from services performed in two countries is typically apportioned between those countries using a formula based on the days of service in each country.

Whether a country uses formulary apportionment or source rules, it is using some proxy to assign a source to items of taxable income. Neither methodology can fairly claim to have discovered the true source of the taxable income because taxable income has no source. The rules for assigning income to a particular geographical area may reflect political, economic, administrative and legal realities, or they may ignore those realities. That is, they may be good rules or bad ones. In the end, however, they are legal rules and can be defended only by reference to the policy goals that they seek to achieve.

An example can illustrate the important definitional point made above. Consider a cake that has been made from sugar, butter, eggs, flour, vanilla flavoring, baking powder, and salt. Each of these ingredients comes from a different country. The question arises as to the country of source of the cake. It is possible, even plausible, to associate the source of the cake with the source of the various ingredients. The cake, however, is something distinct from the sum of its ingredients and has its own characteristics. The analogy of the cake to taxable income is imperfect because the cake actually has a physical presence in some place. The central point of the analogy is that taxable income, like a cake, is distinct from its “ingredients,” and the source of the ingredients does not necessarily determine the source of the end product created from those ingredients.

A Critique of the Source Principle

1 *Tax Notes Int'l* 261-262 (Sept. 1989)

by Michael J. McIntyre

Most disputes among national governments over the right to tax transnational income turn out to be disputes over its source. A few involve the rights of the country of source to determine by itself the tax consequences of activities conducted within its borders. Many controversies are explicitly about source rules. A recent example is the brouhaha generated by the earnings-stripping proposal of the Ways and Means Committee of the U.S. Congress. That proposal, if adopted, would place limitations on the ability of foreign persons to reduce their U.S. source taxable income by claiming a deduction for certain interest expenses. [Ed.: The proposal was adopted as IRC § 163j (1989).]

The tax sparing debate between developing countries and some developed countries (principally the United States) is about the primacy of the source country over the residence country. In form, transfer pricing rules attempt to resolve disputes over the proper taxpayer on items of income, but those disputes generally are interesting because of their impact on a country's source jurisdiction.

> The so-called source principle is a rule of convenience, not a statement of some fundamental concept of international justice.

To resolve controversies over the right to tax transnational income, most government officials and the leading commentators on international taxation have embraced the so-called source principle. According to that principle, the primary right to tax transnational income — that is, income having a nexus with more than one country — belongs to the country of source. Commentators generally treat this principle as the appropriate starting point in developing methods for harmonizing national income tax regimes.

The widespread acceptance of the source principle does not rest on a common agreement among governments or tax analysts about the proper allocation of the right to tax transnational income. Like all widely accepted principles (Do Good and Avoid Evil, Treat Equals Equally), the source principle owes its acceptance to its almost complete lack of substantive content.

Giving Content to the Source Principle

To give content to the source principle, analysts must specify and defend the rules for determining the source of various items of taxable income. Through tax treaties and international custom, some progress has been made in specifying the source of gross income from moveable capital. The consensus rules, however, have yet to be justified. They typically are defended by reference to their general acceptability rather than by reference to their contribution to a rational and fair international tax regime.

For example, interest income is generally considered to be sourced in the country of the obligor, dividend income in the country of residence of the payer, and rental income in the country where the rented property is located. All of these source rules, however, are open to challenge. They can be rejected completely without calling into question the legitimacy of the source principle. Even the rule that income

from the extraction of natural resources is sourced in the country where the resources are found — the most sacrosanct of all source rules — does not rest on a firm footing. A rule that attributed extractive income to the country of use would make as much economic sense as the current rule.

Only a little progress has been made in reaching agreement on the source of business income. Many national tax regimes employ what I would call the “European model.” In the European model, which is embodied in most income tax treaties, a country has the primary right to tax business income only if that income is attributable, according to certain accounting conventions, to a permanent establishment located within its borders. Because of the flexibility of accounting conventions, the European model frequently permits taxpayers to arrange their affairs so as to avoid source jurisdiction. The United States and some other countries have developed formal rules governing the source of business income. Those formal rules only occasionally apply in determining tax jurisdiction over income earned by residents of a treaty country.

Formal source rules are generally dispensed with under the unitary method of taxation. In the unitary method, income is attributed among centers of business activity by formula rather than by the accounting conventions employed in the European model. A well-designed formula is generally quite difficult for taxpayers to plan around. Without some international agreement on the formulas to be used, the use of the unitary method by national governments can easily lead to double taxation.

Determining the Source of Deductions

No consensus at all has been reached on the proper rules for determining the source of deductions. Many governments and some commentators appear to be oblivious to the importance of the source of deduction rules. International tax advisors, however, are well aware of their importance. A great deal of the tax planning undertaken by multinational corporations involves the source of deduction rules. Much of the planning is necessary to prevent double taxation of income. A good deal of it is undertaken to exploit opportunities for undertaxation of transnational income. Indeed, a country having inadequate source of deduction rules should not expect to collect a dime of tax revenue from foreigners conducting business operations within its borders.

To infuse the source principle with content, tax analysts must propose and defend a coherent set of rules for determining the geographical source of taxable income. Any concrete proposal for defining source, however, will generate controversy. Controversies over the source of taxable income cannot be resolved by reference to neutral criteria because no neutral criteria exist that would unambiguously assign an item of transnational income to a single country. By definition, income arising from cross-border transactions does not have a single geographical source.

Tax analysts would all agree that income is sourced in a particular country if all of its links are with that country. Income derived by a subsistence farmer in India, for example, is acknowledged to be Indian source income. Similarly, wages earned by an American from teaching elementary school in the United States is U.S. source income. The source of income that has links with only one country is uninteresting, however, because only one government generally is prepared to tax such income. Once the income has links with more than one country, the source of that income becomes both important and indefinite.

The Conflation of Source and Residence

International custom provides some content to the source principle by distinguishing the power to tax based on the source of income from the power to tax based on the residency or nationality of the taxpayer earning the income. According to that custom, income is treated as having a purely domestic source if its only link to a foreign country is through the residency or nationality of the person earning that income. This

distinction between source and residence, however, has never been absolute and seems to be breaking down.

Some of the recent changes in the source rules of the United States provide examples of the breakdown of the distinction between source jurisdiction and residence jurisdiction. Several of those rules have made the residence of the taxpayer one of the factors in determining the source of income derived from certain activities, such as international shipping, international communications, and international trade. The laudable objective of these rules is to prevent income from having its geographical source outside the national boundaries of any tax jurisdiction.

Perhaps the conflation of source and residence rules will help tax analysts to appreciate that the so-called source principle is a rule of convenience, not a statement of some fundamental concept of international justice. Such a realization is a prerequisite for the development and widespread adoption of effective source rules. As it is currently employed, the source principle impedes agreement among national governments on effective measures to prevent the double taxation and the undertaxation of transnational income.

§ 11.03. Source Rules: In the Courts

In the cases below, the Court has determined the source rules that apply to their particular set of facts presented by the case. Each of the cases involves difficult issues of interpretation, and the results in each case have been criticized by some commentators.

The source rules involved in these cases do not appear to be particularly complex or difficult to apply. One of those rules is that the source of income from services is the place where the services are performed. Another is that the source of income from the production and sale of goods is divided by formula between the place of production and the place of sale. Another is that the source of income derived from the purchase of goods abroad and their sale in the United States is U.S. source income and, conversely, that the source of income from a purchase United States and a sale abroad is foreign source income. Another is that the source of royalty income is the place of use of the property with respect to which the royalty was paid.

Notwithstanding the apparent simplicity of the source rules involved, these cases present some difficult legal problems. The problem in each case is to decide which source rule to apply. These cases demonstrate quite nicely why source rules are primarily legal rules, not accounting or economic rules.

Comm'r v. Piedras Negras Broadcasting Co.

127 F.2d 260 (5th Cir. 1942), aff'g 43 B.T.A. 297 (1941)

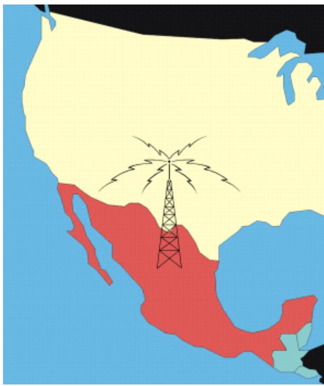
Opinion of Court (Holmes, Circuit Judge)

The respondent is a corporation organized under the laws of the State of Coahuila, Republic of Mexico, with its principal office and place of business at Piedras Negras, Mexico. Its business is the operation of a radio broadcasting station located at Piedras Negras, just across the Rio Grande from Eagle Pass, Texas. The decisive question presented by this petition for review is whether the respondent, from the operation

of its business in 1936 and 1937, derived any income from sources within the United States subject to taxation by the United States.

The taxpayer conducted its affairs in the familiar manner. Its income was derived from the dissemination of advertising over the radio and from the rental of its facilities to customers, referred to as the sale of "radio time." All of its income-producing contracts were executed in Mexico, and all services required of the taxpayer under the contracts were rendered in Mexico. The company maintained a mailing address at Eagle Pass, Texas, and used a hotel room there in which it counted and allocated the funds received in the mails each day.

Contracts with advertisers in the United States were handled through an advertising agent, an independent contractor. The majority of the taxpayer's responses from listeners came from the United States, and ninety-five per cent of its income was from advertisers within the United States. Bank accounts were maintained in Texas and in Mexico. The books and records of the corporation were in Mexico, its only studio was there, and all of the broadcasts by the station originated in Piedras Negras. The broadcasts were equal in volume in all directions, and were heard by listeners in this country and elsewhere.



Section 231(d) of the Revenue Act of 1936 [Ed.: Cf. IRC § 882(b)] . . . provides that the gross income of a foreign corporation includes only the gross income from sources within the United States. If this taxpayer, a foreign corporation, had no income from sources within the United States, no income tax was levied upon it. The Board of Tax Appeals concluded that none of the respondent's income was derived from sources within the United States, and we agree with that decision.

In section 119 of the Revenue Act of 1936, [Ed.: Cf. IRC § 861(a)] . . . Congress classified income, as to the source thereof, under six heads.[10] Since the taxpayer's income was derived exclusively from the operation of its broadcasting facilities located in Mexico, or from the rental of those facilities in Mexico, its income therefrom was either compensation for personal labor or services, or rentals or royalties from property, or both, under the statutory classification. Section 119(a)(3) [Ed.: IRC § 861(a)(3)] provides that compensation for personal services performed in the United States shall be treated as income from sources within the United States. By section 119(c)(3) [Ed.: IRC section 862(a)(3)], income from such services performed without the United States is not from sources within the United States. Likewise, rentals from property located without the United States, including rentals or royalties for the use of or for the privilege of using without the United States franchises and other like properties, are considered items of income from sources without the United States. Section 119(c)(4) of the Revenue Act of 1936 [Ed.: IRC § 862(a)(4)].

We think the language of the statutes clearly demonstrates the intendment of Congress that the source of income is the situs of the income-producing service. The repeated use of the words within and without the United States denotes a concept of some physical presence, some tangible and visible activity. If income is produced by the transmission of electromagnetic waves that cover a radius of several thousand miles, free of control or regulation by the sender from the moment of generation, the source of that income is the act of transmission. All of respondent's broadcasting facilities were situated without the United States, and all of

[10] The six classifications are (1) interest, (2) dividends, (3) personal services, (4) rentals and royalties, (5) sale of real property, and (6) sale of personal property.

the services it rendered in connection with its business were performed in Mexico. None of its income was derived from sources within the United States.[11]

The order of the Board of Tax Appeals is affirmed.

Dissenting Opinion (McCord, Circuit Judge)

I am unable to agree with the majority opinion.

Prior to March, 1935, many programs broadcast over the Mexican station originated in a remote control studio located in Eagle Pass, Texas. After the Communications Commission denied application for continuance of the studio, programs no longer originated in the United States, but the broadcasting company continued its business operations in much the same way that it always had. While the mere broadcasting of electromagnetic waves into this country may not constitute the doing of business which produces income derived from sources within the United States, I do not think the case is as simple as that. The actual broadcasting of message was not the only act, and the facts should be viewed as a whole, not singly, to see what was actually being done.

Various advertising contracts provided that the service to be rendered was to be from the station at Piedras Negras, but these contract provisions do not establish that the company was not taxable in this country. The programs of the Piedras Negras Broadcasting Company were primarily designed for listeners in the United States. Ninety per cent of its listener response came from this country, and ninety-five per cent of its income came from American advertisers. Through agents the broadcasting company solicited advertising contracts in this country, and it is shown that contracts were entered into by the company in the name of the Radio Service Co., an assumed name which for reasons beneficial to the company had been registered in Texas. The contracts also contained a provision that venue of any suit on such contracts would be Maverick County, Texas.

> The programs . . . were primarily designed for listeners in the United States . . . and ninety-five per cent of its income came from American advertisers.

Moreover, the company used Eagle Pass, Texas, as its mailing address, and its constant use of the United States mails was most beneficial to the company if not absolutely essential to the success of its operation. Money was deposited in American banks, obviously for convenience and to avoid payment of foreign exchange. Agents of the broadcasting company made daily trips to Eagle Pass where they met in a hotel room with advertising representatives and opened the mail and divided the enclosed money according to their percentage contracts with advertisers, and it is shown that the company received much of its income in this manner. It was, therefore, receiving income by broadcasting operations coupled with personal contact in this country.

[11] Cf. Commissioner v. East Coast Oil Co., 5 Cir., 85 F.2d 322, certiorari denied 299 U.S. 608, 57 S.Ct. 234, 81 L.Ed. 449; Commissioner v. Hawaiian Philippine Co., 9 Cir., 100 F.2d 988, certiorari denied 307 U.S. 635, 59 S.Ct. 1032, 83 L.Ed. 1517; Helvering v. Stein, 4 Cir., 115 F.2d 468.

I am of opinion that all the facts taken together establish that Piedras Negras Broadcasting Company was doing business in the United States, was deriving income from sources within this country, and was taxable. I think the decision of the Board should be reversed. I respectfully dissent. ◊

Questions

1. Which opinion is better in *Piedras Negras*, the majority or the dissent? What is the statutory basis, if any, for the dissenting opinion? Any difference in result if Piedras Negras sold newspapers produced in Mexico to U.S. customers? Should there be a difference?

2. What is the economic source of profit for Piedras Negras? Is it the broadcasting of signals, the selling of advertising, or some combination? Are there any substantial economic grounds for assigning profits to a particular geographical region in this case? In any case?

3. Was Piedras Negras conducting a business within the United States? What is the relationship between engaging in business in the United States and having U.S. source income?

4. How is Mexico likely to tax Piedras Negras? Does it matter for U.S. tax purposes? Is it relevant that Piedras Negras went to Mexico because it had lost its license to broadcast in the United States.

5. Assume that Mexico has in effect a tax treaty with the United States comparable to the U.S./Canada treaty. What effect on Piedras Negras? Did the taxpayer have a permanent establishment within the United States?

6. Would IRC § 863(e) (international communications income) now govern the *Piedras Negras* case? If so, what result? Is that result an appropriate one?

7. Which taxpayer has greater economic ties to the United States, Frank Handfield (*Folkard* case) or Piedras Negras? ◊

Comm'r v. Hawaiian Philippine Co.

100 F.2d 988 (9th Cir. 1939), cert. den. 307 U.S. 635

Opinion of the Court (Healy, Circuit Judge)

The petition for review presents the question whether the respondent, a Philippine corporation, derived any taxable net income from sources within the United States during the year 1930. The Board of Tax Appeals determined that it did not.

For a number of years respondent has been engaged in the business of milling sugar cane and manufacturing sugar in the Philippine Islands. The cane is obtained from planters under long-term contracts, entered into prior to 1921, whereby the planters agreed to plant their

The cane is obtained from planters under long-term contracts . . . whereby the planters agreed to plant their lands to sugar cane for a period of thirty years. . . . The contracts were to run with the land.

lands to sugar cane for a period of thirty years, cut the cane at their own expense, and deliver it to respondent's railroad cars. Respondent agreed to transport the cane to the mill and to manufacture it into raw centrifugal sugar. The contracts provide that "as full compensation for all its services * * * the Mill shall have and retain forty-five per cent (45%) of the sugar produced from the cane of each Planter milled hereunder (or, at its option, forty-five per cent of the net proceeds of sales of said sugar), based on the weight and analyses of the sugar cane milled, the other fifty-five per cent (55%) thereof to belong to the Planter * * * ." It was provided that "title to the share of sugar belonging to the Mill * * * shall pass to the Mill upon the manufacture thereof, and prior thereto the right of the Mill to receive, retain and mill the sugar cane shall be absolute." The contracts were to run with the land.

Respondent agreed to render each week a statement of the cane received from each planter and the amount of sugar due him. This amount was to be based upon the chemical analyses, the weight of the cane, and the average factory yield. Upon delivery of the sugar to the warehouse, receipts were to be issued to the planters, who were entitled to ninety days' free storage. Respondent was not obligated to segregate each planter's share.

During the taxable year respondent did not purchase any sugar cane. It never exercised its option under the milling contracts to demand 45% of the net proceeds of the sugar produced, in lieu of its proportionate share of the sugar itself. It kept at all times in its warehouse sufficient sugar to cover all outstanding warehouse receipts.

Respondent's share of the sugar manufactured at its mill during the tax year was 299,213 piculs. This amount included 340 piculs derived from respondent's experimental field. In addition respondent had an inventory of 526 piculs carried over from the previous year. A picul for sugar during the relevant period was 139.44 pounds avoirdupois.[12] Of the total amount 356 piculs were sold in the Philippine Islands and 412 piculs were on hand at the close of the fiscal year. The balance of 298,971 piculs was sold in the United States under the terms of an agency contract. The gross proceeds from the sale of the sugar in the United States amounted to $1,506,905.40.

The Commissioner determined a deficiency of $66,403.47, computed on the basis of respondent's total net income from all sources, with the exception of certain items of Philippine income not material here. However, the Commissioner does not now contend, and did not contend before the Board, that this computation is correct. The argument now is that the income realized by respondent from the manufacture of sugar in the Philippine Islands and its sale in the United States constituted "gains, profits, and income * * * from the sale of personal property * * * produced (in whole or in part) by the taxpayer without and sold within the United States," under section 119(e) of the Revenue Act of 1928 . . . [Ed.: Cf. IRC § 863(b)(2)] and that this income should be apportioned between sources within and without the United States as required by the statute and in accordance with a certain formula contained in the regulations.

> The fact that the services rendered [to the planters] were manufacturing services does not . . . render inapplicable the provisions of section [862(a)(3)].

[12] [Ed.] *Avoirdupois* is a system of weights based on a pound containing 16 ounces. Avoirdupois is from Middle English *avoir de pois*, goods sold by weight, from Old French *aveir de peis*, literally, goods of weight, from *aveir*, property, goods+ *peis*, weight.

Section 22(f) of the Revenue Act of 1928 . . . provides that "for computation of gross income from sources within and without the United States, see section 119." Section 119(e) provides in part that gains, profits, and income from the sale of personal property produced by the taxpayer without and sold within the United States shall be treated as derived partly from sources within and partly from sources without the United States. Section 119(f) [Ed.: IRC § 864(a)] . . . provides in part that the word "produced" includes "manufactured" or "processed". Section 119(e) [Ed.: IRC § 863(b)] provides further that in the case of gross income derived from sources partly within and partly without the United States, the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary.

Respondent asserts that the statutory provisions relied on by the Commissioner are inapplicable, and that the case is governed by section 119(c)(3) [Ed. IRS § 862(a)(3)] . . . . This provision is as follows:

> (c) GROSS INCOME FROM SOURCES WITHOUT UNITED STATES. The following items of gross income shall be treated as income from sources without the United States: * * * (3) Compensation for labor or personal services performed without the United States.

If respondent's view be taken, it would not be liable for any tax since it actually sustained a net operating loss for the tax year from sources within the United States.

The Commissioner argues that . . . if the taxpayer is a producer (i.e., manufacturer) of sugar, it is immaterial whether the sugar cane was acquired under bailment or sale.

The Board determined that respondent's share of the sugar manufactured under the milling contracts was received as "compensation for its milling services," and constituted income to it to the extent of its fair market value at the time and place of receipt. It was found that the respondent had offered satisfactory proof of this market value. Adopting such market value as a cost basis (plus the expense of shipment to the United States), the Board determined that there was no gain from the sale of sugar in the United States, but rather a loss; hence there was no taxable income from sources within the United States.

The Board relied principally upon *San Carlos Milling Co. v. Com'r*, 24 B.T.A. 1132; *Commissioner v. San Carlos Milling Co.*, 9 Cir., 63 F.2d 153, in which similar milling contracts were construed as contracts of bailment and not of sale. The Commissioner argues that the case is distinguishable, and, if not, should be overruled. He suggests also that if the taxpayer is a producer (i.e., manufacturer) of sugar, it is immaterial whether the sugar cane was acquired under bailment or sale.

The argument now is that manufacture of sugar in the Philippine Islands and its sale in the United States [results in] income from the sale of personal property produced . . . without and sold within the United States.

We think the Board correctly decided the matter. The milling contracts involved here differ in no material respect from those in *Commissioner v. San Carlos Milling Co.*, supra. The relationship between the taxpayer and the planter was one of bailment. We accept the finding of the Board that the sugar received by the taxpayer was compensation for

milling services and constituted income to it to the extent of the fair market value of the sugar at the time and place of its receipt. See Treasury Regulations 74, Article 53. To this extent the source of respondent's income was outside the United States. Section 119(c)(3), supra. Upon the sale of the sugar in the United States the respondent derived no gain; therefore it received no income from United States sources. *Commissioner v. San Carlos Milling Co.*, supra.

Although in a broad sense the taxpayer may be deemed a "manufacturer" of sugar, as contended by the Commissioner, it is plain that it did not manufacture sugar for its own account. The operation was carried on as a service to the planters. The fact that the services rendered were manufacturing services does not, we think, render inapplicable the provisions of section 119(c)(3). The Commissioner has cited no authority for the proposition he advances, that a corporation cannot perform labor or personal services; and no reason has been advanced why section 119(c)(3) was not intended to apply to corporations. Clearly the section, in general, is applicable to corporations. See Article 671, Regulations 74. The 1928 act itself defines the term "person" as including corporations . . . . Nor do we regard these milling services as any the less personal because they were performed, in part, through the use of machinery, or because of the magnitude of the taxpayer's operations.

We think this construction of the phrase "compensation for labor or personal services performed without the United States" is in harmony with the Congressional intent. While from a casual examination a plausible argument may be made for treating respondent as a producer under subdivision (e) of section 119, on reading together the material parts of the statute we resolve any doubt in favor of the construction just stated. *White v. United States*, 305 U.S. 281 (1938).

Affirmed.

Case Note. Sugar cane is a massive tropical grass that resembles bamboo in appearance. It is grown in many tropical and semi-tropical countries. It is the most efficient plant in the world for producing sucrose. The closest competitors are sugar maple and sugar beet, which compete directly with sugar cane in the world sugar market. Sugar beet is now grown extensively in the United States. Sugar cane is grown extensively in Hawaii, Louisiana, Florida, and Texas. The sugar business is heavily subsidized in the United States and Europe, resulting in low world prices for sugar.

The Philippines began producing sugar cane for export in the 1850s. The sugar business was well established by 1900, when the period of American colonial rule of the Philippines began. In 1909, the U.S. Congress passed the Payne-Aldrich Act (1909),[13] which increased tariffs on sugar imported into the United States. Imports of sugar from the Philippines were exempt from the tax, up to a maximum of 300,000 gross tons of sugar. The act also provided for duty-free imports of U.S. goods into the Philippines. The United States adopted a sugar quota system in 1934 by the passage of the Jones-Costigan Act. That act authorizing controls on both cane and beet sugar produced in the United States in addition to instituting quotas on the amount of sugar imported. The act, and its various extensions, expired in 1974. Since then, sugar production in the United States has been managed by the federal government through various subsidy programs.

In 1930, when the facts of *Hawaiian Philippine Co.* arose, the Jones-Costigan Act had not yet been passed and Payne-Aldrich had been repealed. Because of its colonial relationship with the United States, however, the Philippines continued to have preferred access to the U.S. sugar market. The price of sugar was probably falling at this point, due to the start of the Great Depression, which put downward pressure on

[13] Payne-Aldrich Tariff Act of Aug. 5, 1909, 36 Stat. 11, 105-08, repealed by Act of Oct. 3, 1913, ch. 16, 38 Stat. 114, 201.

commodity prices everywhere. Indeed, Jones-Costigan was a produce of the depression. As with many New Deal pieces of legislation, it tried to restrict domestic output to raise prices, and it imposed minimum wages for sugar workers. The import quotas were intended to prevent imports from supplanting the reduced domestic production that the act sought to induce.

The sugar industry in the Philippines prospered in the early fifties, due to its favored access to the lucrative U.S. market, and it was a source of great wealth to some of the leading Filipino families. That industry also benefitted from the cut-off of the Cuban sugar quota in 1962, do to political conflicts between the U.S. and Cuban governments. It suffered severely in the mid-1980s, when world sugar prices collapsed — from 60 cents a pound in 1984 to 3 cents a pound in 1985. Since 1985, sugar producers in the Philippines have not only lost much of their foreign markets, but they are not able to compete effectively in their domestic markets. Their problems are due in substantial part to the heavy sugar subsidies provided by the United States and especially the members of the European Union.

During the 1920s and 1930s and for many years thereafter, sugar production in the Philippines was dominated by a few wealthy families of Spanish descent. The actual work in the fields was done by Filipino laborers, working for a pittance. It is unclear from the facts of *Hawaiian Philippine Co.* whether the company was dealing with the landed aristocracy or the peasant farmers. The fact that the sugar contracts at issue in the case ran with the land suggests a surf-type relationship between the sugar growers and the processing company.

Questions

1. In *Hawaiian Philippine Co.*, The court repeated a finding of the Board of Tax Appeals [now the Tax Court] that the taxpayer sold the sugar in the United States at a loss. Why did the court want to know about the gain or loss on the sale of sugar? What source rule was it attempting to apply?

2. From the beginning of the 20th century to the mid-1970s, Filipino sugar generally sold in the United States at a price far in excess of the world price, due to the U.S. sugar quotas and/or special tariff rules applicable to sugar imports from the Philippines. Why then, did the Hawaiian Philippine Co. experience a loss on its U.S. sales?

3. The sales source rule, now IRC § 861(a)(6), refers to a "purchase . . . without the United States." Did the Hawaiian Philippine Co. make a purchase without the United States? If so, what was the purchase price? Why did the court look to *value* at the time of shipment rather than at an actual purchase price?

4. Is it consistent with the general statutory framework to treat corporations engaged in manufacturing operations as engaging in the performance of services? What are the likely differences in result under the manufacturing source rules and the services source rule? Which is the better source rule? Under what criteria?

5. Is it realistic to view Hawaiian Philippine as the agent of the farmers? Note that their contracts with Hawaiian Philippine "run with the land." Thus the farm workers, in some respects, may have been serfs. Are such dependent farmers likely to view themselves as the masters of the Hawaiian Philippine Co.? Does it matter for tax purposes? Should it? Is it possible that the owners of the farm are major economic players even if the workers are not? Would that possible fact matter to the tax result?

6. Why is there no discussion in the *Hawaiian Philippine* case of the source of the income of the farmers? Obviously someone is "manufacturing" sugar. If it is not the Hawaiian Philippine Co., is it the farmers? Do they have U.S. source income, at least with respect to their share of the sugar sold in the United States? ◊

Sanchez v. Comm'r

162 F.2d 58 (2d cir. 1947)

Opinion of the Court (Chase, Circuit Judge)

The petitioner is a nonresident alien who filed his income tax return for 1940 on the cash basis with the Collector of Internal Revenue for the Southern District of New York. The Commissioner determined a deficiency based in part on the inclusion of $8,673.30 which the taxpayer was paid in that year by Sucro-Blanc, Inc., a New York corporation, under the following circumstances.

Petitioner had invented and patented in this and in some foreign countries a process for clarifying solutions of sugar by the use of a chemical re-agent, called Sucro-Blanc. In 1934 he granted to a New York corporation called the Buffalo-Electro-Chemical Company (which will be hereinafter referred to as Becco), an exclusive world-wide license to exploit his inventions so patented and to be patented and to sub-license under such patents. He was to receive from Becco a royalty of fifty per cent of its net profits from the sale of Sucro-Blanc used in the process; from its receipts from royalties; from fees from its sublicensees and recoveries from infringers; and from the disposal of any interest in the patents. Becco agreed to pay the petitioner minimum royalties of $25,000 a year and had the right to recoup payments not earned in any year out of royalties earned in any later year in excess of the minimum.

In 1936 Sucro-Blanc, Inc., was organized by Becco under the laws of New York and the Becco contract with the taxpayer was assigned to it. The taxpayer became a stockholder in Sucro-Blanc, Inc., but Becco retained stock control of the new corporation. Thereafter the provisions for royalty payments to the petitioner were modified by an agreement under which Sucro-Blanc, Inc., was to pay to Becco the sum of $30 per short ton on all the sales it made of the re-agent called Sucro-Blanc, and 37 1/2 per cent of whatever it received from any sale, assignment, sub-license or any other disposition of any of the petitioner's patents or rights under any such patent. The same amounts were payable to the petitioner and the minimum royalty due him was reduced to $12,000. In 1937 the agreement was further modified to provide for the payment quarterly by Sucro-Blanc, Inc., to both Becco and the petitioner of 10 per cent of all its sales of Sucro-Blanc f.o.b. Wyandotte, Mich., instead of $30 per short ton.

> Sucro-Blanc, Inc. was to pay to Becco [and Sanchez] . . . 10 percent of all its sales of [the re-agent] Sucro-Blanc.

In June 1940, these three parties again changed the language in the agreement to make it even more plain that they had agreed the amounts to be paid Becco and the petitioner were to be based on a percentage of the selling price of all sales of Sucro-Blanc and the amounts so payable to the petitioner were royalties on all his patents foreign and domestic measured as above stated. Sucro-Blanc agreed to keep separate accounts on its books of the receipts from sales of Sucro-Blanc for use in this country and for use abroad. It granted sub-licenses both in this country and abroad to purchasers of Sucro-Blanc for the use of that re-agent in the patented process royalty free.

The Commissioner determined that the above amount received by the petitioner as his share of the proceeds from sales of Sucro-Blanc by the corporation of that name for use abroad was includable in his gross income and not excluded therefrom under Sec. 212(a) of Title 26 U.S.C.A. Int. Rev. Code as income from sources without the United States. The Tax Court upheld that decision and its action in that respect is the first subject for review.

While the agreement the taxpayer had with Becco and Sucro-Blanc, Inc., as it was last amended, did provide that the amount in controversy should be considered royalties on the petitioner's foreign patents, they could not thereby change the actual facts and make exempt from taxation what was really income from domestic sources by calling it income from abroad. There were provisions in the contract for the division of receipts by Sucro-Blanc, Inc., from its sales of the re-agent and provisions for the division of its receipts from royalties it was paid by sub-licensees. In fact it received nothing within the last named category and consequently the petitioner received nothing for the use of his foreign patents as such. All of the amount in controversy was received by him as of right by virtue of his contract entitling him to it as part of the selling price of the re-agent sold to foreign purchasers and delivered by Sucro-Blanc, Inc., to a common carrier in the United States and when he was paid that amount by such seller, his source of the payments was the seller, an American Corporation which, so far as this record shows, used any of its funds as it pleased to make the payments to the petitioner.

All of the amount in controversy was received . . . as part of the selling price of the re-agent sold to foreign purchasers and delivered . . . in the United States.

Anything which might have been received by it by way of royalties, or otherwise, for use of the petitioner's foreign patents was renounced when purchasers were allowed, presumably as part of the inducement to buy at the sales price charged, to use those patents for nothing. And so the petitioner received only what was due him from a domestic exclusive licensee and nothing for the use of any foreign property. Compare, *Ingram v. Bowers*, 2 Cir., 57 F. 2d 65. * * *

Anything which might have been received by [Sucro Blanc, Inc.] by way of royalties, or otherwise, for use of the petitioner's foreign patents was renounced when purchasers were allowed . . . to use those patents for nothing.

Questions

1. In the *Sanchez* case, how is it possible that the taxpayer, a nonresident alien holding an intangible property interest in the Sucro Blanc patents, ends up with income from the manufacture and sale of goods produced within the United States? Does the court think that Sucro Blanc, Inc. or Becco is a contract manufacturer for Sanchez, *à la* the *Hawaiian Philippine Co.* case?

2. Under the reasoning of the court in *Sanchez*, the taxpayer could have avoided U.S. tax by arranging to have title to the re-agent pass outside the United States. Would that be a sensible result? Sanchez is getting

paid primarily for permitting Sucro Blanc, Inc. (under the contract assigned by Becco) to manufacture the re-agent in the United States. What source rule ought to apply to such income?

3. What is the source of the income earned by Sucro Blanc, Inc. under the facts of *Sanchez*? Does it have U.S. or foreign source income on the sale of the re-agent? Does it seem that the court decided *Sanchez* as if Sucro Blanc, Inc. rather than Sanchez were the taxpayer?

4. The court in *Sanchez* concluded that none of the income was derived from a conveyance of foreign patent rights because Sucro Blanc, Inc. gave those rights away for nothing. Is the court simply holding the taxpayer to the form of his own transaction? Note that the court makes a strong statement that form does **not** control.

5. Can a taxpayer involved both in the sale of a product and the licensing of technology convert royalty income into sales income by waiving its legal right to a royalty and inflating the sales price? Assume, for example, that FCo, a foreign producer of digital clocks, enters into a contract with DCo, an independent U.S. manufacturer. The contract allows DCo to produce the clocks in the United States. FCo agrees to provide DCo with the necessary technology and also to sell DCo the special lighting displays used in the clocks. In lieu of a royalty for the clock technology, DCo agrees to overpay FCo for the displays, with title to the displays passing outside the United States. Does FCo have a reasonable argument under *Sanchez* that it has no U.S. source royalty income — only foreign source sales income? How would you expect the Internal Revenue Service to respond? Would you expect the courts to sustain a fraud penalty?

§11.04. Source Rule Principles

In a model income tax system based upon U.S. tax concepts, the limitations on tax jurisdiction provided by the source rules would be designed to achieve three goals. These goals deserve and have received wide support, at least implicitly, from tax commentators. The first goal would be the elimination of double taxation, which would be achieved by preventing two or more sovereign governments from having unresolved jurisdictional claims to tax revenue from the same item of income. The second goal would be the elimination of undertaxation. That goal would be achieved by assigning jurisdiction over each item of income to at least one sovereign government. Both of these goals are grounded on fairness and efficiency criteria.

The third goal of model source rules should be the distribution of tax jurisdiction over income among sovereign governments in some mutually agreeable fashion. That is, each sovereign government should be given a reasonable share of the world tax base, as determined by a free and fair negotiation process. In practice, agreement among sovereign governments might be impossible to achieve, but in the idealized model, source rules would be assumed to be mutually agreeable if they would be acceptable to rational governments negotiating in good faith.[14]

There are an indeterminate number of ways that the three goals set forth above could be achieved. Indeed, as the U.S. tax treaty experience suggests, sovereign governments may decide to use techniques other than source rules to achieve a division of the world's tax base. No *a priori* principles of justice have yet been formulated that would determine a sovereign government's fair share of revenue from transnational transactions.

[14] In practice, negotiations over tax jurisdiction are dominated by the OECD Model treaty and its derivatives. The OECD Model (2010) typically does not use source rules for dividing up jurisdiction over income arising from transnational transactions. The OECD model does contain a few source rules, some explicit and some implicit.

The source of income rules, nevertheless are not arbitrary. Arbitrary rules are rules designed without a specific purpose and without reference to established criteria. They are neither good nor bad because there is no basis for determining their merits.

Set forth below are five guidelines that tax analysts might use to evaluate or design source rules. Those guidelines are not self-evidently correct. Their merits depend on the merits of the arguments used to defend them. Those arguments are also presented below. These guidelines could serve as organizing principles in fashioning source rules for a model income tax system constructed according to U.S. tax concepts. They are compatible with many of the source rules contained in the Code. To the extent that the guidelines have merit, the source rules designed in accordance with those guidelines have merit.

§ 11.04.1. Administrative Simplicity

The source rules, especially as they apply to foreign taxpayers, should be as simple for the tax authorities to apply as possible. In particular, source rules applicable to foreign taxpayers should not depend for their application on detailed factual inquiries or on refined accounting judgments. Although simplicity is always welcome, it is substantially less important in the design of source rules applicable to domestic taxpayers.

Long experience attests to the importance of simplicity in the design of withholding rules. Many source rules, such as the rules defining the source of dividends, interest, and royalties, are tantamount to withholding rules as they apply to foreign taxpayers. Those rules provide the definition of gross income subject to withholding. All of the traditional arguments for simple withholding rules are supportive of the case for making such source rules as simple as feasible.

Simplicity is also highly desirable for rules determining the source of income taxable to foreigners on a net basis. To the extent that the source rules are complex, they will require government officials or tribunals to resolve the inevitable conflicts over their interpretation. Such conflicts are likely to lead to double taxation in some cases and to undertaxation in others. Double taxation is likely to occur because of the natural tendency of government officials to resolve conflicts in favor of their own government. Undertaxation is likely because of the tendency of many independent tribunals, encouraged by highly competent private attorneys, to resolve conflicts in favor of the taxpayer.

The goal of simplicity generally can be advanced without causing a conflict with the more fundamental goal of fairness to particular taxpayers. In a model tax system, the primary function of source rules is to determine which government will collect taxes from individual taxpayers. The level of taxation imposed on particular taxpayers would be determined under other rules. It is the design of those other rules that traditionally creates the conflicts between simplicity and fairness.

Most U.S. statutory source rules applicable to foreign persons would get good marks on simplicity grounds. The truly complex source rules in the Code generally apply only to domestic taxpayers. There are, however, a few unreasonably complex source rules applicable to foreigners. The source rules for royalty income are complex, requiring determinations of the place of use of intangible property, such as know how, that has no true geographical locus. The rules applicable to sales of personal property, most especially the office source rule, are more complex than they need to be because of the retention, under some circumstances, of the passage-of-title test to determine place of sale. The rules governing the source of deductions for interest for the costs of research and experimentation are difficult to enforce against many foreign taxpayers.

§ 11.04.2. Internal Consistency

A government generally should not unilaterally adopt a source rule that it would find objectionable if adopted by another sovereign government.[15] In general, a rule is objectionable if its use by others would result in taxation of more than all of the income of an enterprise engaged in cross-border activities. In the parlance of the American states, this "good neighbor" policy is referred to as "internal consistency." Unilateral adoption of an internally inconsistent rule is incompatible with the goal of a mutually agreeable sharing of tax jurisdiction. Within the context of bilateral treaty negotiations, the internal consistency criterion may become subordinate to the actual desires of the treaty partners. Even in the treaty context, nevertheless, the treaty partners need to be concerned about the impact of their agreed rules on countries not a party to the treaty.

The internal consistency criterion does not require that foreign persons and domestic persons be subject to identical source rules. In most cases, source rules should do double duty, but not always. For example, the look-through rules applicable to domestic taxpayers in computing the limitation on the foreign tax credit are designed, in part, to take away an incentive for shifting investment income to a foreign jurisdiction. There is no comparable problem arising in the taxation of foreign persons and thus no reason to impose those complex rules on foreigners.

Another example of a reasonable departure from double-duty source rules is the special source rule applicable to foreign persons on the sale of stock in a corporation holding U.S. real property. Under that rule, the sale of such stock is treated as a sale of U.S. real property for purposes of the source rules. Application of that special rule to domestic taxpayers is unwarranted because the tax loophole the rule was designed to close is not available to domestic taxpayers.

§ 11.04.3. Economic Nexus

To the extent possible, income should be sourced in a country where it has some economic nexus. One corollary of this guideline is that income arising from transactions conducted entirely within a country should be sourced in that country. Another corollary is that income should never be sourced in a country unless economically significant activity takes place in that jurisdiction. Thus income generally should not be sourced in tax-haven jurisdictions, assuming that the tax havens are functioning as conduits for income earned elsewhere.

Some income may not have a clear economic nexus with any country. Examples include income arising from activities in space or on the high seas. The economic nexus guideline provides no guidance as to how that income should be sourced. Thus the Code provision assigning the source of such income to the country of residence of the persons carrying on the income producing activities would not violate that guideline.

The economic nexus guideline does not determine the source of many types of income arising from transnational transactions because most such income has a nexus in more than one country. Once it is determined that income has an economic nexus with more than one country, the economic-nexus guideline has limited usefulness. Consistent with that guideline, the income might be assigned to a single country, or it might be divided among the various jurisdictions with which the income has a nexus.

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[15] This proposition is advanced as a principle to govern the design of source rules in Treasury Department, *Tax Reform for Fairness, Simplicity. and Economic Growth* (1984) at 366.

Consider, for example, income arising from the purchase of goods in one country and their sale in another country. That income obviously has an economic nexus in both the country of purchase and the country of sale. The economic activities in each country, moreover, are essential to the earning of income. In such circumstances, the economic-nexus guideline is useful in limiting the country of source to the country of purchase or the country of sale, but it is largely useless in determining which of these countries should be treated as the country of source of the income. Under the inclination-to-tax guideline set forth below, however, the proper source of that income would be the country of sale.

For another example, consider income arising from the licensing of technology for use in a country other than the country where the licensor is located. That income has a nexus in the country where the technology was developed, in the country where it is licensed, and perhaps in the country where the income arising from the use of the technology is being generated. None of these countries can legitimately claim to be the sole economic source of the income.

If a category of income has a substantial economic nexus with one country and a modest economic nexus with another country, it may be appropriate to assign most or all of the income to the country having the substantial economic nexus. As a practical matter, however, degrees of nexus are difficult to specify and typically depend on the facts and circumstances of particular cases. It is unclear, for example, whether income from the purchase and sale of goods has a more substantial economic nexus to the country of sale or the country of purchase, at least as a general rule. Similarly, it is unclear as an economic matter whether a performer has a more substantial nexus with the place of performance or the place where he trained for that performance.

Some economists have claimed that they can determine the economic source of income. That claim is subject to serious challenge. The basis argument is that income, above the average return on capital is due to economic rents and that the location of these economic rents is the true source of the income. Whatever the merits of this argument, it does not provide a sound basis for determining the source of income for purposes of allocating sovereign power to tax under an income tax.

