New Inventory Sourcing Rules

By Lowell D. Yoder

The U.S. taxation of income from the sale of inventory differs depending on whether the income is U.S. source or foreign source. For a domestic corporation, U.S. tax on foreign source sales income generally can be reduced with foreign tax credits, subject to limitation.[1] For a foreign corporation, foreign source sales income generally is not subject to U.S. taxation, whereas U.S. source sales income generally is taxable if attributable to a U.S. trade or business.[2]

The Tax Cuts and Jobs Act of 2017[3] ("TCJA") changed the sourcing rule for income derived from the sale of inventory manufactured by a taxpayer. The Treasury and IRS recently issued proposed regulations implementing that change and modifying the resourcing rules that apply to sales by a foreign person through a fixed place of business in the United States.

Purchased-and-Sold Inventory

The source of income from the purchase and sale of inventory generally is determined based on where the inventory is sold. The TCJA did not modify this rule.

Income from the sale of inventory within the United States generally is U.S. source income,[4] whereas income from the sale of inventory outside the United States generally is foreign source income.[5] The regulations provide that the place where inventory is sold is determined based on the place where title and risk of loss pass from the seller to the buyer.[6]

For example, income from the purchase and sale of inventory by a U.S. corporation to a foreign customer with title and risk of loss passing outside the United States (*e.g.*, at the foreign port of entry) would be foreign source. If instead risk of loss and title passed within the United States (*e.g.*, when transferred to a shipper), the sales income would be U.S. source.[7]

Specific provisions in legal or shipping documents providing the place where title and risk of loss pass from a seller to a buyer will generally be controlling.[8] The cases have uniformly held that parties can agree in a sales contract where title and risk of loss pass from the seller to the buyer.[9]

LOWELL D. YODER is a Partner in the Chicago office of McDermott Will & Emery LLP.

Manufactured-and-Sold Inventory

A different sourcing rule applies to income from the sale of inventory that is manufactured by a taxpayer. As revised by the TCJA, such income is sourced based solely on where the product is produced.[10]

Prior to the TCJA, income from the sale of inventory manufactured by a taxpayer generally was sourced 50% based on where title and risk of loss passed to the buyer and 50% based on where the inventory was produced.[11] Under certain circumstances, a taxpayer could use an independent factory price or a books and records method to apportion the income from the sale of inventory between sales activity and production activity.[12]

> *Under proposed regulations, if a foreign person has an office in the United States that materially participates in the sale of inventory and the place of sale is outside the United States, all income from the sale of purchased inventory and 50% of the income from the sale of foreign manufactured inventory will be resourced as U.S. source income (subject to an exception for sales to foreign customers through a foreign office that materially participates in the sale).*

For example, under prior law income from the sale of a product by a U.S. corporation manufactured in the United States that was sold outside the United States was 50% U.S. source and 50% foreign source. Similarly, income from the manufacture of a product outside the United States and its sale within the United States was 50% foreign source and 50% U.S. source. In the latter example, if title also passed outside the United States, the income would have been 100% foreign source.

Following the TCJA, Code Sec. 863(b) now provides that all of the income from the sale of inventory manufactured by a taxpayer is sourced solely based on where the production activities take place with respect to the property.[13] Thus, the place where title passes to inventory manufactured by a taxpayer generally is no longer relevant to the determination of the source of the sales income.

The Treasury and IRS issued proposed regulations implementing the change to the rules for sourcing income from sales of inventory manufactured by a taxpayer.[14] Proposed Reg. §1.863-3(b) merely restates the language added to Code Sec. 863(b), providing that income from the sale of products manufactured by a taxpayer is sourced "solely on the basis of the production activities with respect to the inventory."[15] The proposed regulations also would remove from the current regulations the three methods for apportioning income between sales activity and production activity.

Under the current regulations, income attributed to production activity is sourced where the taxpayer's production assets are located.[16] Production assets are tangible and intangible assets owned directly by the taxpayer that are used by the taxpayer to produce inventory.[17] Where the taxpayer's production assets are located both within and without the United States, income is sourced to the United States based on the ratio of the average adjusted basis of U.S. production assets to the average adjusted basis of all production assets.[18]

For example, if a taxpayer manufactures a product only in the United States and sells the product outside the United States, 100% of the income would be U.S. source. On the other hand, if the products are manufactured by the taxpayer entirely outside the United States, 100% of the income generally would be foreign source, even if the products were sold to U.S. customers. The result is the same regardless of the place where title and risk of loss to the products pass from the seller to the customer.[19]