First, assuming that the existence of an rent has been established, the physical location of that rent is largely a matter to be determined through legal analysis and cannot be determined through economic analysis. In large part, an economic rent is the return on some intangible asset, such as a manufacturing patent or a marketing trademark. Intangible property, however, has no physical location by definition. One might assign a marketing trademark to the place of sale of the goods sold with that trademark affixed. This assignment may be reasonable, but it is not based on any economic principle. The criteria to be used for assigning a geographical location to intangible property are likely to be very similar to the guidelines suggested here for assigning a geographical source to items of income.

Second, source rules are *ex ante* rules contained in a taxing statute. That is, a source rule fixes the source of income of a particular category in the statute before the taxpayer has actually earned income falling within that category. Those claiming that they can determine the economic source of income are not asserting that they know the source of a particular category of income prior to the earning of that income. Their claim is that they can determine the source after the fact by an analysis of all of the facts and circumstances of the particular case. In some cases, they may determine that the income from the production and sale of goods has its economic source primarily in the country of production. In other cases, they may determine that the economic source is primarily the country of sale. That is, these commentators are using an *ex post* concept of source when they claim they can determine the source of income. This *ex post* concept of source has little or no relevance to the design of statutory source rules.

Even if economics were able to determine the economic source of income *ex ante*, they would not have determined what the source of the income should be as a matter of law. The economic link between an item of income and a particular geographical area is only one of the five factor set forth in this section that should be taken into account in determining the legal source of that income.

§ 11.04.4. Inclination to Tax

To the extent feasible, income with an economic nexus in more than one country should be sourced in a country that is inclined to subject the income to taxation. By designing source rules to conform to the inclination-to-tax guideline, policy makers would reduce the risk of undertaxation, thereby promoting fairness and economic efficiency. They would also make possible a generally lower rate of tax on other sources of income.

Most countries are unwilling to tax exports and are eager to tax imports, for reasons that may or may not make good economic sense. Under the inclination-to-tax guideline, the source of sales income should be assigned to the country of import. The result would be that profits from transnational sales transactions probably would be subject to taxation. Assigning the source of sales profits to the country of export would result in an inefficient worldwide bias in favor of export activities and the undertaxation of exporters. Of course the assignment of source to the country of import is incompatible with the permanent establishment requirement of tax treaties because importers routinely avoid having a permanent establishment through the use of subsidiary corporations or by the careful use of agents.

The inclination-to-tax guideline would indicate that interest income should be sourced in the country of the recipient rather than in the country of the obligor, despite the widely accepted practice to the contrary. Many countries do not tax interest income arising from interest payments made by their residents to foreigners, generally in the belief that a tax on such income would cause interest rates on domestic taxpayers to go up. Countries have no comparable disinclination to impose taxes on their residents who receive interest income. Under such circumstances, fairness and efficiency might be advanced by reversing the widely accepted source rule for interest income. Administrative efficiency would be sacrificed, however, because the country of the obligor is in the best position to impose withholding taxes on interest income. Perhaps the best solution would be to provide for some sharing of tax jurisdiction, as is provided for in many tax treaties.[16]

§ 11.04.5. Sovereign Control of Source

Taxpayers should not be allowed to determine the source of income, except by choosing where to conduct their economic activities giving rise to income. That is, the application of source rules should be under the control of sovereign governments. Without sovereign control, the actual or deemed agreement among sovereign governments over the sharing of possible tax revenues will not be implemented. In response to their own self-interest, taxpayers having control over source rules can be expected to determine the source so as to minimize their own taxes. They cannot be expected to manage their affairs so as to minimize the undertaxation of transnational income.

[16] Tax treaties based on the OECD model typically place a cap on the withholding rate that can be imposed by the obligor country. A low cap, such as 5%, would greatly reduce the risk of over taxation of persons, such as commercial banks, that typically incur significant costs in earning interest income. The imposition of some tax in the obligor country, coupled with an exchange of information agreement between the obligor and lender countries, would reduce otherwise available opportunities for tax avoidance and evasion.

An example of a source rule that gives improper control to the taxpayer is the passage-of-title test for determining the place of sale. Experience has shown that taxpayers make use of their control over the place of sale to minimize their tax burdens, often by shifting sales income to tax-haven jurisdictions.[17] Another example is the rule making the source of dividends the country where the corporation paying the dividend is incorporated.[18] A third example is the source of deduction rules governing interest payments made by foreign corporations. In general, any source rule that provides an election to the taxpayer is improper under the sovereign-control criterion.

[17] In 1986, Congress substantially curtailed the ability of foreign persons to use the passage-of-title test on imports into the United States because it was being used by taxpayers to minimize U.S. taxes.

[18] Congress has adopted look-through rules to control abuse of the place-of-incorporation rule by domestic taxpayers. The branch profits tax places some limits on abuse of the rule by foreign taxpayers.

Chapter 12
Source of Periodical Income

This section presents the source rules governing four types of periodical income derived from capital. The source rules for interest income are discussed in section 12.01. Section 12.02 discusses the source rules applicable to dividend income. The source rules applicable to rental income and royalty income are discussed in section 12.03. The source of income derived from a securities rental transaction is addressed in section 12.04. Income of this type is typically a substitute for interest or dividends.

Interest and dividends that are characterized as foreign source income under the source rules described below may be characterized as U.S. source income, for purposes of computing the limitation on the foreign tax credit, under the resourcing rules of Code section 904(g). The purpose of the resourcing rules is to prevent U.S. taxpayers from increasing their foreign tax credit limitation by channeling U.S. source income through an intermediate foreign corporation. Those resourcing rules are discussed in part 5.

§ 12.01. Interest

The general rule is that the source of an interest payment is the place of residence of the person obligated to make that payment. The Code provides certain exceptions to the residence-of-the-obligor rule. One exception is for so-called 80-20 companies, and there are several others of modest importance. Special source rules apply to various interest-equivalent income such as interest-rate swaps and various related financial transactions.

§ 12.01.1. Residence-of-Obligor Rule

An interest payment generally has its source in the country where the person obligated to make the payment is located.[19] The obligor is typically the payer — that is, the person who actually makes the interest payment. For purposes of this source rule, individuals, partnerships, and other unincorporated entities generally are located in the country where they are resident.[20] Corporations generally are located in the country where they are incorporated.

Under the general rule, interest paid with respect to U.S. government bonds or other interest-bearing obligations of the United States is U.S. source gross income.[21] So also is interest paid by a state government or by the District of Columbia.[22] Payments made by an agency or instrumentality of a government are treated as paid by that government.[23] The general rule also provides that interest paid by domestic

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[19] IRC §§ 861(a)(1) (providing generally that interest paid by U.S. residents is U.S. source income) and 862(a)(1) (providing that interest is foreign source income if it is not U.S. source income).

[20] The regulations under IRC § 861(a)(1) provide that for purposes of the source rule, a "resident of the United States" includes a foreign corporation or a foreign partnership, which at any time during its taxable year is engaged in trade or business in the United States. Reg. § 1.861-2(a)(2)(iv) (1997). It is unclear whether this language is intended to apply to current law or to the Code prior to amendments made by the 1986 tax act.

[21] Reg. § 1.861-2(a)(1) (1997).

[22] Id.

[23] Id.

corporations and by resident individuals, whether citizens or aliens, is U.S. source gross income.[24] In general, interest paid by a foreign government or a foreign corporation is foreign source gross income, as is interest paid by a nonresident alien or a U.S. citizen resident outside the United States.[25] Residence is determined at the time of payment of the interest.[26] Thus the source of interest on a loan would change over the term of a loan if the payor changed its residence during that period.

For purposes of the source of income rules, interest presumably includes any payment made on a note, bond, or other interest-bearing obligation for the use of borrowed money.[27] It includes the unstated interest component of deferred payments on the sale of property, treated as interest under Code section 483, and original issue discount (OID), as defined in section 1273(a)(1).[28] It also includes income obtained from a trade or service receivable that is characterized as related person factoring income under section 864(d). As discussed in section 3/A1.4, below, a substitute interest payment made as part of a securities lending transaction is treated as interest for purposes of the source rules.

§ 12.01.2. The 80-20 Company Exception (Repealed)

Prior to changes made in 2010, effective for tax years beginning after December 31, 2010, Code section 861(a)(1)(A) provided that interest paid by a domestic corporation or a resident alien individual will be characterized as foreign source income if 80 percent or more of the gross income of that corporation or individual for a three-year testing period is active foreign business income. A domestic corporation meeting the 80-percent active foreign business requirement is referred to in the tax literature as an 80-20 company. The Obama administration proposed the repeal of the 80/20 provisions on the ground that they "can be manipulated."[29]Congress responded affirmatively.

§ 12.01.3. Some Exceptions to the Obligor Rule

There are several exceptions to the residence-of-the-obligor rule. One exception provides that payments made by a foreign branch of a U.S. corporation or partnership will be foreign source income if the branch is engaged in the commercial banking business or if the payments qualify as "deposits" within the meaning of Code section 871(i)(3).[30] The effect of this rule is that the business income earned by a U.S. bank in a foreign country constitutes foreign source income.[31]

Another exception, adopted as part of the branch profits tax provisions, treats interest paid by a branch of a foreign corporation engaged in a U.S. trade or business as if it had been paid by a U.S. corporation. The typical effect of this rule is to make the interest paid to a foreign taxpayer subject to tax under Code section 871(a) or 881 and subject to withholding.[32]

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[24] Reg. § 1.861-2(a)(2) (1997).

[25] IRC § 862(a)(1).

[26] Reg. § 1.861-2(a)(2) (1997).

[27] No general definition of interest for source-rule purposes is offered in the Code or regulations.

[28] Reg. § 1.861-2(a)(4) (1997). See IRC § 871(g)(3) (providing that the source of OID, for purposes of the U.S. withholding tax on nonresident aliens, is to be determined as if the gain from the disposition of any OID obligation constituted interest).

[29] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals [Greenbook] (February 2010), p. 47. The estimated revenue gain from repeal over the next 10 years is around $1.1 billion. Id. at 150.

[30] IRC § 861(a)(1)(B).

[31] See Reg. § 1.861-2(b)(5) (1997).

[32] IRC § 884(f)(1)(A); Reg. § 1.884-4(a)(1) (1996). This rule does not apply in case of a treaty conflict if the taxpayer is a qualified resident of the treaty country. IRC § 884(f)(3).

§ 12.01.4. Notional Principal Contracts (Interest-Rate Swaps, Etc.)

The source of income derived from an interest-rate swap or other notional principal contract is generally the country of residence of the taxpayer receiving the payment.[33] Residence is determined under the special definition of Code section 988(a)(3)(B)(i).[34] Expenses and losses relating to a notional principal contract generally are allocated under rules applicable to interest and interest equivalents.[35]

For foreign persons receiving payments under a notional principal contract, the source of notional principal contract income typically would be outside the United States. The income would have a U.S. source and would be treated as effectively connected income, however, if it arose from the conduct of a trade or business in the United States.[36]

A notional principal contract is a type of hedging arrangement.[37] It typically allows a person owing money to insulate itself from fluctuations either in short-term interest rates or in foreign currency exchange rates.[38] A common type of notional principal contract is an interest-rate swap. There are many types of swap arrangements. In the paradigm case, a debtor who is obligated to pay interest at a variable rate would enter into a contract with a third party — a person other than the holder of the debt obligation. Under that contract, the debtor would become obligated to pay interest at a fixed rate to the third party and that person would promise to pay either the debtor or the holder an amount equal to the interest owed to the holder.

Consider, for example, an individual, J, who has borrowed $100 from BCo, a bank. The principal on the loan is due in five years, and interest is payable at a variable rate, pegged to the short-term federal rate at the time the interest payments become due. To avoid the risks inherent in that arrangement, J enters into a hedging contract with S, a speculator. The contract provides (1) that J will pay $10 per year to S and (2) that S will pay BCo the annual interest on J's loan at the prevailing federal rate. The contract between J and S would be an interest-rate swap. S will realize a gain on the contract with J during a taxable year if the interest due to BCo in that year is less than $10. J will realize a gain if the interest owed to BCo is greater than $10.

Gain derived from a notional principal contract is called notional principal contract income.[39] Such income does not include certain foreign currency gains derived from a transaction conducted in a nonfunctional currency, as described in Code section 988.[40] In general, taxpayer's functional currency is a

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[33] Reg. § 1.863-7(b)(1) (1991); Reg. § 1.988-4(a) (1992).

[34] For discussion of the definition of residence under IRC § 988, see section 14.06, below.

[35] Reg. § 1.861-9T(b) (2009). For the source of gains on section 988 transactions, see Reg. § 1.988-4(a) (1992) and section 14.06, below.

[36] Reg. 1.863-7(b)(3) (1991).

[37] For more extensive discussion of this topic, see Frances Augustyn, "Tax Treatment of Notional Principal Contracts and Financial Products, " 45 Tax Notes 1353 (December 11, 1989).

[38] The term "notional principal contract" is apparently difficult to define in language that would be understandable to people who do not already know its meaning. It is defined in Reg. § 1.863-7(a)(1) (1991) 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 specific consideration or a promise to pay similar amounts." See also Reg. §§ 1.988-1(a)(2)(iii)(B)(2) (2001) and 1.446-3(c)(1)(i) (1994). The term "notional principal amount" is defined in Reg. § 1.446-3(c)(3) (1994). Within the financial community, "cap," "floor," and "collar" are slang for certain types of notional principal contracts. For discussion of various issues relating to notional principal contracts, see Notice 87-4, 1987-1 C.B. 416 (dollar denominated swaps); Notice 89-21, 1989-1C.B. 651 (lump-sum swap payments); and Notice 89-90, 1989-2 C.B. 407 (subpart F aspects of swap income).

[39] Reg. § 1.863-7(a)(1) (1991).

[40] Id. Such income is considered to be gain from a "section 988 transaction" and is governed by the provisions of IRC §§ 985-989. For discussion of the source of such gains, see section 5.4, below.

currency in which it normally conducts its business, and a nonfunctional currency is any other currency. Notional principal contract income can include foreign currency gain if payments under the notional principal contract are determined by reference to the taxpayer's functional foreign currency.[41]

For U.S. taxpayers having a foreign "qualified business unit" (QBU), the source of notional principal contract income is the residence of the QBU if certain conditions are met.[42] In general, the QBU must be engaged in business where it is resident, and the swap contract must have a substantial enough relationship to the activities of the QBU to justify its inclusion on the QBU's books of account.[43] An agreement between a taxpayer and its QBU is not a notional principle contract because a taxpayer cannot enter into a contract with itself.[44]

The following example illustrates the operation of the rules summarized above. Consider P, a U.S. corporation that does not have a QBU outside the United States. P borrows US $10,000 from a German bank under a five-year loan contract, at a variable annual interest rate pegged to the short-term rate on U.S. government bonds. To protect itself against the risk of an increase in that rate, P enters into a contract with F, a Canadian investor. Under the swap contract, F agrees to pay P the interest owed under the contract with the German bank, and P agrees to pay US $1,000 per year to F. In year one, P derives income of US $100 as a result of this arrangement. The source of that income is the United States because P is a resident of the United States. If P had been engaged in business in Germany through a QBU and the contract with F was properly related to the books of the German QBU, then the source of the notional principal contract income would have been Germany.

§ 12.01.5. Loan Guarantees

Under section 861(a)(9), adopted in 2010, an amount received, directly or indirectly, from a U.S. resident (an individual or legal entity) for guaranteeing its debt constitutes U.S. source income. U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person which is effectively connected with conduct of a U.S. trade or business. A conforming amendment to section 862(a)(9) provides that an amount received from a foreign person, directly or indirectly, for guaranteeing that person's debt, is treated as foreign source income if the amount is not treated as U.S. source income under section 861(a)(9).

§ 12.02. Dividends, Deemed Dividends and Dividend Equivalents

In general, a dividend has its source in the country where the corporation paying the dividend is incorporated. The general rule is described in section 12.02.1, below. A variation of the rule, discussed in section 12.02.2, applies to deemed dividends from controlled foreign corporations. Exceptions to the general rule for dividends paid by domestic corporations are explained in section 12.02.3. Section 12.02.4 describes the exceptions applicable to dividends paid by foreign corporations.

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[41] Reg. § 1.988-1(a)(2)(iii)(B)(1) (1992).

[42] Reg. § 1.863-7(b)(3) (1991).

[43] Reg. § 1.863-7(b)(2)(iii) and (iv) (1991).

[44] Reg. § 1.446-3(c)(1)(i) (1994).

§ 12.02.1. General Rule

The general rule is that the source of a dividend is the country where the corporation paying the dividend is incorporated.[45] That is, dividends from domestic corporations generally produce U.S. source income, and dividends from foreign corporations generally produce foreign source income.

The definition of a dividend for purposes of the source rules is taken from the definition provided in subchapter C of the Code to govern the taxation of distributions from corporations to their shareholders. In general, a dividend is a distribution of cash or property made out of the current or accumulated profits of a corporation.[46] Included in the definition of a dividend would be a stock dividend taxable under Code section 305, a redemption that is treated as equivalent to a dividend under section 302, a distribution of nonqualifying property in certain corporate reorganizations that is taxable as boot under section 356(a)(2), and a sale of certain tainted stock that is taxable as a dividend under section 306.

§ 12.02.2. Deemed-Dividend Rule

Under subpart F of the Code, a U.S. shareholder may be treated as having received a deemed dividend from a controlled foreign corporation (CFC). In the simple case of a deemed dividend from a foreign corporation directly owned by the shareholder, the source would be the country where that foreign corporation is organized.[47]

For foreign corporations beyond the first tier, the source is more complicated, due to the so-called hopscotch rule. Under that rule, subpart F income derived by a foreign corporation beyond the first tier is taxable directly to the U.S. shareholders, without passing through the other foreign corporations in the chain of ownership. Assume, for example, that F-1 is a foreign subsidiary of PCo, a U.S. corporation, and F-2 is a subsidiary of F-1. If F-2 earns subpart F income, PCo is taxable on that income directly, without any deemed distribution to F-1.

Notwithstanding the hopscotch rule, a deemed dividend received from a foreign corporation owned indirectly through a chain of foreign entities has its source in the country of incorporation of the foreign corporation that would have paid the dividend to the U.S. shareholder if an actual distribution had occurred. Assume, for example, that P, a U.S. parent corporation, owns all the stock of FCo, a foreign corporation organized in Country F, and that FCo owns all the stock of SCo, a foreign corporation organized in Country S. P is taxable under subpart F on a deemed dividend from SCo. The source of that dividend would be Country F because an actual dividend from SCo would have passed through FCo before being received by P.[48]

§ 12.2.3. Domestic Corporation Exceptions

There are two exceptions to the general rule that dividends from a domestic corporation produce U.S. source income. Under the first exception, a dividend from a domestic corporation is treated as foreign source income if the corporation paying the dividend has made a valid election under Code sections 936 or 30A (relating to certain domestic corporations operating in a U.S. possession).[49] In effect, the electing

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[45] IRC § 861(a)(2)(A).

[46] IRC § 316.

[47] Reg. § 1.960-1(h)(1) (1997).

[48] Reg. § 1.960-1(h)(3) (1997).

[49] IRC §§ 861(a)(2)(A) and 862(a)(2).

corporation engaged in business in a U.S. possession is treated as a foreign corporation for purposes of the source rules.[50]

The second exemption is for certain distributions from domestic corporations that qualify as a DISC or a former DISC.[51] In general, a distribution is treated as foreign source income when the income is derived directly from the export of property produced within the United States. The DISC provisions violated U.S. trade obligations under GATT and were repealed in most respects in 1984.[52] Those provisions were replaced by the Foreign Sales Corporation (FSC) provisions, which were also found to violate GATT. Congress responded by repealing FSC and enacting a new export subsidy called the Extraterritorial Income Exclusion Act of 2000 (ETI). When ETI was also found to violate GATT, Congress repealed ETI without a replacement.[53]

§ 12.2.4. Foreign Corporation Exceptions

There are three exceptions to the general rule that dividends from a foreign corporation are foreign source income. Those three exceptions are explained below.

Second-tier Dividend Tax. The first exception is for dividends paid by a foreign corporation that has derived 25 percent or more of its income over a three-year base period from the active conduct of a trade or business in the United States. Under certain circumstances set forth below, a dividend paid to a foreign person by such a corporation out of its effectively connected income for the three-year period would be characterized as U.S. source income.[54]

The purpose of this first exception to the general rule is to provide for the imposition of a 30-percent withholding tax, in addition to the general corporate tax, on income derived by foreign corporations from business operations within the United States. This withholding tax is popularly referred to as the second-tier dividends tax.

The second-tier dividends tax does not apply to a foreign corporation for a taxable year if the branch profits tax of Code section 884 may be imposed on that corporation for that year, whether or not the branch profits tax is actually imposed.[55] It does apply, however, to dividends paid by a foreign corporation to a foreign person out of pre-1987 profits. It also may apply if the foreign corporation making the distribution is exempt from the branch profits tax by treaty.[56]

Consider, for example, FCo, a corporation organized under the laws of Country F, that is engaged in business in the United States. Its only shareholder is S, a nonresident alien individual residing in Country B. The tax treaty between the United States and Country B prohibits the imposition of the branch profits tax but does not prohibit the imposition of the second-tier dividends tax. For years 1, 2, and 3, FCo earns $100

[50] Corporations making a valid election under IRC §§ 936 or 30A are generally exempt from U.S. taxes on business income arising within a possession.

[51] IRC § 861(a)(2)(D). IRC §§ 991 to 994 provide favorable tax treatment for a domestic corporation that qualifies as a DISC.

[52] Some DISC benefits remain available for certain qualifying small DISCs.

[53] For discussion, see Michael J. McIntyre, "How the United States Should Respond to the ETI Dilemma," 26 TAX NOTES INT'L 865-872 (May 20, 2002).

[54] IRC § 861(a)(2)(B).

[55] IRC § 861(a)(2)(B) (as amended by TAMRA, 1988). The branch profits tax overrides a tax treaty for treaty shoppers.

[56] The 1986 tax act reduced from 50% to 25% the percentage of effectively connected income that a foreign corporation must have to trigger the second-tier withholding tax. The addition of the branch profits tax by the 1986 act has substantially reduced the significance of the second-tier dividends tax. Congress believed that enforcement of that tax was ineffective. See GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (1987) at 1036.

per year that is effectively connected with its U.S. business. It also earns foreign source income of $50 per year during that period. At the end of year 3, F distributes a dividend of $90 to S. Of that amount, $60 ($90 × $300/($300 + $150)) will be characterized as U.S. source income and will be subject to the second-tier dividends tax under Code section 871.

Avoidance of Double Relief. The second exception to the general rule provides that, under certain circumstances, a dividend paid by a foreign corporation to a U.S. corporation will be U.S. source income, for purposes of computing the limitation on the foreign tax credit. This exception applies to dividends that qualify, in whole or in part, for a dividends received deduction under Code section 245.[57] In general, section 245 provides a dividends received deduction for dividends that have been paid by certain foreign corporations out of accumulated profits derived from the active conduct of a trade or business within the United States.[58] By classifying dividends eligible for the dividends received deduction as U.S. source income, the Code prevents U.S. corporations that have received relief from double taxation under the dividends received deduction mechanism from also obtaining such relief under the foreign tax credit mechanism.

Dividends from Former U.S. Corporation. The third exception to the general rule provides that a dividend paid by a foreign corporation to either a foreign or a domestic corporation is U.S. source income to the extent that the dividend is treated under Code section 243(e) as a distribution from a domestic corporation.[59] Section 243(e) generally provides that dividends paid by a foreign corporation out of the accumulated profits of a predecessor domestic corporation are to be considered dividends from a domestic corporation.[60]

The objective of this third exception is to prevent taxpayers from converting what would otherwise be a U.S. source dividend into a foreign source dividend by transferring the stock or assets of a domestic corporation to a foreign corporation.

Consider, for example, P, a U.S. corporation that earns income of $100 from U.S. sources. P is subsequently acquired by F, a foreign corporation, through a merger. If F then distributes to its shareholders the $100 of profits earned by P, the dividend is sourced in the United States, just as it would have been if the distribution had been made by P prior to the merger.

§ 12.2.5. Dividend Equivalents

A dividend equivalent, as defined in Code section 871(m)(2), "shall be treated as a dividend from sources within the United States" for various purposes, including the withholding rules applicable to foreign persons.[61]

In general, a dividend equivalent is a payment that is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. A payment made under a notional principal contract that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States would be a dividend equivalent. Assume, for example,

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[57] IRC § 861(a)(2)(B). If a tax treaty prevents characterization of the dividends as U.S. source income, then a special limitation on the credit applies. IRC § 245(a)(10).

[58] See IRC § 245(a)(1) and (b). Except in the case of a dividend from a wholly owned foreign subsidiary, a U.S. corporation can claim a dividends received deduction for only part of the dividend. Only U.S. corporations owning at least 10% (by vote and value) of a foreign corporation are eligible for a dividends received deduction under IRC § 245.

[59] IRC § 861(a)(2)(C).

[60] This exception overrides IRC § 861(a)(2)(B).

[61] IRC § 871(m)(1).

that F, a foreign individual, entered into a contract with P, a domestic person, under which P would pay F an amount equal to the dividends paid by General Electric, a U.S. company, each year in exchange for guaranteed payments of $500 per year. The amount paid by P to F would be a dividend equivalent. It would be treated as a U.S. source dividend.

In general, the source of income from a notional principle contract is the residence of the recipient of the income. Thus, under the general rule, the income in the above example would be foreign source income.

§ 12.03. Rents and Royalties

The general rule is that rental income and royalty income derived from the use of property has its source in the country where the property is used.[62] For tangible property, the place of use is the place where the tangible property is actually located. For intangible property, the place of use is less clear. Issues relating to rents and royalties paid with respect to computer software are discussed in section 14.05, below.

Code section 861(a)(4) states that "royalties for the use of or the privilege of using in the United States patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade brands, franchises, and other like property" will be U.S. source income. Under section 862(a)(4), payments for use of such property outside the United States will be foreign source income. How the country of use is to be determined, however, is not specified.

The generally accepted rule is that the country of use of intangible property is the country that protects the owner of that property against its unauthorized use by other persons.[63] Thus a royalty received on the license of the United States copyright to a book generally would have its source in the United States.

Some intangible property, such as know-how, may not be protected against unauthorized use by the laws of any country. For such property, the country of use apparently is determined under the terms of the agreement under which the royalties are being paid. Thus payments made under a contract granting a person the right to the use of a secret process in a particular country would have its source in that country. Difficult problems of allocation arise if the contract under which a royalty is being paid grants rights to the use of intangible property in more than one country or without reference to any country.[64]

Payments received on the sale of intangible property will be treated as royalty income, for purposes of the source rules, if the payments are contingent on the productivity, use, or disposition of the intangible property.[65] Such income is also treated as royalty income for purposes of imposing U.S. withholding taxes.[66] Payments that are not contingent on productivity, use, or disposition generally have their source in the country where the person making the sale is resident.[67]

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[62] IRC §§ 861(a)(4) and 862(a)(4).

[63] Rev. Rul. 68-443, 1968-2 C.B. 304.

[64] See, e.g., Comm'r v. Wodehouse, 337 U.S. 369 (1949) (concerning allocation between the United States and Canada of North American serial rights to a book).

[65] Reg. § 1.861-5 (1975) (referring to IRC § 871(a)(1)(D), which treats certain income from the sale of intangible property that is contingent on the use of that property as periodic income subject to withholding).

[66] IRC §§ 871(a)(1)(D) (taxation of nonresident alien individuals) and 881(a)(4) (taxation of foreign corporations).

[67] IRC § 865(a) and (d). The source of gross income from the sale of intangible personal property in discussed below.

SDI Netherlands v. Comm'r

107 T.C. 161 (1996)

Editor's Summary

Petitioner, SDI Netherlands, is a foreign corporation organized in 1974 under the laws of the Kingdom of The Netherlands. The issue in dispute is whether petitioner is liable for withholding taxes in excess of $3 million for taxable years 1987 to 1990 on royalties paid to a Bermuda corporation, and additions to tax of around $756,000 for failure to file Forms 1042 for each of the years in issue.

During the years in issue, petitioner was a member of an affiliated group of companies (the SDI Group) whose members designed, manufactured, marketed, and serviced commercial systems software for use on IBM mainframe computers worldwide. SDI Ltd., a corporation organized under the laws of Bermuda, is the parent company of the SDI Group. During the years in issue, petitioner was a wholly owned subsidiary of SDI Antilles, a Netherlands Antilles corporation, which was a wholly owned subsidiary of SDI Ltd. The SDI Group included SDI Bermuda Ltd. (SDI Bermuda), a corporation organized under the laws of Bermuda which, during the years in issue was a wholly owned subsidiary of SDI Ltd. SDI USA, Inc. (SDI USA), a corporation organized under the laws of the State of California was, during the years at issue, a wholly owned subsidiary of petitioner.

Opinion of the Court (Tannenwald, Judge)

* * *

During the years in issue, petitioner licensed from SDI Bermuda, pursuant to a license agreement dated November 28, 1986 (Bermuda license agreement), the worldwide rights to certain commercial systems software for use on IBM mainframe computers (the software). The Bermuda license agreement granted petitioner a nonexclusive license to use or to market the use of, on a worldwide basis, all of the software and any and all industrial and intellectual property rights SDI Ltd. had or would acquire from the effective date of the agreement n3, in exchange for certain royalty payments. The agreement further provided that petitioner "shall specifically have the right to grant sublicenses and Agents for the right to use and to market the use of any and all marketing rights granted to [petitioner] under the terms" of the agreement. The agreement was valid for an indefinite period and could be unilaterally terminated by either party on 3 months' written notice.

The Bermuda license agreement contained no express reference to the United States.

With respect to royalties, the Bermuda license agreement provided:

> 8.1 The royalties payable to [SDI Bermuda] by [petitioner] under this Agreement are fixed at 93% of the net amount of all of the royalties due to [petitioner] by all persons, entities and institutions which [petitioner] sublicensed any of the rights licensed to [petitioner] under this Agreement ("Sublicensees"). The aforementioned net amount is the amount that remains after the deduction of the withholding tax on royalties to be withheld when the Sublicensees of [petitioner] or Agents of [petitioner] pay the royalties due to the [petitioner].

* * *

During the years in issue, petitioner was a party to an exclusive license agreement with SDI USA, dated October 1, 1972, and as modified from time to time, regarding the use and licensing of the software in the

United States (the U.S. license agreement). SDI USA was responsible for the direct marketing and sales of the software in the United States.

The U.S. license agreement provided in part:

> 2.1 In consideration for the payment of the royalties provided hereunder and the performance of the other terms and conditions hereof by [SDI USA], [petitioner] hereby grants and transfers to [SDI USA], upon [**11] the terms and subject to the conditions hereinafter set forth, the exclusive right and license during the Term hereof, to have disclosed to it by [petitioner] and to exploit, use and lease and otherwise obtain the benefit of [the software] within the Territory.
>
> 2.2 This Exclusive License shall include, (i) the right to sublicense to others the use and lease of [the software] within the Territory, subject, however, to the terms and conditions of this License; and (ii) this License shall also include the right and, as hereinafter provided, the obligation of [SDI USA], to provide or to provide for the exclusive maintenance, servicing and repair of [the software] within the Territory.
>
> * * *
>
> 2.4 The Territory of this License shall mean and be restricted to the continental United States, Hawaii and Alaska.

Petitioner agreed not to license the software for use or to compete directly or indirectly with SDI USA's exploitation of the software in the United States during the term of its license to SDI USA.

Until February 1987, the agreement provided that SDI USA would pay to petitioner "an annual royalty equal to fifty percent (50%) of the annual gross revenues of [SDI USA] from leasing and sublicensing of [the software], without any deductions therefrom except rebates, discounts and sales or value added taxes."

The U.S. license agreement was modified in February 1987 to provide that SDI USA would pay petitioner "a royalty equal to (50%) fifth percent of the gross billable or invoiced revenues of [SDI USA] with regard to all products licensed herein or further licensed in the future, without any deductions therefrom except rebates, or, sales or value added taxes."

Petitioner received royalty payments pursuant to the U.S. license agreement from SDI USA, during the years in issue, in the following amounts:

1987	$2,663,401
1988	$2,936,889
1989	$3,092,710
1990	$2,139,458

Respondent mailed notices of deficiency to petitioner, one for 1987, 1988, and 1989, and one for 1990, on July 29, 1994.

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Liability for Withholding

Section 881(a) provides that a 30-percent tax shall be imposed on "the amount received from sources within the United States by a foreign corporation" falling within certain categories of income. Section 1442 provides a method for collecting that tax. *Central de Gas de Chihuahua, S.A. v. Commissioner*, 102 T.C. at 519.

Section 1442 provides in part:

> (a) General Rule.-- In the case of foreign corporations subject to taxation under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof. * * *

Royalties are among the types of income included in section 1441(b). Sec. 1.1441-2(a), Income Tax Regs.; see also sec. 1.881-2(b), Income Tax Regs. In addition, section 861(a)(4) provides that U.S. source income includes:

> (4) *Rentals and Royalties*.-- Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property.

Section 1441(a) completes the picture of the statutory provisions involved herein. It provides:

> all persons * * * having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) [which includes "royalties"] (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual or of any foreign partnership shall * * * deduct and withhold from such items a tax equal to 30 percent thereof * * *

There can be no dispute that the royalty payments received by petitioner from SDI USA constitute U.S. source income and were received by petitioner as such within the meaning of section 1442(a). See *Commissioner v. Wodehouse*, 337 U.S. 369 (1949); see also *Estate of Marton v. Commissioner*, 47 B.T.A. 184 (1942). However, royalties paid by SDI USA to petitioner are exempt from taxation by virtue of section 894 and article IX of the United States-Netherlands Income Tax Convention . . . ... There is no comparable U.S. treaty exemption that would apply to royalty payments from SDI USA to SDI Bermuda.

The parties have locked horns on several aspects of the application of the statutory provisions in light of the impact of the U.S.-Netherlands treaty exemption: (1) Whether the royalties paid by petitioner to SDI Bermuda constitute income "received from sources within the United States by" SDI Bermuda and are thus subject to withholding under section 1441(a); (2) whether petitioner can be considered a "withholding agent"; (3) whether there is a limitations period that has expired in respect of respondent's right to assess a deficiency in withholding tax against petitioner; and (4) whether petitioner is liable for additions to tax under section 6651(a)(1) for failure to file withholding tax returns.

For reasons hereinafter set forth, we resolve the first issue in petitioner's favor with the result that it is unnecessary for us to address the remaining issues. Before proceeding with our analysis of the first issue, however, it is important to note that respondent does not question the existence of petitioner as a valid Netherlands corporation or the application of the treaty exemption insofar as the payments by SDI USA to petitioner are concerned. Similarly, respondent does not attack the arrangements under which petitioner had a license of the worldwide rights and SDI USA had a license of the U.S. rights, although respondent does

ask us to take into account the close relationship of the various corporations involved. Compare *Gaw v. Commissioner*, T.C. Memo. 1995-531, on appeal (D.C. Cir., May 20, 1996).

Rather, respondent focuses her argument solely on the proposition that, since the royalties paid by SDI USA to petitioner were U.S. source income, they retained that character as part of the royalties paid by petitioner to SDI Bermuda and, as a matter of law, constitute income "received from sources within the United States by" SDI Bermuda under section 881(a). Respondent contends that the fact that such royalties were combined with non-U.S. source royalties received by petitioner to determine the amount of royalties payable by petitioner to SDI Bermuda does not preclude the tracing of the royalties received by petitioner from SDI USA to U.S. sources. To implement such tracing, respondent simply applies the percentage specified in the worldwide license agreement between petitioner and SDI Bermuda and utilized in computing the amount of the required payment by petitioner to SDI Bermuda. To support her contention that such an allocation is permissible, respondent cites *Wodehouse v. Commissioner*, 15 T.C. 799 (1950); *Rohmer v. Commissioner*, 14 T.C.1467 (1950); *Rohmer v. Commissioner*, 5 T.C. 183 (1945), affd. 153 F.2d 61 (2d Cir. 1946); *Estate of Marton v. Commissioner*, 47 B.T.A. 184 (1942); *Molnar v. Commissioner*, 156 F.2d 924 (2d Cir. 1946), affg. a Memorandum Opinion of this Court. In all of these cases, however, the payments, upon which a withholding tax was imposed, were directly from a U.S. payer and the U.S. withholding tax was imposed on that payer. None of them address the situation involved herein, where there is a second licensing step under which royalties are being paid and upon which the U.S. withholding tax is sought to be imposed. Thus, these cases provide no guidance in respect of whether the U.S. source characterization of the royalties paid by SDI USA to petitioner flows through to the royalties paid by petitioner to SDI Bermuda.

Petitioner argues that the royalties paid by SDI USA to petitioner and exempt from tax under the Netherlands treaty became merged with the other royalties received by petitioner from non-U.S. sources and consequently lost their character as U.S. source income. Petitioner submits that, while the royalty payments from SDI USA may be U.S. source income, its royalty payments to SDI Bermuda were made on a separate and independent basis. With respect to the payments to SDI Bermuda, petitioner contends that they were made pursuant to a worldwide licensing agreement between two foreign corporations, and as such do not constitute income "received from sources within the United States" so that no withholding is required under section 1442(a).

Pertinent authority on the issue before us is sparse. Indeed respondent relies solely on Rev. Rul. 80-362, 1980-2 C.B. 208, for her "flow-through" position. In Rev. Rul. 80-362, A, a resident of a country other than the United States and The Netherlands, licensed the rights to a U.S. patent to X, a Netherlands corporation. X agreed to pay a fixed royalty each year to A. X relicenses those rights to Y, a U.S. corporation, for use in the United States. In ruling that X was liable for a withholding tax under section 1441, the ruling states:

In the present factual situation, the royalties from Y to X are exempt from United States tax under Article IX(1) of the Convention. However, the royalties from X to A are not exempt from taxation by the United States because there is no income tax convention between A's country of residence and the United States providing for such an exemption. Since the royalties from X to A are paid in consideration for the privilege of using a patent in the United States, they are treated as income from sources within the United States under section 861(a)(4) of the Code and are subject to United States income taxation under section 871(a)(1)(A). [Rev. Rul. 80-362, 1980-2 C.B. at 208-209.]

We are not persuaded that Rev. Rul. 80-362, supra, provides any significant support for respondent's position herein. It fails to reflect any reasoning or supporting legal authority. This circumstance is particularly

relevant in applying the usual rule that, in any event, revenue rulings are not entitled to any special deference. See *Northern Indiana Public Service Co. v. Commissioner*, 105 T.C. 341, 350 (1995), on appeal (7th Cir., March 13 and 25, 1996); *Halliburton Co. v. Commissioner*, 100 T.C. 216, 232 (1993), affd. without published opinion 25 F.3d 1043 (5th Cir. 1994).

At this point, we note that respondent has not argued that petitioner was a mere conduit or agent of SDI USA in paying royalties to SDI Bermuda or that SDI Bermuda was the beneficial owner of the royalties petitioner received from SDI USA so that the U.S.-Netherlands treaty exemption should not apply. Compare *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971), with *Northern Indiana Public Service Co. v. Commissioner*, supra; cf. *Estate of Petschek v. Commissioner*, 81 T.C. 260 (1983), affd. 738 F.2d 67 (2d Cir. 1984). Presumably such an argument would have produced a situation where SDI USA rather than petitioner would have been targeted by respondent as the taxpayer liable for the withholding tax under section 1442(a). See *Northern Indiana Public Service Co. v. Commissioner*, 105 T.C. at 347.

Although *Aiken Industries, Inc. v. Commissioner*, supra, and *Northern Indiana Public Service Co. v. Commissioner*, supra, involved the conduit concept, we think they provide some guidance for our disposition of the instant case. We take this view because the flow-through characterization concept is, in a very real sense, the conduit concept albeit in a somewhat different garb, i.e., whether the U.S. source income is being received as such, because of the status of the paying entity in one case, and the status of the subject matter of the payment in the other.

In *Aiken Industries, Inc. v. Commissioner*, supra, back-to-back loans, in the identical amounts of principal and rates of interest, were made between a U.S. corporation and a related corporation organized under the laws of the Republic of Honduras, and between the Honduran corporation and its indirect parent. Respondent argued that the Honduran corporation should be disregarded for tax purposes, and that the parent corporation should be deemed the true owner and recipient of the interest payment from the U.S. corporation. We held the Honduran corporation to be a mere conduit for the passage of interest payments and imposed withholding tax liability on the U.S. corporation.

In *Northern Indiana Public Service Co. v. Commissioner*, supra, the taxpayer, a domestic corporation, organized a finance subsidiary incorporated in Curacao under the Commercial Code of the Netherlands Antilles, (to which the U.S.-Netherlands treaty applied) for the purpose of issuing notes in the Eurobond market. The finance subsidiary borrowed $ 70 million at 17-1/4 percent interest in that market and lent that amount to the taxpayer at 18-1/4 percent interest. Respondent argued that the finance subsidiary should be ignored and that the taxpayer was liable for withholding taxes under section 1441 on the interest payments to the foreign Eurobond holders. Finding that the finance subsidiary engaged in substantive business activity that resulted in significant earnings, we held that the finance subsidiary was not a mere conduit or agent.

We think the within situation falls more within the ambit of *Northern Indiana* than *Aiken Industries*. In the latter case, there was an identify both in terms and timing between the back to back loans, as well as a close relationship between the parties involved. In the former case, although there was a clear connecting purpose between the borrowing and lending transactions, i.e., to obtain the benefit of the exemption from the withholding tax on interest under the U.S.-Netherlands treaty; there were differences in terms, i.e., in the interest rate (albeit not large); and a close relationship between all the parties was not present since the borrowings by the finance subsidiary were from unrelated parties.

In the instant case, there was a close relationship between the parties. However, although respondent asks us, in passing, to take that relationship into account, she does not pursue the matter to the point where she contends that it is a significant factor. Given the fact that respondent recognizes the existence of all of

the parties as valid corporate entities and does not attack the bona fides of the license agreements between SDI USA and petitioner, on the one hand, or petitioner and SDI Bermuda, on the other, we are not disposed to allow the close relationship element to control our decision.

The facts of the matter are that the two license agreements had separate and distinct terms and that petitioner had an independent role as the licensee from SDI Bermuda and the licensor of the other entities, including but not limited to SDI USA. The schedules of royalty payments provides for a spread, not unlike the spread involved in *Northern Indiana*, which compensated petitioner for its efforts. Like the finance subsidiary in *Northern Indiana*, petitioner engaged in licensing activities from which it realized substantial earnings. In fact, on a percentage basis, it earned between 5 and 6 percent, compared to the 1 percent earned by that finance subsidiary in *Northern Indiana*. Under the circumstances herein, we think these arrangements should be accorded separate status with the result that, although the royalties paid by petitioner to SDI Bermuda were derived from the royalties received by petitioner from SDI USA, they were separate payments.

We find support for our conclusion herein in that respondent's view of the law could cause a cascading royalty problem, whereby multiple withholding taxes could be paid on the same royalty payment as it is transferred up a chain of licensors. See, e.g., 1 Isenbergh, *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income*, par. 7.8, pp. 7:20-7:21 (2d ed. 1996); 2 Kuntz and Peroni, *U.S. International Taxation* C1-45 -C1-46 (1992); Dale, "Withholding Tax on Payments to Foreign Persons," 36 *Tax L. Rev.* 49, 66-67 (1980). But for the U.S.-Netherlands treaty, the royalty payments from SDI USA could be subject to withholding tax twice under respondent's reasoning herein.

Respondent argues that only one withholding tax is being sought herein. However, this ignores the fact that, by treaty, the U.S. agreed to forgo taxing royalties and to allow them to be taxed by The Netherlands. Whether or not The Netherlands actually taxed the royalties is irrelevant.

Respondent also infers that she would use her discretion not to apply more than one level of withholding tax on multiple transfers of income that originated as U.S. source income. We think this places an improper exercise of discretion in respondent's hands. To avoid the imposition of interest and additions to tax as determined by respondent herein, each payer in the chain might well feel compelled to file returns and pay withholding taxes. See Glicklich, "Final Regulations on Conduit Financing Arrangements Empower the IRS", 84 *J. Taxn.* 5, 12 (1996). We are not disposed to conclude, in the absence of any legislative expression on the subject, that Congress intended the statutory provisions to permit "cascading" with the question of relief left to the mercy of respondent.

We hold that the payments by petitioner with respect to which respondent seeks to impose liability for the 30 percent withholding tax herein were not "received from sources within the United States by" SDI Bermuda under sections 881(a), 1441(a), and 1442(a).

Decision will be entered for petitioner.

Questions

1. What source rule, if any, is the Tax Court in *SDI Netherlands* applying to hold that the second level royalty does not have a U.S. source? Is there any statutory support for the Tax Court's position?

2. Why did the court ignore the plain meaning of the statute in that case? Is "plain meaning" a doctrine only invoked for the benefit of taxpayers?

3. The Internal Revenue Service has indicated that it does not intend to pursue an appeal of *SDI Netherlands*. Any ideas as to why? Do you expect to see some new regulations under IRC § 861(a)(4)? The case was decided in 1996, yet no new regulations have been issued. Why? The rumor, proved false, was that the Service would issue regulations that would overturn *SDI Netherlands* for future cases but would also prevent the double-tax result that the court was concerned about in that case. Is that approach consistent with the Code? Is it good policy?

4. What is the root cause of the cascading effect noted by the court? Is it the result of the source rule or something else? See Michael J. McIntyre, "The Royalty Source Rule, Treaty Shopping, Cascading Effects, and the Tax Court's Indefensible Decision in *SDI Netherlands*," 15/25 *Tax Notes Int'l* 2031-2034 (Dec. 22, 1997). See also Erin L. Guruli, "International Taxation: Application of Source Rules to Income from Intangible Property," 5 Houston Business & Tax Law Journal 204-239 (2005).

5. Assume that HCo owns real property located in the United States. HCo is organized in a tax haven. HCo leases the property to CCo, an unrelated Canadian corporation, for $10,000 per year. CCo improves the property and leases it to UCo, a United States corporation, for $15,000 per year. What is the source of the income earned by HCo? Is the answer affected by the decision in *SDI Netherlands*? Does it matter whether HCo has elected to be taxed as having effectively connected income? What does your answer here suggest about the answer to question 4, above?

§ 12.04. Securities Lending Transactions

A securities lending transaction is an arrangement under which one taxpayer (the lender) transfers nominal title to stocks, bonds, or other securities for some specified period to some other person (the borrower) in exchange for a promise to return the same or equivalent securities and the income generated by those securities at the end of the period. Tax planners have developed a variety of securities lending transactions. The general theme is that the nominal owner (the borrower) obtains favorable tax treatment for the income generated by the loaned securities and then pays over the proceeds, minus some service charge, to the true owner (the lender).

Assume, for example, that Q, a resident of Country X, holds stock in GM, a U.S. company. Country X has no tax treaty with the United States. As a result, dividends paid by GM to Q are subject to the 30-percent withholding tax. To avoid that tax, Q transfers title to the GM stock to R, a resident of Germany. R promises to return the GM stock, or other stock of equivalent value, to Q after five years. R also promises to pay Q at the end of the five-year period the amounts received as net dividends from GM, with appropriate interest. R intends to claim rights under the U.S./Germany treaty to a reduced withholding rate on the dividends.

The volume of securities lending transactions is large. The aggregate daily volume of those transactions in the U.S. market has been estimated at nearly $2 trillion (as of 2005). The international market is estimated to be significantly larger.[68]

To prevent taxpayers from using securities lending transactions or their functional equivalent, sale-repurchase transactions, to avoid U.S. taxes, regulations issued under the authority of Code sections 861, 862, and 7701(l) provide, in effect, that the tax consequences of those transactions is to be determined by reference to their substance rather than their form. In general, the regulations provide that the source of

[68] See James R. Hardin, Jr. & David M. Maloney, "Cross-Border Securities Lending Transactions and the Withholding Tax: The Ambiguity Continues," 20/18 *Tax Notes Int'l* 1977 (May 1, 2000), citing Technical Committee of the International Organization of Securities Commissions, Securities Lending Transactions: Market Development and Implications (July 1999).

substitute interest or dividend payments received under a securities lending transaction is the same as the source of the payments (dividend or interest) for which they substitute.[69] In the example above, the regulations provide that the payments received by Q from R will be characterized as dividend payments.

In addition, the regulations provide that the substitute payments generally are treated as having the same character as the dividend or interest income for which they substitute.[70] That is, the substitute payments are treated as interest or dividends, as the case may be, for purposes of applying Code sections 864(c)(4)(B) (foreign effectively connected income), 871 (taxation of nonresident aliens), 881 (taxation of foreign corporations), 894 (income affected by a tax treaty),[71] and the withholding provisions. In the above example, Q will be treated as receiving a U.S. dividend that does not qualify for treaty benefits and on which withholding at the 30-percent rate is required.

In determining its source, a substitute payment is treated like the payment it substitutes for whether the recipient of the income is a U.S. person or a foreign person. In addition, the source so determined applies for all purposes of the Code, including the computation of the limitations on the foreign tax credit under sections 904 and 906. The character of a substitute payment, however, is determined by reference to the payment it substitutes for only in limited circumstances. The transparency rule does apply in taxing nonresident aliens and foreign corporations on income subject to withholding. It does not apply, however, for purposes of determining whether the dividend or interest income paid to the "borrower" of the security is effectively connected to the U.S. trade or business. Nor can it be applied affirmatively by U.S. persons to claim a foreign tax credit for taxes nominally paid by the "borrower."

[69] Reg. §§ 1.861-2(a)(7) (1997) (interest); 1.861-3(a)(6) (2008) (dividends).

[70] Id.

[71] Reg. §§ 1.894-1(c) (2002).

Chapter 13
Source of Income from Sale of Property

THIS SECTION DISCUSSES THE SOURCE RULES applicable to sales, exchanges, and other dispositions of real and personal property. Section 13.01 presents the source rule governing income derived from the sale of real property interests. The complex source rules applicable to the purchase and resale of personal property are addressed in section 13.02. Those rules were modified in many important respects by the 1986 tax act. Section 13.03 presents the source rules governing the sale of inventory property manufactured or otherwise produced by the seller. The special rules applicable to income derived from the extraction and sale of natural resources are addressed in section 13.04.

§ 13.01. Sale of Real Property

Income from the sale or other disposition of an interest in real property is governed by Code sections 861(a)(5) and 862(a)(5). Under section 861(a)(5), income from the sale of a United States real property interest, as defined in section 897(c), is U.S. source income. A United States real property interest would include ownership of real property located within the United States.[72] It would also include an interest in certain domestic corporations used to hold real property located within the United States. Income from the sale of real property located outside the United States is foreign source income.

Mines, wells, and other natural deposits are characterized as real property for purposes of the source rules.[73] The term "United States" includes the continental shelf of the United States.[74]

§ 13.02. Purchase and Resale of Personal Property

The source of gross income from the purchase and sale of personal property is generally determined under Code section 865. Sections 13.02.1 through 13.07 describe the source rules and related rules contained in that Code section.

§ 13.02.1. General

Subject to many important exceptions, Code section 865 provides that income from the sale of personal property has its source in the country where the seller is resident. The term "sale" includes an exchange or other disposition.[75] In general, the deduction for a loss on the sale of personal property is determined by reference to the source rules that would have applied if the property had been sold at a

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[72] IRC § 897(c)(1)(A)(i) classifies real property located within the Virgin Islands as a United States real property interest. IRC § 862(a)(8) provides, however, that the disposition of a United States real property interest generates foreign source income when the real property is located in the Virgin Islands.

[73] IRC § 897(c)(1)(A)(i).

[74] See IRC § 638 ("the term 'United States' when used in a geographical sense includes the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources").

[75] IRC § 865(i)(2).

gain.[76] The residence-of-the-seller rule is described in Code section 865 as the general rule; it should be understood to be the residual rule. Special residency rules, described in section 13.02.7, below, are applicable in determining the source of income under section 865.

Most income derived from the purchase and sale of personal property is governed by one of the exceptions to the residence-of-the-seller rule. Code section 865 provides four exceptions to the residence-of-the-seller rule based upon the type of property sold. One exception, discussed in section 13.02.2, below, is applicable to the sale of property that satisfies the definition of inventory property contained in section 865(h)(1). In general, inventory property would be personal property sold in the normal course of a taxpayer's business.

The second exception to the residence-of-the-seller rule applies to sales of depreciable personal property. The rules governing the source of income from such sales are presented below in section 13.02.3. Section 13.02.4 presents the rules governing the source of income derived from the sale of intangible property. The source rules applicable to the sale of stock in a corporation are described in section 13.02.5. That section explains the special source rule applicable to certain sales by U.S. corporations of stock in affiliated foreign corporations.

Special source rules, which may override the source rules based upon the type of property sold, apply to sales of property made through a U.S. or foreign office (or other fixed place of business). The office source rule is described in section 13.02.6. A major purpose of that rule is to tax foreign persons on their income derived from importing goods into the United States through a U.S. office.

Gains and losses arising from a transaction in foreign currency are not governed by Code section 865, even if the transaction giving rise to a gain or loss arose from the sale of inventory property. For discussion of the source of income from currency exchange transactions, see section 14.06, below. Ordinary income derived from the sale of section 1248 stock (stock in a CFC or former CFC) has its source determined under the dividend source rules rather than under the personal property source rules. The source rules applicable to dividend income are described in section 12.02, above.

Although the Code characterizes the residence-of-the-seller rule as the general rule for sales of personal property, the residual situations in which that rule actually applies are few. With some exceptions under the office source rule, the residence-of-the-seller rule would apply to income derived from the sale of investment assets, such as stocks, bonds, gold coins, and works of art. It also would apply to income from the sale of patents, copyrights, and other intangibles, to the extent that the income from those intangibles is not contingent on their productivity, use, or disposition and is not inventory property or depreciable personal property subject to the recapture rule.

The tax authorities are authorized to issue regulations that would specify the source rules applicable to gains and losses from trading in futures contacts, forward contracts, option contracts, and similar property.[77] The residual rule is likely to apply to at least some of those transactions.

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[76] See Int'l Multifoods Corp., v. Comm'r, 108 T.C. 579 (1997) (holding that losses on sale of stock were U.S. losses under the residence-of-seller rule of IRC § 865(a)).

[77] See IRC § 865(j)(2), authorizing such regulations.

§ 13.02.2. Inventory Property

Code section 865(b) provides that the source of income derived from the purchase and sale of inventory property shall be determined under the source rules of sections 861(a)(6) and 862(a)(6). Under those sections, income from the purchase and sale of inventory property has its source in the country where the goods are deemed to have been sold. Treasury regulations and a long line of court cases hold that the place of sale is generally the place where title to the goods has passed to the buyer.[78]

Before the enactment of the 1986 tax act, the passage-of-title test determined the source of income from all sales of personal property. Changes made by the 1986 tax act generally limit the passage-of-title test to sales of certain inventory property. Congress was aware that taxpayers typically can make title pass wherever they want, assuming they are willing and able to satisfy certain formal requirements.[79] The decision was made to retain the passage-of-title test for inventory property, nevertheless, because of a Congressional fear that its elimination for inventory property would have a negative impact on U.S. exports.[80]

The place-of-sale rule of Code sections 861(a)(6) and 862(a)(6) does not apply to inventory property imported into the United States by nonresident taxpayers through a U.S. office or other fixed place of business. Under the office source rule, the income generated by such sales produces U.S. source income.[81] The office source rule is explained below in section 2.2.6. Inventory property imported into the United States by a U.S. resident produces foreign source income as long as title to the property is passed outside the United States. That result cannot be justified by the policy goal of encouraging exports. Income from the sale of unprocessed timber that is a softwood and was cut from a U.S. forest is U.S. source income without reference to where title to the softwood passes.[82] The intent of the rule, adopted by the 1993 tax act, is to remove an incentive to process logs abroad.

[78] Reg. § 1.861-7(c) (1960). See, e.g., A. P. Green Export Co. v. U.S., 284 F.2d 383 (Ct. Cl. 1960). For a case upholding the passage-of-title test in a tax-motivated transaction, see Liggett Group, Inc. v. Comm'r, TC Memo 1990-18, 58 T.M.C. 1167 (1990), nonacq., AOD No. 1991-03 (April 3, 1991). The taxpayer failed in an attempt to avoid the passage-of-title result in Hunt v. Comm'r, 90 T.C. 1289 (1988).

[79] There are some limits. Reg. § 1.861-7(c) (1960) provides that passage of title, can be ignored "[w]here bare legal title is retained by the seller" or where a transaction "is arranged in a particular manner for the primary purpose of tax avoidance." The courts, however, have rarely prevented taxpayers from using the passage-of-title test for tax avoidance purposes. But see U.S. Gypsum Co. v. U.S., 304 F. Supp. 627 (1969), aff'd in part, rev'd in part, and remanded, 452 F.2d 445 (7th Cir. 1971) (holding that a corporation owning gypsum rock under the passage-of-title test for the period it took for the rock to fall from a conveyor belt into a barge was not engaged in an active trade or business).

[80] See General Explanation of the Tax Reform Act of 1986 (1987) at 918. Although Congress might have designed a more efficient export incentive, it found retention of the passage-of-title test to be appealing because the United States is generally prohibited under the General Agreement on Tariffs and Trade (GATT) from enacting new tax incentives for exports. Because of doubts about the wisdom of its action, Congress directed the Treasury Department to prepare a report on the consequences of retaining the passage-of-title test. That report estimated the revenue cost of the passage-of-title test at $2.1 billion for 1990. U.S. Department of the Treasury, Report to the Congress on the Sales Source Rules (1993). A subsequent unofficial report reduced the revenue loss estimate to around $800 million. See Donald J. Rousslang, "The Sales Source Rules for U.S. Exports: How Much Do They Cost?," 8 Tax Notes Int'l 7 527-535 (Feb. 21, 1994). The special source rules have substantial positive effects on foreign trade for some U.S. companies. As should be expected, however, they were found to have no significant impact on net trade flows and to have a negative impact on U.S. welfare.

[81] Nonresidents who import inventory property into the United States without the use of a U.S. office could generate foreign source income by having title to the property pass outside the United States. By generating foreign source income on such sales, a nonresident otherwise engaged in business in the United States would avoid taxation under the force-of-attraction rule of IRC § 864(c)(3).

[82] IRC § 865(b)(2) (last two sentences).

Inventory property, for purposes of the source rules, is personal property excluded from the definition of a capital asset under Code section 1221(a)(1).[83] That is, it is property, other than real property, that is "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[84] The courts have interpreted this language to refer to stocks and bonds held by a dealer but not by a trader or by an investor.

Most inventory property is personal property that was either purchased by the taxpayer for resale or produced by the taxpayer for resale. It would include depreciable property and intangible property held for sale to customers. The source rules for inventory property are subordinate, however, to the special source rules applicable to depreciable property and intangible property. Those special rules are discussed below in sections 13.02.3 and 13.02.4. The rules governing the source of income derived from the production and sale of inventory property are discussed in section 13.03.

§ 13.02.3. Depreciable Personal Property

Income derived from the sale of depreciable personal property is subject to a recapture rule. The recapture rule applies to gain derived from the sale of depreciable personal property, to the extent of prior depreciation deductions taken with respect to that property. Depreciation, for recapture purposes, includes any capital recovery allowance that was allowed as a deductible expense against taxable income.[85] Gains from the sale of intangible property, to the extent that they represent recapture of amortization deductions, are sourced under the recapture rule.[86]

The source of income derived from the sale of depreciable property in excess of prior depreciation deductions generally is determined as if the depreciable property were inventory property.[87] That is, the country of source is the country where the sale is deemed to have taken place under the passage-of-title test.[88]

Under the recapture rule, gain subject to recapture generally has its source in the country of source of the income against which the prior depreciation deductions were taken.[89] The recapture gain will be allocated between U.S. and foreign sources if depreciation deductions have been taken against both U.S. source income and foreign source income.[90] Thus a taxpayer that has taken a depreciation deduction against

[83] IRC § 865(i)(1).

[84] IRC § 1221(a)(1). The legal significance of that language has been the subject of extensive litigation. Much of the litigation, however, has been concerned with the characterization of gains from the sale of real property. Real property is not inventory property because it is not personal property.

[85] See IRC § 865(c)(4)(C). IRC § 865(c)(3)(A) describes the amount to be recaptured on the sale of depreciable property as "the portion of the depreciation adjustments to the adjusted basis of the property which are attributed to the depreciation deductions *allowable* in computing taxable income from sources in the United States." (Emphasis added.) That language should be interpreted as follows: First, the taxpayer determines the actual adjustment to its adjusted basis (that is, the amount allowed). Second, the taxpayer computes the portion of that allowed amount to be recaptured. That portion is the amount of the deduction that was allocable to U.S. source gross income under the principles of Reg. § 1.861-8 — that is, the amount *allowable* under the applicable source of deduction rules. Cf. IRC § 1245(a)(2)(B).

[86] IRC § 865(d)(4)(A) (as amended by TAMRA (1988). On contingent sales, all payments are treated as recapture income until prior amortization deductions have been fully recaptured.

[87] IRC § 865(c)(2). The source of gain from the sale of intangible property in excess of the recapture amount is determined under the source rules applicable to the sale of intangibles. IRC § 865(d)(4)(B).

[88] The source of income from the purchase and resale of inventory property is discussed in section 13.02.2, above.

[89] IRC § 865(c)(i).

[90] Id.

U.S. source income will generally have U.S. source income on the sale of the depreciable property with respect to which the depreciation deduction was taken, but only to the extent that the gain represents a recapture of depreciation deductions previously taken against U.S. source income.[91] Gain on the sale of depreciable personal property will generate foreign source income to the extent that the depreciation deductions were taken against foreign source income.[92] The operation of the depreciation recapture rule is illustrated by the following example.

Example 13.1: Depreciation Recapture Source Rule

> *X is a U.S. corporation engaged in the manufacture and sale of widgets in the United States and in Country B. During year 1, X has gross income of $600 derived from the manufacture and sale of its widgets. Of that gross income, $400 is sourced in the United States and the remaining $200 is sourced in Country B. It has no other gross income for the year.*
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> *At the beginning of year 1, X purchased a widget machine for $1,000. It properly took a deduction of $150 for depreciation on the widget machine, chargeable to inventory as a cost of goods sold. The depreciation deduction reduced U.S. source income by $100 and reduced foreign source income by $50.*
>
> *In year 2, X sold the widget machine for $1,200. Its gain from the sale is $350, computed by deducting the adjusted basis of the machine ($1,000 minus $150) from the proceeds of the sale ($1,200). The part of the gain derived from the sale of the widget machine for an amount in excess of its original basis ($200) is not subject to the depreciation recapture rule. That part of the gain is source as if it were derived from the sale of inventory property. The country of source of inventory is the place of sale, determined under the passage-of-title test.*
>
> *The remaining gain of $150 is subject to the depreciation recapture rule. Under that rule, the source of gain is determined by reference to the source of the income against which the depreciation deduction was taken. Because $100 of the depreciation deduction reduced U.S. source income, that amount of the gain is sourced in the United States. The $50 of gain that reduced foreign source income is sourced outside the United States.*

An exception to the general recapture rule applies to simplify its operation in the case of depreciable property used predominantly within or without the United States. Under the exception, the entire gain subject to recapture is attributed to the country of predominant use. Thus gain subject to recapture that is used predominantly within the United States will be characterized as U.S. source income. Similarly, the recapture gain will be foreign source income if the property giving rise to the gain was used predominantly outside the United States. This exception does not apply to gain from the sale of certain vehicles and other transportation and communications equipment described in Code section 168(g)(4).[93]

The depreciation recapture rule takes precedence over the office source rule in the case of sales of depreciable property made by U.S. residents.[94] It is subordinate to the office source rule in the case of sales made by nonresidents.[95]

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[91] IRC § 865(c)(1)(A).

[92] IRC § 865(c)(1)(B).

[93] IRC § 865(c)(3)(B).

[94] IRC § 865(e)(1)(A).

[95] IRC § 865(e)(2).

§ 13.02.4. Intangible Property

The source of income from the sale of intangible property depends upon whether or not payments received with respect to the property are contingent upon its productivity, use, or disposition. Contingent payments are treated as royalties for purposes of the source rules. They have their source in the country where the intangible property is used.[96] Other income from the sale of intangible property generally has its source in the country of the residence of the seller. That is, the general rule of Code section 865(a) is applicable. Intangible property is defined as "any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property."[97]

A special source rule applies to sales of goodwill. Payments for goodwill that are not contingent upon productivity, use, or disposition have their source in the country where the goodwill was generated.[98] The exception for goodwill does not apply when the sale of the goodwill is inherent in the sale of trademarks, franchises, or other intangible property governed by the general rule.[99]

The source rules for intangible property are subordinate to the depreciation recapture rule of Code section 865(c)(1). Gain attributed to amortization deductions taken with respect to intangible property is allocated between U.S. and foreign sources under the recapture rule, and only the gain in excess of the recapture amount is subject to the source rules for intangibles described above.

The intangible property source rules are subordinate to the office source rule in the case of payments received by nonresidents. They are also subordinate to the office source rule in the case of noncontingent payments received by U.S. residents, other than payments for goodwill. They take priority over the office source rule in the case of contingent payments and payments for goodwill received by U.S. residents.[100]

§ 13.02.5. Corporate Stock

Income derived from the sale of stock generally would have its source in the country of residence of the seller.[101] Thus sales of stock by a U.S. resident generally would produce U.S. source income. An exception to the residence-of the-seller rule applies to the sale by a domestic corporation of stock in certain foreign affiliated corporations. The residence-of-the-seller rule may also be inapplicable because of a U.S. treaty obligation.[102]

The exception for sales of affiliate stock, contained in Code section 865(f), provides domestic corporations with a place-of-sale source rule for sales of stock of certain foreign affiliates. An affiliate is

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[96] For discussion of the source of royalty payments, see section 1.3, above.

[97] IRC § 865(d)(2). A treaty source rule would prevail over the Code rule, but taxpayers electing the treaty rule are subject to a special limitation on the foreign tax credit. IRC § 865(h).

[98] IRC § 865(d)(3).

[99] Int'l Multifoods Corp. v. Comm'r, 108 T.C. 25 (1997) (holding that the entire gain from sale of Asian rights to "Mr. Donut" franchise agreements, trademarks, system of preparing and merchandising donuts, and exclusive right to secret formulas and processes was U.S. source income under residence-of-the-seller rule, notwithstanding taxpayer claim that some portion of the sale represented foreign goodwill).

[100] See IRC § 865(d)(1)(A) and (2). See IRC § 865(e)(1)(A).

[101] Stock sold by a trader might qualify as inventory property, and the source of income from its sale would be determined under the place-of-sale rule of IRC §§ 861(a)(6) and 862(a)(6), subject to the exception to the inventory source rules for sales made through a U.S. office.

[102] Under IRC § 865(h), as amended by the 1988 tax act, a U.S. taxpayer that invokes a tax treaty to convert what would be U.S. source income under the residence-of-the-seller rule into foreign source income is subject to a special limitation on the foreign tax credit with respect to such income.

defined as a member of a chain of related corporations that satisfy the common ownership requirements for filing consolidated returns.[103] To satisfy those requirements, the domestic corporation must own 80 percent or more of the stock of the affiliate, measured by voting power and value.[104]

Three conditions must be met for the affiliated-stock exception to apply. First, the affiliate must be engaged in the active conduct of a trade or business. Second, the sale of stock must have been made in the foreign country where the affiliate is engaged in that active business.[105] Third, more than 50 percent of the gross income of the affiliate must have been derived from that active business during a three-year testing period.[106] In determining whether these conditions have been met, the income of an affiliate may be consolidated with the income of its wholly owned foreign subsidiaries, at the election of its U.S. parent corporation.[107]

A U.S. corporation realizing income from the sale of stock in an affiliated corporation may benefit from the conversion of what would otherwise be U.S. source income into foreign source income because of the rule governing the foreign tax credit. If the U.S. corporation has excess foreign tax credits in its general limitation basket and the sale of stock would result in general limitation income, then the excess credits can be used to reduce the U.S. tax otherwise imposed on the gain from the sale of the affiliated stock. It is at best unclear under the Code, however, when the foreign source income derived from the sale of affiliated stock would be placed in the general limitation basket. Under a literal reading, the income would be placed in the passive basket.

In general, gain from the sale of an asset that produces passive income is characterized as passive income.[108] A dividend is a prime example of passive income.[109] Dividends from an affiliated corporation generally are not treated as passive income for purposes of computing the limitation on the credit under the look-through rules of Code section 904(d)(3). The look-though rules, however, are not applicable in determining whether a foreign affiliate has passive income. The clear implication of the affiliated stock exception is to provide a tax benefit to its U.S. shareholders. Exactly how that benefit is obtained under the Code may have to be resolved by regulation or by the courts.

§ 13.02.6. Sales Through a U.S. or Foreign Office

Code section 865(e) provides an exception to the otherwise applicable source rules for certain sales income attributable to an office or other fixed place of business. This office source rule, when applicable, provides that income from the sale of property that is attributable to an office (or other fixed place of business) has its source in the country where the office is located. The applicability of the office source rule depends on the residence of the seller and the type of personal property being sold.

As applied to nonresidents, the office source rule favors the tax collector because it converts what would be foreign source income, under the place-of-sale rule or the residence-of-the-seller rule, into U.S.

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[103] IRC § 865(i)(4). The taxpayer may elect to treat an affiliate, and corporations wholly owned, directly or indirectly, by that affiliate, as one corporation. IRC § 865(f) (last sentence).

[104] See IRC § 1504(a) (defining affiliated group).

[105] IRC § 865(f)(2).

[106] IRC § 865(f)(3).

[107] IRC § 865(f) (last clause).

[108] See IRC § 904(d)(2)(A)(i), incorporating by reference the definition of FPHC income contained in IRC § 954(c)(1)(B)(i).

[109] IRC § 954(c)(1)(A).

source income. As applied to U.S. residents, the office source rule favors the taxpayer, by converting what would be U.S. source income under the residence-of-the-seller rule into foreign source income.

Nonresidents having an office or other fixed place of business in the United States are generally subject to the office source rule on income derived from the sale of personal property that is attributable to their U.S. office or other fixed place of business in the United States.[110] That is, income of a nonresident attributable to a U.S. office generally is U.S. source income.

A sale of inventory property through a U.S. office, for example, generally would produce U.S. source income under the office source rule, notwithstanding the fact that title to the property sold was passed outside the United States. Similarly, income from intangible property would be U.S. source income if the intangible property is sold through a U.S. office. But for the office source rule, the income would be foreign source income under the residence-of-the-seller rule.

An exception to the office source rule is provided for nonresidents selling inventory property for use, disposition, or consumption outside the United States, but only if an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale of that property.[111] This foreign office exception does not apply to property other than inventory property.

Prior to the adoption of the office source rule in 1986, some income earned by nonresidents through a U.S. office would have been subject to tax by the United States as foreign source income effectively connected with a U.S. trade or business.[112] Congress believed, however, that the office source rule was needed because some foreign taxpayers were able to avoid taxation under the effectively connected rule by invoking the protection of a tax treaty or by manipulating the place-of-sale rule.[113]

U.S. residents having an office or fixed place of business outside the United States benefit from the office source rule on the sale of certain property.[114] The office source rule does not apply to a U.S. resident on income from the sale of personal property that has its source determined under Code section 865(b), (c), (d)(1)(B), (d)(3), or (f). That is, income received by a U.S. resident from the sale of inventory property, income subject to the depreciation recapture rule, contingent income from intangible property, income from the sale of goodwill, and income from the sale of stock in certain affiliated foreign corporations are not subject to the office source rule. The office source rule would apply, however, to most sales of stocks and bonds and other investment assets.

The office source rule generally does not apply to a sale of property by a U.S. resident unless the income from the sale has been subjected to a foreign income tax of at least 10 percent.[115] This exception prevents U.S. residents having an office in a tax haven jurisdiction from generating foreign source income by

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[110] IRC § 865(e)(2)(A). An exception applies for purposes of defining an export trade corporation under IRC § 971.

[111] IRC § 865(e)(2)(B).

[112] That rule was repealed by the 1986 tax act. It was reinstated by TAMRA, 1988, to prevent foreign persons who are treated as U.S. residents under the source rules from escaping tax on the sale of inventory property. See IRC § 864(c)(4)(B)(iii).

[113] General Explanation of the Tax Reform Act of 1986 (1987) at 918-919. Residents of France, for example, were only taxable on U.S. source income from the sale of property under Art. 22(2)(b) of the old U.S./France treaty (1967). The problem was corrected when the U.S./France treaty was modified in 1995.

[114] IRC § 865(e)(1)(A).

[115] IRC § 865(e)(1)(B). Special rules apply to benefit U.S. possessions.

shifting their sales income to that tax haven. It is similar in operation to the 10-percent rule applicable in defining a U.S. resident for purposes of the personal property source rules.[116]

The office source rule incorporates by reference the provisions of Code section 864(c)(5) (relating to the definition of foreign source income effectively connected with a trade or business) for determining whether a taxpayer has a fixed place of business and whether income is attributable to that fixed place of business.[117]

§ 13.02.7. Special Residency Rules

For purposes of the source rules applicable to sales of personal property, a special definition of residence is provided by Code section 865(g). Under that definition, domestic corporations — that is, corporations created or organized in the United States — are generally U.S. residents, as are domestic trusts and estates.[118]Foreign corporations, foreign trusts, and foreign estates are nonresidents.[119] The source of partnership income generally is determined by reference to the residence of the partner to which the income is attributed.[120]

An individual generally is a resident of the country where his tax home is located. The term "tax home" is defined by case law to be a geographical area at or near a taxpayer's primary place of business or duty post.[121] U.S. citizens and resident aliens are U.S. residents for source rule purposes unless they have a tax home in a foreign country. Thus U.S. citizens and residents having no tax home or having a tax home on the high seas are U.S. residents under the source rules.

An exception to the tax home rule provides that a U.S. citizen or resident alien having a foreign tax home will be considered to be a U.S. resident for the purpose of determining the source of income derived from the sale of an item of personal property unless the gain from the sale of that property has been subjected to a 10-percent or higher foreign income tax.[122] This exception generally prevents U.S. citizens and resident aliens living outside the United States from having foreign source income under the residence-of-the-seller source rule with respect to sales of property made in a tax haven jurisdiction.[123] An exception to the exception allows bona fide residents of Puerto Rico to take advantage of the residence-of-the-seller rule with respect to sales of stock in certain corporations engaged in the active conduct of a trade or business in Puerto Rico.[124]

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[116] See IRC § 865(g)(2).

[117] IRC § 865(e)(3). In general, an office must be a material factor in the production of an item of income for that income to be attributed to the office.

[118] IRC § 865(g)(1)(A)(ii).

[119] IRC § 865(g)(1)(B).

[120] IRC § 865(i)(5).

[121] IRC § 865(g)(1)(A)(i) provides that the term tax home, for purposes of the source rules, is defined by IRC § 911(d)(3) (providing an exemption for certain foreign source earned income of U.S. citizens having a foreign tax home). That latter provision refers to the definition of "tax home" developed in the case law under IRC § 162(a)(2) (relating to the deduction for expenses while traveling away from home). The concept of the taxpayer's tax home has been developed, but without precision, by a series of court cases. The leading case is Flowers v. Comm'r, 326 U.S. 465 (1945).

[122] IRC § 865(g)(2).

[123] Without this rule, U.S. taxpayers having excess foreign tax credits could inflate the limitation on the credit and thereby obtain the income from the tax haven sales free of U.S. tax.

[124] See IRC § 865(g)(3). Regulatory authority is given to the Service to waive the 10-percent rule for the benefit of a possessions corporations. See IRC § 865(j)(3).

§ 13.03. Sale of Inventory Property Produced by the Seller

Gross income from the sale of inventory property produced by the seller is generally treated as derived partly in the country of production and partly in the country of sale.[125] Property produced by the seller includes property that the seller has "created, fabricated, manufactured, extracted, processed, cured, or aged."[126] Income derived from the extraction or production of natural resources is not treated as income from the sale of inventory property.

Inventory property that is produced and sold within the same country has its source in that country. The problems of apportionment arise with respect to income from inventory property that a taxpayer produces within the United States and sells outside the United States or produces outside the United States and sells within the United States. The regulations initially issued in 1996 (the "1996 regulations") refer to these cross-border sales of inventory property as "section 863 sales." Income derived from a section 863 sale is partly U.S. source income and partly foreign source income.

Section 13.03.1, below, describes the rules of general application in determining the source of income from section 863 sales. Section 13.03.2 describes the three alternative methods for allocating income from section 863 sales between income from production activities and income from sales activities. The rules for linking income from production activities with assets located within and without the United States are described in § 13.03.3. The rules mentioned above do not apply to income derived from space and certain ocean activities.

§ 13.03.1. General Rules

The source of taxable income derived from section 863 sales is determined in three steps. Each of those steps is described below.

Step One.

In *step one*, the taxpayer determines its gross income from the production and sale of section 863 property and apportions that income between gross income from production activities and gross income from sales activities. One of the three apportionment methods described below must be applied in determining gross income from production activities and gross income from sales activities.

In most cases, U.S. taxpayers can be expected to use the 50/50 method. Under that method, one half of the income from section 863 sales is apportioned to production activity and the other half to sales activity. By electing the 50/50 method, U.S. taxpayers producing goods within the United States and selling them abroad can allocate 50 percent of their income to foreign sources even if their sales activities abroad are minimal.

The two other permissible methods are the independent factory price (IFP) method and the books-of-account method. Taxpayers importing goods into the United States may wish to elect the IFP method if they can show through sales to third parties that most of their profits come from production activities rather than sales activities. The books-of-account method may be elected only with the consent of the tax authorities and is rarely (if ever) used.

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[125] IRC § 863(a). A special source rule applies for income derived in part from the sale or production of inventory property within a possession of the United States.

[126] Reg. § 1.863-3(a)(2) (2006).

Consider, for example, PC, a U.S. corporation that manufactures beer in Mexico and sells the beer in the United States. It has gross receipts of $100,000. Using the 50/50 method, $50,000 will be treated as derived from the production of beer and the remaining $50,000 from the sale of beer.

For a slightly more complicated example, assume that PCo manufactures beer both in Mexico and the United States and sells the beer in the United States. The portion of the gross income derived from the manufacture of been within the United States and its sales within the United States would not be income from a section 863 sale. All of that income would be allocated to the United States. The 50/50 method would apply only to the income derived from manufacturing beer in Mexico and selling it in the United States.

Whichever method the taxpayer elects to use for apportioning income from section 863 sales between income from production activities and income from sales activities, it must apply the method separately for section 863 sales in the United States and section 863 sales outside the United States. Assume, for example, that PCo, a U.S. corporation, produces beer in Mexico and the United States and sells some beer in the United States and sells the rest in foreign countries. PCo must apportion its gross income from beer sales in the United States between income from production activities outside the United States and income from sales activities within the United States using an approved method. It must then apply that same method to apportion gross income from beer sales derived from production in the United States and sale outside the United States.

Income derived from production within the United States and sale within the United States would not be derived from a section 863 sale, nor would income derived from production outside the United States and sale outside the United States. The gross income from those activities would be allocated directly to the place of production and sale, and the 50/50 method would not be applied.

Step Two.

In *step two*, the taxpayer must determine the source of its gross income from production activities and sales activities.[127] Gross income from sales activities generally is determined under the passage-of-title test.[128] That is, the place of sale is the place where title to the goods passes to the buyer. An anti-abuse rule provides that sales income derived from the sale of goods produced in the United States and sold in the United States under a destination test is U.S. source income, even if title to the goods passes outside the United States.[129] The taxpayer cannot avoid this anti-abuse rule by engaging in packaging, repackaging, labeling, or minor assembly operations outside the United States.[130] Under the destination test, a sale is attributed to the United States if the property is sold for use, consumption, or disposition in the United States.[131]

The use of a passage-of-title test for sales outside the United States is consistent with prior law. Its application to sales within the United States through a U.S. office conflicts, however, with the office source rule of Code section 865(e)(2)(A). That rule, discussed in section 13.02.6, above, provides that income derived by foreign persons from the sale of inventory property through a U.S. office has its source in the

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[127] Reg. § 1.863-3(a)(1) (2006).

[128] Reg. § 1.863-3(c)(2) (2006).

[129] Id.

[130] Id.

[131] Id. See Reg. § 1.864-6(b)(3)(ii) (1972) for rules used to determine the country of destination.

United States. On its face, the U.S. office source rule makes no distinction between inventory property purchased by the seller and inventory property produced by the seller.[132]

If all of the taxpayer's production activities took place in one country, then the gross income from production activities has its source in that country.[133] An apportionment formula is used when production took place in more than one country. Under that formula, the gross income from production activities apportioned to the United States is determined by multiplying total gross income from production activities by a fraction. The numerator of that fraction is the average adjusted basis of production assets that are located outside the United States, and the denominator is the average adjusted basis of all production assets located within or without the United States.[134] Rules defining production assets and determining their location are set forth below.

Consider, for example, PCo a beer manufacturer with a plant in Mexico and in the United States. Its gross receipts from the sale of beer is $100,000, of which $40,000 are in the United States under the passage of title test.. PCo's production assets in Mexico have an adjusted basis of $300,000. The average adjusted basis for its production assets located in the United States is $100,000. Under *step one*, using the 50/50 method, PCo must determine its income from production sales activities separately for U.S. sales and foreign sales. Applying *step one* to U.S. sales, PCo has $20,000 from production activities and $20,000 from U.S. sales activities. Again applying *step one*, PCo has $30,000 from foreign sales activities and the same amount for production activities relating to foreign sales.

PCo now must apply *step two* to determine its U.S. source and foreign source gross income from the production and sale of beer. Under *step one*, PCo has gross income of $50,000 ($20,000 + $30,000) from production activities in the United States and Mexico. That amount is apportioned between U.S. and Mexican sources by formula. The amount treated as foreign source income from production activities will be $37,500, determined by multiplying the total gross sales by a fraction, the numerator of which is the adjusted basis of foreign assets and the denominator is total adjusted bases of production assets ($50,000 × $300,000/$400,000). The gross income of $50,000 from sales activities is apportioned using the passage of title test. Assuming title to the beer passed in the place the beer was sold, PCo has U.S. source income of $20,000 from sales activities and $30,000 of foreign source gross income from those activities.

Step Three.

In *step three*, the gross income amounts determined under *step one* and *step two* are reduced to taxable income. The general rule, applicable to taxpayers using the IFP method and books-of-account method, is that deductions are allocated to items of gross income in accordance with the generally applicable source of deduction rules.[135] In general, those rules match deductions with gross income based on the factual relationship between them. For example, the costs that a company running a hotel incurs in cleaning the lobby of the hotel typically would be linked to the gross income generated by the hotel.

For taxpayers electing the 50/50 method, most deductions relating to section 863 sales are allocated pro rata between U.S. source gross income and foreign source gross income, as determined under the 50/50

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[132] Foreign source income derived by a foreign taxpayer from the sale of inventory property through a U.S. office generally would constitute foreign source effectively connected income under IRC § 864(c)(4)(B)(iii). One purpose of the office source rule was to reduce the significance of the foreign effectively connected rules. The override of the U.S. office rule by Reg. § 1.863-3(c)(2) (2006) has increased its significance.

[133] Reg. § 1.863-3(c)(1)(i) (1998).

[134] Reg. § 1.863-3(c)(1)(ii)(A) (2006).

[135] Reg. § 1.863-3(d) (2006).

method.[136] The one exception is for deductions for research and experimental costs. Taxpayers apportion those deductions in accordance with Treasury regulation section 1.861-17.[137] This treatment is favorable to U.S. taxpayers because the R&E regulations apportion a liberal portion of R&E deductions to U.S. source gross income.

Prior to changes in the regulations made in 1988, the old 50/50 formula explicitly apportioned taxable income rather than gross income. That is, gross income was reduced to taxable income before application of the formula. This treatment is in accord with Code section 863(b), which permits the tax authorities, by regulation, to apply formulas to determine the portion of *taxable income* attributable to U.S. sources. The 1988 change preserved the old rule in substance by applying the formula to gross income but then allocating deductions pro rata to gross income. The advantage of the 1988 change was that it allowed taxpayers to determine the source of their gross income from section 863 sales, which they may need to know to apply various other Code provisions.

The regulations adopted in 1996 continue to require a pro rata allocation of deductions, with the major exception for R&E deductions discussed above. The feature of the 1996 regulations allowing a separate deduction for R&E costs would appear to have no statutory basis.

The following example illustrates the operation of the three steps described above. Additional aspects of the apportionment rules applicable to the production and sale of inventory property are addressed below.

Example 13.2: Production and Sale of Inventory Property

PCo, a U.S. corporation, produces wheelbarrows in Michigan at a cost of $50 and sells them to customers in Canada for $80. Title to the wheelbarrows passes in Canada at the time of sale. PCo's gross income from the production and sale of wheelbarrows is $30 ($80 – $50). PCo incurs $10 of selling expenses associated with the sale of wheelbarrows in Canada.

Step One. *PCo must apportion its gross income between income from production activities and income from sales activities. Assuming that PCo elects the 50/50 method, then one half of the gross income of $30 is allocated to production activities and the remaining $15 is allocated to sales activities.*

Step Two. *PCo must determine the source of its gross income. Because all of PCo's production activities took place in the United States, all of its gross income from those activities is U.S. source income. The income derived from sales activities is determined under the passage-of-title test. Under that test, the sales income is sourced outside the United States because title to the goods sold passed in Canada.*

Step Three. *PCo must reduce its gross income in each category to taxable income. Its only deductible amount is the $10 of sales income incurred in Canada. Because PCo elected to use the 50/50 method, that amount is allocated ratably between U.S. and foreign sources. As a result, PCo has U.S. source taxable income of $10 ($15 – ($10 × $15/$30)) and foreign source taxable income in the same amount. The fact that the $10 of expenses can be linked factually to foreign activities is irrelevant under the regulations as long at the 50/50 method is employed.*

[136] Id. For discussion of the allocation and apportionment of research and experimental costs, see section 15.03, below.

[137] Id.

§ 13.03.2. Apportionment Methods

Income derived from the production and sale of inventory property is allocated between production activities and sales activities according to three alternative methods of apportionment. Those methods are (1) the 50/50 method, (2) the independent factory price (IFP) method, and (3) the books-of-account method. The 50/50 method is the default method. It applies unless the taxpayer elects to apply the IFP method or, with the consent of the tax authorities, elects to apply the books-of-account method.

§ 13.03.2.1. The 50/50 Method

The 50/50 method apportions 50 percent of the gross income from section 863 sales to production activities and the remaining 50 percent to sales activities.[138] For example, PCo, a U.S. corporation, produces widgets in the United States and sells them in Country D to DCo, an independent distributor, for $100. Its cost of goods sold is $40, and its gross income is $60 ($100 – $40). Under the 50/50 method, $30 is apportioned to income from production activities and the remaining $30 is apportioned to income from sales activities.[139] A more detailed example illustrating the operation of the 50/50 method is presented below. As the example indicates, only the income from section 863 sales is governed by the formula.

Example 13.3: 50/50 Method

MCo is a U.S. company engaged in the manufacture of spark plugs in Michigan, U.S.A.. The spark plugs are sold within and without the United States. MCo has gross receipts from the sale of spark plugs of $6,000. Under the passage-of-title test, $2,000 of those receipts are treated as amounts derived from sales made in the United States and $4,000 from Canadian sales. MCo's cost of goods sold is $3,000. MCo has an allowable deduction for shipment of spark plugs to Canada of $500. Thus MCo has worldwide taxable income of $2,500 ($6,000 – $3.000 – $500). MCo has not made an election to use a particular apportionment method. As a result, it uses the favorable 50/50 method. Under these conditions, MCo has U.S. source taxable income of $1,750 and foreign source taxable income of $750, calculated as follows.

(1) MCo's gross income from sales of spark plugs ($6,000 gross receipts – $3,000 cost of goods sold) $3,000

(2) MCo's U.S. source gross income attributable to production of goods within the United States and sold within the United States (line (1) × ($2,000 U.S. gross receipts/$6,000 worldwide gross receipts)) 1,000

(3) Gross income from section 863 sales (line (1) – line (2)) 2,000

(4) Gross income from section 863 sales attributed to production activities under the 50/50 method (line (3) × ½) 1,000

(5) Percentage of U.S. production assets to total production assets 100%

(6) Gross income from section 863 sales attributed to production activities that is apportioned to the United States (line (4) × (line (5)) 1,000

(7) Gross income from section 863 sales apportioned to sales activities (½ × (line (3)) 1,000

(8) Percentage of section 863 sales apportioned to the U.S. 0%

[138] Reg. § 1.863-3(b)(1)(i) (2006).

[139] Reg. § 1.863-3(b)(1)(ii) (2006).

(9) *Gross income from section 863 sales attributed to sales activities that is apportioned to the United States (line (7) × (line (8))* 0

(10) *Total gross income from section 863 sales apportioned to the United States (line (6) + line (9))* 1,000

(11) *Total gross income apportioned to the United States (line (2) + line (10)* 2,000

(12) *MCo's allowable deductions for the cost of shipping spark plugs to Canada (from statement of facts)* 500

(13) *Deduction allowable in computing U.S. source taxable income from section 863 sales (line (12) × line (10)/line (3))* 250

(14) *Deduction allowable in computing foreign source taxable income from section 863 sales (line (12) ×(line (3) – line (10))/line (3))* 250

(15) *Total taxable income apportioned to the United States (line (11) – line (13))* $1,750

(16) *Total taxable income apportioned to foreign countries (line (3) – line (10) – (line (14))* $750

In the above example, the income generated by the taxpayer from the production and sale of assets in the United States was separated out from the income generated by section 863 sales and treated as U.S. source income. The taxable income of $1,500 generated from section 863 sales was split 50/50 between domestic and foreign sources. Note that the expense for shipping to Canada was apportioned pro rata between domestic and foreign sources even though it actually related only to foreign sales. The reason is that, under the Code, the apportionment is supposed to be made with respect to taxable income. Apportionment of gross income under the 50/50 formula followed by pro rata apportionment of the related deductions is equivalent to 50/50 apportionment of taxable income. None of the amount spent for shipments to Canada was apportioned to the sales made within the United States because those sales were not section 863 sales and were not apportioned under the 50/50 method.

A U.S. manufacturer making foreign sales to unrelated persons often may be able to increase the percentage of income characterized as foreign source income by inserting a related corporation between the U.S. manufacturer and the ultimate unrelated foreign purchasers. The following example illustrates a common arrangement.

Assume that PCo manufactures widgets in the United States at a cost of $50 and sells them abroad to unrelated persons for $150, producing gross income of $100. Under the 50/50 method, PCo has income from production activities of $50 and income from sales activities of $50. To obtain a more favorable result, PCo establishes HCo as a wholly owned foreign subsidiary. PCo sells the widgets to HCo at an arm's-length price of $100 per widget, with title to the widgets passing outside the United States. HCo resells the widgets at $150 each to unrelated persons through its foreign branch.

Under this modified arrangement, P would apply the 50/50 formula to characterize $25 of its $50 of income per widget as income from production activities and $25 as income from sales activities. The former would be U.S. source income and the latter foreign source income. All $50 of HCo's income would be characterized as foreign source income on the ground that it arose from the purchase and sale of inventory property outside the United States.[140] Thus $75 ($25 + $50) of the income from the manufacture and sale of a widget by PC and its related company would be characterized as foreign source income.

Tax-avoidance arrangements of the type illustrated above can be successful as long as the intermediary corporation is a foreign corporation that is not permitted to file a consolidated tax return with its U.S. parent. If the intermediary entity is a U.S. corporation, the U.S. tax authorities can attack the arrangement

[140] See IRC § 862(a)(6).

under the consolidated return regulations by applying the 50/50 method on a consolidated basis.[141] For example, if HCo in the above example is a U.S. corporation, the 50/50 method would be applied to the combined income of PCo and HCo, with the result that $50 of the total income of $100 would be characterized as U.S. source income. The attack under the consolidated return regulations generally would not affect sales made by a U.S. manufacturer to a related distributor organized outside the United States because foreign corporations generally are not eligible to file consolidated tax returns.

§ 13.03.2.2. Independent Factory Price Method

The taxpayer may elect to use the independent factory price method if the stringent conditions for its application are met. The basic condition is that the taxpayer "fairly establish" an independent factory price (IFP) for the goods it has produced and sold. The taxpayer may fairly establish that price only by reference to regular sales that it has made "to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity."[142] In addition, a sale to an independent person will not be considered to have established an IFP if the taxpayer's sales activities with respect to that sale are "significant."

The prototypical example of an IFP is a manufacturer that sells intermediate goods to other manufacturers with minimal advertising or other sales activities. Because the sales activities cannot be substantial, most of the profit derived from section 863 sales would be allocated to production activities under the IFP method. Consequently, taxpayers exporting goods produced in the United States rarely would benefit from establishing an independent factory price. The election might be attractive, however, to importers. Indeed, importers might fairly claim a treaty right to use an independent factory price method.[143]

Under the IFP method, the taxpayer is treated as if it has sold its goods for a price equal to the IFP for purposes of apportioning its gross income between production activities and sales activities. The taxpayer's gross income attributable to production activities will be the gross sales receipts, determined using the IFP as the sales price, reduced by the taxpayer's cost of production. The amount attributed to sales activity will be the actual sales proceeds, reduced by the gross sales receipts determined using the IFP.[144]

Assume, for example, that PCo manufacturers 100 widgets at a unit cost of $50 and sells them to consumers for $100. It establishes an IFP for widgets of $90. Under these conditions, PCo will have gross income apportioned to production activities of $4,000 (100 × ($90 – $50)) and gross income apportioned to sales activities of $1,000 (100 × ($100 – $90)).

A taxpayer that elects to use the IFP method must use that method for all section 863 sales of substantially similar inventory goods that are sold under comparable conditions.[145] The conditions are not comparable if they are made in a different geographical region or are not reasonably contemporaneous with the sales establishing the IFP.[146] The election to use an IFP carries over to subsequent taxable years if an IFP can fairly be established, by the taxpayer or the Service, for those subsequent years.[147] For sales to which an IFP does not apply, the taxpayer must apply one of the other two methods.

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[141] Reg. § 1.1502-13(c)(7)(ii)(Ex. 14) (2012).

[142] Reg. § 1.863-3(b)(2)(i) (2006). No reference is made in this regulation to the arm's length standard of IRC § 482. By its terms, the arm's length standard is applicable to sales between related parties, whereas the independent factory price method is concerned with constructive sales between branches of the same entity.

[143] See U.S. Model Treaty (2006), Art. 7(2) (suggesting the use of an arm's length analog in computing the income of a PE). The OECD has been promoting the use of the arm's-length method for transactions between branches of the same company.

[144] Reg. § 1.863-3(b)(2)(ii) (2006).

[145] Id.

[146] Id.

[147] Id.

By making the use of an IFP elective, the 1996 regulations retreat from the positions taken by the tax authorities under the prior regulations. The prior regulations stated that an IFP was to be used if such a price "was established" by sales to wholly independent distributors. Prior to 1988, the common practice of U.S. multinational corporations, apparently unchallenged by the Service, had been to avoid the use of the IFP method by not establishing an independent price. In 1988, the Service issued Rev. Rul. 88-73, holding that it was permitted to establish an independent factory price in some circumstances.[148] Under a broad reading of that ruling, a substantial portion of exports by U.S. manufacturers might have the source of their exports determined under the IFP method.

The controversy engendered by the publication of Rev. Rul. 88-73 was quieted by the subsequent publication of Notice 89-10.[149] Under that notice, the Service repeated that it had authority to establish an IFP if a U.S. manufacturer makes regular sales to independent distributors or other resellers. The notice stated, however, that the IFP method would not be appropriate when the U.S. manufacturer maintained a valuable trade mark with respect to the products sold or engaged in substantial activities, such as advertising, with respect to those products. These and additional qualifications in the notice indicate that the Service has backed off considerably from the position initially suggested in Rev. Rul. 88-73.

The Service did seek to impose an independent factory price on the taxpayer in the first of two *Phillips Petroleum* cases.[150] The taxpayer resisted, arguing that the IFP method was elective to the taxpayer. On that issue, the Tax Court held for the Service. In the second *Phillips Petroleum* case, which was a continuation of the first one, the court held that the requirements for establishing an IFP set forth in the old regulations had not been met.[151] In particular, the court concluded that Phillips Petroleum had not made sales to "wholly independent distributors or other selling concerns" when it made sales of liquified natural gas (LNG) to a wholly independent Japanese utility company that resold the LNG in modified form.

§ 13.03.2.3. Books-of-Account Method

The third apportionment method — the books-of-account method — is rarely discussed in the tax literature, suggesting that its use is uncommon. The taxpayer must apply to the Internal Revenue Service to use this method. According to the Treasury regulations, permission will not be granted unless the taxpayer establishes, to the satisfaction of the tax authorities, that it will employ that method "in good faith and unaffected by considerations of tax liability." The books of account must regularly provide a detailed allocation of receipts and expenditures that "clearly reflects the amount of the taxpayer's income from production and sales activities."[152] The Service may revoke the election if the taxpayer fails to comply with a material condition.

§ 13.03.3. Production Assets

The source of income from cross-border sales of goods that is attributed to production activities, as determined under any of the three methods described above, depends on the location of the assets used to produce those goods. The regulations provide detailed rules for determining which assets of the taxpayer are treated as production assets. It also provides rules for determining the location of those assets. These two sets of rules are addressed in this section. The apportionment of income under the production-assets formula described above depends on the "average adjusted basis" of the production assets. The definition of that term is also addressed in this section.

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[148] Rev. Rul. 88-73, 1988-2 C.B. 173.

[149] Notice 89-10, 1989-1 C.B. 631.

[150] Phillips Petroleum v. Comm'r, 97 T.C. 30 (1991).

[151] Phillips Petroleum v. Comm'r, 101 T.C. 78 (1993).

[152] Reg. § 1.863-3(b)(3) (2006).

§ 13.03.3.1. Definition of Production Assets

The production assets of a taxpayer are limited to its tangible and intangible assets that are directly used by the taxpayer to produce inventory property. Assets relating to the sale of inventory property are not classified as production assets. Thus, production assets do not include accounts receivables, marketing intangibles, such as trademarks and customer lists, transportation assets, warehouses, goods held for sale, unfinished goods, or raw materials. In addition, production assets do not include cash or other liquid assets, investment assets, prepaid expenses, or stock of a subsidiary.[153] These exclusions are logical, given that the purpose of the definition is to establish the location of the taxpayer's production activities and the excluded items really do not have a geographical location.

To qualify as a production asset, an asset generally must be owned directly by the taxpayer. Thus, assets owned by affiliates and leased property generally do not count in determining the source of income derived from production activities.[154] An anti-abuse rule provides, however, that the tax authorities may ignore or restructure certain transactions entered into by the taxpayer to manipulate the formula.[155] For example, leased assets may be taken into account if the taxpayer arranged a sale and lease-back transaction in order to manipulate the production-asset formula.[156] In addition, certain assets of a partnership must be taken into account in determining the source of a partner's income.[157] A taxpayer filing a consolidated return with other members of the control group may be required to take into account the assets of those members in determining the source of income from production activities.[158]

The failure to include leased assets in the definition of production assets seems odd, in that those assets certainly contributed to production. Leased assets could be included by using a formula to gross up the amount of the lease payments. The anti-abuse rule provided in the regulations would appear to be unworkable; at best it would catch taxpayers who wee both greedy and unsophisticated. Some state government, in applying their apportionment formula, include a grossed-up amount for leased assets.

§ 13.03.3.2. Location of Production Assets

The location of a tangible production asset is easy to establish. It is simply the geographical location where the asset is physically present.[159] In theory, an intangible asset is difficult to locate, given that it lacks a physical presence by definition. The regulations solve this potential dilemma by linking intangible production assets to tangible production assets.

To qualify as an intangible production asset for purposes of the source rule, intangible property must be used in conjunction with tangible assets to produce inventory property. An intangible production asset, so defined, is then located where the tangible assets to which it relates are located.[160] For example, a patent on some industrial process would be located where that process is being utilized to produce inventory property.

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[153] Reg. § 1.863-3(c)(1)(i)(B) (2006).

[154] Id.

[155] Reg. § 1.863-3(c)(1)(iii) (2006).

[156] See Reg. § 1.863-3(c)(1)(iv)(Ex. 3) (2006).

[157] Reg. § 1.863-3(g)(2) (2006).

[158] See Reg. §§ 1.863-3(c)(1)(i)(A) (2006) and 1.1502-13 (2009).

[159] Reg. § 1.863-3(c)(1)(i)(C) (2006).

[160] Id.

§ 13.03.3.3. Average Adjusted Basis

In determining the amount of foreign source income generated by production activities, the production-asset formula employs a fraction. The numerator is the average adjusted basis of production assets that are located outside the United States and the denominator is the average adjusted basis of all production assets within or without the United States. The "adjusted basis" of an asset for purposes of the formula is the adjusted basis determined under Code section 1011. The "average" adjusted basis generally is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year. Reasonable allocation rules must be applied if an asset is used to produce section 863 sales income and also some other category of income.[161]

§ 13.03.3.4. An Example

The production-assets formula requires a fair number of calculations to apply even in fairly simple cases. Example 13.4, below illustrates the operation of the formula in the case of property produced partly in the United States and partly abroad and sold in a foreign country. Sales of inventory property produced partly within and partly without the United States constitute section 863 sales wherever the property is sold. The taxable income from those section 863 sales is sourced partly within the United States and partly without.

Example 13.4: Production-Assets Method

TCo is a U.S. company engaged in the manufacturer and sale of telephone equipment in the United States and Canada. Under the passage-of-title test, it has no U.S. sales and Canadian sales of $3,000. Its cost of goods sold is $1,600. The average adjusted basis of its assets used to produce telephone equipment is $500; of that amount, $200 worth of assets are located in the United States and $300 in Canada. TCo has an allowable deduction for sales of its telephone equipment of $30. Thus TCo has worldwide taxable income of $1,370 ($3,000 – $1,600 – $30). Under these conditions, TCo has U.S. source taxable income of $274 and foreign source taxable income of $1,096, calculated as follows.

(1) TCo's gross income from sales of telephone equipment ($3,000 gross receipts – $1,600 cost of goods sold) $1,400

(2) Gross income from foreign section 863 sales (line (1) × ($3,000 foreign gross receipts/$3000 worldwide gross receipts)) 1,400

(3) Gross income from foreign section 863 sales attributed to production activities (line (2) × ½) . 700

(4) Average adjusted basis of equipment used to produce telephone equipment 500

(5) Portion of the adjusted basis of telephone manufacturing equipment located in the United States (from statement of facts) 200

(6) Portion of the adjusted basis of telephone manufacturing equipment located in foreign countries (from statement of facts) 300

(7) Gross income from production activities apportioned to United States (line (3) × (line (5)/line(4))) 280

(8) Gross income from production activities apportioned to foreign countries (line (3) × (line (5)/line(4))) 420

(9) Gross income apportioned to sales activities (½ × line (1)) 700

[161] Reg. § 1.863-3(c)(1)(ii)(B) (2006).

(10) Gross income from sales activities apportioned to foreign countries (line (9) × ($3,000 foreign gross receipts/$3,000 worldwide gross receipts)) 700

(11) Total gross income apportioned to United States (line (7)) 280

(12) Total gross income apportioned to foreign countries (line (8) + line (10)) 1,120

(13) TCo's allowable deductions (from statement of facts) 30

(14) Deductions apportioned to United States (line (13) × line (11)/(line (11) + line (12))) 6

(15) Deductions apportioned to foreign countries (line (13) × line (12)/(line (11) + line (12))) 24

(16) Taxable income apportioned to United States (line (11) – line (14)) 274

(17) Taxable income apportioned to foreign countries (line (12) – line (15)) 1,096

The example above can be simplified significantly. In that example, the taxpayer had taxable income of $1,370. One half of that amount is treated as sales income and is sourced outside the United States under the 50/50 method. The remaining half ($685) is considered to be income from production activities. It is apportioned to the countries where the production assets are located in proportion to the adjusted basis of those assets. The adjusted basis of TCo's production assets located in the United States equals 40 percent of the total adjusted basis of its production assets ($200/$500). As a result, 40 percent of TCo's taxable income derived from production activities ($685 × 0.40 = $274) is apportioned to the United States.

§ 13.04. Natural Resources Income

Treasury regulations adopted in 1921 provided that income derived from the ownership or operation of a natural resource, including any farm, mine, oil or gas well, other natural deposit, or timber, generally has its source in the country where the natural resource is located.[162] In the first of two *Phillips Petroleum cases*,[163] the Tax Court declared that the natural resources regulation was invalid as applied to income derived from the sale of natural resources produced in the United States and sold abroad. The U.S. tax authorities responded by issuing new regulations that eliminate what the Tax Court considered to be a flaw in the old regulations.[164]

The current regulations divide natural resources income into two components — an initial production component and a residual component that often would constitute the sales component.[165] The initial production component has its source in the country where the natural resource is located.[166] The source of the residual component is determined under the source rules that apply to the type of residual income involved. For example, if the residual income is sales income, its source would be determined under the passage-of-title test.[167]

The apportionment between extraction or production income and sales income is based on the fair market value of the product at the "export terminal." That is, the natural resource is assumed to have been

[162] Reg. § 1.863-1(b), as in effect prior to 1997. See also Rev. Rul. 67-194, 1967-1 C.B. 183 (determining the source of income from a natural resource located within a foreign country). This ruling is inconsistent with the logic of the 1996 regulations and should be revoked.

[163] Phillips Petroleum v. Comm'r, 97 T.C. 30 (1991), aff'd without opinion, 70 F.3d 1282 (10th Cir. 1995).

[164] The court-created exception to the natural resources source rule, if allowed to stand, would have made the United States one of the only, perhaps *the only*, country in the world that does not claim the right to tax income derived from its own natural resources. Some U.S. tax treaties expressly reserve the right of the Contracting States to tax income derived from natural resources located within their borders. See U.S./Japan treaty, Art. 6(2) (2003).

[165] Reg. § 1.863-1(b)(1) (2008).

[166] Id.

[167] Reg. § 1.863-1(b)(1)(ii) (2008).

sold for its fair market value at the place of export. The regulations provide that the source of gross receipts equal to the fair market value of the product at the export terminal is the place where the farm, mine, well, deposit, or uncut timber is located.[168]

Source rules generally are defined in terms of gross income, not gross receipts. The natural resources source rule is an exception to that general rule. It requires the taxpayer to compute the amount of its gross income in two steps. First, it computes its gross receipts from the production or extraction of natural resources. Then it subtracts from the gross receipts so computed the cost of goods sold properly attributed to those gross receipts. The gross income so computed has its source in the place where the gross receipts are sourced.[169]

In general, a U.S. export terminal is the final point in the United States from which goods are shipped from the United States to a foreign country. A foreign export terminal is the final point in a foreign country from which goods are shipped to the United States. If the natural resource property is extracted and produced on the high seas, the export terminal is the place of production.[170]

In some cases, additional production activities may be conducted in addition to activities from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber. In that event, the source of income from these additional production activities would not be determined under the natural resources source rule.[171] It generally would be determined under the rules for section 863 property described above. Activities that prepare the natural resource for export, including activities that facilitate the transportation of the natural resource to or from the export terminal, are not considered additional production activities.[172]

Example 13.5: Source of Natural Resources Income

PCo is an oil and gas company that extracts natural gas from an oil field located in Alaska. The gas is transported by pipeline from the oil field to a processing plant. That plant constitutes an export terminal. At the processing plant, the natural gas is liquified by refrigerating it to minus-260 degrees Fahrenheit. The LNG is then transported by tanker to Japan, where it is sold to JCo, an unrelated utility company. During the taxable year, PCo produces 1,000 MMBtu of LNG. The 1,000 MMBTUs OF LNG have a value at the processing plant of $2,500 The LNG is sold in Japan for $3,000. with title passing in Japan. The conversion of the natural gas into LNG is essential to its transportation and is not an "additional production activity." PCo has inventory costs of $1,000 in extracting the natural gas and producing the LNG. It pays $100 in legal fees that relate to the extraction of natural gas and are not included in inventory costs. It has costs of $300 associated with the transportation and sale of the LNG to Japan.

Under these circumstances, PCo has worldwide gross income of $2,000 ($3,000 – $1,000) and worldwide taxable income of $1,600 ($2,000 – $100 – $300). It has gross receipts of $2,500 from the deemed sale of the LNG at the export terminal. Those gross receipts are treated as having a U.S. source because they are derived from a deemed sale of LNG extracted in the United States. The cost of goods sold associated with those gross receipts is $1,000, so PCo has gross income of $1,500 from the deemed sale of the LNG at the export terminal. That gross income is U.S. source income because the

[168] Reg. § 1.863-1(b)(1) (2008).

[169] Reg. § 1.863-1(b)(5) (2008).

[170] Reg. § 1.863-1(b)(3)(iii) (2008).

[171] Reg. § 1.863-1(b)(3)(ii) (2008).

[172] Id.

gross receipts are treated as U.S. source gross receipts.[173] *PCo has taxable income from U.S. sources of $1,400 ($1,500 – $100) because the legal fees of $100 are associated with the extraction of the natural gas.*

PCo has gross income of $500 ($2,000 – $1,500) from the sale of the LNG to JCo. That gross income has a foreign source because title to the LNG passed in Japan. In computing its foreign source taxable income, PCo can deduct its $300 of expenses associated with the foreign sales. Thus, its foreign source taxable income is $200 ($500 – $300). In sum, 87.5 percent ($1,400/$1,600) of PCo's taxable income from the extraction of natural gas in the United States and its sale in Japan is U.S. source taxable income, and the remaining 12.5 percent is foreign source income.

Although the current Treasury regulations under code section 863 are consistent with the Tax Court's decision in *Phillips Petroleum*, they take away most of the tax benefit that the taxpayer obtained in that case. In *Phillips Petroleum*, the taxpayer was allowed to use the old 50/50 splitting formula to allocate to foreign sources all of the sales income and much of the production income derived from the extraction of natural gas in the United States. Because the taxpayer apparently had excess foreign tax credits in that case, the result was that the taxpayer paid no U.S. taxes on most of its income from extracting natural gas in the United States. The key change in the current regulations is that all of the gross income deemed to arise from the extraction of natural resources is allocated to the country where the resources were extracted. In addition, the 50/50 splitting formula was modified to prevent assets such as marketing intangibles and accounts receivable, which are unrelated to production and are easily moved offshore, from being used to allocate income derived from production activities.

[173] See Reg. § 1.863-1(b)(7)(Ex. 2) (2008).

Chapter 14
Additional Source of Income Rules

§ 14.01. Personal Services Income

Compensation for what the Code refers to as "labor or personal services" generally has its source in the country where the services are performed. That is, services performed within the United States generate U.S. source income,[174] and services performed in a foreign country generate foreign source income.[175] Gross income derived from the performance of services partly within the United States and partly within another country must be apportioned between the two countries.[176]

Neither the Code nor the Treasury regulations define the term "labor or personal services." The case law and administrative practice, however, have given a broad meaning to that term. It includes the activities of employees working for a wage and the activities of doctors, lawyers, architects, and other professionals working as independent contractors. It also includes the activities of artists, entertainers, and athletes. Corporations have been held to perform personal services under some conditions. Indeed, any corporation that offered accounting, advertising, or similar professional services to the public would be treated as performing personal services.[177]

For individuals performing services within and without the United States, the apportionment of compensation between foreign and U.S. sources generally is often based on the time spent in each location. For example, if the taxpayer received wages for the taxable year of $120,000 and worked 200 days in the United States and spent 100 days in Europe, then $80,000 ($120,000 × 200/300) of the compensation would be U.S. source income and $40,000 would be foreign source income.[178]

A test based on time of performance works well for employees or independent contractors who are being paid based on the time they have spent in earning their compensation. The test works less well when the link between compensation paid and time spent is weak. In 2005, the U.S. tax authorities issued regulations that provided a good deal of flexibility in apportioning income from personal services. In general, the regulations provide that income from personal services is to be apportioned between U.S.

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[174] IRC § 861(a)(3).

[175] IRC § 862(a)(3). Special rules apply in determining the source of income from services performed in space or on the high seas.

[176] IRC § 863(b)(1).

[177] See Comm'r v. Hawaiian Philippine Co., 100 F.2d 988 (9th Cir. 1939) (characterizing as services income the gains obtained by a corporation from the production of refined sugar from sugar cane for a fee, payable under contract with planters who delivered the cane to the corporation under long-term contracts that ran with the land); Piedras Negras Broadcasting Co. v. Comm'r, 127 F.2d 260 (1942) (characterizing the revenues of a foreign corporation running a radio station located in Mexico, just across the U.S./Mexico border, as income from services performed outside the United States, although the revenues of the corporation came largely from payments made by U.S. customers who purchased broadcast time in order to advertise to a U.S. audience). See also Rev. Rul. 60-55, 1960-1 C.B. 270 (characterizing fees received for promotional services performed outside the United States as foreign source income).

[178] For an example of the apportionment of a hockey player's salary between U.S. and foreign sources on a "time basis," see Stemkowski v. Comm'r, 690 F.2d 40 (2d Cir. 1982), rev'g in part and aff'g in part, 76 T.C. 252 (1981). The Second Circuit determined the amount of the player's salary apportioned to U.S. sources by multiplying it by a fraction. The numerator of the fraction was the number of regular season and training camp days spent by the player in the United States during the taxable year, and the denominator was the total regular season and training camp days in the taxable year. The Internal Revenue Service would have eliminated the training camp days from both the numerator and the denominator. The training camp was located outside the United States. See also Favell v. U.S., 16 Cl. Ct. 700 (1989) (excluding off-season period from allocation formula, despite evidence that hockey players needed to work out during that period to keep in shape for hockey); Charron v. U.S., 200 F.3d 785 (Fed. Cir. 1999).

sources and foreign sources "on the basis that most correctly reflects the proper source of the income under the facts and circumstances of the particular case."[179] Of course, that test is unhelpful. It appears intended primarily to overturn the prior rule, found in the case law and regulations, that used time of performance as the nearly exclusive basis for apportionment.

Despite its nearly useless general rule, the 2005 regulations do provide significant guidance for apportioning income from personal services. Two tests applicable to individuals are provided, the "time" test[180] and the "geography" test.[181] In general, the time test is the traditional test based on days of performance within and without the United States.[182] The geography test allocates income from personal services to the taxpayer's principal place of work. In general, the geography test applies only to certain enumerated fringe benefits. The amount of those benefits must be reasonable and substantiated.[183] The apparent rationale for the geography test is that certain portions of an individual's compensation package are fixed costs of the business and do not relate well to days worked in a particular location.

The following three types of fringe benefits are allocated to the individual's principal place of work[184] under the geography test: (1) housing for the individual and family members;[185] (2) education expenses of the individual's dependents;[186] and (3) a local transportation fringe benefit, including the rental fee for an automobile made available to the individual.[187] The 2005 regulations provide that three additional fringe benefits are to be allocated under the geography test. An individual who is reimbursed for foreign taxes incurred as a result of the services performed should allocate that income to the jurisdiction that imposed the tax for which the individual is reimbursed.[188] An individual receiving hazardous or hardship duty pay should allocate that income to the hazardous or hardship duty zone.[189] In general, an individual who is reimbursed for moving expenses should allocate the reimbursed amount to the location of the employee's new principal place of work.[190] Under certain circumstances, the employee may allocate the amount to the location of the prior place of work by showing that the employer had agreed in writing to pay the expenses the employee would incur in moving back to the prior place of work.[191]

If an employee received compensation in a particular year for work performed over more than a year, the entire period for which the compensation was received is taken into account in apportioning the income

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[179] Reg. § 1.861-4(b)(1)(i) (legal entities) and(2)(i) (individuals) (2005).

[180] Reg. § 1.861-4(b)(2)(ii)(A) (2005).

[181] Reg. § 1.861-4(b)(2)(ii)(B) (2005).

[182] In appropriate circumstances, a unit of time other than the day may be used for apportionment purposes. Reg. § 1.861-4(b)((2)(ii)(E) (2005).

[183] Reg. § 1.861-4(b)(2)(ii)(D)(1) (2005).

[184] An individual's principal place of business is determined under Reg. § 1.217-2(c)(3) (1995) (relating to moving expanses). Reg. § 1.217-2(c)(3)(i) (1995) states: "A taxpayer's 'principal place of work' usually is the place where he spends most of his working time. The principal place of work of a taxpayer who performs services as an employee is his employer's plant, office, shop, store, or other property. The principal place of work of a taxpayer who is self-employed is the plant, office, shop, store, or other property which serves as the center of his business activities."

[185] Reg. § 1.861-4(b)(2)(ii)(D)(1) (2005).

[186] Reg. § 1.861-4(b)(2)(ii)(D)(2) (2005).

[187] Reg. § 1.861-4(b)(2)(ii)(D)(3) (2005).

[188] Reg. § 1.861-4(b)(2)(ii)(D)(4) (2005).

[189] Reg. § 1.861-4(b)(2)(ii)(D)(5) (2005).

[190] Reg. § 1.861-4(b)(2)(ii)(D)(6) (2005).

[191] Id.

between U.S. and foreign sources.[192] Assume, for example, that an individual receives income from the exercise of a stock option. the option was received in year 1 that vested in year 5. Apportionment of the income from that stock option will be based on the days the services that resulted in the stock option were performed within and without the United States over the 5-year period.[193]

Corporations and other legal entities that perform personal services partly within and partly without the United States must apportion their compensation using a facts-and-circumstances test.[194] A corporation probably should use a time-based formula to apportion compensation under a contract if all of the employees performing services under that contract were paid at approximately the same rate.[195] If rates of compensation differ, however, then a formula based on the payroll costs for employees performing services under the contract might be appropriate.[196]

Problems can arise in distinguishing services income from royalties when the work product of the services has been embodied in a property right. A writer, for example, may produce a manuscript for a book under contract with a publisher, with payments under the contract contingent on sales of the book. Should payments received by the writer be characterized as services income, sourced in the country where he wrote the book, or as royalty income, sourced in the country where copies of the book were sold?

A similar question would arise if a researcher makes a patentable discovery under a contract with a drug company, with payments for his services conditional on exploitation by the drug company of the resulting patent. The answer appears to be that such income is characterized as services income unless the person performing the services retains some ownership right in his work product.[197]

The Code provides a modest exception to the place-of-performance source rule for nonresident alien individuals temporarily working within the United States.[198] For this so-called commercial traveler's exception to apply, the taxpayer can be present in the United States for no more than 90 days, and the aggregate amount of the compensation attributable to services performed within the United States during the taxable year cannot exceed $3,000. In addition, the compensation must have been paid by a foreign taxpayer not engaged in business in the United States or by a foreign branch of a domestic taxpayer for services performed on behalf of the foreign branch.[199] For the purpose of applying the commercial traveler's exception, a foreign taxpayer having an employee temporarily in the United States will not be treated as being engaged in a trade or business in the United States on account of the activities of that employee as long as the employee earns less than $3,000 for the taxable year and is present in the United States for less than 90 days.[200]

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[192] Reg. § 1.861-4(b)(2)(ii)(F) (2005).

[193] Id. See Reg. § 1.861-4(b)(2)(ii)(G)(Ex.6) (2005).

[194] Reg. § 1.861-4(b)(1)(i) (2005).

[195] Id.

[196] Reg. § 1.861-4(b)(1)(ii) (2005).

[197] See Karrer v. U.S., 138 Ct. Cl. 385, 152 F. Supp. 66 (1957) (holding that a Swiss scientist doing basic research under contract has personal services income sourced in the country of performance rather than royalty income sourced in the country where the patent resulting from his research activity was exploited). See also Boulez v. Comm'r, 83 T.C. 584 (1984) (holding that compensation received by conductor for producing recordings, with payment contingent on the sale of records, is personal service income because conductor had no property rights in the recordings). For discussion, see Marvin A. Chirelstein with Elisabeth A. Owens, Taxation in the United States (World Tax Series) (1963) at 993-995.

[198] IRC § 861(a)(3). These persons also are deemed not to be engaged in business within the United States.

[199] Id.

[200] See IRC § 864(b)(1) and Reg. § 1.861-4(a)(3) (2005).

All U.S. tax treaties provide a commercial traveler's exception. The treaty exception is typically more liberal than the Code exception described above. For example, most treaties provide that an employee can be present in a contracting state for up to 183 days without becoming taxable. In addition, almost all U.S. treaties eliminate the Code's $3,000 cap on compensation.[201] The commercial traveler's exception provided by tax treaty is a direct exemption granted to individuals rather than a special source rule.

Another minor exception to the place of performance rule applies to nonresident alien individuals who are temporarily present in the United States as part of the regular crew of a foreign vessel engaged in international trade.[202] Under the exception, their income is considered to be income from foreign sources and is exempt from U.S. income and withholding tax.[203]

Retief Goosen v. Comm'r

136 T.C. 547 (2011)

Findings of Fact

* * *

Petitioner [Retief Goosen] is a professional golfer. He began his professional golf career on the South African Tour in 1988. He earned "Rookie of the Year" in his first year on the South African Tour, and he developed as one of the better golfers in South Africa. Petitioner's success in South Africa allowed him to earn his tour card[204] on the European Tour in 1991. Petitioner met his wife, a citizen of the United Kingdom, shortly after joining the European Tour, and the two decided to make London, England, their permanent residence.

* * *

Petitioner's Golf Career in the United States

Though popular on the European Tour, petitioner was unknown in the United States leading up to the years at issue. Petitioner rarely played in the United States, and he did not have a U.S. Professional Golf Association Tour (PGA Tour) card. He instead focused on maintaining his status and high ranking on the European Tour. Petitioner's career took a dramatic upswing when he won the 2001 U.S. Open golf tournament in Tulsa, Oklahoma. The U.S. Open is one of four prestigious Major Championships in professional golf, and professional golfers are largely remembered for how they perform in these tournaments. Petitioner's profile skyrocketed both in the United States and globally after winning the U.S. Open.

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[201] For example, there is no cap in the U.S.-France treaty or the U.S.-India treaty. See U.S. Model Treaty (2006), Art. 14 (Income from Employment). The exemption does not apply to compensation for government service (Art. 19), to pensions, annuities, alimony, or child support (Art. 17), or to directors fees (Art. 15). For services performed by self-employed individuals, the 183-day limit is not applicable (Art. 14). A special exemption is provided for students and trainees (Art. 20). The U.S.-Canada treaty raises the cap to $10,000 (U.S. or Canadian dollars).

[202] IRC § 861(a)(3) (last sentence). This provision was added by the 1997 tax act, allegedly because of administrative difficulties encountered by ship operators.

[203] Id.

[204] A professional golfer must obtain and maintain a tour card to play on a particular golf tour. Each golf tour has its own requirements for obtaining and maintaining a tour card that often include attending a tour school and participating in a certain number of tour tournaments each year.

Petitioner's accomplishments on the golf course made him famous, though it was his image that made him marketable. Golf is often called "the gentleman's game," and many sponsors see petitioner as one who epitomizes the gentleman golfer. Petitioner has maintained a positive image throughout his career. Sponsors appreciate his cool demeanor on the course, his golf success, his recognition around the world and his involvement in charities and other notable causes. He is often branded as "the Goose" because of his name or "Iceman" because he is cool under pressure.7

Petitioner's name and likeness have been marketed in South Africa and Europe since the 1990s. Sponsors began to aggressively market petitioner in the United States and increased his global marketing following his 2001 U.S. Open victory. Petitioner entered into or renegotiated six endorsement agreements during the years at issue. Petitioner entered into endorsement agreements with TaylorMade, Izod, Acushnet, Rolex, Upper Deck and Electronic Arts. These sponsors had global reach and were consistent with petitioner's image and brand. The TaylorMade, Izod and Acushnet endorsement agreements (collectively, the on-course endorsement agreements) required petitioner to wear or use their products during golf tournaments. In contrast, the Rolex, Upper Deck and Electronic Arts endorsement agreements (collectively, the off-course endorsement agreements) did not have this requirement.

* * *

Opinion

Kroupa, Judge: We are asked to decide how petitioner, a U.K. resident, should characterize and source the income he received under the worldwide endorsement agreements for U.S. tax purposes. Petitioner contends that the sponsors paid the endorsement income primarily for the right to use his name and likeness, not for any services he may have provided. He argues that the endorsement income should therefore be taxed as U.S.-source royalty income. Respondent counters that the sponsors paid him the endorsement income primarily for personal services and therefore such income should be taxed as U.S.-source personal services income. The parties also dispute whether petitioner is eligible for any benefits under the U.S.-U.K. tax treaties.

* * *

Taxation of Nonresident Aliens Under the Code

We now consider how petitioner's endorsement income should be taxed in the United States. The United States generally taxes nonresident aliens only if they engage in a U.S. trade or business or receive U.S.-source fixed and determinable annual or periodic income. See sec. 864(b). Engaging in a U.S. trade or business includes any business activity in the United States that involves one's own physical presence. See sec. 1.864-2, Income Tax Regs. The parties agree that petitioner's golf play in the United States amounts to his engaging in a U.S. trade or business. We must therefore determine the character and source of the income and whether such income was effectively connected with his golf play in the United States. We will consider each issue in turn. We begin by considering the character of the income.

The United States generally taxes nonresident aliens only if they engage in a U.S. trade or business or receive U.S.-source fixed and determinable annual or periodic income.

A. Character of Income — Personal Services Income or Royalties

We first decide whether the endorsement income constitutes personal services income or royalty income. The parties agree that the endorsement fees under the off-course endorsement agreements constitute royalty income. We will therefore examine endorsement income only from the on-course endorsement agreements, which includes the TaylorMade, Izod and Acushnet agreements.

Respondent argues that the personal services petitioner was required to perform included playing golf and carrying or wearing the sponsors' products.

Petitioner asserts that the sponsors paid him for the right to co-market and co-brand their products with petitioner's name and likeness. Courts have repeatedly characterized payments for the right to use a person's name and likeness as royalties because the person has an ownership interest in the right. . . . Petitioner submitted an expert report from Jim Baugh (Mr. Baugh), former president of Wilson Sporting Goods, to support his contention that TaylorMade, Izod and Acushnet paid for his name and likeness rather than for the performance of services. Mr. Baugh has spent more than 35 years in sports marketing and has extensive experience in professional athlete endorsement agreements.

Respondent argues that the sponsors primarily paid petitioner to perform personal services. Respondent argues that the personal services petitioner was required to perform included playing golf and carrying or wearing the sponsors' products. Respondent relies on this personal services argument by focusing on the proration of the endorsement fees if petitioner failed to play in a specific number of golf tournaments. Respondent claims that any income received for the use of petitioner's name and likeness should be considered *de minimis*.

The characterization of petitioner's on-course endorsement fees and bonuses depends on whether the sponsors primarily paid for petitioner's services, for the use of petitioner's name and likeness, or for both. . . . We must divine the intent of the sponsors and of petitioner from the entire record, including the terms of the specific endorsement agreement. . . .

[W]e find that the sponsors paid for both the services provided and the right to use petitioner's name and likeness.

The on-course endorsement agreements granted sponsors TaylorMade, Izod and Acushnet the right to use petitioner's name and likeness for advertising and promotional materials worldwide. Petitioner also agreed to wear or use the sponsors' products, make promotional appearances and participate in photo and filming days. The sponsors paid petitioner a base endorsement fee, though the fee would be prorated if he did not play in a specified number of tournaments. The sponsors also paid petitioner tournament and ranking bonuses based on his on-course performance. The endorsement agreements fail to allocate the endorsement income between services petitioner was to provide and the amount paid for the right to use petitioner's name and likeness. As we view the record as a whole, we find that the sponsors paid for both the services provided and the right to use petitioner's name and likeness.

* * *

Acushnet and Izod even included a morals clause and an illegal activities clause in their respective endorsement agreements to terminate the agreements if petitioner compromised his image. Mr. Baugh cited the rise and fall of Tiger Woods (Mr. Woods) as an endorser to illustrate the importance sponsors place on an athlete's image. Mr. Woods built the most powerful, valuable and carefully orchestrated brand and image in sports. He lost most of his sponsorships, however, when his extra-marital affairs made front page news. Sponsors determined that Mr. Woods' image was no longer compatible with their products.

* * *

We find it appropriate to allocate the endorsement fees from the on-course endorsements between personal services income and royalty income. While we recognize that precision in making such an allocation is unattainable, we must do the best we can with the evidence presented. . . . We find that 50 percent of the endorsement fees petitioner received represented royalty income and 50 percent represented personal services income.

B. Sourcing and Effectively Connected Income

We must next determine what portion of the endorsement income should be sourced to the United States. We accept the parties' stipulations for sourcing the personal services income, tournament bonuses and ranking bonuses to the United States. The parties disagree as to what portion of the royalty income from the on-course and off-course endorsement fees should be U.S.-source income. We first consider what portion of the royalty income is U.S.-source income. We then consider whether any U.S.-source royalty income was effectively connected to a U.S. trade or business.

1. Sourcing Petitioner's Royalties

Royalty income paid for the right to use intangible property generally is sourced where the property is used or is granted the privilege of being used. Secs. 861(a)(4), 862(a)(4). For example, royalty income received for the use of trademarks in making foreign sales is sourced outside the United States. Rev. Rul. 68-443, 1968-2 C.B. 304. Thus, we must consider where petitioner's name and likeness were used or would be used to determine the source of petitioner's royalty income.

Taxpayers must make an appropriate sourcing allocation if the royalty income relates to the right to use property both within and outside the United States. The contracting parties to the transaction have the burden of making a reasonable allocation of the royalty income between the U.S. and foreign sources. Here, petitioner granted his sponsors the right to use his name and likeness worldwide. The contracting parties agreed to source 25 percent to the United Kingdom and 75 percent to rest of the world. The contracting parties did not specify, however, how the income should be sourced to the United States. We therefore cannot accept their sourcing allocation for purposes of determining U.S.-source royalty income.

Courts have generally allocated all the royalty income to the United States if the contracting parties failed to make a reasonable allocation, unless the taxpayer can show there is a sufficient basis for allocating the income between U.S. and foreign sources. . . . A sufficient basis exists when a taxpayer establishes that he or she has property rights outside the United States and furnishes evidence on the value of those rights. . . .

Petitioner has established that he owns the rights to his name and likeness outside the United States and that those rights have value. We must therefore determine the value of those rights by examining where the sponsors actually used petitioner's name and likeness. Petitioner's name and likeness were used in magazine and newspaper advertisements, commercials, websites and other promotional materials. The parties have presented little statistical evidence on the use of petitioner's name and likeness. This does not

absolve us, however, from valuing rights merely because there is difficulty in fixing their value. . . . We therefore consider the evidence to make the reasonable sourcing allocation.

a. Upper Deck and Electronic Arts Endorsement Fees

We first consider sourcing petitioner's royalty income from Upper Deck and Electronic Arts. The record reflects that Upper Deck sold 92 percent of its golf cards in the United States and eight percent outside the United States. The record reflects that Electronic Arts sold 70 percent of the video games in the United States and 30 percent of the video games outside the United States. The parties do not dispute these sales figures.

We recognize that product sales do not necessarily reflect the relative worldwide value of the intangible rights. See Molnar v. Commissioner, supra; Rohmer v. Commissioner, supra. Here, however, the golf card and video game sales appear to indicate where Upper Deck and Electronic Arts used petitioner's name and likeness. Petitioner added value to both Upper Deck's and Electronic Arts' international sales because he was a citizen of South Africa, resided in England and played worldwide. The record shows, however, that the golf cards and the video game were primarily marketed in the United States. Petitioner's name and likeness also were valued greatly in the United States following his 2001 U.S. Open win.

Moreover, petitioner's name and likeness value was inextricably tied to the sales of the video game and golf cards. Petitioner's endorsement agreement granted Electronic Arts the right to use petitioner's name and likeness only with the video game, and not in advertising or other promotional materials. The parties agree that Upper Deck's golf card sales, rather than its use of petitioner's name and likeness in advertising and promotional material, should be a determining factor in sourcing the Upper Deck endorsement fees. We agree.

We find that the sale of the trading cards and video game provide a sufficient basis for determining where Upper Deck and Electronic Arts used petitioner's name and likeness rights. We therefore find that petitioner's royalty income from Upper Deck is 92 percent U.S.-source income and Electronic Arts is 70 percent U.S.-source income.

b. On-Course and Rolex Endorsement Fees

We next consider whether the parties presented sufficient evidence to value petitioner's royalty income under the on-course and Rolex endorsement agreements. Petitioner, Mr. Kinnings and Mr. Prestagacio all testified that petitioner was marketed aggressively in the United States following his 2001 U.S. Open victory. Petitioner testified that the United Kingdom, United States and South Africa were his three largest markets for golf endorsements. We find perplexing, however, that he allocated 25 percent of his royalty income to the United Kingdom and only 6.4 percent of his royalty income to the United States. On the evidence presented, we cannot accept petitioner's contention that less than seven percent of his royalty income is U.S.-source income.

We look to the rest of the facts. Petitioner has shown that the sponsors paid for the right to use petitioner's name and likeness outside the United States. Petitioner has demonstrated that he had a global image and that he was marketed all over the world. His market includes the United Kingdom, the United States, South Africa, Australia and the Far East. Thus, it would be unreasonable to source all the royalties to the United States. Petitioner testified that the United States is the largest golf market in the world, and it is one of his largest markets for golf endorsements. Taking into account all the evidence, it is our best judgment and we so find that 50 percent of the royalty income petitioner received from the on-course and Rolex endorsement agreements is U.S.-source income.

2. Effectively Connected Income

We next consider whether such U.S.-source income is effectively connected with a U.S. trade or business. The parties agree that petitioner engaged in the U.S. trade or business of playing golf. A nonresident alien engaged in a U.S. trade or business is taxed on income that is effectively connected with the conduct of that trade or business. Sec. 882(a)(1). We apply different rules depending on whether the income is U.S.-source income or not U.S.-source income. In the case of U.S.-source income that is effectively connected with a U.S. trade or business, a nonresident alien will be subject to the graduated tax rates applicable to U.S. residents. In the case of U.S.-source income that is not effectively connected with a U.S. trade or business and consists of rents, dividends, royalties or other fixed or determinable annual or periodic income, the nonresident alien will be subject to a flat 30-percent withholding tax. The parties do not argue, nor do we find, that petitioner maintained an office or fixed place of business in the United States. We therefore find that petitioner is not subject to U.S. tax on his income that is not from U.S. sources.

Taking into account all the evidence, it is our best judgment and we so find that 50 percent of the royalty income petitioner received from the on-course and Rolex endorsement agreements is U.S.-source income.

The parties also do not dispute that petitioner's personal services were effectively connected with petitioner's golf play and that the U.S.-source income earned playing golf is taxed at regular graduated rates. We must still determine whether petitioner's U.S.-source royalty income is effectively connected with his U.S. trade or business. U.S.-source royalty income will be effectively connected with a U.S. trade or business if the activities of the trade or business are a material factor in the realizing the royalty income. Sec. 1.864-4(c)(3)(i), Income Tax Regs. We will consider separately the U.S.-source royalty income petitioner received under the on-course endorsement agreements and those under the off-course endorsement agreements.

We first consider whether petitioner's U.S.-source royalty income from the on-course endorsement agreements was effectively connected with his golf play in the United States. As we previously discussed, petitioner's income from the use of his name and likeness depended on whether he played in a specified number of golf tournaments. In other words, petitioner's participation in a golf tournament was material to receiving income for the use of his name and likeness. We therefore find that such income is effectively connected with a U.S. trade or business, and petitioner will be subject to the graduated tax rates applicable to U.S. residents.

We next consider whether petitioner's U.S.-source royalty income from the off-course endorsement agreements was effectively connected with a U.S. trade or business. The income petitioner received from the off-course endorsement agreements did not depend on whether he played in any golf tournaments. He would be paid regardless of whether he played in or won any tournament. Moreover, the off-course endorsement agreements did not require petitioner to be physically present in the United States. We therefore find that the income petitioner received from off-course endorsement agreements was not effectively connected with a U.S. trade or business. See sec. 1.864-4(c)(3)(ii), Example (2), Income Tax Regs. Accordingly, a flat 30-percent tax is imposed on petitioner's gross U.S.-source royalty income from the off-course endorsement agreements. See secs. 881(a), 871(a)(1).

Favell et al v. U.S.

16 Cl. Ct. 700 (1989)

Opinion of the Court (Horn, Judge)

During the tax years in question, each of the five representative plaintiffs were professional hockey players. Each of them was a nonresident alien of the United States, playing for hockey clubs from which each player received compensation from sources within the United States for labor and personal services. Each plaintiff signed a standard player's contract some time before or at the beginning of training camp, for a period of one year, or longer, which commenced on October 1 of each year. Each player worked for hockey clubs . . . pursuant to a contract covering the taxable years at issue. Each plaintiff complied with the terms of the standard contracts under which he performed his services. * * *

Douglas R. Favell, case no. 525-76, the first of the five above-captioned test-case plaintiffs, claims the overpayment of United States income tax for the years 1968 through 1971. During the tax years in question, Mr. Favell signed National Hockey League Standard Player's Contracts agreeing to play goalie for the Philadelphia Flyers. . . .

Mr. Favell claims that after recognizing the hockey club's emphasis on a player's physical condition and how his condition might translate into a higher salary . . . he performed vigorous off-season conditioning programs.

Mr. Favell's hockey club asked him to attend certain off-season promotional functions and the hockey club also showed an interest in his physical condition during off-season. During the off-season of one of the tax years at issue, the general manager of the Philadelphia Flyers, Keith Allen, corresponded with Mr. Favell, indicating the hockey club's interest in Mr. Favell's physical condition. Following an injury in 1970, Mr. Favell was directed by the team physician, on May 13, 1975, to exercise in order to help heal an injury to his leg. As one of the test-case plaintiffs, Mr. Favell claims that after recognizing the hockey club's emphasis on a player's physical condition and how his condition might translate into a higher salary on his next contract, he performed vigorous off-season conditioning programs to arrive at training camp in good physical condition and to impress the club's management.

Jean Gilles Marotte, who played defense and the left wing position [for the Chicago Blackhawks and other clubs] is the second test-case plaintiff, case No. 531-76. . . . Frederick E. Speck [of the Detroit Red Wings of the National Hockey League and their minor league team, the Fort Worth Wings of the Central Hockey League], case No. 42-77, is the third test-case plaintiff. . . . Francis William Speer [of the Pittsburgh Penguins], case No. 43-77, the fourth test-case plaintiff, claims the overpayment of United States income tax for the years 1968, 1969 and 1971. Garnet "Ace" Bailey [occasionally with the Boston Bruins], case No. 122-77, is the fifth test-case plaintiff. . . .

The issue before the court is whether, in accordance with Treasury Regulation § 1.861-4(b) (1969), the plaintiff hockey players, who have nonresident alien tax status, should be allowed to exclude from United States taxable income for the tax years in question, that portion of salaries earned for alleged contractual

services performed outside the United States during the off-season. The underlying issue before the court, which was articulated somewhat differently by both parties, requires a determination, as a matter of law, as to whether conditioning programs, fitness exercises and similar activities, engaged in by the plaintiffs, during the off-season, outside the United States, should be viewed as contractual conditions, or labor or services required to be performed under the Standard Player's Contracts at issue. . . .

As nonresident aliens who rendered services both within and outside the United States, plaintiffs are subject to United States federal income tax only on that portion of their income properly attributable to the conduct of a trade or business (including the performance of personal services) within the United States. . . . To determine the apportioned amount of each plaintiff's total gross income which is properly subject to inclusion as income earned within the United States, the parties agree, that because the Standard Player's Contracts at issue do not specifically assign a dollar figure to each contractual obligation, Treasury Regulation § 1.861-4(b) applies in this case.

The regulation provides, in pertinent part, that where no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis; that is, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made. [Ed.: This regulation was modified in 1975 to provide that the time basis method applies in appropriate circumstances but not automatically for post 1975 years. Reg.§ 1.861-4(b)(1) (1975). The rule for pre-1975 years is found in Reg. § 1.861-4(b)(2) (1975). Proposed regulations issued in 2000 would modify the time rule in ways not germane to this case.]

The application of this regulation in the instant case has raised an issue which has become known as the "income allocation issue." For ease of understanding, allocation of income in accordance with the regulation can be reduced to the following "time basis" formula:

Number of days of performance of services within the United States	×	Total contract compensation	=	Amount included in United States income

The parties agree that Treasury Regulation § 1.861-4(b) and the above formula control in this case because the Standard Player's Contracts at issue provide no specific allocation of income between payment for services performed within and without the United States. Furthermore, there is no issue as to the number of days on which plaintiffs performed services within the United States, since the defendant has acknowledged that whatever time the plaintiffs spent in the United States from the beginning of training camp to the end of the season, including play-off and Cup games, may be considered as work in the United States. In contrast, all days spent during the same period performing services under the Standard Player's Contract outside the United States, in Canada, may be considered services performed outside the United States. The controversy at issue in the pending motions, therefore, centers on the correct number to be used as the regulatory formula's denominator: the total number of days of performance of labor or services for which plaintiffs received their salaries under the relevant Standard Player's Contracts.

In this regard, plaintiffs claim that the compensation they were paid, pursuant to the Standard Player's Contracts at issue, covered services performed throughout the entire 12-month year (including the off-

season), and that the proper denominator is thus 365 days. This argument is predicated on the plaintiffs' notion that the salary specified in each player's contract was paid to fulfill each and every clause in the agreement. Plaintiffs reason that since they were contractually bound by the Standard Player's Contract to do various things during the off-season, e.g., to achieve a level of physical fitness sufficient to report to training camp in "good physical condition," to participate in promotional activities, and to refrain from engaging in certain contact sports and improper conduct, they were effectively "on the job" and providing contractual services every day of the year. The defendant, however, submits that to the extent the plaintiffs, or any others performing under Standard Player's Contracts, assumed obligations or responsibilities which extended into the off-season, such duties were conditions of employment for which no compensation was to be paid. . . .

Each of the five test-case plaintiffs contend, nonetheless, that under the Standard Player's Contracts at issue, it was intended that they be compensated for activities performed during the off-season to fulfill their obligation to report to training camp in good physical condition. . . . According to the plaintiffs, conditioning programs traditionally include participation in sports activities, such as basketball, tennis, golf, racquetball, and hockey with the express consent of the club, and exercise programs, consisting of calisthenics, sit-ups, push-ups, and jogging. In addition, sometimes complete teams were sent to special fitness conditioning centers or power skating camps. The plaintiffs claim that such off-season activities were contemplated to be compensated contractual services when the parties to the Standard Player's Contracts at issue executed the respective agreements. Plaintiffs, consequently, claim that Treasury Regulation § 1.861-4(b) entitles them, as non resident aliens, to apportion their salaries on an annual basis and thus exclude from United States taxable income, income earned during the time activities were performed outside the United States, including any services performed during the off-season.

The plaintiffs' brief directs this court's attention to two main areas of evidentiary support as to why they believe they should prevail in this action: off-season mandatory conditioning programs and off-season hockey club supervision or control over the hockey players. The plaintiffs believe that the absence of sufficient evidence on these two points in the records before the United States Courts of Appeals for the Second and Fourth Circuits was the reason that those courts of appeals did not hold in favor of [hockey players] Stemkowski and Hanna on the income allocation issue [in two otherwise similar cases]. *Hanna v. Com'r*, 763 F.2d 171 (4th Cir. 1985); *Stemkowski v. Com'r*, 690 F.2d 40 (2d Cir. 1982).

A lawyer is required to keep abreast of new developments in the law.

The defendant, however, contends that the National Hockey League Standard Player's Contract clause, paragraph 2(a), and the World Hockey Association Uniform Player's Contract, paragraph 2.2, which require hockey players to arrive at training camp in "good physical condition," should be read as a condition of each contract, not as a promise to perform services for the benefit of the hockey club during the off-season. The defendant argues, therefor, that both the National Hockey League Standard Player's Contract and the World Hockey Association Uniform Player's Contract contemplated that the contractual service term would not include the off-season period, during which time these plaintiffs lived outside the United States, and that the player's contractual salary was not intended to pay for off-season preparation for contract performance.

The court is unpersuaded by plaintiffs' position that off-season conditioning activities are to be compensated under the contract, despite the mountains of material delivered to the court. Given the words

of the standard form contracts themselves, a reasonable reader must conclude that the plaintiffs were being employed, and more important, compensated for their performance as professional hockey players.

It is not surprising, perhaps even to be expected, that hockey players are supposed to maintain a level of physical ability, under the Standard Player's Contracts at issue, in order to ably perform as professionals in their field. The court notes that professional athletes, like members of all professions, are expected to maintain a minimum level of ability to perform, or else risk losing their positions. In common parlance, maintaining an ability to properly perform a professional obligation is not generally compensated separately, but is assumed a condition for retaining employment. The words of the contracts at issue here do not suggest otherwise. For example, a college professor must be aware of all new developments in his or her field of expertise. A lawyer is required to keep abreast of new developments in the law, and a doctor must keep advised of rapidly changing technology and pharmacology to maintain the requisite level of competence necessary to practice medicine. In the case of the professional hockey player plaintiffs, they are being required by their profession and the contracts they signed to maintain the required level of skill and physical fitness to play hockey, or else they risk demotion, suspension, or loss of employment. Such a requirement is a condition of the professional's continued employment and seemingly not unusual for professionals in various disciplines which require continuous competence.

This court finds itself in agreement with the United States Court of Appeals for the Second Circuit, that fitness is a condition of the hockey player's employment. *Stemkowski v. U.S.*, 690 F.2d at 46. . . . The court of appeals held that the Standard Player's Contract compensates the hockey player for the time period which includes the regular season championship games, the play-off and cup games, as well as the training camp exercises. However, "[t]he off-season is not covered by the contract." Id. . . . It is this court's determination that the only proper construction of the Standard Player's Contracts and the Uniform Player's Contract is one which is consistent with the Second Circuit's interpretation that the off-season is not covered by the contract.

§ 14.02. Income Arising Outside the Geographical Boundaries of Any Country

Code section 863(d) provides that income derived from a "space or ocean activity" has its source in the country where the person deriving that income is resident, except as provided for by regulation. Regulations issued in 2006 provide significant exceptions to the residence rule. Under the exceptions, income having a close connection to the United States generally is U.S. source income, and income having a close connection to a foreign country is foreign source income. The space or ocean activity source rule governs virtually all income arising outside the geographical borders of any country, with exceptions for income sourced under certain other source rules, including the rules applicable to international communication income and to transportation income.[205]

A space or ocean activity generally would include the performance of services in space or on the high seas and the leasing of equipment, such as deep-sea diving bells or satellites, for use on or beneath the ocean or in space. Deep-sea mining outside the jurisdiction of any country is a paradigm example of an ocean activity. Licensing of technology for use on or beneath the ocean or in space and the manufacture of property in space or on the high seas also would be examples of a space or ocean activity. Any activity

[205] See IRC § 863(d)(2)(B)(I) and (ii).

conducted in Antarctica is treated as an ocean activity for purposes of the space or ocean activity source rule.[206]

In general, a space activity is any activity conducted in any area not within the jurisdiction of a foreign country, possession of the United States, or the United States, and not in international waters. The following activities are treated by regulation as space activities: (1) performance of services in space; (2) leasing of equipment located in space, including satellites; (3) licensing of technology or other intangibles for use in space; (4) production, processing, or creation of property in space; (5) certain communications activity occurring in space and not governed by the international communications source rule; (6) underwriting income from the insurance of risks on activities that produce space income; and (7) sales of property in space.[207]

An ocean activity generally is any activity conducted in international waters—that is, on or under water and outside the jurisdiction of any country according to U.S. law. Activities that constitute ocean activity include: (1) performance of services in "international water' (the term used in the regulations); (2) leasing of equipment located in international water, including underwater cables; (3) licensing of technology or other intangibles for use in international water; (4) production, processing, or creation of property in international water; (5) certain communications activity occurring in international water and not governed by the international communications source rule; (6) underwriting income from the insurance of risks on activities that produce income from ocean activities; (7) sales of property in international water; (8) any activity performed in Antarctica; (9) the leasing of a vessel that does not transport cargo or persons for hire between ports-of-call, such as a vessel used to engage in research activities in international water; and (10) the leasing of drilling rigs, extraction of minerals, and performance and provision of services related thereto, outside the jurisdiction of any country.[208]

As noted above, the general rule provided in the statute is that the source of income from ocean and space activities is sourced in the country of residence of the taxpayer earning the income. Thus, income from a space or ocean activity is U.S. source income under the residence rule if earned by a U.S. person, including U.S. citizens, resident aliens, and domestic corporations. Such income earned by a foreign person generally is foreign source income.

Congress authorized the Treasury Secretary to modify the residence rule by regulation. Regulations issued in 2006 make the following modifications in the general rule that the country of source for space and ocean activity income is the residence of the person earning the income.

(1) Income from a space or ocean activity that is earned by a "controlled foreign corporation" (CFC), as defined for purposes of the anti-avoidance rules of subpart F,[209] generally is treated as U.S. source income. As a result, a U.S. corporation cannot shift the source of space and ocean activity income from the United States to foreign sources merely by having the income earned by a foreign affiliate. The legislative history of Code section 863(d) suggested that Congress expected this obvious gambit to be

[206] IRC § 863(d)(2)(A) (last sentence).

[207] Reg. § 1.863-8(d)((1)(i)(A-G) (2006).

[208] Reg. § 1.863-8(d)((1)(ii)(A-J) (2006).

[209] See IRC § 957.

defeated by the subpart F rules.[210] The subpart F rules were later modified, however, to leave this gambit wide open.

(2) Income from a space or ocean activity earned by a U.S. person or by a CFC may be treated as foreign source income under a facts-and-circumstances test if the income is attributable to "functions performed, resources employed, or risks assumed in a foreign country or countries".[211] No guidance is given as to what foreign activities are sufficient to meet this facts-and-circumstances test. As a possible example, assume that PCo, a U.S. corporation, has a satellite in space capable of acquiring images on the geographical terrain of certain areas in Country A. It also has an office in Country A. The images are collected from the satellite by a remote receiving station located in Country A and transferred electronically to PCo's office in Country A. That office sells the unprocessed images to construction firms located in Country A. The resulting income would constitute income from space activities. The construction firms, after processing the images with some computer software, use the images to assist in the development of their construction sites. Under the facts-and-circumstances test, PCo may be able to demonstrate that enough of the important income-producing activities took place in Country A to shift the source of the income to that county.

(3) The income that a foreign person earns from space or ocean activities will constitute U.S. source income if (1) the foreign person is engaged in a trade or business in the United States , (2) the foreign person is not a CFC, and (3) the income, under a facts-and-circumstances test, is attributable to "functions performed, resources employed, or risks assumed within the United States. Assume, for example that FCo is a foreign corporation (not a CFC) engaged in business in the United States and in foreign countries. It derives its income from the operation of satellites in space. FCo operated a ground station in the United States and in Country X. FCo will have U.S. source income to the extent that FCo's income is attributable to functions performed, resources employed, or risks assumed within the United States.[212]

An activity giving rise to transportation income, as defined in Code section 863(c), is not treated as an ocean activity.[213] Thus, the operation of a vessel on the high seas to transport cargo or persons would be considered a transportation activity rather than an ocean activity for source rule purposes. Similarly, activities giving rise to international communications income, as defined in Code section 863(e) are not considered to be space activities.[214] For example, income derived from the transmission by satellite of international telephone calls is treated as international communications income, not space activity income.

Mining or similar activities within the United States, including activities on the continental shelf of the United States, are not considered to be ocean activities. Nor would ocean activities include mining

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[210] See General Explanation of the Tax Reform Act of 1986 (1987) at 934: "Congress recognized that sourcing income derived from space and high-seas activities in the country of residence could have provided an unintended incentive for U.S. persons to conduct such activities through controlled foreign corporations. Congress believed, however, that since the Act included this income in the separate foreign tax credit limitation for shipping income . . . and subjected this income to current U.S. tax under the subpart F rules . . . , its concerns that U.S. persons would conduct their space and ocean activities in a low-tax jurisdiction through the use of foreign corporations were generally abated. The separate foreign tax credit limitation generally provided Congress adequate assurance that high foreign taxes on unrelated income would not inappropriately offset U.S. taxes on this generally low-taxed income." That was then, this is now. Foreign base company shipping income is no longer a category of subpart F income, and the special foreign tax credit basket for shipping income has been repealed.

[211] Reg. § 1.863-8(b)(1) (2006).

[212] See Reg. § 1.863-4(f)(Ex.13) (2006).

[213] IRC § 863(d)(2)(B)(i) and Reg. § 1.863-4(d)(3)(i) (2006).

[214] IRC § 863(d)(2)(B)(ii) and Reg. § 1.863-4(d)(3)(iii) (2006).

conducted within a foreign country or within the continental shelf of any foreign country, to the extent that the United States recognizes the country's jurisdiction over that continental shelf.[215] Income derived from mining within the jurisdiction of a country might be characterized, for source rule purposes, as personal services income, as income from the production and sale of natural-resource property, or as income from the sale of real property, depending on the nature of the activities giving rise to the income.

The 2006 regulations provide special rules for the source of income from the purchase and sale of inventory property and from the production and sale of inventory property. Those rules apparently are intended to preserve for U.S. taxpayers the benefits of the passage-of-title test for income from the sale of inventory property that otherwise would constitute income from a space or ocean activity.[216]

In addition, the 2006 regulations provide special rules for determining the source of income from the performance of services in space or on the high seas. The general rule is that the performance of services will be treated entirely as a space or ocean activity if any part of the service, above a *de minimis* amount,[217] is performed in space or on the high seas.[218] Services may be performed by human beings, by equipment, or otherwise.[219] An exception allows the taxpayer to treat the income as partly from space or ocean activities and partly from other activities by demonstrating, under a facts-and-circumstances test, the value of the services performed within and without space and international waters.[220]

Congress adopted the source rule for income derived from space and ocean activities as part of the 1986 tax act. Its purpose was to restrict the definition of foreign source income, for purposes of computing the limitation on the foreign tax credit, to income "which arises within a foreign country's jurisdiction and which might reasonably be subject to foreign tax."[221] Prior to the adoption of this source rule, U.S. taxpayers were able to characterize income from space and ocean activities as foreign source income, although no foreign government had the apparent right to tax that income and generally did not tax that income. The result, according to Congress, was an inappropriate inflation of the limitation on the foreign tax credit for taxpayers engaging in space and ocean activities at a profit and an inappropriate reduction in that limitation for U.S. taxpayers engaging in those activities at a loss.[222]

§ 14.03. Transportation Income

The source of transportation income is apportioned on a 50-50 basis between the country where the transportation begins and the country where it ends.[223] Transportation that begins and ends in the same

[215] IRC § 863(d)(2)(B)(iii) and Reg. § 1.863-4(d)(3)(ii) (2006).

[216] Reg. § 1.863-4(b)(3) (2006).

[217] Reg. § 1.863-4(d)(2)(ii)(B) (2006). the de minimis rule is interpreted broadly. See Reg. § 1.863-4(f)(Ex.3) (2006) (Taxpayer running a security firm is allowed to treat the transmission by satellite of images from the customer's premises to a foreign country for monitoring as *de minimis*, apparently on the ground that the satellite was used merely as medium of delivery and not as a method of surveillance).

[218] Reg. § 1.863-4(d)(2)(ii)(A) (2006).

[219] Id.

[220] Reg. § 1.863-4(d)(2)(ii)(B) (2006).

[221] See General Explanation of the Tax Reform Act of 1986 (1987) at 933.

[222] Id.

[223] IRC § 863(c)(2).

country is apportioned to that country.[224] Round-trip travel between the United States and a foreign country is considered to be transportation income subject to 50-50 apportionment.[225]

Transportation income is defined to include income derived from, or in connection with, the use, hiring, or leasing of a vessel or aircraft.[226] An example would be income derived from transporting goods or persons by ship or aircraft. Income derived from a bareboat leasing of a vessel or aircraft also constitutes transportation income. The term "vessel or aircraft" includes a container used in connection with a vessel or aircraft.[227] Income derived from the lease of a vessel not used to transport persons or cargo is treated as income from a space or ocean activity rather than as transportation income.[228]

Income from the performance of services by seamen or airline employees is treated as transportation income if the income is derived from transportation between two U.S. ports or between the United States and a possession of the United States.[229] Services income derived from transportation between a U.S. port and the port of a foreign country (not including a possession of the United States) is classified as personal services income rather than as transportation income.[230]

Many U.S. tax treaties contain provisions that limit U.S. tax jurisdiction over transportation income.[231] Those treaty provisions, as applied to residents of the treaty country, prevail over the Code provisions.[232]

§ 14.04. International Communications Income

Income derived by a United States person from international communications activity is apportioned between U.S. and foreign sources on a 50-50 basis.[233] Such income derived by foreign persons is apportioned, with important exceptions, entirely to foreign sources.[234] The international communications income of a controlled foreign corporation (CFC) is apportioned as if the CFC were a U.S. person — that is, on a 50/50 bases.[235]

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[224] IRC §§ 863(c)(1) (apportioning income from transportation that begins and ends in the United States to the United States) and 863(c)(2) (treating one-half of income that begins or ends in the United States as U.S. source income). There is no explicit source rule provided for transportation income that neither begins nor ends in the United States, but, obviously, the income is foreign source income.

[225] See General Explanation of the Tax Reform Act of 1986 (1987) at 929.

[226] IRC § 863(c)(3).

[227] IRC § 863(c)(3) (last sentence).

[228] See General Explanation of the Tax Reform Act of 1986 (1987) at 929.

[229] See IRC §§ 863(c)(3)(B) (defining transportation income generally to include income from services directly related to the use of a vessel or aircraft) and 863(c)(2)(B) (providing an exception for transportation between the United States and a possession and between two U.S. ports). As amended by the 1997 tax act, the exemption in IRC § 863(c)(2)(B) does not apply in the case of transportation income derived from, or in connection with, a vessel if the taxpayer is not a U.S. citizen or resident alien. The legislative history does not identify the purpose or the intended beneficiary of this special rule.

[230] IRC § 863(c)(2)(B).

[231] See U.S. Model Treaty (2006), Art. 8 (Shipping and Air Transport).

[232] See Technical and Miscellaneous Revenue Act of 1988 at § 1012aa(3)(B) (not codified).

[233] IRC § 863(e)(1)(A) and Reg. § 1.863-9(b)(1) (2006).

[234] IRC § 863(e)(1)(B)(i) and Reg. § 1.863-9(b)(2)(i) (2006).

[235] Reg. § 1.863-9(b)(2) (ii) (2006). See General Explanation of the Tax Reform Act of 1986 (1987) at 935.

Foreign person, other than CFCs, that earns international communications income through an office or other fixed place of business located in the United States have that income sourced in the United States.[236] The amount of telecommunications income attributed to a U.S. office or other fixed place of business is determined under a facts-and-circumstances test. Under that test, income is attributed to an office or fixed base to the extent of the functions performed, resources employed, or risks assumed by the office or other fixed place of business.[237] Similar rules apply to foreign persons, other than CFCs, that do not have a fixed place of business in the United States but nevertheless are engaged in a trade or business in the United States.[238]

International communications income is defined in the Code as income derived from the transmission of communications or data between the United States and a foreign country.[239] That is, to have international communications income, the taxpayer must be paid to transmit a communication beginning in the United States and ending in a foreign country or beginning in a foreign country and ending in the United States. That term would include income attributable to a transmission of signals, images, sounds, or data. The transmission may be by cable, including a buried or underwater cable, or by satellite. For example, a telephone call originating in one country and terminating in another would constitute an international communication.[240]

The 2006 regulations make clear that communications activity includes the provision to customers of the capacity to transmit communications.[241] For example, assume that TCo, a domestic corporation, owns an underwater fiber optic cable. It permits its customers for a fee to transmit communications over that cable. The cable runs in part through U.S. waters, in part through international waters, and in part through foreign country waters. TCo derives international communications income because TC is paid to make available capacity to transmit communications between points in the United States and points in a foreign country.[242]

A communication between two points within the United States would not constitute an international communication, even if the communication is routed through a foreign country or through a satellite located in space.[243] Such activity is referred to as a U.S. communications activity.[244] Communications between a point in the United States and an airborne plane or a vessel at sea are considered to be U.S. communications activities.[245] The income derived from a U.S. communications activity is sourced entirely within the United States for all taxpayers.[246] Income from a communications activity within a foreign country, between one foreign country and another, or between a foreign country and a point in space or on the high seas is

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[236] Reg. § 1.863-9(b)(2)(iii) (2006).

[237] Id.

[238] Reg. § 1.863-9(b)(2)(iv) (2006).

[239] IRC § 863(e)(2). For the purpose of defining the various categories of communications income, a U.S. possession is treated as a foreign country.

[240] See General Explanation of the Tax Reform Act of 1986 (1987) at 935.

[241] Reg. § 1.863-9(h)(1)(i) (2006).

[242] Reg. § 1.863-9(j)(Ex.3) (2006).

[243] Reg. § 1.863-9(h)(3)(iii) (2006). See also Reg. § 1.863-9(j)(Ex.6) (2006).

[244] Reg. § 1.863-9(h)(3)(iii) (2006).

[245] Id. See Reg. § 1.863-9(j)(Ex.

[246] Reg. § 1.863-9(c) (2006).

referred to as foreign communications income.[247] That income is sourced outside the United States, whether earned by a U.S. person or a foreign person.[248]

A taxpayer has income from a communications activity even if it does not perform the actual transmission function or performs only a portion of it. It must be paid, however, to transmit the communication and must bear the risk of transmitting the communication. Assume, for example, that PCo, a U.S. corporation, is paid to transmit a communication from London, Ontario to Paris France. It transmits the communication itself from London to New York and pays an international carrier, ICo, to transmit the communication from New York to Paris. PCo's income derived from the transmission of the communication from London to Paris is foreign communications income because the beginning point and the end point are both in foreign countries. The income has its source without the United States The fact that PCo hires a third party to transmit the message from New York to Paris does not matter because PCo was paid to transmit the communication between London and Paris and bore the risks associated with the transmission. ICo, however, has international communications income because it was paid to transmit a communication from a point in the United States (New York) to a point in a foreign country (Paris).[249]

To constitute a communications activity, the communication must be *transmitted*. Delivery of communications, for example, by delivery of physical packages and letters is not communications activity for purposes of the communications source rule.[250] Perhaps to avoid obsolescence, the term "transmit" is not defined in the Code or regulations. It appears to include the delivery of any communication by electronic means, including by telephone, satellite, or the Internet.

The taxpayer has the burden of providing proper evidence of the beginning point and end point of communications.[251] If taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication, then the income is from sources within the United States.[252] For example, assume that SCo purchases capacity from TCo to transmit telephone calls. SCo sells prepaid telephone calling cards that give customers access to TCo's telephone lines for a certain number of minutes. SCo is unable to establish the endpoints of its customers' telephone calls. Consequently, SCo's communications income is U.S. source income.[253]

In some cases, a taxpayer may be paid both to transmit a communication and to provide a customer with content or otherwise to engage in an activity that does not constitution communications income. In such cases, the taxpayer must bifurcate the transaction into a communications activity and some other activity unless either the communications activity or the other activity is *de minimis*.[254] An activity is *de minimis* if it has little value.[255] For example, assume that PCo, a U.S. corporation is paid by DCo, a foreign cable company, to provide television programs and to transmit the television programs from the United States to Country D. Using its own satellite transponder, PCo transmits the television programs from the United States to downlink facilities owned by DCo in Country D. DCo receives the transmission, unscrambles the signals, and

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[247] Reg. § 1.863-9(h)(3)(iv) (2006).

[248] Reg. § 1.863-9(d) (2006).

[249] Reg. § 1.863-9(j)(Ex.5) (2006).

[250] Reg. § 1.863-9(h)(1)(i) (2006).

[251] Reg. §§ 1.863-9(h)(3)(1) (2006) and 1.863-9(k) (2006).

[252] Reg. § 1.863-9(f) (2006).

[253] Reg. § 1.863-9(j)(Ex.8) (2006).

[254] Reg. § 1.863-9(h)(1)(i) (2006).

[255] Id.

distributes the broadcast to its cable customers in Country D. Under these facts, PCo must determine its foreign communications income from the transmission of the programs and its income from the provision of the programming. The foreign communications income is sourced 50 percent within the United States and the remaining 50 percent without the United States.[256] The income from providing the programming presumably would be sourced under the rules applicable to income derived from the production of property in the United States and its sale outside the United States.

§ 14.05. Income Derived from Computer Software

The source of income generated by a transaction involving computer software depends on how that transaction is characterized under the source rules. Assume, for example, that a taxpayer produces a computer game, copies the software that runs the game onto CDs, packages each CD with instructional material in a sealed container ("shrink wrapped") and sells the packages at retail outlets. The resulting income would be characterized as income from the production and sale of inventory property, and the source of the income would be partly within the country of production and partly within the country of sale, determined under the rules set forth in section 13.03, above.[257] In contrast, if a taxpayer is hired to write computer code that might be used to produce a computer game, the income the taxpayer receives would be characterized as personal service income, and its source would be the country where the services are performed, under the rules described in section 14.01, above.[258]

In 1998, the U.S. tax authorities published detailed regulations that classify transactions involving computer software into four broad categories.[259] Taxpayers are required to use this classification scheme in determining the source of income derived from a transaction in computer software. If a transaction can fairly be considered to fall into more than one of these categories, then the transaction must be bifurcated, with each part of the transaction treated as falling exclusively into one of the categories.[260] The labels attached by the taxpayer to particular transactions generally are not determinative in classifying a transaction.[261] In some cases, they may be given no weight at all.

For purposes of the computer-software regulation, a computer program is "a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result."[262] In general, a computer program includes materials incidental to its use, such as the media on which it is transferred to the computer, any user manuals, documentation, or similar items.[263] The computer-software regulation establishes and explains the four exclusive categories of software transactions set forth below.

(1) A transfer of a "copyright right" in the computer program.[264] An example of a software transaction falling in this category is the sale or license of a right to make copies of a computer program for sale to the

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[256] See Reg. § 1.863-9(j)(Ex.15) (2006).

[257] See Reg. § 1.861-18(h)(Ex. 1) (1998).

[258] See Reg. § 1.861-18(h)(Ex. 15) (1998).

[259] Reg. § 1.861-18(a)(2) (1998).

[260] Reg. § 1.861-18(b)(2) (1998).

[261] Reg. § 1.861-18(g)(2) (1998).

[262] Reg. § 1.861-18(a)(3) (1998).

[263] Id.

[264] Reg. § 1.861-18(b)(1)(i) (1998).

public.[265] The source of the income from a sale of a copyright right typically is determined under the rules applicable to sales of personal property.[266] If substantially all of the rights to the copyright right are not transferred, the transaction is treated as a license.[267] The source of income derived from the license of a copyright right is determined under the rules applicable to rents and royalties. A transfer of all of the copyright rights having commercial value for a particular geographic region is treated as a sale of those rights, even if the transaction is structured in the form of a license and the transferor retains residual rights of little commercial value.[268]

(2) A transfer of a "copyrighted article" — that is, a copy of a computer program.[269] An example falling in this category is the sale of boxed computer programs, with accompanying manuals, at retail outlets. The fact that the software may include a so-called shrink-wrap license to use the software would not convert the transaction from a sale into a license.[270] The source of income from the sale of a copyrighted article is determined under the rules for sales of personal property.[271] A license of a copyrighted article has its source determined under the rules for rents and royalties.[272] Because of the special nature of computer programs, a requirement that the recipient of a computer program destroy the diskette on which it was received after some period will be treated as a requirement that the diskette be returned after that period for purposes of determining whether there was a sale or a license of the computer program.[273]

(3) The provision of services for the development or modification of a computer program.[274] An example of a computer-software transaction falling into this category is a company writing a computer program for another company under a service contract.[275] Whether an arrangement between parties is properly understood as a service contract is based on all the facts and circumstances of the transaction.[276] An agreement is likely to be characterized as a service contract if the company for which the program is being written will end up owning the computer program and bears the risk of loss during the development period.

(4) The provision of know-how relating to computer programming techniques.[277] An example of a transaction in this category is a transaction between two companies under which the first company demonstrates its secret computer-programming techniques to the second company for a fee. For a transaction to qualify as a transfer of computer-related know-how, the information must relate to computer programming techniques, it must be furnished under the terms of a non-disclosure agreement, and it must constitute property subject to trade secret protection.[278]

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[265] Reg. § 1.861-18(c)(2)(i) (1998). For other types of copyright rights, see Reg. § 1.861-18(c)(2)(ii)–(iv) (1998).

[266] Reg. § 1.861-18(f)(1) (1998).

[267] Reg. § 1.861-18(f)(1) (1998).

[268] Reg. § 1.861-18(h)(Ex. 5) (1998). In determining whether a sale or license has occurred, the principles of IRC §§ 1222 (defining various types of capital gains and losses) and 1235 (relating to sale or exchange of patents) are applicable. Reg. § 1.861-18(f)(1) (1998).

[269] Reg. § 1.861-18(b)(1)(ii) (1998).

[270] Reg. §§ 1.861-18(g)(1) and 1.861-18(h)(Ex. 1) (1998).

[271] Reg. § 1.861-18(f)(2) (1998).

[272] Reg. § 1.861-18(f)(2) (1998).

[273] Reg. § 1.861-18(f)(3) (1998). Similarly, a computer program that self-destructs after some period will be treated as if the program must be returned after that period. Id.

[274] Reg. § 1.861-18(b)(1)(iii) (1998).

[275] Reg. § 1.861-18(h)(Ex. 15) (1998).

[276] Reg. § 1.861-18(d) (1998).

[277] Reg. § 1.861-18(b)(1)(iv) (1998).

[278] Reg. § 1.861-18(e) (1998).

An important principle applicable under the regulations is that the source of income from a computer-related transaction should not depend on the media or method used in the transaction.[279] For example, a sale of a software program to the public through a transfer of the program on a CD is treated the same, for purposes of determining its source, as a sale of software downloaded from the Internet.[280] Similarly, a transfer of a copyright will not be treated, in part, as a transfer of tangible personal property simply because that right is transferred through the transfer of a floppy diskette.[281]

§ 14.06. Foreign Exchange Income

The source rule for gains or losses from currency exchange transactions is similar to the general rule for income from the sale of personal property. That is, such gains and losses generally have their source in the country where the person realizing the gain is resident.[282] For individuals, the country of residence is considered to be the country where the individual has his tax home.[283] All U.S. persons other than individuals are treated as residents of the United States.[284] Persons that are not U.S. persons and are not individuals are treated as foreign residents.[285]

The general residence rules set forth above are subject to an exception for income attributable to a qualified business unit (QBU) of the taxpayer.[286] A QBU is "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records."[287] The source of currency gains and losses attributed to a QBU is the country where the principal place of business of the QBU is located.

Currency gains and losses of a foreign QBU whose functional currency is a currency other than the dollar are not subject to the residence-of-the-taxpayer source rule. Code section 987 requires taxpayers having such a QBU to compute income or loss for the unit in its functional currency and then to convert that income or loss into U.S. dollars at an appropriate exchange rate. On remittance of currency from the QBU, the taxpayer may have an exchange gain or loss to the extent that the value of the currency at the time of remittance differs from its value when earned. The Code provides that such gains or losses have their source determined by reference to the source of the income giving rise to post-1986 accumulated earnings.[288] The statutory rule presents a serious problem because some portion of the currency gain taxable under section 987 may be derived from fluctuations in the U.S. dollar value of contributed capital.

Revised proposed regulations issued under Code section 987 in 2006 would solve the mixed-gain problem by providing that the source of "section 987 gain or loss" is generally to be determined under the

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[279] Reg. § 1.861-18(g)(2) (1998).

[280] Reg. § 1.861-18(h)(Ex. 2) (1998).

[281] Reg. § 1.861-18(h)(Ex. 5) (1998).

[282] IRC § 988(a)(3)(A) and Reg. § 1.998-4(a) (1992). This residence source rule generally applies to gains and losses arising from a "section 988 transaction." Section 988 transactions are certain transactions carried out in a currency other than the currency in which the taxpayer normally keeps its books. Currency gains or losses from loan transactions, from accruing expenses or income, or from certain futures transactions are considered to be section 988 transactions.

[283] IRC § 988(a)(3)(B)(i)(I). The term "tax home" is defined in IRC § 911(d)(3). See Reg. § 1.988-4(d) (1992).

[284] IRC § 988(a)(3)(B)(i)(II).

[285] IRC § 988(a)(3)(B)(i)(III).

[286] IRC § 988(a)(3)(B)(ii) and Reg. § 1.988-4(b) (1992).

[287] IRC § 989(a).

[288] IRC § 987(3)(B).

principles of regulation section 1.861-8.[289] In the typical case, the application of that regulation would require the taxpayer to use the asset method to determine the source of currency gains and losses on remittances from a QBU branch.

The residence-of-the-taxpayer rule does not apply to currency gains and losses from distributions of earnings and profits previously taxed under subpart F or under the passive foreign investment company (PFIC) provisions. In the case of gain or loss on a section 988 transaction, the income has the same source as the associated income that is distributed.[290] Currency gains and losses on section 988 transactions that are attributable to a U.S. business are sourced in the United States and are taxable as effectively connected income.[291]

The Code provides a special source rule for determining the source of currency gains and losses arising from certain related party loans.[292] Under this rule, the loans are marked to market on an annual basis.[293] That is, the accrued gains and losses on the debt instruments are taxed each year, based on the change during the year in the market value of those instruments. Interest income earned on the loan is treated as U.S. source income for purposes of determining the limitation on the foreign tax credit, but only to the extent of any marked-to-market loss on the loan.[294] This special rule only applies to loans made by a U.S. person or a related party to a 10-percent owned foreign corporation. A 10-percent owned foreign corporation is defined as a foreign corporation in which the United States shareholder owns 10 percent or more of the voting stock.[295] Loans are not subject to the special rule unless they are denominated in a currency other than the U.S. dollar and they bear an interest rate that is at least 10 percentage points higher than the mid-term rate payable on federal obligations at the time of the loan.[296]

§ 14.07. Additional Source Rules

Scholarships and Awards. In general, the source of a payment made to a nonresident alien as a genuine scholarship is the country of residence of the person making the scholarship grant.[297] For example, if a student from France receives a scholarship from her government for study at an American university, it would be sourced in France and would not be taxable by the United States.[298] In contrast, a scholarship paid by a U.S. foundation to a nonresident alien for study within the United States would be U.S. source income.[299]

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[289] Prop. Reg. § 1.987-6(b)(2) (2006). Cf. General Explanation of the Tax Reform Act of 1986 (1987) at 1109. For the asset method, see Reg. § 1.861-9T(g) (2009).

[290] IRC § 986(c).

[291] Reg. § 1.988-4(c) (1992).

[292] IRC § 988(a)(3)(C) and Reg. § 1.988-4(e) (1992).

[293] IRC § 988(a)(3)(C)(i).

[294] IRC § 988(a)(3)(C)(ii).

[295] IRC § 988(a)(3)(D).

[296] IRC § 988(a)(3)(C).

[297] Reg. § 863-1(d)(2) (2008).

[298] Reg. § 863-1(d)(2)(ii) (2008).

[299] Reg. § 863-1(d)(2)(i) (2008).

A generous exception to this rule applies to scholarships awarded to nonresident aliens with respect to activities conducted outside the United States. In such circumstances, the scholarship has a foreign source.[300] For example, if Wayne State University makes a scholarship award to an Irish citizen and resident for purposes of studying the Book of Kells in Dublin, Ireland, the scholarship recipient will have foreign source income and will not be subject to tax in the United States. Parallel rules generally apply in determining the source of certain awards and prizes.[301] The apparent intent of this asymmetrical mixture of a residence-of-the-grantor rule with a place-of-activities rule is to give a tax preference to foreign students and their sponsoring organizations.

Letters of Credit Income. In *Bank of America*,[302] the Court of Claims held that fees paid for issuance of a letter of credit are sourced, by analogy to interest, in the country of residence of the obligor. The court held, however, that fees for checking documents to determine whether a letter of credit should be paid were akin to payments for the performance of personal services. Thus they have their source in the place where the checking activities were carried out.

Underwriting Income. Code section 861(a)(7) provides that underwriting income derived from the issuing or reissuing of an insurance or annuity contract covering risks of U.S. residents is U.S. source income.[303] Other underwriting income generally would be foreign source income.[304] Section 861(a)(8) provides that social security benefits are U.S. source income. Under section 861(e), income from the lease of certain railroad rolling stock for use principally within the United States is U.S. source income.

Miscellaneous Other Source Rules. If no statutory or regulatory source rule is applicable, the source of a receipt must be determined according to principles derived from the statutory source rules. Nonstatutory determinations, by the courts or by the tax authorities, have held that the following income items are U.S. source income: alimony paid by a U.S. resident;[305] cotton export subsidies paid by the U.S. government;[306] gain from the proceeds of a theft insurance policy on goods shipped from the United States to Cuba that were stolen in transit;[307] a refund of New York City taxes;[308] a purse won on a horse race conducted within the United States;[309] and prize winnings for a contestant who performed the work necessary to enter the contest in the United States.[310]

[300] Reg. § 863-1(d)(2)(iii) (2008).

[301] Reg. § 863-1(d)(2)(i)-(iii) (2008).

[302] Bank of America v. U.S., 230 Ct. Cl. 679, 680 F.2d 142 (1982).

[303] For the definition of underwriting income, see IRC § 832(b)(3).

[304] IRC § 862(a)(7).

[305] Manning v. Comm'r, 614 F. 2d 815 (1st Cir. 1980); Warwick Housden v. Comm'r, TC Memo 1992-91, 63 T.C.M. 2063 (holding that alimony paid by a resident alien to his two former wives in Canada was U.S. source income subject to withholding).

[306] G.A. Stafford & Co. v. Pedrick, 171 F.2d 42 (2d Cir. 1948).

[307] Rev. Rul. 70-304, 1970-1 C.B. 163.

[308] Helvering v. Suffolk Co., 104 F.2d 505 (4th Cir. 1939).

[309] Rev. Rul. 58-63, 1958-1 C.B. 624.

[310] Rev. Rul. 66-291, 1966-2 C.B. 279 (if entering the contest was a mere clerical act, the source of the winnings would be the country where the contest was conducted).

Chapter 15
Source of Deductions

(WARNING: Not updated)

THE SOURCE OF A DEDUCTION is determined by reference to the source of the gross income to which that deduction relates. Thus, the source rules for deductions are matching rules, similar in some respects to the inventory accounting rules that taxpayers use to link the cost of goods sold with their receipts from the sale of goods included in inventory.[311] Whenever possible, deductions are matched with the gross income that they help to generate. When direct matching is considered to be impractical, indirect methods for relating deductions with gross income have been developed.

Foreign persons generally want their allowable deductions to be sourced in the United States. Because foreign persons generally are not taxable on their foreign source income, a deduction attributed to foreign source income would provide them with no tax benefit, whereas a U.S. source deduction generally would reduce the amount of income subject to taxation by the United States.

U.S. persons also want their allowable deductions sourced in the United States, but for a different reason. These taxpayers generally can utilize a deduction in computing their taxable income without reference to its source. The source of a deduction is relevant, however, in determining the limitation on their foreign tax credit. By maximizing their U.S. source deductions, they minimize their foreign source deductions. By so doing, they maximizes their foreign source taxable income, thereby maximizing the amount that qualifies for a foreign tax credit under the credit limitation rules.

Section 15.01, below, discusses the general rules that have been developed, largely in Treasury regulation section 1.861-8, for determining the source of deductions. Section 15.02 describes the complex set of rules applicable to the deduction for interest. The special source rules applicable for research and experimental (R&E) costs are addressed in § 15.03.

§ 15.01. General Source of Deduction Rules

Section 15.01.1, below, provides an introduction into the basic methods for determining the source of various allowable deductions. Because the source of a deduction is determined by reference to the source of the gross income that it reduces, the source rules applicable to deductions are primarily matching rules. Section 15.01.2, below, describes the so-called one-taxpayer rule for affiliated companies. The major purpose of the one-taxpayer rule is to prevent an affiliated group of companies from defeating the purpose of the various matching rules by isolating deductions in affiliated companies that earn relatively little foreign source income.

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[311] Gross receipts, for purposes of computing gain from the sale of inventory property, are the amounts received by the seller from the buyer on the sale. Gross income from the sale of inventory property is computed by subtracting the cost of goods sold from gross receipts.

The various provisions of the Code concerned with the source of income generally do not depend for their operation on the source of gross receipts or on the source of the deduction for the cost of goods sold. Thus, there generally is no need for rules that determine the source of those items. It is implicit in the source rules for gross income from the sale of inventory property, nevertheless, that gross receipts from the sale of inventory property and the deduction for costs of inventory property have their source in the country where the gross income from the sale of inventory property is sourced. The source of income from natural resources does depend on the source of gross receipts from the extraction of those natural resources.

The Code and regulations offer many specific rules for determining the source of various deductible amounts. Section 15.01.3, below, addresses issues that arise in linking state and local taxes with particular items of income. The basic point made in that section is that taxes imposed by a local jurisdiction are not necessarily sourced where that jurisdiction is located. Section 15.01.4 deals with the deduction for losses. In general, a loss arising from the sale of an asset has its source in the place where the gross income from the sale would have been sourced if that asset had been sold at a gain. There are important exceptions, however, to this general rule. Section 15.01.5 describes a variety of rules that specify the source of deductions that have no obvious link to income or have a link that is at best ambiguous.

§ 15.01.1. Allocation and Appointment of Deductions

Under Treasury regulation section 1.861-8, the source of deductions is determined by allocating deductions to a class of gross income and then apportioning the deductions so allocated between U.S. and foreign sources.[312] More precisely, deductions are apportioned "between the statutory grouping of gross income . . . and the residual grouping of gross income."[313] The statutory grouping of gross income is gross income from one or more countries that must be determined under some operative provision of the Code. In the taxation of foreign persons, the statutory grouping is U.S. source income and the residual grouping is foreign source income. In determining the limitation on the foreign tax credit, the statutory grouping is foreign source income and the residual grouping is U.S. source income.

Apportionment of deductions is based upon the factual relationship between the deductions allocated to a class of gross income and the U.S. and foreign source gross income in that class.[314] Guidelines for apportioning income between U.S. and foreign sources are provided in Treasury regulation section 1.861-8.[315] The allocation and apportionment of deductions is illustrated in the following example.

Example 15.1: Allocation and Apportionment of Deductions

XCo is a U.S. corporation engaged in the hotel business. It has one hotel located in Canada and another hotel in the United States. Its gross income from the hotel business is $300. According to the gross income source rules, $200 is sourced in Canada and the remaining $100 is sourced in the United States. XCo also has unrelated royalty income of $400, all of which is derived from U.S. sources. It has deductible business expenses of $100 related to its hotel business and deductible expenses of $6 related to the royalty income.

Under these facts, XCo has two relevant classes of gross income — business income and royalty income. The $100 of hotel expenses is allocated to the $300 of gross income generated by the hotel business. The $6 of royalty expenses is allocated to the $400 of royalty income.

The deductions allocated to income from the hotel business are apportioned between U.S. and foreign sources by reference to the factual relationship between those deductions and the gross income in the two countries. If $60 was spent running the Canadian hotel and the remaining $40 was

[312] Reg. § 1.861-8(a)(2) (1999).

[313] Reg. § 1.861-8(a)(2) and (4) (1999).

[314] Reg. § 1.861-8(c) (1999).

[315] See Reg. § 1.861-8T (1999).

spent running the U.S. hotel, then $60 of deductions would be apportioned to sources in Canada and $40 of deductions would be apportioned to sources in the United States.

If the hotel expenses cannot be definitely related to a specific activity, then they would be apportioned on some reasonable basis. Ratable apportionment on the basis of U.S. and foreign gross receipts from the hotel business might be an acceptable method.

The royalty expenses are attributed to U.S. sources. No apportionment of the royalty expenses between U.S. and foreign sources is required because all of the gross income to which they relate is U.S. source income.

The Code provides that "expenses, losses, and other deductions that cannot definitely be allocated to some item or class or gross income" are to be ratably allocated to all gross income.[316] Under Treasury regulation section 1.861-8, the only deductions that cannot be allocated to some class of gross income are the personal expense deductions. The amount of a deduction ratably allocated to the United States would be determined by multiplying the deduction by a fraction. The numerator of the fraction would be gross income sourced in the United States, and the denominator would be worldwide gross income.

Allocation and apportionment of deductions based on the fraction described above is called the gross-to-gross method of allocation. Prior to the adoption of the section 1.861-8 regulations in 1977, many U.S. taxpayers used the gross-to-gross method for most deductions that had no obvious links with specific items of gross income. That method, for example, was routinely used by U.S. taxpayers to allocate interest expenses and head office expenses.

Treasury officials believed that the gross-to-gross method systematically attributed excessive deductions to U.S. source income, thereby inflating the limitation on the foreign tax credit. The gross-to-gross method gave many U.S. corporations a substantial degree of control over the source of their deductions because of the control they have over the payment by their foreign subsidiaries of dividends, royalties, and similar items of gross income.

Application of the gross-to-gross method to the facts of *Example 3.4*, above, would produce clearly erroneous results. In that example, U.S. source gross income is $500, foreign source gross income is $200, and worldwide gross income is $700. The total allowable deductions of the company are $106, of which $46 are attributed to U.S. sources under the section 1.861-8 regulations. Under the gross-to-gross method, deductions attributed to the U.S. sources would equal $75.71 ($106 × $500/$700). Foreign source deductions would equal only $30.29 ($106 × $200/$700). The improper result reached under the gross-to-gross method is avoided under the section 1.861-8 regulations by requiring the taxpayer to separate deductions relating to business income from deductions relating to royalty income before making an apportionment between U.S. and foreign sources.[317]

In some circumstances, the gross-to-gross method would produce unacceptable results even if the taxpayer had only one class of gross income. Assume, for example, that P, a U.S. holding company, has a foreign subsidiary, F, and a U.S. subsidiary D. D and F have identical businesses, and each earns $6,000 of taxable income. P has management expenses of $600 that relate to the supervision of F and D. During the taxable year, P received a dividend of $2,000 from F and a dividend of $6,000 from D. It has no other

[316] IRC § 861(b).

[317] It is not clear from the facts of the above example whether the business expenses are definitely related to a specific activity. If they are so related, they would not have been apportioned under the gross-to-gross method even prior to the adoption of the section 1.861-8 regulations.

income. Under the gross-to-gross method of allocation, the head office expenses allocated to U.S. source income would be $450, determined by multiplying the amount of the deduction ($600) by the ratio of P's U.S. source gross income ($6,000) to its worldwide gross income ($8,000).

The result reached above under the gross-to-gross method is inappropriate. It is utterly implausible to contend that P incurred $450 of its management expenses to obtain income from D and only $150 to obtain income from F. Indeed, the gross-to-gross method would allocate none of the management expense to foreign source income if P caused F to make no dividend distribution. No source rule should be so divorced from economic realities or so under the control of the taxpayer.

The section 1.861-8 regulations would require a more reasonable basis for apportioning the management expenses between U.S. and foreign sources. Apportionment according to the earnings and profits of the subsidiaries might be a good method. The appropriate method would depend on the facts and circumstances of each case. Under other circumstances, an appropriate method might be apportionment by gross receipts, unit sales volume, or gross income of the subsidiaries, or by comparisons of time spent by employees weighted to take into account differences in compensation.[318]

Tax-exempt assets and income from tax-exempt assets generally are not to be taken into account for purposes of allocating or apportioning any deductible expense.[319] This rule, added to the Code by the 1986 tax act, is designed principally to prevent U.S. banks and other U.S. taxpayers holding tax-exempt state and local bonds from improperly increasing the amount of their deductions attributed to U.S. sources. The theory of the rule is that expenses incurred to earn taxable income should not be matched for source purposes with tax-exempt income.

§ 15.01.2. One-Taxpayer Rule for Affiliated Companies

Corporations that are members of an affiliated group are treated as if they were one taxpayer in determining the source of deductions that are not directly attributable to a specific income-producing activity.[320] Under this one-taxpayer rule, interest, head office expenses, and other unspecific deductions of U.S. corporations included in an affiliated group are consolidated before being allocated and apportioned between U.S. and foreign sources. An affiliated group is composed of a chain of U.S. corporations with a common parent owning (by vote and value) 80 percent or more of the stock of the other members of the group.[321] The one-taxpayer rule was adopted to prevent taxpayers from isolating the unspecified deductions of an affiliated group in corporations earning mostly U.S. source income.[322]

The tax avoidance schemes blocked by the one-taxpayer rule can be illustrated by the following example. Assume that P, a U.S. corporation, holds all of the stock of D, its domestic subsidiary. P has a U.S. savings account of $1,400 earning annual interest of $100 and has no other assets. It incurs expenses of $100

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[318] See Reg. § 1.861-8(e)(4) (1999).

[319] IRC § 864(e)(3) and Reg. § 1.861-8T(d)(2) (1999). Note that interest specifically allocable to tax-exempt income is disallowed as a deduction under IRC § 265(a)(2).

[320] IRC §§ 864(e)(6) (for expenses other than interest) and 864(e)(1) (for interest). This rule was added to the Code by the 1986 tax act.

[321] See IRC § 1504(a).

[322] See *General Explanation of the Tax Reform Act of 1986* (1987) at 944-945. For special allocation rules applicable to affiliated taxpayers, see Reg. § 1.861-14T (1988). The one-taxpayer rule has caused some taxpayers to want to avoid meeting the consolidation tests with respect to some of their subsidiaries. For discussion, see Lee Sheppard, "Ford Motor Company Avoids Interest Expense Allocation by Deconsolidating Its Financial Operations," 1 *Tax Notes Int'l* 472 (November 1989).

that are not directly attributable to a specific income-producing activity. D derives $200 of gross income from U.S. sources and $200 of gross income from foreign sources. Under the one-taxpayer rule, the $100 of unspecified expenses incurred by P would be allocated between foreign and U.S. sources as if P and D were a single corporation. But for the one-taxpayer rule, P would be able to contend that the entire $100 should be allocated to U.S. sources on the ground that all of its gross income is sourced in the United States and all of its assets are U.S. assets.

§ 15.01.3. State and Local Taxes

Some taxes, such as a sales tax or a property tax, operate like a cost of doing business in that they must be paid whether or not the operation of the business is successful. Income taxes, in contrast, are not costs of earning income; they are an expense imposed on a company only after the income has been earned. This difference in the nature of state and local taxes justifies some differences in the source rules applicable to those taxes. Section 3/B.1.3.1, below, discusses the rules applicable in determining the source of income taxes. Those rules are complicated by the fact that most states do not use source rules in determining the limitations on their taxing jurisdiction. Section 3/B.1.3.2, below, describes the source rules applicable to property taxes, and section 3/B.1.3.3 describes the rules applicable to sales taxes.

§ 15.01.3.1. Income Taxes

Deductions for state and local income taxes are to be attributed to the gross income with respect to which the taxes were imposed.[323] If a state or local government imposes a tax on foreign source income, as determined under federal concepts of source, then Treasury regulations have long provided that a portion of the federal deduction for those taxes must be attributed to foreign source gross income. Although this rule has attracted some criticism, it is correct in principle.

The practical problem for taxpayers is to determine what portion, if any, of an income tax imposed by a state or local government should be treated as imposed on their foreign source income. The problem is particularly difficult when taxpayers are required to use an apportionment formula, based, for example, on their sales, payroll, and property, to determine the amount of their state taxable income.

The Treasury regulations provide several methods for determining the source of deductions for state and local taxes, depending on the tax laws of the jurisdiction imposing the tax. The least favorable method applies when a state uses a formulary apportionment method and does not specify in its tax laws that foreign source income is exempt from tax. In such circumstances, a taxpayer, at least initially, must treat the portion of its income subject to taxation by the state that exceeds the amount of its U.S. source income, as computed for federal income tax purposes but without the deduction for state taxes, as foreign source income. The taxes paid to the state are then attributed ratably to foreign source and U.S. source income.[324]

Assume, for example, that T, a U.S. taxpayer, has taxable income, determined without a deduction for state income taxes, of $1 million, of which $800,000 is U.S. source income and $200,000 is foreign source income under federal tax concepts. The states collectively impose tax under their apportionment formulas on income of $950,000. Under these facts, the regulations initially presume that the states have taxed $150,000 of foreign source income.

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[323] Reg. § 1.861-8(e)(6) (1999). Regulations specifying the source of deductions for state and local taxes were issued in temporary form in 1988 and reissued in final form in March, 1991. The temporary regulations were controversial, and rightly so. The final regulations give taxpayers many more opportunities to demonstrate that the taxes they paid to state and local governments were imposed with respect to U.S. source income.

[324] See Reg. § 1.861-8(g)(Ex. 25) (1999).

Taxpayers can avoid the harsh result illustrated in the example above by showing that the states did not in fact impose a tax on foreign source income. For example, they might demonstrate that the difference between the amount subject to tax by the states and the amount of their U.S. source income for federal purposes was due to the allowance by the states of less generous deductions for depreciation.[325]

If a state explicitly exempts all foreign source income from taxation, then all taxes paid to that state are allocated to U.S. source income. In the example above, the entire amount of the taxes paid to the states would be allocated to U.S. source income if the laws of each of the states prohibited the taxation of foreign source income. If only one of the states had such a prohibition in its laws, then its taxes would be allocated solely to domestic source income and the taxes of the other states would be allocated in part to foreign source income.[326]

Some states impose a tax on the foreign source dividends received by their taxpayers but otherwise exempt foreign source income from taxation under their tax laws. In such circumstances, the amount of taxes imposed with respect to the foreign dividends will be allocated to foreign source income and the remaining taxes will be allocated to domestic source income.[327] Two safe-harbor rules are provided in the regulations to assist the taxpayer in determining the amount of taxes properly allocable to foreign source dividends.[328]

The validity of the section 1.861-8(e)(6)(i) regulations, as applied to a California taxpayer, were upheld in *Chevron.*[329] At the time of the case, California determined the net income of a corporate group operating a unitary business within its borders by applying a three-factor formula to the total worldwide net income ("preapportionment income" in state tax terminology) of that group. Dividends received from members of the corporate group are excluded from the group's total income, but dividends received from other corporations are included in total worldwide income. Chevron was engaged in a unitary business (extraction, refining, and sale of petroleum products) in California and received very substantial dividends from Aramco, a Saudi Arabian corporation not included in Chevron's corporate group. The basic position of the Internal Revenue Service was that the California income tax should be allocated to foreign source gross income to the extent that the tax was imposed on foreign source income. That position was upheld by the Tax Court.

Treasury regulation section 1.861-8(e)(6)(i) specifically provides that a state income tax that is imposed on foreign source dividends received by a unitary business will be apportioned directly to those dividends if the state is using a formulary apportionment method of taxation and does not include the factors of the distributing corporation in the apportionment formula. In the language of the regulations, the specially taxed foreign dividends constitute a separate class of gross income. Chevron's dividends from Aramco fell within this regulatory rule. In accordance with the regulatory rule, which was upheld by the Tax Court, the Service allocated the portion of the California income tax attributable to the Aramco dividends to foreign source gross income.

Chevron had allocated nearly all of the California tax to U.S. source gross income, using methods that were not sanctioned by the regulations. In upholding the regulations, the Tax Court rejected Chevron's allocation methods. As a fallback position, Chevron contended that it should be permitted to use the

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[325] See Reg. § 1.861-8(g)(Ex. 31) (1999). Example 31 solves a weakness in the temporary regulations pointed out in an earlier edition of this book.

[326] See Reg. § 1.861-8(g)(Ex. 26) (1999).

[327] See Reg. § 1.861-8(e)(6)(i) (1999).

[328] See Reg. §§ 1.861-8(e)(6)(ii)(D) (1999) and 1.861-8(g)(Ex. 33) (1999).

[329] *Chevron v. Comm'r*, 104 T.C. 719 (1995). The author consulted with the Service on this case.

allocation and apportionment method suggested by Example 25 of the regulations.[330] The Tax Court agreed, rejecting the claim of the Service that Chevron had failed to make a timely election to use the method of Example 25.

Example 25 exemplifies what may be called the "America First" method. Under America First, a state unitary income tax generally is treated as attributable to U.S. source net income to the extent that the net income taxable by the state (after certain adjustments) does not exceed the taxpayer's net U.S. source income. Assume, for example, that the taxpayer's California pre-apportionment net income is $1,000, of which $500 is U.S. source net income. California imposes tax of $40 on net income of $400. All of that tax will be considered under America First to be attributable to U.S. source income. A pro rata method, advocated by the Service in *Chevron,* would attribute one half of the tax ($500/$1,000 × $40 = $20) to foreign source net income. If California had imposed a tax of $60 on net income of $600, then $50 of the tax would be attributed to U.S. source income under America First, and the remaining $10 would be attributed to foreign source income.

§ 15.01.3.2. Property Taxes

The section 1.861-8 regulations do not deal specifically with the allocation and apportionment of state and local taxes other than income taxes. Under the matching principle embodied therein, however, all state and local taxes should be attributed to the gross income they help produce. Thus, state property taxes imposed on a taxpayer's manufacturing facility should be allocated to the class of gross income derived from the manufacture and sale of the goods produced at that facility. A U.S. manufacturer typically would determine the source of income derived from the manufacture and sale of goods under the two-factor allocation formula set forth in the regulations under Code section 863(b). Taxpayers using the 50/50 formula generally must apportion their deductible expenses ratably between their U.S. source gross income and their foreign source gross income.

A state or local property tax imposed on equipment used by the taxpayer to earn international communications income would be allocated to that class of gross income. For a U.S. person, gross income from the transmission of communications or data between the United States and a foreign country is apportioned on a 50-50 basis between U.S. sources and foreign sources. Property tax deductions relating to that gross income should be apportioned by the same formula.

A state or local property tax imposed on equipment held for rent should be allocated to the gross income derived from the rental of that property. The source rule for income derived from the rental of property is the place of use. Thus, a property tax imposed by a U.S. state on rental property used within that state would be allocated and apportioned entirely to U.S. source income. If the rental property is used outside the United States, however, the section 1.861-8 regulations require the taxpayer to apportion the taxes between the domestic and foreign sources on some reasonable basis. For example, if a U.S. person is running a car rental business and some of the cars are rented for use in Canada, then the taxpayer must apportion some of the property taxes imposed on those cars to the rental income derived from the use of the cars in Canada.

Some weak authority is provided by *Missouri Pacific Railroad* for allocating to the United States the entire amount of state property taxes imposed on rental property used in interstate and international

[330] Reg. § 1.861-8(g)(Ex. 25) (1999).

commerce.[331] The case predates the section 1.861-8 regulations and is badly reasoned in any event. In support of its holding, the court stated that "[p]ayment of the property taxes to the several states in no way affected the right of the taxpayer to operate in Mexico or enhanced its ability to earn income in that nation." That observation, although undoubtedly correct, is irrelevant under the section 1.861-8 regulations. The correct issue for the court under the regulations would have been whether the property taxes were paid with respect to property used to earn income in Mexico. If the answer was yes, then some portion of the deductions for property taxes should be allocated to foreign source income.[332]

Missouri Pacific Railroad is good authority for the proposition that a state property tax on railway cars or other rolling stock should be attributed to gross rental income derived within that state from the rolling stock if the tax is reasonably apportioned by the state to apply only to the use of the rolling stock within that state. The case is not good authority for the more general proposition that a property tax imposed on property used to earn foreign source income can be apportioned entirely to the state where the property is located. That latter proposition is illogical and is directly contrary to the principles of Treasury regulation section 1.861-8.

§ 15.01.3.3. Sales Taxes

Sales taxes imposed by a state or local government should be allocated and apportioned according to the matching principal of Treasury regulation section 1.861-8. Sales taxes imposed on goods used in the production of inventory property might best be treated as an inventory cost, with the allocation and apportionment then made under the inventory accounting rules. Sales taxes imposed on office supplies might be allocated and apportioned according to the methodology used to allocate and apportion head office expenses. A taxpayer who purchases an automobile for use in his business should allocate the sales tax imposed on that purchase to his business income.[333] Whatever method is used to attribute state and local taxes to a grouping of gross income, it "must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income."[334]

§ 15.01.4. Losses

The source of a deduction for a loss resulting from the sale or other disposition of personal property described in Code section 865 ("section 865 property") is generally the place where gain from the sale of that property would have its source.[335] For example, a loss recognized by a United States resident on the sale of a bond generally is allocated to reduce United States source income because gain on that sale would be U.S. source income under the residence-of-the-seller rule.[336] Similarly, a loss on the sale of stock by a U.S.

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[331] *Missouri Pacific Railroad Company v. U.S.,* 411 F.2d 327 (8th Cir. 1969), cert. denied, 396 U.S. 1037 (involving state property taxes imposed on railroad cars used to generate rental income in the United States and Mexico).

[332] In addition, the court apparently was under the mistaken opinion that an allocation of some portion of the state taxes to Mexican source income would impugn the constitutionality of the state property taxes.

[333] For property used predominantly for earning either U.S. source income or foreign source income, a *de minimis* rule should be provided by regulation that would allocate the entire state tax to U.S. source or to foreign source gross income, as the case may be. *See* IRC § 865(c)(3)(B) (providing such a *de minimis* rule for determining the source of gain derived from the sale of depreciable property).

[334] Reg. § 1.861-8T(c)(1) (1999).

[335] Reg. §§ 1.865-1T(a)(1) (1998) and 1.865-2(a)(1) (1998). The current general rule was adopted by regulation in 1998. Under prior regulations, the general rule was that losses on a sale of personal property constituting a capital asset were sourced where the income from that property was generated (or were expected to be generated). Reg. § 1.861-8(e)(7)(i) (1999). See *Black & Decker Corp. v. Comm'r,* TC Memo 1991-557 (applying prior general rule to hold that loss on deemed disposition of stock of Japan affiliate is a foreign source loss despite failure of affiliate to pay dividends).

[336] Id. (providing this example). See IRC § 865(a)(1) (stating the residence-of-seller rule).

resident would reduce U.S. source income.[337] The residence of the seller is determined under the special residency rules of Code section 865(g).[338] A partner's share of a loss recognized by a partnership is treated as if the partner had recognized the loss.[339]

A taxpayer who suffers a net operating loss from engaging in a business activity generally is allowed to deduct that loss under Code section 172. The source of the loss carryover is the place where the deductions giving rise to the loss carryover were located.[340]

The general rule produces results that are favorable for most U.S. persons and unfavorable for foreign persons and U.S. persons treated as foreign persons under the special residency rules of Code section 865(g). Exceptions to the general rule and several anti-avoidance rules reduce the benefits otherwise obtainable under the general rule.

There are some important exceptions to the general rule described above for locating the source of a loss on the disposition of section 865 property in order to prevent abuses of the general rule. Different exceptions apply to losses on stock and losses on other categories of personal property. The following exceptions to and clarifications of the general rule apply to dispositions of personal property other than stock:

(1) *Foreign Office*. A loss on the disposition of personal property incurred by a U.S. resident that is attributable to a foreign office is sourced in the country where the office is located if a gain would have been attributed to that office.[341]

(2) *Foreign Tax Home*. With certain exceptions, a loss recognized by a U.S. citizen or resident alien having a foreign tax home will be foreign source income.[342]

(3) *Inventory*. Losses attributable to inventory property described in Code section 1221(a)(1) are not governed by the regulations under section 865.[343] Whether the location of a loss on the sale of inventory property is determined under the passage-of-title test is unsettled. Taxpayers electing a method for apportioning gains from the production and sale of inventory property presumably must use that method in determining the source of losses.[344]

(4) *Depreciation Recapture*. To maintain parallel treatment of gains and losses, a loss on the disposition of depreciable property subject to recapture is located in the country where the property was predominantly used.[345]

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[337] Reg. § 1.865-2(a)(1) (1998) (providing this example). This result was reached in *Int'l Multifoods Corp. v. Comm'r*, 108 T.C. 579 (1997). For an early discussion of making the source of losses on the sale of stock the place where the gain on such stock would be sourced, see Gail W. Taylor, "Determining the Source and Category of Losses on Dispositions of Stock," 3 *Tax Notes Int'l* 205 (February 1991).

[338] See Reg. § 1.861-2(d)(4) (giving cross reference to IRC § 865(g)). No similar cross reference is provided in Reg. § 1.861-1T (1998). For discussion of the section 865 residency rules, see section 3/A.2.2.7, above.

[339] Reg. §§ 1.865-1T(a)(5) (1998) and 1.865-2(c) (1998).

[340] Reg. § 1.861-8T(e)(8) (1999).

[341] Reg. § 1.861-1T(a)(2) (1998).

[342] Reg. § 1.861-1T(a)(3) (1998).

[343] Reg. § 1.861-1T(c)(2) (1998).

[344] See Reg. § 1.863-3(e)(1) (requiring taxpayer to obtain permission of tax authorities to change its apportionment method).

[345] Reg. §§ 1.861-1T(b)(1) (1998) and 1.861-1T(e)(Ex. 1) (1998). See section 3/A.2.2.3 for discussion of the depreciation recapture rule applicable to gains.

(5) *Interest and Interest Substitutes*. Losses attributable to assets that generate amounts taxable as interest or interest substitutes generally are allocated and apportioned under the rules applicable to deductions for interest.[346]

(6) *Currency and Certain Financial Instruments*. Currency losses and loss recognized with respect to options contracts or derivative financial instruments are not governed by the regulations under section 865.[347]

Some of the above exceptions also apply to losses on the disposition of stock, and some additional exceptions also apply. In general, the following exceptions to and clarifications of the general rule apply to dispositions of stock:

(1) *Common Exceptions*. The foreign office exception,[348] the foreign tax home exception,[349] and the inventory exception,[350] described in items 1-3 above, also apply to dispositions of stock.

(2) *Real Property Interest*. A loss recognized by a nonresident alien individual or a foreign corporation with respect to stock that constitutes a United States real property interest is sourced in the United States.[351]

(3) *Stock of an S Corp*. A loss recognized with respect to stock in an S corporation (as defined in Code section 1361) is not treated as a loss on section 865 property.[352]

(4) *Dividend Recapture*. Subject to some exceptions, a loss on the disposition of stock has its source where the dividends received on that stock within the prior two years had their source, up to the amount of those dividends.[353] Assume, for example, that PCo, a U.S. corporation, received dividends of $400 from FCo, its foreign subsidiary, during year 1 and year 2. At the end of year 2, PCo sells the FCo stock at a loss of $1,000. Assuming no exceptions or special rules apply, PCo would have a foreign loss of $400 and a U.S. loss of $600.

In addition to the exceptions to the general rules described above, the following three anti-abuse rules apply to losses arising from the disposition of section 865 property. For these rules to apply, the circumstances must indicate that the taxpayer was attempting to manipulate the source of its loss to avoid taxes.

(1) *Built-in Losses*. If a taxpayer holds an asset that would generate a foreign loss on its disposition, the loss will continue to be a foreign loss under the built-in loss rule even if the taxpayer transfers the asset to a related person or otherwise engages in a transaction that would cause the built-in loss to become a U.S. loss under the general rule.[354] For example, assume that FCo, a foreign affiliate of PCo, holds assets valued at $100 with a tax basis of $200. A sale of that asset by FCo would produce a foreign loss. To change the

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[346] Reg. §§ 1.861-1T(b)(2) (1998) and 1.861-1T(c)(3)–(5) (1998)

[347] Reg. § 1.861-1T(c)(1) (1998). Losses from global trading are sourced under the regulations dealing with global dealing operations. See Prop. Reg. § 1.863-3(h)(2) (1998) (adopting a residence-of-participant rule).

[348] Reg. § 1.865-2(a)(2) (1998).

[349] Reg. § 1.865-2(a)(3)(i) (1998). The rule also applies to bone fide residents of Puerto Rico. Reg. § 1.865-2(a)(3)(ii) (1998).

[350] Reg. § 1.865-2(b)(2) (1998).

[351] Reg. § 1.865-2(a)(4) (1998).

[352] Reg. § 1.865-2(b)(3) (1998).

[353] Reg. § 1.865-2(b)(1)(i) (1998).

[354] Reg. §§ 1.865-1T(c)(6)(i) (1998) and 1.865-2(b)(4)(i) (1998).

source of the loss, FCo transfers that asset to PCo as part of a tax-free exchange, and PCo disposes of it. The loss is a foreign loss under the built-in loss rule.[355]

(2) *Offsetting Positions*. Under the offsetting positions rule, a taxpayer must treat a loss as a foreign loss if it disposes of personal property that would constitute a U.S. loss under the general rule and it, or a related person, holds an offsetting position with respect to that property that has produced or will produce an equivalent amount of foreign source gain.[356] For purposes of this rule, two positions are offsetting if the risk of loss of holding the first position is substantially diminished by holding the second position. Assume, for example, that PCo, a U.S. corporation, purchases for $200 a contractual right to purchase 1,000 bushels of corn on the last day of year 1 for $4,000. FCo, its foreign affiliate, holds a contractual right to sell 1,002 bushels of corn on the third day of year 2 for $4,001. These positions in corn are offsetting. As a result, if PCo disposes of its contract right for a loss of $50, the loss will be a foreign loss.[357]

(3) *Matching Rule*. Subject to certain exceptions, a taxpayer must recognize a foreign loss under the matching rule if it engages in a transaction generating foreign source income that results in the creation of a corresponding loss that would constitute a U.S. loss under the general rule.[358] Assume, for example, the PCo establishes FCo, a foreign corporation. In year 1, PCo contributes $1,000 to the capital of FCo in exchange for one share of so-called fast-pay preferred stock. The preferred share is entitled to a dividend in year 1 and year 2 of $400 per year and is redeemable at the end of year 3 for $210. PCo received preferred dividends of $400 in years 1 and 2. At the start of year 3, it sells the preferred stock to NCo, an unrelated purchaser, for $200, recognizing a loss of $800. Because PCo recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the FCo preferred stock, the $800 loss is characterized as a foreign loss under the matching rule.[359]

Making the rules determining the source of losses reciprocal to the source rules for gains is unsound, in theory and practice. The practical objections are evident from the many exceptions and complex anti-avoidance rules that are required to prevent major abuses. It is unsound in theory because it is not fully consistent with the justification for allowing a deduction for business losses.

The basic fairness rationale for allowing a deduction for business losses is that a government that treats itself as a silent partner of the taxpayer in collecting revenue on income ought to treat itself as a silent partner in sharing losses. With respect to investment made in a foreign country, there are two silent partners, the government exercising residence jurisdiction and the government exercising source jurisdiction. When the U.S. government makes itself a silent partner with a U.S. person investing in a foreign country for purposes of collecting taxes on income, it is the junior partner (the residual tax collector) and the government of the foreign country is the senior partner (the primary tax collector). The U.S. government should remain the junior partner when the income does not materialize and the taxpayer suffers a loss. That result is achieved by characterizing the loss as a foreign loss. As a foreign loss, it reduces income that the United States taxes only on a residual basis and does not reduce U.S. source income, over which the United States exercises primary jurisdiction.

When a U.S. person makes a foreign investment that is expected to generate unrealized capital appreciation, the reciprocal approach often produces an appropriate result. A foreign government cannot

[355] See Reg. § 1.865-2(b)(iv)(Ex. 1) (1998).

[356] Reg. §§ 1.865-1T(c)(6)(ii) (1998) and 1.865-2(b)(4)(ii) (1998).

[357] See Reg. § 1.865-2(b)(iv)(Ex. 2) (1998).

[358] Reg. §§ 1.861-1T(c)(6)(iii) (1998) and 1.862-2T(b)(4)(iii) (1998).

[359] Reg. § 1.865-2T(b)(iv)(Ex. 4) (1998).

reasonably expect to obtain income tax revenue from unrealized appreciation or from the sale by a U.S. person of stock or certain other categories of intangible property. It should not be required, therefore, to share the loss. When the U.S. person invested in a foreign country with an expectation that it would generate foreign source dividends, interest, royalties, or other income subject to tax by the government of that country, however, then the foreign government should be required to act as the senior partner in sharing any resulting loss.

The proper tax policy result would be achieved in most cases by linking the source of a loss on an investment in personal property to the source of the income that the investment was expected to generate when it was made. That rule is superior to the current rule in theory and would be less complex to administer.

§ 15.01.5. Miscellaneous Other Deductions

Specific guidance is provided in the section 1.861-8 regulations for determining the source of a variety of deductions that are not linked clearly with any particular item of income. Sections 3/B.1.5.1 through 3/B.1.5.5, below, discuss the source rules applicable to those deduction.

§ 15.01.5.1. Supportive Functions

Deductions for overhead costs, supervisory expenses, general administration, and the like may be difficult to link with specific classes of gross income. The section 1.861-8 regulations offer two alternatives to making such linkage for supportive functions other than stewardship expenses. First, if the taxpayer can establish that those supportive expenses relate to other deductions that are more easily allocated to gross income, it may allocate them according to the methodology used to allocate those other deductions.[360] For example, if the taxpayer hires an outside accountant for which accurate time allocation records are kept, and the accounting services relate closely to the taxpayer's supervisory activities, then the allocation and apportionment method used for the accounting charges also might be used for the supervisory activities.

Second, the taxpayer may allocate the supportive expenses directly to all gross income or to another broad class of gross income and apportion the expenses in some appropriate manner.[361] For example, the taxpayer might allocate supervisory expenses to gross income from sales of its products and then apportion the expenses between U.S. sources and foreign sources by reference to gross receipts from U.S. and foreign sale of its products.[362] If the supervisory deductions relate to all classes of income, the taxpayer might allocate and apportion them using the asset method, which is used primarily to allocate and apportion interest deductions.[363]

§ 15.01.5.2. Stewardship Expenses

A stewardship expense, as defined in the section 1.861-8 regulations, is a cost incurred by a corporation to oversee its investments in its affiliated companies. In a refined accounting system, such expenditures might be considered capital in nature. In most circumstances, nevertheless, they appear to be

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[360] Reg. § 1.861-8T(b)(3) (1999).

[361] Id.

[362] See Reg. § 1. 861-8(g)(Exs. 19-21) (1999).

[363] Reg. § 1.861-8T(b)(3) (1999). See also Reg. § 1.861-8T(c)(2) (1999) (allowing taxpayers to use the asset method to apportion deductions other than interest in appropriate cases). For description of the asset method, see section 3/B.2.1, below.

deductible in the year the expense was paid. These expenditures are considered to be definitely related and allocable to dividends received, or to be received, from the affiliated companies.[364]

Assume, for example, that P, a U.S. holding company, has two subsidiaries, F and D. F is organized in Country X and earns only foreign source income. D is a domestic company and earns only U.S. source income. P spends $1,000 in supervising F and $500 in supervising D. P's only income is a dividend of $10,000 from D. Under these conditions, the $1,000 spent on supervising F is allocated to foreign source gross income, with the result that P has a loss of $ 1,000 from sources without the United States. The $500 of supervisory expenses relating to D is allocated to U.S. source income, producing net taxable income from U.S. sources of $9,500.[365]

§ 15.01.5.3. Legal and Accounting Fees

Fees for legal or accounting services generally should be allocable to the specific class or classes of gross income to which they relate or to all classes of gross income, depending on the nature of the services rendered.[366] For example, accounting fees paid for the preparation of a study on the costs of manufacturing a product in the United States for sale in Country A would be allocated to gross income derived from the manufacture and sale of that product and apportioned between those two countries,[367] presumably under the two-factor formula provided in the regulations under Code section 863(b). An allocation to one or more classes of gross income must be made even if the provider of the legal or accounting services fails to provide an itemized bill.[368]

§ 15.01.5.4. Charitable Contributions

The general rule is that charitable deductions are allocated pro rata to the taxpayer's worldwide gross income.[369] This venerable rule is a model of simplicity, is consistent with the treatment of other personal deductions, conforms with the statutory language, and is supported by case law.[370]

A proposed regulation issued in 1991 would modify the general rule.[371] It provides that a deduction for a charitable contribution generally would be allocated solely to U.S. source gross income if the taxpayer has designated the contribution for use in the United States and has reason to believe that the contribution will be so used.[372] Thus, a gift to an American university for minority scholarships typically would have a U.S. source. A donation by a substantial contributor to a private foundation would be eligible for this exception only if the contributor has required the foundation to set up a restricted account and to keep full records of the use of the funds in that account.[373]

A deduction would be allocated solely to foreign source gross income under the proposed regulation if the taxpayer designated the gift for use outside the United States or has reason to believe that the gift

[364] Reg. § 1.861-8(e)(4) (1999).

[365] The example is drawn from Reg. § 1.861-8(g)(Ex. 17) (1999).

[366] Reg. § 1.861-8(e)(5) (1999).

[367] Id.

[368] Reg. § 1.861-8(e)(5) (1999).

[369] Reg. § 1.861-8(e)(9)(iv) (1999).

[370] See *Grunebaum v. Comm'r,* 50 T.C. 710 (1968), aff'd, 420 F.2d 332 (2d Cir. 1970).

[371] IL-116-90, March 11, 1991.

[372] Prop. Reg. § 1.861-8(e)(12)(i) (1991).

[373] Prop. Reg. § 1.861-8(e)(12)(iv) (1991).

could be used only outside the United States.[374] Thus, a gift of blocked currency that could be used only in a particular foreign country would result in a foreign source deduction. Similarly, a gift of medication with an expired or expiring date should result in a foreign source deduction if sale of that medication within the United States would be contrary to federal regulations.

In all other circumstances, the proposed regulations would ratably apportion a charitable deduction to the taxpayer's gross income.[375] Assume, for example, that P, a U.S. corporation, makes an untied gift of $100 to an organization benefitting persons afflicted with cancer. P has gross income from U.S. sources of $5,000 and gross income from foreign sources of $20,000. Under these facts, the deduction does not relate solely for use either within or without the United States because cancer victims are found both within and without the United States. Thus, the deduction would be apportioned ratably to P's gross income under the proposed regulations. P would apportion $20 ($100 × $5,000/$25,000) of the gift to U.S. sources and the remaining $80 ($100 × $20,000/$25,000) to foreign sources.[376]

The result reached under the proposed regulation for gifts designated for use in a particular country is curious, to say the least. A company making what it designates as a charitable contribution may actually be making the contribution for business reasons, without any charitable impulse. In that event, deductions for such contributions should be treated as business expenses and allocated to the class of income they help generate. The country of use of the deduction by the charity would be irrelevant unless, by happenstance, the particular use by the charity resulted in a business advantage to the donor.[377]

Congress generally has viewed the deduction for charitable contributions as an incentive for charitable giving. To achieve the maximum incentive for charitable giving, Congress might provide that all charitable deductions are allocated to U.S. source income. Or it might do what the proposed regulations do — provide an incentive for charities that provide exclusive benefits within the United States and a disincentive for charities operating abroad. That choice, however, is for Congress to make. The regulation writers should not be making spending choices for Congress under the guise of interpreting the Code.[378]

§ 15.01.5.5. Personal Expenses

Deductions for personal expenses and losses are apportioned ratably to gross income. Under this rule, pro rata apportionment applies to deductions for (1) property taxes on a personal residence; (2) medical expenses; (3) alimony payments; and (4) personal interest.[379] As discussed in section 3/B.1.5.4, above, it also

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[374] Prop. Reg. § 1.861-8(c)(12)(ii) (1991).

[375] Prop. Reg. § 1.861-8(e)(12)(iii) (1991).

[376] Prop. Reg. § 1. 861-8(g)(Ex. 34) (1991). The proposed rule raises serious problems of interpretation. Is an unrestricted gift to an American university that conducts research with international implications to be attributed exclusively to the United States or allocated pro rata? How are gifts to a U.S. public radio station that occasionally broadcasts outside the United States to be allocated? Because the proposed regulation is not based on any discernible principle, it offers little or no guidance in answering such questions.

[377] See Reg. § 1.170A-1(c)(5) (1996) ("[t]ransfers of property to an organization described in section 170(c) which bear a direct relationship to the taxpayer's trade or business and which are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions"). Most business advantages obtained from a charitable gift constitute goodwill, the cost of which does not qualify for a current deduction.

[378] By failing to revoke the proposed regulation, the U.S. tax authorities are encouraging taxpayers who would benefit from it to file their tax returns in accordance with it, whereas taxpayers who do not benefit from it are filing in accordance with current law. In effect, the tax authorities have placed the U.S. government in a whipsaw position.

[379] Reg. § 1.861-8(e)(9) (1999).

applies under the current regulations to charitable deductions. The personal exemptions for the taxpayer and dependents are allowed without allocation or apportionment.[380]

§ 15.02. Interest Payments

Two separate methods are used for allocating and apportioning interest payments. The general rule, discussed in section 3/B.2.1, below, is provided in Treasury regulation section 1.861-8 and Code section 864(e)(2). In general, it allocates interest deductions to all classes of gross income and apportions those deductions by reference to the location of the taxpayer's assets.

A special rule, contained in Treasury regulation section 1.882-5, is applicable only for the purpose of determining the income of foreign corporations that is effectively connected with a U.S. trade or business. This special rule is described below in section 3/B.2.2. It is a hybrid of an asset method of apportionment and a tracing of liabilities method. This rule does not apply to nonresident alien individuals.

§ 15.02.1. The Section 1.861-8 Interest Source Rule

In many circumstances, interest payments are capital in nature. That is, they are costs incurred to earn income in some future period. The Code, nevertheless, allows a deduction against current gross income for such expenditures in many circumstances. The congressional purpose in providing a special status for interest payments is unclear. It may be due, at least in part, to the lack of a scholarly consensus as to the proper tax treatment of those payments.[381] Over the past several years, Congress has required taxpayers to capitalize many types of interest payments, although payments made in the ordinary course of business generally can be deducted in the year paid or accrued.[382]

To the extent that interest deductions do not relate to gross income earned in the current period, the matching principal of Treasury regulation section 1.861-8 is not useful for relating those deductions to particular items of current income. That is, deductions that help earn income accruing in future periods are not related, under the matching principle, with income accruing in the current period. Some rules must be employed, nevertheless, to determine the country of source of those deductions. The rules provided are above average in complexity.

As a simplification measure, a U.S. citizen or resident having an interest expense of no more than $5,000 is allowed to apportion the entire interest expense to U.S. sources without reference to the principles of Treasury regulation section 1.861-8.[383] This *de minimis* rule also applies to U.S. estates and certain trusts.[384] If the $5,000 threshold is exceeded, then business interest, investment interest, and passive interest of a U.S. individual are apportioned under a modified asset method. Deductible interest paid with

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[380] Reg. § 1.861-8(e)(11) (1999).

[381] For discussion of the conventional view of interest as a current expense and a detailed critique of that view, see Michael J. McIntyre, "An Inquiry into the Special Status of Interest Payments," 1981 *Duke Law Review* 765 (1981), reprinted in Michael J. McIntyre, Frank E. A. Sander & David Westfall, *Readings in Federal Taxation,* Foundation Press (2d ed. 1983).

[382] For discussion of the various U.S. interest deduction rules, see Michael J. McIntyre, "Tracing Rules and the Deduction for Interest Payments: A Justification for Tracing and a Critique of Recent U.S. Tracing Rules," Chapter 17 of *Taxation Towards 2000*, John G. Head & Richard Krever, Eds. (1997).

[383] Reg. § 1.861-9T(d)(1) (2009).

[384] Id.

respect to a qualified residence and other deductible personal interest are apportioned according to a gross income method.[385]

A nonresident alien individual can deduct interest only to the extent that it is attributable to income that is effectively connected with a U.S. trade or business. Interest expense is not considered to be related to effectively connected income unless it is incurred (1) with respect to liabilities that are entered on the books and records of the U.S. trade or business or (2) with respect to liabilities that are secured by assets that generate effectively connected income.[386] Nonresident aliens cannot deduct interest that is paid or accrued with respect to liabilities that exceed 80 percent of the gross assets of the U.S. trade or business.[387] In addition, interest on debts that are secured by property other than the assets of the nonresident's U.S. trade or business are not deductible.[388]

Section 15.02.1.1, below, describes in appropriate detail the operation of the asset method that taxpayers other than foreign corporations generally must use to determine the source of their interest deductions. Exceptions to the asset method, other than the *de minimis* exception described above, are addressed in section 15.02.1.2, below. The policies underlying the asset method are analyzed in § 15.02.1.3.

§ 15.02.1.1. Operation of Asset Method

Under the general interest source rule of Treasury regulation section 1.861-8, each interest payment is allocated ratably to the assets of the taxpayer, generally in proportion to the tax book value of those assets.[389] The interest payment is then apportioned between U.S. and foreign sources. The amount apportioned to U.S. sources is determined by multiplying the interest payment by a fraction. The numerator of the fraction generally is the tax book value of those assets expected to generate taxable gross income sourced in the United States, and the denominator is the tax book value of the taxpayer's worldwide assets expected to generate taxable gross income.[390] This method of determining the source of interest deductions is referred to in the section 1.861-8 regulations as the "asset method" of apportionment. The following example illustrates its operation.

Example 15.2: Asset Method of Apportionment

P is a U.S. corporation conducting business in the United States and in Country A. During the taxable year, P makes a deductible interest payment of $100. It owns a valuable patent right that has a tax book value of $600. One-third of the income derived from that patent is U.S. source gross income and the remaining two-thirds is foreign source gross income. P has assets with a tax book value of $800 used in connection with its business operations in the United States. The U.S. assets include inventory, working capital, trade receivables, depreciable equipment, plant, and patent rights used to earn income within the United States.

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385 Reg. § 1.861-9T(d)(1)(i)-(iv) (2009).

386 Reg. § 1.861-9T(d)(2)(i) (2009).

387 Reg. § 1.861-9T(d)(2)(ii)(A) (2009).

388 Reg. § 1.861-9T(d)(2)(ii)(B) (2009).

389 The tax book value of assets is typically determined by averaging the tax book value of assets held at the beginning and at the end of the taxable year.

390 Reg. § 1.861-9T(g)(1) and (2) (2009). Apportionment on the basis of assets is specifically authorized in IRC § 864(e)(2), as amended by the 1986 tax act. Proposed revisions of the regulations relating to interest were published by the Treasury Department in 1984 and then withdrawn in 1987. New temporary regulations were issued to reflect the changes in the interest source rules and the interest deduction rules enacted as part of the 1986 tax act. See Reg. §§ 1.861-9T to -13T.

P's assets relating to its business in Country A have a tax book value of $2,600. Those assets include inventory, working capital, trade receivables, depreciable equipment, patent rights, and plant used to earn income within Country A.

To compute its foreign tax credit limitation, P must determine the amount of its foreign source taxable income. For that purpose, it must apportion its interest deduction between the statutory grouping, foreign source gross income, and the residual grouping, U.S. source gross income. The amount of the interest deduction apportioned to foreign source income is $75 and the amount apportioned to U.S. sources is $25, computed as follows:

(1)	*Total interest payments*	*$100*
(2)	*Tax book value of assets related to earning taxable U.S. income ($200 + $800)*	*1,000*
(3)	*Tax book value of assets related to earning taxable income in Country A ($400 + $2,600)*	*3,000*
(4)	*Total tax book value of worldwide assets used to earn taxable income*	*4,000*
(5)	*Interest apportioned to foreign sources (line (1) × line (3)/line (4))*	*75*
(6)	*Interest apportioned to U.S. sources (line (1) × line (2)/line (4))*	*25*

The world of Treasury regulation section 1.861-8 is substantially more complex than the example above suggests. In computing the limitation on the credit, it is not enough for a U.S. person to determine interest apportioned to foreign source gross income. It must also determine the amount of interest apportioned to each of the applicable credit limitation baskets established by Code section 904(d). For example, if P, the above example, has some passive foreign source income and also some foreign business income, it must determine the amount of interest apportioned to the "passive income basket" and the "general limitation basket."

The method for apportioning the interest deduction among the separate limitation baskets is simply an extension of the method illustrated above. To employ that method, the taxpayer must determine the value (generally tax book value) of its assets used to produce foreign source gross income in each of the limitation baskets. It then must apportion the interest deduction to each basket by multiplying the deduction by the ratio of assets related to that basket over total worldwide assets. In the above example, if P used assets with a tax book value of $400 to produce foreign source passive gross income, then the interest deduction apportioned to its passive income basket would be $10 ($100 × $400/$4,000).

To apply the apportionment formula mandated by the asset method, taxpayers must divide their assets into two categories — those likely to generate income in the statutory grouping and those likely to generate income in the residual grouping.[391] The actual physical location of the assets is not important.[392] For example, if a taxpayer holds inventory located in the United States and the inventory is expected to be sold outside the United States, then the inventory is as an asset held for production of foreign source income.[393] Taxpayers may elect to sort their assets based on their fair market value or their tax book value.[394]

Problems can arise in determining the proper division of assets between those likely to generate income in the statutory grouping and those likely to generate income in the residual grouping. The

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[391] Reg. § 1.861-9T(g)(1)(i) (2009).

[392] Reg. § 1.861-9T(g)(3) (2009).

[393] Reg. § 1.861-12T(b) (1988).

[394] Reg. § 1.861-9T(g)(1)(ii) (2009).

regulations provide some detailed guidance in solving those problems.[395] The basic approach is to classify assets into three types. Type I assets are labeled "single category assets." These assets are ones that are likely to generate income exclusively within a single statutory grouping or the residual grouping.[396] In the above example, the inventory, working capital, trade receivables, depreciable equipment, plant, and patent rights used to earn income within the United States would all be Type I assets. Type I assets are attributable either to the statutory or to the residual grouping, as the case may be.

Type II assets are called "multiple category assets," and, as the name suggests, they are assets that are likely to produce income within more than one statutory or residual grouping.[397] The patent right in the above example is a Type II asset. A Type II asset is obviously attributable partly to the statutory grouping and partly to the residual grouping. The attribution to the statutory grouping is made by multiplying the value of the asset (typically tax book value) by a fraction. The numerator is the amount of income actually generated in the statutory grouping by that asset during the taxable year, and the denominator is the total income actually generated by the asset during the taxable year.[398]

The remaining division, Type III assets, are called "assets without directly identifiable yield."[399] These assets fall into a hard-to-classify category either because they do not produce an obvious income stream or because they support the production of all income. A corporate headquarters is the example given in the regulations of a Type III asset.[400] A piece of art work in the president's office might be another example. Type III assets are simply ignored in applying the asset method. In effect, their value is apportioned pro rata between assets in the statutory grouping and the residual grouping, based upon the value of the Type I and Type II assets attributable to those groupings.

Interest expenses of affiliated corporations are apportioned under the asset method using the one-taxpayer rule. That is, the interest expenses of all members of an affiliated group are aggregated and then apportioned as if the family of corporations were a single corporation.[401] The one-taxpayer rule applies primarily for purposes of computing limitations on the foreign tax credit.[402] It does not apply in computing the income of controlled foreign corporations subject to taxation under subpart F or for the computation of the effectively connected income of foreign corporations.[403] In applying the asset method under the one-taxpayer rule, stock of corporations within the affiliated group is ignored.[404] A special rule treats financial corporations that are part of an affiliated group as a separate taxpayer for purposes of the one-taxpayer rule.[405]

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[395] See Reg. §§ 1.861-9T(g)(3) (2009) and 1.861-12T (1988).

[396] Reg. § 1. 861-9T(g)(3)(i) (2009).

[397] Reg. § 1. 861-9T(g)(3)(ii) (2009).

[398] Reg. §§ 1.861-9T(g)(3) (2009) and 1.861-12T(j) (Ex. 1) (1988). It is inconsistent with the theory of the asset method to have the apportionment depend on actual income for the taxable year. According to the theory, the apportionment of interest should depend upon the income expected to be generated by assets in the past, present, and future. Using current income obviously is more simple and more certain than indulging in speculation about future income.

[399] Reg. § 1.861-9T(g)(iii) (2009).

[400] See Reg. § 1.861-12T(j)(Ex. 1) (1988).

[401] IRC § 164(e)(1) and Reg. § 1.861-11T(c) (1988). For discussion of the one-taxpayer rule, see section 3/B.1.2, above.

[402] Reg. § 1.861-11T(b)(1) (1988).

[403] Reg. § 1.861-11T(b)(2) (1988).

[404] Reg. § 1.861-11T(c) (1988).

[405] Reg. § 1.861-11T(d)(4) (1988).

In theory, the asset method should apportion interest expenses on the basis of the fair market value of assets held by the taxpayer. In practice, however, the apportionment is generally based on the tax book value of assets. Tax book value is the taxpayer's adjusted tax basis in its assets, as determined under Code section 1011, with the adjustments required by regulation for application of the tax-book-value method.[406] Taxpayers may elect to use fair market value for apportionment purposes if they establish the market value of their assets to the satisfaction of the tax authorities.[407]

The tax book value of assets would produce appropriate results in the apportionment formula employed in the asset method only if the tax book value is systematically proportionate to market value. Unfortunately, many taxpayers hold assets that have a basis that bears no systematic relationship to market value. Common examples of assets that typically have a market value substantially in excess of their book value are stock in related corporations, intangible property developed by the taxpayer, and property with respect to which depreciation has been taken using an accelerated cost recovery method.

A refined asset method of apportionment would make some adjustments for cases in which a systemic discordance between book value and market value has been identified. The only adjustment actually required under the asset method because of discordance between book and market values, however, is for stock in certain related corporations.

In most cases, the tax book value of stock of a related corporation equals the amount of capital originally contributed to it. The market value of the stock, however, depends in substantial part on the amount of the retained earnings of the corporation. The Code provides that a taxpayer owning 10 percent or more of the stock of a corporation (domestic or foreign) must increase the tax book value of the stock by the amount of the corporation's undistributed profits for purposes of applying the asset method.[408] The important consequence of this rule is to increase the tax book value that U.S. corporations must use in allocating interest deductions to the stock of their foreign affiliates.

In applying either the tax-book-value method or the fair-market-value method, the value used is the average values of assets for the taxable year. Those average values are computed by taking the mean of the opening values and the closing values for each asset.[409]

Some additional adjustments to tax book value are required under the regulations. For example, a reduction in basis is required for the amount of a debt instrument if the interest on that debt is directly allocated to assets under one of the exceptions to the asset method.[410] Similarly, a reduction in basis is required for the amount of a debt if interest paid on that debt is capitalized, deferred, or disallowed under any provision of the Code.[411]

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[406] The term "tax book value" is not defined in the regulations, although its meaning is clear. A definition of tax book value was included in the regulations when they were first issued in 1977.

[407] Reg. § 1.861-9T(g)(1)(ii) and (h) (2009)

[408] IRC § 864(e)(4), as amended by the 1986 tax act, and Reg. § 1.861-12T(c) (1988).

[409] Reg. § 1.861-9T(g)(2)(i) (2009). Some special rules apply in determining the tax book value of branches that compute their income in a currency other than the U.S. dollar. See Reg. § 1.861-9T(g)(2)(ii)(A) (2009).

[410] Reg. § 1.861-9T(g)(2)(iii) (2009).

[411] Reg. § 1.861-12T(f)(1) (1988).

§ 15.02.1.2. Exceptions to Asset Method

The section 1.861-8 regulations provide the following three exceptions to the use of the asset method for apportioning interest deductions. These exceptions require direct attribution of interest to particular assets. Section 15.02.1.2.1, below, describes the so-called "CFC netting rule." That rule, which has major revenue implications, prevents taxpayers from exploiting the averaging built into the asset method to borrow money, lend it to a foreign affiliate, and get a substantial portion of the interest paid on the loan apportioned to U.S. source income. Section 15.02.1.2.2, below, describes the direct allocation of interest relating to certain purchase-money nonrecourse loans. Section 15.02.1.2.3 describes a direct allocation rule applicable to certain integrated financial transactions.

§ 15.02.1.2.1. CFC Netting Rule

The CFC netting rule provides that certain interest expenses incurred by the U.S. parent of a controlled foreign corporation (CFC) will be directly allocated to interest income received from that CFC under certain circumstances. This rule can have important consequences for many U.S. parent corporations. Its typical effect is to increase the amount of the U.S. parent's interest expense that it must attribute to one or more categories of foreign source income, thereby reducing, in many cases, the amount of its allowable foreign tax credit.

The CFC netting rule is above average in complexity.[412] It applies when a U.S. affiliated group is considered to have increased its borrowings from unrelated third parties and then re-lent the borrowed money to its related CFCs for tax-motivated reasons. Regulations provide that the CFC netting rule generally will not apply if the pattern of third-party borrowing and lending to a related CFC in the current year is consistent with the U.S. affiliated group's pattern over the prior five years.[413] Safe harbor rules are also provided.

The amount of interest expense of a U. S. affiliated group that must be directly allocated to its interest income received from its CFCs is determined by a three-step procedure under the regulations. In step one, the taxpayer determines the amount of its lending to related CFCs that is considered to be incurred for tax-avoidance reasons (its "excess related group indebtedness"). Step two determines the amount of the borrowings of the U.S. affiliated group that is treated as having been incurred to finance loans to its related CFCs (its "excess U.S. shareholder indebtedness"). A taxpayer having both excess related group indebtedness and excess U.S. shareholder indebtedness is considered to have engaged in tax-motivated borrowing and lending, and a portion of its interest expense must be directly allocated to its interest income from its CFCs. That direct allocation is accomplished in step three. The operation of the CFC netting rule, in highly simplified form, is illustrated in the following example.

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[412] The U.S. Supreme Court made reference to the CFC netting rule in *Hunt-Wesson, Inc. v. Franchise Tax Board of California,* 120 S. Ct. 1022, 528 U.S. 458 (2000). In that case, the Court, after misstating the CFC netting rule, held that California's similar direct allocation rule violated the Commerce Clause and the Due Process Clause of the U.S. Constitution. For discussion, see Michael J. McIntyre, "Constitutional Limitations on State Power to Combat Tax Arbitrage: An Evaluation of the Hunt-Wesson Case," 86 *Tax Notes* 1907 (March 27, 2000); Michael J. McIntyre, "Hunt-Wesson and the Continuing Problem of Tax Arbitrage," 6 *The State and Local Tax Lawyer* 57-87 (2001).

[413] See Reg. §§ 1.861-10(e)(1992), 1.861-10T(e) (1988) and 1.861-12T(j)(Ex. 1) (1988).

Example 15.3: CFC Netting Rule

P is a U.S. parent corporation, and F is its wholly owned CFC. For all years prior to the current year, P had U.S. assets with a tax book value of $40,000 and foreign assets with a tax book value of $10,000. Over that same period, F had assets with a tax book value of $100,000. During the current year, P has earned taxable income from U.S. sources, computed before any deduction for interest, of $40,000. F has earned taxable income, before any deduction for interest, of $20,000. All of F's income was derived from its business operations and is properly characterized as general limitation income. At the start of the current year, F needed additional capital of $100,000 to finance the purchase of a business asset. It could have obtained that amount by borrowing from an unrelated bank at an annual interest charge of $10,000.

Instead, P borrowed the money from the unrelated bank and incurred an annual interest expense of $10,000. It re-lent the $100,000 to F, charging annual interest of $10,000. The note from F increased the tax book value of P's assets by $100,000. After paying the interest to P, F had taxable income of $10,000 ($20,000 minus $10,000) and paid a foreign income tax of $5,000. It distributed the remaining $5,000 to P as a dividend.

Under these rather special conditions, all of the debt of F to P is characterized as "excess related group indebtedness," and all of the amount borrowed from the unrelated bank is characterized as "excess U.S. shareholder indebtedness." P is required to allocate all of its interest deduction on its bank loan directly to the interest income received from F. Its gross foreign source income will be $20,000 ($5,000 dividend from F plus the gross-up amount of $5,000 plus interest income of $10,000), and its net foreign source income will be $10,000 ($20,000 minus the directly allocable interest deduction of $10,000). The limitation on the foreign tax credit will be $3,500 (35 percent of $10,000), with the result that $1,500 of the foreign taxes deemed paid by P will not be creditable.

If P had been allowed to use the asset method under the facts above, it would have been required to allocate only $7,333 ($10,000 interest × $110,000 of foreign assets/$150,000 of worldwide assets) of its interest deduction to foreign source income. Thus, its net foreign source income would have been $12,667, and the limitation on the foreign tax credit would go up to $4,433 (35 percent of $12,667).

The U.S. tax consequences that a U.S. parent corporation would receive under the CFC netting rule from re-lending the proceeds of a third-party loan to its CFC are occasionally identical and generally similar to those that would result from a direct third-party borrowing by a related CFC. Assume, in the above example, that F had borrowed $100,000 directly from a commercial bank instead of borrowing the money from P. In that event, F would have paid interest of $10,000 to the unrelated bank (rather than to P) and would have had net income of $10,000. It would have paid a foreign tax of $5,000 and distributed $5,000 as a dividend to P. On receipt of that dividend, P would have had net foreign source income of $10,000 ($5,000 dividend plus gross-up amount of $5,000), and it would have been entitled to a foreign tax credit of $3,500 (35 percent of $10,000). This is the result reached under the CFC netting rule in the example above.

§ 15.02.1.2.2. Qualified Nonrecourse Indebtedness

Another exception to the asset method is made in the case of interest paid with respect to certain purchase money mortgages, referred to in the regulations as "qualified nonrecourse indebtedness."[414] This

[414] Reg. § 1.861-10T(b) (1988).

exception is narrowly drawn, with extensive anti-avoidance rules for debts lacking in economic substance. This exception does not apply if the creditor can look to property other than the property acquired with the loan proceeds as security for payment, and the taxpayer must show that the property generates sufficient cash flow to service the debt in the first year of ownership and in all subsequent years.

If this exception applies, the deduction for interest on the purchase-money loan is matched against the income generated by the property acquired with the loan proceeds. Assume, for example, that T, a U.S. citizen and resident, purchases an office building in Houston, Texas, for $1.1 million, paying $100,000 in cash and paying the remaining $1 million through a 20-year purchase-money loan. Annual interest is due on the loan of $80,000. T is not personally liable on the loan. She rents out the building under a 20-year net lease arrangement for a guaranteed annual payment of $90,000. The loan qualifies as "qualified nonrecourse indebtedness." T also earns $1 million of royalty income from foreign sources, on which a foreign income tax of $350,000 is imposed. T is not required to allocate any of the interest on the loan used to acquire the Houston office building to foreign source income. As a result, T can claim a credit for the full amount of the foreign taxes paid on her foreign source income.

§ 15.02.1.2.3. Integrated Financial Transactions

A third exception to the asset method applies to loans used to finance an identified term investment that produces interest income or income equivalent to interest.[415] To qualify for this exception, the taxpayer must identify on its books of account, within a 10-business-day grace period, that it has incurred indebtedness to make an investment intended to qualify as an integrated financial transaction.[416] The investment cannot be part of the operation of the taxpayer's business.[417] The expected return on the term investment must be sufficient to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of principal and interest.[418] In addition, the debt and the investment must mature within ten business days of each other.[419]

If the tests for application of this exception are met, then the interest on a loan is directly allocated to the income generated by the related investment. Assume, for example, that PCo, a U.S. corporation, earns $20,000 of foreign source income, on which it pays a foreign income tax of $7,000. It borrows $100 for six months at an annual interest rate of 10 percent and properly identifies the loan as part of an integrated financial transaction. Three days later, PCo uses the proceeds to purchase a portfolio of U.S. stock that approximates the composition of the Standard & Poor's 500 Index. On that day, PCo also enters into a forward sale contract that requires it to sell the stock six months later for $110. PCo also identifies on its books that the portfolio stock purchases and the forward sale contract constitute part of the integrated financial transaction with respect to which the identified borrowing was incurred.

Under these conditions, the interest on the borrowing by PCo is directly allocated to the gain from its portfolio stock investment.[420] As a result, none of the interest expense is allocated to foreign source income, and PCo is not prevented by the limitation on the credit from claiming a foreign tax credit for the $7,000 it paid in foreign income taxes.

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[415] Reg. § 1.861-10T(c)(1) and (2)(ii)(1988).

[416] Reg. § 1.861-10T(c)(2)(i) (1988).

[417] Reg. § 1.861-10T(c)(2)(v) (1988).

[418] Reg. § 1.861-10T(c)(2)(ii) (1988).

[419] Reg. § 1.861-10T(c)(2)(iv) (1988).

[420] See Reg. § 1.861-10T(c)(4)(Ex. 1) (1988).

§ 15.02.1.3. Policy Evaluation of Asset Method

The main alternative to the asset method of the section 1.861-8 regulations, which the drafters of the regulations rejected, would be to match interest payments on a loan with the gross income generated by the loan proceeds, using some type of presumptive tracing rules. Tracing is the method of choice in relating cost of goods sold with gross receipts from sales, and it is the method generally applicable for determining the source of most deductions under Treasury regulation section 1.861-8. An advantage of using tracing rules for linking deductions with gross income is that a taxpayer cannot overstate the amount of its deductions allocated to U.S. sources without also overstating the amount of its U.S. source gross income.

The authors of the section 1.861-8 regulations rejected any tracing method for interest deductions because of the commonly held opinion that the fungibility of money prevents meaningful allocation of interest to particular uses of the loan proceeds.[421] They contended that the interest expenses of a taxpayer should be allocated "to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate."[422] Interest so allocated would then be apportioned between U.S. and foreign sources in accordance with the value of the assets of the taxpayer.[423]

Determining the past, present, and future gross income generated by the activities and property of the taxpayer would be difficult, perhaps impossible. *A fortiori*, it would be difficult to determine the source of such gross income. The section 1.861-8 regulations sidestep such difficulties by adopting the asset method of apportionment. The implicit premise underlying the asset method is that the best available proxy for the source of the past, present, and future gross income generated by an interest deduction is the source of the income likely to be generated by the assets of the taxpayer.[424]

As a matter of tax theory, the attempt to match interest payments with all past, present, and future gross income of the taxpayer is misguided. Under the matching principle generally followed in the section 1.861-8 regulations, deductions should be linked with the income they help generate. If an interest payment made in the current period helped generate income in some other period, then the interest payment should be deductible in that period. The probability that a taxpayer would incur an interest payment to earn income he had already earned in a prior period seems quite small. Thus, it is unlikely that any interest payments are properly traceable to prior taxable periods. Interest payments are commonly incurred, however, to generate income in a future period. An example would be interest on a loan used to finance the purchase of a capital asset. Such payments should not be deductible in the current period. They would be capitalized in a properly designed income tax.

Despite the weakness in the underlying theory, the asset method is superior to the old gross-to-gross method that it replaced.[425] The gross-to-gross method gives most U.S. corporate taxpayers substantial

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[421] Reg. § 1.861-8(e)(2)(i) (1999).The case against tracing of interest payments is challenged in Michael J. McIntyre, "An Inquiry into the Special Status of Interest Payments," 1981 *Duke Law Review* 765 (1981). Congress has embraced tracing for domestic interest payments in the 1986 tax act, although some of the tracing rules it adopted do not conform to any theoretical model.

[422] Reg. § 1.861-8(e)(2)(ii) (1999).

[423] To be consistent with their theory, the drafters of the regulations should also have prohibited tracing for rental payments because a taxpayer's decision to rent property rather than purchase frees up capital for other uses. Thus, a rental payment for tangible property relates to all past, present, and future income in much the same way that a rental payment for the use of someone else's money so relates.

[424] Reg. § 1.861-8(e)(2)(v) (1999).

[425] The section 1.861-8 regulations retained an optional gross-to-gross method, applicable in some circumstances. See Reg. § 1.861-8(e)(2)(vi) (1999). The use of the gross-to-gross method for apportionment of interest payments is now prohibited under IRC

(continued...)

control over the source of their deductions because most of their foreign source income is derived from dividends and other largely discretionary receipts from their foreign subsidies. More fundamentally, the gross-to-gross method is unacceptable because income generated through the use of borrowed money does not relate in any systematic way to the gross income generated by the taxpayer's income-producing activities.

The asset method may be superior to a tracing method, given the current provisions of the Code governing the deduction of interest. Tracing methods work well only if the taxpayer is required to match expenses with income in order to claim a deduction for those expenses. Current law requires some matching of interest expenses with certain classes of gross income, largely to avoid the tax shelter problems created by the unrestricted interest deduction of prior law.[426] There is, however, no general matching requirement for claiming an interest deduction. Consequently, a source rule for interest deductions based on the matching principle would be difficult, perhaps impossible, to administer.[427]

Although the asset method is grounded on an anti-tracing theory, it does employ an implicit tracing rule for linking interest payments with assets. Under the implicit tracing rule, taxpayers are presumed to finance their assets by drawing in equal proportions from their pools of equity and debt capital. For example, if a taxpayer has \$100,000 of equity capital and \$400,000 of debt capital, then one-fifth of each of its assets will be presumed to be financed by equity and the remaining four-fifths by borrowing.

Also incorporated into the asset method is an implicit average cost convention — similar to the average cost convention sometimes used in inventory accounting for determining the cost of goods sold — in order to determine the interest rate for capital expended from the taxpayer's pool of borrowed funds. Consider, for example, X, a U.S. corporation that borrows \$10,000 at a 10-percent annual rate and borrows another \$10,000 at a 12-percent rate. X has a pool of borrowed money of \$20,000 (\$10,000 + \$10,000), and it pays annual interest of \$2,200 (\$1,000 + \$1,200). The presumed interest rate for capital drawn from the pool of borrowed funds would be 11 percent (\$2,200/\$20,000).

The asset method of apportionment satisfies one of the criteria for good source rules — it prevents taxpayers from exploiting the fungibility of money to control the source of their deductions. Consider, for example, a newly organized U.S. corporation that borrows \$2 million — \$1 million at a 6-percent annual interest rate and the other \$1 million at an 8-percent rate. The corporation raises another \$2 million from the issuance of its own stock. It uses the \$4 million to finance construction of two identical hotels, one located in the United States and the other located in Country A. The funds from the loans are commingled with the equity funds, so that physically tracing the loan proceeds to particular expenditures is impractical.

Under the asset method, half of the expenditures made for each hotel will be presumed to come from the pool of equity funds and the other half of those expenditures will be presumed to come from borrowed money. The dollars drawn from the pool of borrowed money will be presumed to bear an interest rate of 7 percent — the average of the two actual interest rates paid by the taxpayer.

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[425] (...continued)
§ 864(e)(2), as amended by the 1986 tax act.

[426] See IRC § 163(d) and (h) (limiting the deduction for interest on loans used to finance investments and denying the deduction for consumer credit).

[427] If the taxpayer were required to trace in order to claim an interest deduction, then a source rule based on the matching principle would not be difficult to administer, although the tracing rules may themselves present administrative problems. For example, the inventory accounting rules for determining the cost of goods sold present some serious problems of administration. Matching gross receipts from the sale of inventory goods with the cost of goods sold, however, is a relatively simple task, once the problems of determining the cost of goods sold have been resolved.

The result reached by the asset method in the example above is appealing because the taxpayer was prevented from controlling the source of its interest deduction through economically insignificant choices between the use of borrowed funds and equity capital. Other techniques could be employed, however, to prevent taxpayers from controlling the source of their deductions. For example, a tracing rule that presumed that money borrowed during the taxable year is used to acquire foreign assets, to the extent that foreign assets were acquired during that year, would prevent taxpayers from controlling the source of their deductions. Indeed, any system of presumptive tracing would have that effect.

The asset method produces somewhat less appealing results when the taxpayer is not drawing from uncommitted pools of equity and debt capital. Consider, for example, a taxpayer that has built in year 1 a $2 million hotel in Country A, which is financed entirely with equity capital. In year 2, the taxpayer decides to build an identical hotel in the United States. The construction of the U.S. hotel is financed by a $2 million loan. Under the asset method, only half of the interest expense would be allocated to the U.S. hotel. The remaining half would be treated as a cost of continuing to hold the hotel located in Country A. That is, the tracing formula would treat the taxpayer as having financed one-half of the U.S. hotel with the equity capital already invested in the hotel located in Country A.

The rationale for the result reached in the example above is that the taxpayer, at least in theory, could have sold the Country A hotel for $2 million and borrowed an additional $2 million, thereby creating a capital pool of $4 million. Then it would have financed the construction of the U.S. hotel and a repurchase of the Country A hotel by drawing from its capital pool of $4 million. That rationale is strained; obviously many taxpayers are not in a position to draw down their equity capital to make new investments without incurring unacceptable damage to their existing business.[428] They might also incur tax liability from conversion of operating assets into cash. Because the rationale for attributing interest expenses pro rata to equity capital and debt capital is unconvincing, it should be no surprise that apportionment of interest based on that rationale has limited intuitive appeal in some instances.

Another weakness of the asset method is that it fails to take into account the different functions of loans in a business. Consider, for example, PCo, a U.S. automobile manufacturer. Its wholly owned subsidiary, FCo, is organized in Country F and manufactures cars in that country for the local market. PCo earns income from the manufacture of cars in the United States. It also earns income from financing the sale of its cars to U.S. customers. To finance those sales, PCo has borrowed money from a local bank. It has also borrowed money that it used, in conjunction with its equity capital, to finance its manufacturing plant in the United States and FCo's manufacturing plant in Country F.

Under the asset method, a portion of the interest on the capital-investment loan and the consumer-credit loan is apportioned to foreign source income. This result is proper with respect to the capital-investment loan because the proceeds of that loan were used, directly or indirectly, to finance the manufacturing plant in Country F. The result reached under the asset method is improper, however, with respect to the loan used to finance PCo's consumer credit loans. In that case, the loans are not properly considered part of the pool of capital from which PCo drew to finance the manufacturing plants.

The chief justification for the asset method is that it allegedly takes control over the source of the interest deduction out of the hands of the taxpayer. The premise is that the situs of business assets is determined largely by business needs. That premise cannot be supported in practice. Many taxpayers have

[428] Consider, for example, goodwill. An ongoing business generally cannot sell its goodwill unless it is prepared to terminate its business. The asset method generally ignores goodwill in making allocations because goodwill typically has a zero tax book value. That result is another of the many deficiencies of the asset method.

considerable control over the situs of intangible assets, such as intercompany loans. Even tangible assets may be shifted around for tax purposes through the use of intercompany leasing transactions. To protect the integrity of the asset method, therefore, the Treasury Department must develop regulations that establish the situs of assets by reference to objective indicia outside the control of most taxpayers.[429]

§ 15.02.2. The Section 1.882-5 Interest Source Rule

A foreign corporation engaged in business in the United States is not subject to the asset method set forth in the section 1.861-8 regulations in determining the amount of interest that is deductible from the gross income effectively connected with its U.S. business. Instead, the allocation and apportionment of interest paid by a foreign corporation is determine under Treasury regulation section 1.882-5. That regulation was adopted in 1980 and revised significantly in 1996.

The section 1.882-5 regulations were developed largely in response to problems created for foreign banks by the asset method of the section 1.861-8 regulations.[430] Under the asset method, the interest expenses of a bank are spread ratably to all of its domestic and foreign loans, without reference to the actual interest costs incurred in obtaining funds for a particular loan. Banks, however, typically do not have uniform interest costs for obtaining loanable funds.

First of all, the loanable funds obtained by a bank in its home country generally come in substantial part from demand deposits on which the bank pays little or no interest, whereas foreign loans typically are financed with money borrowed at a market interest rate. In addition, the interest rate on a loan depends in part on the expected inflation or deflation of the currency in which the loan is to be repaid. If the loan must be repaid in a strong currency — that is a currency that is appreciating relative to other currencies — the nominal interest rate will understate the real interest rate. In contrast, the real interest rate will be lower than the nominal interest rate if the lender is able to repay its loan in a depreciating currency.[431]

For U.S. banks, the asset method was advantageous because it caused the high interest rates paid to acquire funds for foreign loans to be apportioned in part to U.S. sources. Foreign banks, particularly banks resident in Japan and Germany, felt that they were being treated unfairly by the asset method. Under the asset method, the high interest rates paid on loans traceable to their branch operations in the United States were being averaged with the low or zero rates paid on demand deposits in their home country. In addition, because the German mark and Japanese yen were strong relative to the U.S. dollar throughout the 1970s, the German and Japanese banks faced the prospect of having the relatively high interest rates paid on their loans denominated in U.S. dollars averaged with the relatively low interest rates on loans denominated in their home currency.

Treasury officials during the Carter administration believed that the complaints made by the German and Japanese banks had some merit. These officials also were concerned that the foreign banks might be able to establish by litigation a special treaty rule for apportioning interest expenses that was at odds with

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[429] For the attempted solution to the problems created under subpart F by taxpayer control over the situs of assets, see Reg. § 1.954-2(b)(4)(vi) (1999).

[430] See H. David Rosenbloom, "The Source of Interest Payments Made by Nonresidents," 30 *Wayne Law Review* 1023, 1028-1030 (1984).

[431] Under inflationary conditions, the nominal interest rate paid by the borrower has two real components: a rental fee for the use of someone else's money and a prepayment of principal to compensate the lender for the decline in the real value of the principal amount due under the loan agreement. Under deflationary conditions, the nominal interest rate is lower than the real interest rate because the lender expects to be repaid in currency worth more than the amount lent. U.S. tax law, however, allows a deduction for nominal interest, without any adjustment for inflation or deflation.

the section 1.861-8 rule. They believed that a hybrid of a treaty and Code rule imposed by the courts would present serious technical and administrative difficulties and might complicate the treaty process. In addition, Treasury realized that the asset method was providing an unwarranted benefit to foreign corporations that made loans in a currency that was weaker than the U.S. dollar. The high interest rates paid on those loans were being averaged under the asset method with the relatively low rates on loans incurred to fund the U.S. operations of those corporations.[432]

Treasury concerns about a treaty rule for interest deductions proved to be well founded. In the *NatWest* case,[433] decided in 1999 by the Court of Federal Claims, the court concluded that a U.S. branch of a U.K. bank is entitled, under the tax treaty between the United States and the United Kingdom, to deduct as interest the accounting entries representing imputed interest between the bank and its U.S. branch.[434] How the U.S. tax authorities and Congress will respond to this ill-considered opinion is yet to be seen. Some response is required because the court-created treaty rule is unworkable and inconsistent with U.S. tax policy.

The section 1.882-5 rule is a hybrid of a tracing rule and the pro rata apportionment rule implicit in the asset method. Leaving aside its many special features, the basic idea of the rule is to allocate the taxpayer's liabilities pro rata to its assets and to allow an interest deduction with respect to that fraction of the liabilities that are allocated to U.S. assets. For example, assume that FCo, a foreign corporation, has a branch, B, in the United States. B has U.S. assets of $1,000 and the total assets of FCo are $5,000. FCo has total liabilities of $3,000. Under these highly stylized facts, the section 1.882-5 regulations would allocate liabilities of $600 ($3,000 × $1,000/$5000) to B. Assuming the interest rate on the U.S.-connected liabilities is 10 percent, B would be allowed a deduction of $60 in computing its taxable income effectively connected with a U.S. trade or business.

The example above illustrates the pro rata apportionment aspect of the section 1.882-5 regulations that corresponds to the asset method of the section 1.861-8 regulations. A tracing aspect, not illustrated in that example, allows the foreign corporation to deduct interest payments attributed to liabilities shown on the books of its U.S. branch as long as the amount of the liabilities does not exceed the amount determined under the pro rata allocation described above. If the liabilities do exceed that amount, they are reduced under a pro rata rule to the acceptable level. In general, interest is determined in U.S. currency or in the functional currency of the foreign corporation. An election is available, however, that allows the U.S. branch to compute its interest deduction in the currencies in which the interest was actually paid.

The regulations establish a three-step procedure for computing the amount of interest that a foreign corporation is allowed to deduct in computing its effectively connected income. In step one, the taxpayer computes the amount of its U.S. assets — that is, the amount of the assets it used to produce U.S. effectively connected income. In step two, the taxpayer determines the amount of its U.S.-connected liabilities. That amount is calculated by determining the ratio of worldwide liabilities to worldwide assets and multiplying that ratio by the amount for U.S. assets computed in step one.

In step three, the taxpayer calculates the amount of interest attributable to its U.S.-connected liabilities. In computing the interest deduction attributable to U.S.-connected liabilities, the taxpayer may elect to use

[432] The statements in the text regarding the motives of Treasury officials are drawn from H. David Rosenbloom, "The Source of Interest Payments Made by Nonresidents," 30 *Wayne Law Review* 1023, 1028-1030.(1984). Mr. Rosenbloom was International Tax Counsel at Treasury when the section 1.882-5 regulations were drafted.

[433] *National Westminster Bank v. U.S.,* 44 Fed. Cl. 120 (1999) (hereafter "*NatWest*").

[434] Reg. § 1.882-5(a)(2) specifically provides that no special treaty rule is available. The 1980 regulations at issue in *Natwest* contained a similar provision.

an average interest rate determined in U.S. dollars, or it may use the average rates for the various currencies in which it actually paid interest. If the taxpayer make the latter election, the three-step procedure, modified in certain respects, is referred to as the "separate currency pools method."[435] If the former election is made, the method is called the "adjusted U.S. booked liabilities method."[436]

U.S. assets, as determined under step one, generally are the assets of the foreign corporation that are held to produce U.S. effectively connected income.[437] The section 1.882-5 regulations incorporate by reference the detailed rules for determining whether an asset is a U.S. asset that were developed in the branch profits tax regulations.[438] In effect, the regulations require a foreign corporation to treat the income derived from an asset as producing effectively connected income in order to treat the asset as a U.S. asset in computing the amount of its U.S. interest deduction.[439]

For tax avoidance reasons, a foreign corporation would like to increase the amount of its U.S. assets, thereby increasing its U.S. interest deduction, if it could do so without causing its U.S. effectively connected income to increase by enough to offset the tax benefits of the larger interest deduction. To prevent perceived abuses, the regulations provide that an asset will not be treated as a U.S. asset if it was acquired or used to artificially inflate the amount of U.S. assets.[440]

A foreign corporation determines the value of its U.S. assets according to their U.S. tax book value unless it has made an election to use their fair market value.[441] The U.S. tax book value is the adjusted basis of the assets, as determined under Code section 1011.[442] An election to use fair market value must be used for all purposes under the section 1.882-5 regulations and cannot be changed without the consent of the tax authorities.[443] The value of assets must be determined at intervals — monthly for large banks, semiannually for other foreign corporations — and the average values used in calculating the taxpayer's U.S. assets for the year.[444]

In the second step, the foreign corporation determines the amount of its U.S.-connected liabilities. Two alternative methods are provided. Under the first method, referred to as the "actual ratio method," the taxpayer multiplies the value of its U.S. assets by the ratio of its worldwide liabilities to its worldwide assets.[445] For example, if the foreign corporation has worldwide liabilities of $700 and worldwide assets of $800, its actual ratio would be 87.5 percent, and its U.S.-connected liabilities would be 87.5 percent of its U.S. assets. The taxpayer must employ a consistent method that substantially complies with U.S. tax

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435 Reg. § 1.882-5(e)(1) (1996).

436 Reg. § 1.882-5(d)(1) (1996).

437 Reg. § 1.882-5(b)(1)(i) (1996).

438 See Reg. §§ 1.884-1(d) (1996) (defining U.S. assets) and 1.864-4(c)(2) (1996) (specifying effectively connected income under the asset-use test).

439 For exceptions to the general rules defining U.S. assets, see Reg. § 1.882-5(b)(1)(ii) and (iii) (1996).

440 Reg. § 1.882-5(b)(1)(v) (1996).

441 Reg. § 1.882-5(b)(2) (1996).

442 Reg. § 1.882-5(a)(2) (1996).

443 Reg. § 1.885-5(b)(2)(ii) (1996). These rules are coordinated with the fair-market-value rules under the asset method. See Reg. § 1.861-9T(g)(1)(iii) (1996).

444 Reg. § 1.882-5(b)(3) (1996).

445 Reg. § 1.882-5(c)(2)(i) (1996).

principles in computing its worldwide liabilities and worldwide assets.[446] The amounts must be expressed in U.S. dollars or in the functional currency of the foreign corporation's home office.[447]

Under the second method, referred to as the "fixed ratio method," the taxpayer multiplies the value of its U.S. assets by a fixed percentage. That percentage is 93 percent in the case of a foreign corporation engaged in the banking business in the United States.[448] It is 50 percent in the case of any other foreign corporation.[449]

In step three, the foreign corporation determines the amount of its interest expense allowable as a deduction against U.S. effectively connected income. That amount is the interest expense of the taxpayer that was paid or deemed paid with respect to its U.S.-connected liabilities. As noted above, the taxpayer has a choice of using the "adjusted U.S. booked liabilities method" or the "separate currency pools method." The taxpayer may not elect the separate currency pools method if the value of a taxpayer's U.S. assets valued in a hyperinflationary currency exceeds 10 percent of its U.S. assets.[450] Once the taxpayer has elected one of these methods, it generally cannot change methods for at least five years without the permission of the U.S. tax authorities.[451]

Under the adjusted U.S.-booked liabilities method, the foreign corporation first determines whether the amount of its U.S.-connected liabilities, determined in step two, equals or exceeds the average amount of the liabilities shown on the books of its U.S. branch (its "U.S.-booked liabilities").[452] If the U.S.-booked liabilities equal the U.S.-connected liabilities, then the foreign corporation is allowed to deduct the amount of the interest shown on the books of the U.S. branch.[453]

If U.S.-connected liabilities exceed the U.S.-booked liabilities, then the allowable interest deduction is the sum of (1) the actual interest expense shown on the U.S. books and (2) the interest deemed paid with respect to U.S.-connected liabilities in excess of the U.S.-booked liabilities.[454] The interest deemed paid with respect to the excess liabilities is generally the amount of the excess liabilities multiplied by the taxpayer's average interest rate paid on its foreign liabilities.[455]

A foreign corporation is allowed to deduct only a portion of the interest shown on its U.S. books if its U.S.-booked liabilities exceeds its U.S.-connected liabilities, as determined in step two. The interest deduction allowed is the amount shown on the U.S. books, scaled back to eliminate the interest paid with respect to the excess U.S.-booked liabilities.[456] For example, assume that FC, a foreign corporation, has U.S.-booked liabilities of $1,000, U.S.-connected liabilities of $800, and an interest payment on its U.S. books of

[446] Reg. § 1.882-5(c)(iii) and (iv) (1996).

[447] Reg. § 1.882-5(c)(2)(ix) (1996).

[448] Reg. § 1.882-5(c)(4) (1996).

[449] Id. A taxpayer cannot use the fixed ratio method to deduct more interest from its U.S. effectively connected income than it actually paid. Reg. § 1.882-5(a)(3) (1996).

[450] Reg. § 1.882-5(e)(4) (1996).

[451] Reg. § 1.882-5(a)(7) (1996).

[452] Reg. § 1.882-5(d)(1) (1996).

[453] Reg. § 1.882-5(d)(4)(i) (1996) (last sentence).

[454] Reg. § 1.882-5(d)(5)(i) (1996).

[455] Reg. § 1.882-5(d)(5)(ii) (1996).

[456] Reg. § 1.882-5(d)(4) (1996).

$100. The interest deduction will be scaled back to $80 ($100 × $800/$1,000). The operation of the adjusted U.S.-booked liabilities method is illustrated in the example below.[457]

Example 15.4: Interest Deduction Under Section 1.882-5

FCo is a foreign corporation organized in Country F with a U.S. branch office. For the taxable year, FCo has assets used to generate U.S. effectively connected income with a tax book value of $300. The average total amount of FCo's worldwide liabilities is $2,700 and the average value of its worldwide assets is $3,000. FCo has elected in a prior year to use the actual ratio rather than the fixed ratio in determining its U.S.-connected liabilities. It has also elected to use the adjusted U.S.-booked liabilities method. Its U.S.-connected liabilities equal $270, determined as follows:

(1) U.S. assets $300

(2 Worldwide liabilities $2,700

(3) Worldwide assets (at tax book value) $3,000

(4) Actual ratio (line (2)/line (3)) 90%

(5) U.S.-connected liabilities (line (1) × line (4)) $270

On the books of its U.S. branch, FCo has average liabilities of $200 (U.S.-booked liabilities). That amount is less than the U.S.-connected liabilities in line (5). The interest expense shown on the books of the U.S. branch of FCo is $20. The average interest rate paid by FCo on its loans not connected with its U.S. business is 10 percent.

If F elects to use the adjusted U.S.-booked liabilities method, its interest deduction for the year against the effectively connected income of its U.S. branch will be the sum of the interest shown on its U.S. books and the interest deemed paid on its U.S.-connected liabilities in excess of the liabilities shown on its U.S. books. That amount is $27, computed as follows:

(6) Average U.S.-booked liabilities $200

(7) Interest expense shown on U.S. books $20

(8) Excess of U.S.-connected liabilities over U.S.-booked liabilities (line (5) minus line (6)) $70

(9) Average interest rate on foreign loans 10%

(10) Interest expense on U.S.-connected liabilities in excess of liabilities on U.S. books (line (8) × line (9)) $7

(11) Interest deduction allowable under adjusted U.S.-booked liabilities method (line (7) + line (10)) $27

Foreign corporations electing the separate currency pools method determine their allowable interest deduction separately for each currency in which they have borrowed money.[458] A three-step process is followed that parallels the three-step procedure used under the adjusted U.S.-booked liabilities method. In

[457] Example 15.4 is based on the examples in Reg. § 1.882-5(d)(6) (1996).

[458] Reg. § 1.882-5(e)(1) (1996). The taxpayer may compute its deduction in U.S. dollars for any currency in which it holds less then 3% of its U.S. assets. Reg. § 1.882-5(e)(1)(i) (1996).

step one, the taxpayer determines its U.S. assets in each currency pool.[459] In step two, it determines the U.S.-connected liabilities in each currency pool.[460] In step three, it determines the amount of interest expense attributable to each currency pool by multiplying its U.S.-connected liabilities in that pool by the average interest rate paid in the currency of that pool.[461]

Assume, for example, that ZCo, a foreign bank, is engaged in the banking business in the United States.[462] It has U.S. assets held in U.S. dollars with an average value of $20,000, and U.S. assets denominated in Country Z francs of Zf30,000. The exchange rate is US $1 equals Zf2. ZCo's actual ratio of worldwide liabilities to worldwide assets is 96 percent. The average interest rate on its U.S. dollar denominated liabilities is 9 percent, and the average rate on its liabilities denominated in Country Z francs is 20 percent.

Under these facts, ZCo has U.S.-connected liabilities denominated in U.S. dollars of $19,200 (96% of $20,000) and U.S.-connected liabilities denominated in Country Z francs of $28,800 (96% of $30,000). Its deductible interest expense in the U.S. dollar pool is $1,728 (9% of $19,200). Its interest expense in the Country Z franc pool is Zf5,760 (20% of $28,800), which, converted into U.S. dollars, equals $2,880. Thus, ZCo's total interest deduction against U.S. effectively connected income is $4,608 ($1,728 + $2,880).

A foreign corporation may elect to directly allocate its interest deduction to U.S. assets without pro rata apportionment under exceptions comparable to the exceptions to the asset method for qualified nonrecourse indebtedness[463] and integrated financial transactions.[464] In computing its remaining interest expense, the taxpayer must reduce its worldwide liabilities and amount of interest paid by the amount of the liabilities and interest subject to direct allocation.[465]

Any provision of the Code that disallows, defers, or capitalizes an interest expense is applied after the interest apportioned to U.S. effectively connected income has been determined.[466] For example, assume that FCo, a foreign corporation, has interest of $1,000 attributed to U.S. assets under the section 1.882-5 regulations. One quarter of its U.S. assets are held to produce income that is exempt from U.S. tax under a U.S. tax treaty. The interest on a loan used to finance the acquisition or holding of such assets is disallowed under Code section 265(b). Under these circumstances, $250 (25% of $1,000) of FCo's interest expense attributed to U.S. assets is disallowed as a deduction under section 265(b).[467]

§ 15.03. Research and Experimental (R&E) Costs

Research and experimental (R&E) expenditures typically are capital in nature because the typical objective of the taxpayer in making them is to increase earnings in future years by developing new products or improving existing products. The Code allows a current deduction, nevertheless, for most R&E

[459] Reg. § 1.882-5(e)(1)(i) (1996).

[460] Reg. § 1.882-5(e)(1)(ii) (1996).

[461] Reg. § 1.882-5(e)(1)(iii) (1996).

[462] This example is based on Reg. § 1.882-5(e)(5)(Ex. 1) (1996).

[463] Reg. § 1.882-5(a)(1)(ii) (1996).

[464] Reg. § 1.882-5(a)(1)(ii) (1996).

[465] Reg. § 1.882-5(a)(1)(ii) (1996).

[466] Reg. § 1.882-5(a)(5) (1996).

[467] See Reg. § 1.882-5(a)(8)(Ex. 3) (1996).

expenditures.[468] The resulting mismatch of deductions with the income they help generate creates a problem for the taxpayer and the tax authorizes in determining the source of R&E deductions.

The colorful history leading to the current rules is recounted briefly in § 15.03.1, below. The basic operative rules are described in § 15.03.2. Section 15.03.3 describes the sales method — a method used to allocate and apportion R&E expenditures to the place where sales are expected to be made of products improved or developed as a result of those expenditures. Section 15.03 4 describes two gross-to-gross methods that taxpayers may elect as a substitute for the sales method. Policy notes are provided in § 15.03.5.

§ 15.03.1. Background

The method to be used for allocating and apportioning deductions for research and experimental (R&E) expenditures has been controversial since the late 1960s. The section 1.861-8 regulations, which were initially published in 1977 after a decade of political wrangling, contain detailed rules governing the source of deductions for R&E expenditures. These rules were in effect from 1977 to 1981. They were scheduled to go back into effect many times over the next decade and have done so for very brief periods. Before they went into effect, or before they remained in effect for very long, Congress would provide a temporary moratorium on their application, sometimes retroactively.

During the various legally sanctioned moratorium periods, Congress provided a temporary alternative to the section 1.861-8 rules that was more favorable to U.S. taxpayers than the 1977 regulations. The temporary nature of these measures was dictated by the high costs in forgone revenue of adopting permanent rules. The moratoriums were created by various amendments to Code section 864(f). During a moratorium period ending in 1992, that section provided, *inter alia*, that 64 percent of R&E costs could be allocated to the place where the expenditures were made. Tax specialists referred to this rule as "the 64-percent solution," playing on the title of the Sherlock Holmes pastiche, "The Seven-Per-Cent Solution," by Nicholas Meyer. That particular moratorium ran out without congressional action, due to the unwillingness of the Bush administration to raise taxes enough to pay for the multi-billion dollar cost of an additional moratorium.

Notwithstanding the absence of congressional action, the Bush administration extended the moratorium period for 18 months by issuing Rev. Proc. 92-56.[469] Many commentators from the public and private sector criticized this action as cynical, unprincipled, and lawless. The revenue procedure also called for a study by the Treasury Department to determine whether some liberalization of the R&E rules was required under the principles of Treasury regulation section 1.861-8. The study, completed by the Treasury Department early in the Clinton administration, found that the 30-percent solution contained in the 1977 regulations already provided excessive benefits to U.S. based multinationals in a significant majority of cases.[470]

In 1993, Congress amended and extended Code section 864(f) to provide the 50-percent solution by statute. That subsection terminated, however, in 1995. As a practical matter, nevertheless, the moratorium game ended in 1995 when the Treasury Department adopted new regulations that include the 50-percent solution without any specified termination date.

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[468] IRC § 174.

[469] Rev. Proc. 92-56, 1992-2 C.B. 409.

[470] See Treasury Department, *The Relationship Between U.S. Research and Development and Foreign Income* (1995).

§ 15.03.2. General Rules

R&E expenditures made solely to meet certain legal requirements are allocated to gross income derived in the country that imposed those requirements.[471] This legal-requirement rule applies if it is reasonable to assume that the entire benefits of a particular R&E expenditure, beyond *de minimis* amounts, will be derived in a particular country. For example, a requirement for product testing imposed by the U.S. Food and Drug Administration would be allocated solely to U.S. source gross income if the testing was required for making sales in the United States and would not affect foreign sales materially. If the exception applies, then the entire deduction for that R&E expenditure is allocated to gross income arising in the country where the benefit is expected to be derived before allocations are made under any other rules.

Whether the legal-requirement rule is important or relatively insignificant depends on how it is enforced. If it is enforced strictly, the rule has modest importance because most government mandated testing of a product is likely to produce substantial benefits that could affect profits derived from foreign sales. For example, the testing might lead to improvements to the product, to an enhanced reputation of the produce for safety or reliability, or to a better understanding of side effects that might reduce risks of injury to customers. Only mindless regulatory requirements or requirements narrowly focused on local matters are likely to have exclusively local effects.

A key feature of the regulations revised in 1995 is the attribution of at least 50 percent of the otherwise unallocated R&E expenses to U.S. source income if more than 50 percent of the expenditures are attributable to activities performed within the United States.[472] A mirror-image rule attributes 50 percent of expenditures to foreign source income if the activities were performed outside the United States.[473]

The taxpayer may allocate more than 50 percent of its unallocated R&E expenditures to the place of performance of its R&E activities if it establishes to the satisfaction of the tax authorities that the research and experimentation expenditures are reasonably expected to have very limited or long delayed application outside the geographic location where the activities associated with those expenditures were performed.[474] In determining whether future sales outside the place where the R&E activities were performed is likely, the taxpayer's past experience with research and experimental expenditures may be considered.[475]

The general rule for allocating and apportioning the remaining unallocated portion of R&E expenditures is the sales method.[476] The sales method requires the taxpayer to allocate its various R&E expenditures to the product categories to which they best relate. The deductions allocated to each product category are then apportioned ratably between U.S. source gross income and foreign source gross income by reference to gross receipts from U.S. sales in the product category and gross receipts from foreign sales in that category. A taxpayer may elect to use a gross-to-gross method instead of the sales method. A taxpayer making that election, however, must apportion to foreign source gross income at least 50 percent

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[471] Reg. § 1.861-17(a)(4) (1995).

[472] Reg. § 1.861-17(b)(1)(i) (1995).

[473] Id. The mirror-image rule fails to specify how R&E expenditures relating to activities conducted outside the United States are to be apportioned to various classes of foreign source income for purposes of determining the separate basket limitations on the foreign tax credit. Those limitation rules are important only for U.S. persons, however, and most U.S. persons will not be governed by the mirror-image rule.

[474] Reg. § 1.861-17(b)(2)(i) (1995).

[475] Id.

[476] Reg. § 1.861-17(c)(1) (1995).

of the amounts that would have been apportioned to foreign source income under the sales method.[477] Most U.S. taxpayers are likely to elect to use one of the alternative gross-to-gross methods.

In general, the one-taxpayer rule applies for allocating R&E expenditures.[478] A special exception to the one-taxpayer rule applied to sales derived from products produced in a U.S. possession by an electing possessions corporations.[479]

§ 15.03.3. Sales Method

Under the sales method, unallocated R&E deductions are allocated to gross income derived from the business activities to which they relate.[480] Business activities are classified according to a list of product categories incorporated by reference into the regulations.[481] These product categories define the relevant classes of gross income for purposes of allocating the R&E deductions. The deductions are then apportioned between U.S. source gross income and foreign source gross income by reference to the gross receipts from U.S. sales and foreign sales.[482] The sales method is sometimes referred to as the gross receipts method because the apportionment is made with respect to gross receipts.

The product categories incorporated by reference into the regulations are the three-digit classifications contained in the Standard Industrial Classification Manual (SIC code) used by the U.S. government in preparing statistical summaries of business operations.[483] There are many SIC product categories on that list. The classification scheme has one-digit divisions, two-digit major groups, three-digit industry groups, and then four-digit subgroups. Within the subgroups, there often are unnumbered lists. The following table is an edited sample from the SIC code list, with the three-digit categories in italics.

[477] Reg. § 1.861-17(d)(2) and (3) (1995).

[478] Reg. § 1.861-17(a)(3)(i) (1995).

[479] Reg. § 1.861-17(a)(3)(ii) (1995).

[480] Reg. § 1.861-17(c)(1) (1995).

[481] Reg. § 1.861-17(a)(2)(i) (1995).

[482] Amounts received from the lease of equipment are treated as sales receipts. Reg. § 1.861-17(c)(1)(ii) (1995).

[483] Reg. § 1.861-17(a)(2)(ii) (1995). The SIC manual is available in electronic form at the OSHA website. See http://www.osha.gov/oshstats/sicser.html.

Excerpts from Standard Industrial Classification Manual (SIC code)	
A	Agriculture, forestry, and fisheries
	01: Agricultural Production Crops
	011: Cash Grains
	111 Wheat
	112 Rice
	0115 Corn
	013: Field Crops, Except Cash Grains
	0131 Cotton
	0132 Tobacco
	017: Fruits And Tree Nuts
D	Manufacturing
	20: Food And Kindred Products
	28: Chemicals And Allied Products
	30: Rubber And Miscellaneous Plastics Products
	301: Tires And Inner Tubes
	35: Industrial And Commercial Machinery And Computer Equipment
	352: Farm And Garden Machinery And Equipment
	3524 Lawn and Garden Tractors and Home Lawn and Garden Equipment
	356: General Industrial Machinery And Equipment
	357: Computer And Office Equipment
	3571 Electronic Computers
	3572 Computer Storage Devices
	3575 Computer Terminals
	3577 Computer Peripheral Equipment, Not Elsewhere Classified

The general apportionment rule is that R&E deductions allocated to a class of gross income should be apportioned between U.S. and foreign sources with respect to gross receipts from sales of products in that class.[484] For example, gross income derived from "computer and office equipment" would be a class of gross income. R&E expenditures relating to that class would be apportioned between U.S. source gross income and foreign source gross income in accordance with the taxpayer's U.S. and foreign sales during the taxable year of products in that class.

The apportionment formula can be represented as follows:

$$R\&E_{us} = R\&E_{ww} \times \text{U.S. Sales}/\text{WW Sales}$$

where

$R\&E_{US}$ is the R&E deduction apportioned to the United States in a SIC product category;

$R\&E_{ww}$ is the total worldwide R&E deduction in that product category;

U.S. Sales is the gross receipts from U.S. sales in that product category; and

WW Sales is the worldwide gross receipts from sales in that product category.

[484] Reg. § 1.861-17(a)(2)(1) (1996).

For an illustration of the operation of the sales method, consider PCo, a U.S. corporation that manufactures various products, including tires, for sale within and without the United States. PCo spends \$1,200 on R&E relating to tires that is deductible in the current year. During the year, it sells \$30,000 worth of tires, which are classified under the SIC list as "SIC code 301: Tires and Inner Tubes." Sales of \$10,000 were made within the United States. Under these circumstances, \$400 (\$1,200 × \$10,000/\$30,000) of PCo's R&E deduction would be apportioned to U.S. source gross income derived from the sale of "tires and inner tubes." The remaining \$800 would be apportioned to foreign source gross income.

For a more complex example, assume that PCo, the U.S. corporation in the example above, has two other businesses — the manufacture and sale of inner tubes and the production and sale of wheat. In addition to the \$1,200 R&E deduction relating to tires, PCo has an R&E deduction of \$300 relating to inner tubes and an R&E deduction of \$500 relating to wheat. The worldwide inner tube sales are \$10,000, of which \$4,000 are made in the United States. All of the sales of wheat are made in the United States.

Because tires and inner tubes are in the same SIC category, the R&E deductions of \$1,500 (\$1,200 + \$300) for tires and for inner tubes are apportioned with respect to the \$40,000 of total sales of tires and inner tubes (\$30,000 + \$10,000). The amount apportioned to the U.S. source gross income of \$14,000 (\$10,000 + \$4,000) is \$525 (\$1,500 × \$14,000/ \$40,000). No apportionment is required within a SIC category. The \$500 deduction relating to wheat is allocated to gross income in the SIC category 011, "cash grains" and apportioned to U.S. source gross income.

In the examples above, the taxpayer allocated R&E deductions to a three-digit category. The taxpayer may elect to combine categories for purposes of making its allocations.[485] The taxpayer may not subdivide the three-digit categories.[486] For example, a taxpayer could elect to combine the category for computers (SIC 357) and the category for general industry machinery (SIC 356) and allocate and apportion its R&E deductions to that broader category. It cannot, however, break down the category for computers into subcategories for computer storage devices (SIC 3572) and computer terminals (SIC 3575) and allocate and apportion its R&E deductions with respect to those subcategories. A taxpayer cannot change its product categories from year to year unless it establishes to the satisfaction of the Commissioner that a change is appropriate due to a change in relevant facts.[487]

Some taxpayers exploit technology that they have developed from R&E activities by licensing or selling that technology to other persons. A taxpayer so exploiting the fruits of its R&E expenditures must take into account the sales made by a licensee or purchaser in applying the sales method if the licensee or purchaser can reasonably be expected to benefit, directly or indirectly, from the taxpayer's R&E expenditures.[488] A person is expected to benefit from a taxpayer's R&E expenditure if the taxpayer can reasonably be expected to make any resulting technology available, by sale or otherwise, to that person.[489] In effect, the taxpayer claiming the R&E deduction is treated, for the purpose of applying the sales method, as if it had made all of the sales of products produced from the technology that its R&E expenditure is deemed to have created.

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[485] Reg. § 1.861-17(a)(2)(i) (1995). Under the 1977 regulations, the taxpayer was required to use two-digit SIC categories. The 1995 regulations, in effect, allow the taxpayer to subdivide the two-digit categories at its election.

[486] Id. Restrictions apply in using the two-digit categories "Wholesale Trade" and "Retail Trade." Reg. § 1.861-17(a)(2)(iv) and (v) (1995).

[487] Reg. § 1.861-17(a)(2)(iii) (1995).

[488] Reg. §§ 1.861-17(c)(2) (1995) (relating to license arrangements, etc., with uncontrolled parties) and 1.861-17(c)(3) (1995) (relating to license arrangements, etc., with controlled parties).

[489] Id.

Consider, for example, a U.S. corporation, XCo, that manufactures lawn mowers. During the taxable year, XCo has an allowable R&E deduction of $1,000 relating to the SIC category 3524 (Lawn and Garden Tractors and Home Lawn and Garden Equipment) for lawn mowers. It licenses its small motor technology used to make the engines for lawn mowers to an unrelated foreign corporation, YCo, in exchange for a royalty on YCo's sales of mowers. As part of the licensing arrangement, XCo agrees to license to YCo all future motor technology that it develops.

During the year, XCo sells $10,000 worth of mowers in the United States, and YCo sells $40,000 worth of mowers in Country B, for total worldwide sales of $50,000. XCo receives a royalty from YCo of $5,000. In applying the sales method for apportioning the deduction between its U.S. source sales income and its foreign source royalty income, XCo must take into account the $10,000 of gross receipts from its own sales of motors. It also must take into account the gross receipts of $40,000 from YCo's sales of mowers in Country B. Of the $1,000 R&E deduction, $200 ($1,000 × $10,000/$50,000) is apportioned to U.S. gross income, and $800 ($1,000 × $40,000) would be apportioned to foreign source gross income.

In some circumstances, the taxpayer claiming an R&E deduction cannot be expected to know the amount of the sales of products produced from technology it has sold or licensed to an unrelated person. In such circumstances, the taxpayer must make a reasonable estimate of the amount of the gross receipts from sales of those product.[490]

§ 15.03.4. Optional Gross-to-Gross Methods

The R&E regulations permit a taxpayer to apportion R&E deductions using a gross-to-gross apportionment method instead of using the sales method. Two gross-to-gross methods are provided. An election to use an optional gross-to-gross method rather than the sales method is binding on the taxpayer for the current year and for four succeeding years.[491] The taxpayer may elect to use the first of the two methods only if it meets certain conditions. The second method is the residual method. These methods are used to apportion R&E deductions after those deductions have been allocated to a product category under the rules applicable under the sales method.

Under both gross-to-gross methods, 25 percent, rather than 50 percent, of the taxpayer's R&E deduction, after application of the legal-requirement test, is allocated to the country where the R&E activities were performed.[492] The election to use the gross-to-gross method must be made with respect to the taxpayer's entire R&E deduction. The taxpayer cannot use the sales method for R&E deductions allocated to one product category and the gross-to-gross method for R&E deductions allocated to another product category.[493]

The first gross-to-gross method permits a taxpayer to apportion its R&E deduction in each product category ratably to its U.S. source gross income and the foreign source gross income derived in that product category. Assume, for example, that PCo has foreign source gross income from sale of wheat of $500 and U.S. source gross income from sale of wheat of $1,500. Its previously unallocated R&E deduction relating to wheat is $400. The activities relating to that deduction were performed in the United States. No part of the R&E deduction is allocated under the legal-requirement test.

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[490] Reg. § 1.861-17(c)(2)(iii) (1995).

[491] Reg. § 1.861-17(e)(1) (1995).

[492] Reg. § 1.861-17(b)(1)(ii) (1995).

[493] Reg. § 1.861-17(d)(1)(ii) (1995).

Before applying the gross-to-gross method, PCo allocates 25 percent, or $100, of its $400 R&E deduction to the United States. Under the gross-to-gross method, it apportions $75 ($300 × $500/$2,000) of this deduction to foreign source gross income and the remaining $225 to U.S. source gross income. Thus, the total amount of the $400 R&E deduction apportioned to the U.S. source income is $325

To qualify for this gross-to-gross option, the taxpayer must meet two conditions. First, the amount apportioned to the statutory grouping (foreign source income in the case of a U.S. person computing the limitation on its foreign tax credit) must be at least 50 percent of the amount that would be apportioned to the statutory grouping under the sales method.[494] Second, the amount apportioned to the residual grouping (foreign source income in the case of a foreign person computing its U.S. effectively connected income) must be at least 50 percent of the amount that would be apportioned to the residual grouping under the sales method.

Assume, for example, that PCo in the above example has gross receipts from the sale of wheat of $20,000 in the United States and the same amount in foreign markets. Under the sales method, PCo would apportion 50 percent of the $400 deduction to U.S. source gross income. The remaining $200 R&E deduction that would be apportioned under the sales method to U.S. source gross income would be $100 ($200 × $20,000/$40,000). Thus, the total amount apportioned to U.S. source gross income (the residual grouping) under the sales method would be $300 ($200 + $100). The amount allocated to foreign source gross income (the statutory grouping) under the sales method would be $100 ($400 – $100).

PCo apportions $75 to foreign source gross income (the statutory grouping) under the gross-to-gross method. That amount is more than 50 percent of the $100 that would be apportioned to foreign source gross income under the sales method. As a result, the first condition is met. The second condition is also met because the $325 apportioned to U.S. source income (the residual grouping) is more than 50 percent of the $300 apportioned to U.S. source income under the sales method. Indeed, U.S. taxpayers would never consider electing the gross-to-gross method if this second condition were not met. Its function is to prevent foreign persons from apportioning an excessive amount of R&E deductions to U.S. source income under the gross-to-gross method.

A taxpayer that fails one of the two conditions for electing the first alternative gross-to-gross method may elect to use the second gross-to-gross method. Under that method, a U.S. person may allocate to foreign source gross income (statutory grouping) only 50 percent of the amount that would have been allocated to foreign source gross income under the sales method. Assume, for example, that DCo, a U.S. corporation, has an R&E deduction of $20,000. Assume also that it would apportion $5,000 of its R&E deduction to foreign source gross income under the sales method and only $1,000 to foreign source income under the first gross-to-gross method. As a result, it would not be able to elect the first gross-to-gross method.

Under the second method, DCo would be permitted to apportion $2,500 (50% of $5,000) to foreign source income and the remaining $17,500 to U.S. source income. Thus, it should elect to use the second gross-to-gross method rather than the sales method. A comparable result would be achieved if DCo were a foreign corporation.

[494] Reg. § 1.861-17(d)(2)(i) (1995).

§ 15.03.5. Policy Notes

The allocation and apportionment of R&E expenditures has been controversial for more than three decades. The normatively correct rule is the sales method, modified to allow direct allocations to a particular country when the R&E is likely to provide disproportionate benefits in that country. The safe-harbor rule allowing some portion of R&E expenditures to be allocated directly to the country where the R&E activities are performed is correct in theory. The tax policy issue for discussion is the size of that direct allocation.

The various gross-to-gross methods have never been justified. Indeed, no one seems prepared to even offer a justification. They were introduced into the 1977 regulations to soften the expected angry response of U.S. multinationals to those regulations. They did not serve that purpose very well then, and they do not serve any discernable public purpose now.

On the contrary, the gross-to-gross rules cut against important U.S. tax and trade policies. By making low foreign source gross income the key to high U.S. R&E deductions, the gross-to-gross rules encourage U.S.-based multinationals to license their technology abroad. In that way, the gross income they receive has been reduced by almost all of the major costs of earning that income. At best, this incentive will cause U.S.-based companies to make formal changes in the way they deal with their foreign affiliates. At worst, it will encourage those companies to manufacture their products abroad rather than in the United States. When the best that can be said for a rule is that it encourages international tax avoidance, the rule is indefensible on public policy grounds.

Allocation and apportionment of R&E expenditures is complicated by the fact that the expenditures are deductible currently, notwithstanding the fact that most of those expenditures are made to earn future income. If the expenditures were capitalized, then matching the deductions with U.S. source income and foreign source income would be simplified greatly and the quality of the matching would be improved.

Analysts have attempted to justify the current deduction for R&E expenses on tax expenditure grounds. They claim that R&E activities are good for society over and above the return they provide to investors because of certain external benefits that the investors are unable to capture for themselves. The analogy is sometimes made to the external benefits created in the nineteenth century by the building of railway lines in the western states. To encourage railway construction, the federal government gave away large blocks of public lands to the railway companies. Analysts suggest that a similar subsidy for R&E makes good economic sense.

The theory supporting a subsidy for R&E is plausible, but the factual basis for its premises have not been established. Obviously many kinds of research generate external benefits. The federal government subsidizes academic research for exactly that reason. The question is whether the multinational companies generate enough external benefits from their research activities to justify the cost in forgone revenue of an R&E subsidy. Much of the research undertaken by multinationals is not shared with the public, resulting in fairly limited external benefits. In addition, much of the research is directed at differentiating products in the marketplace. There are unlikely to be external benefits from such research, and there may be some social detriment if the research promotes monopoly pricing.

The R&E regulations were written to give benefits to U.S.-based multinationals. In accordance with U.S. treaty obligations, however, they do not discriminate against foreign-based multinationals. Indeed, in some respects, they are more favorable to foreign companies than to U.S. companies. For example, foreign companies are not subject in any meaningful way to the one-taxpayer rule because foreign companies are not permitted under U.S. tax law to file consolidated returns. In addition, the ability of the U.S. tax authorities

to monitor the legal-requirement test, as it applies to foreign companies, is minimal. This neutrality is good tax policy but bad spending policy. It is highly unlikely that a spending program designed to promote research would award large, unmonitored benefits to foreign-based multinational corporations.

For good or for bad, the Code currently provides a tax subsidy for R&E expenditures by allowing a current deduction. Tough rules applicable to the allocation and apportionment of R&E expenditures would weaken that subsidy. The current R&E allocation and apportionment rules may be understood as a crude compromise between the dictates of tax policy and the dictates of spending policy. For the most part, spending policy has prevailed over tax policy.

Supporters of special allocation rules for R&E expenditures contend that some U.S.-based multinational companies have encountered great difficulties in obtaining a deduction in foreign countries for R&E activities conducted within the United States. In principle, double taxation problems of this type should be resolved through the competent authority mechanism of U.S. tax treaties. Unilateral action by the United States to solve those problems for U.S.-based multinationals results in an unwarranted subsidy to foreign governments.