Resourcing Rule for Foreign Taxpayers

Code Sec. 865 provides a special sourcing rule for income from the sale of personal property (including inventory) by a foreign person. Income from the sale of inventory that is otherwise foreign source income under the above rules will be U.S. source income to the extent the income is attributable to an office or fixed place of business in the United States.[20]

Code Sec. 865(e)(3) provides that the principles of Code Sec. 864(c)(5) apply in determining whether a taxpayer has an office or fixed place of business in the United States and whether a sale is attributable to such office or other fixed place of business. Code Sec. 864(c)(5) provides rules for determining the amount, if any, of a foreign person's foreign source income that is treated as effectively connected with a U.S. trade or business, and therefore subject to net-basis U.S. taxation.[21]

Regulations provide that a taxpayer is considered as having a fixed place of business in the United States if it has a "place, site, structure, or other similar facility" through which the taxpayer conducts a trade or business.[22] Under certain circumstances a dependent agent can be treated as a fixed place of business of a foreign corporation, *i.e.*, where it has authority to negotiate contracts in the name of the taxpayer and regularly exercises such authority.[23]

Under Code Sec. 864 foreign source income will be attributable to a U.S. fixed place of business only if it is a material factor in the production of such income, and such fixed place of business regularly carries on activities of the type from which such income is derived.[24] Regulations provide that activities of the U.S. office will be a material factor if "they provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss."[25] A fixed place of business is a material factor with respect to income from the sale of inventory if it actively participates in soliciting the order, negotiating the contract for sale, or performing other significant services necessary for the consummation of the sale.[26]

Code Sec. 864(c)(5)(C) provides that the amount of income attributable to a U.S. fixed place of business is the amount of income properly allocable thereto. For this purpose, the amount of income from the sale of inventory which is treated as attributable to a U.S. fixed place of business shall not exceed the amount of income which would be U.S. source "if the sale or exchange were made in the United States." Under this hypothetical determination, a sale or exchange should generally be treated as made in the United States if title and risk of loss to the property had transferred from the seller to the buyer in the United States.[27]

As discussed above, under the general sourcing rules, income derived by a foreign corporation from the purchase and sale of inventory outside the United States would be foreign source income. Nevertheless, under the resourcing rules, such income generally would become U.S. source income if the foreign corporation has a fixed place of business in the United States that materially participates in the sale of the inventory.[28]

When a foreign corporation manufactures property outside the United States, as discussed above under the general sourcing rules income from the sale of the inventory would be foreign source income based on the location of the production activities. The place where title and risk of loss pass from the seller to the buyer is not relevant. As a result, treating the sale as occurring in the United States would not change the source of the income under Code Sec. 863(b). Therefore, under the principles of Code Sec. 864(c)(5)(C), no amount of income derived by a foreign corporation from the sale of products manufactured outside the United States should be attributable to a U.S. fixed place of business in the United States, and thus none of the income should be resourced as U.S. source income under Code Sec. 865(e).

The proposed regulations would take a different approach in applying the resourcing rule to income from products manufactured by a foreign corporation outside the United States and sold through an office or fixed place of business in the United States. The regulations would treat 50% of the income as properly allocable to the U.S. fixed place of business. Therefore, in effect 50% of the income would be sourced based on sales activity and 50% of the income would be sourced based on production activity.[29] Under this approach, in the above example 50% of the foreign corporation's income would be U.S. source income, and therefore treated as effectively connected with a U.S. trade or business.[30]

The language in the Code does not support the rule in the proposed regulations resourcing income from the sale of property manufactured outside the United States. It is true that the Code Sec. 865(e)(2) resourcing rule applies "[n]otwithstanding any other provisions of [sections 861-865]," but the key operative rule of the resourcing rule itself (in Code Sec. 865(e)(3)) goes on to invoke certain principles of Code Sec. 864 and, by extension, Code Sec. 863(b). Furthermore, there is nothing in the legislative history to the TCJA that supports the proposed regulations' interpretation.[31]

An exception is provided to the application of the resourcing rule when the inventory is sold by a foreign person to a foreign customer. Income from the sale of inventory by a foreign corporation will not be treated as attributable to a foreign corporation's U.S. office (and therefore not treated as U.S. source income) if the inventory is sold for use, disposition, or consumption outside the United States and the taxpayer has a foreign office or other fixed place of business that materially participates in the sale.[32] The proposed regulations would not change this rule.[33]

Conclusion

Income from the sale of inventory that is purchased and sold generally is sourced based on where title and risk of loss pass from the seller to the buyer, and income from the sale of inventory manufactured by a taxpayer is sourced based solely on the location of the production activities. Under proposed regulations, if a foreign person has an office in the United States that materially participates in the sale of inventory and the place of sale is outside the United States, all income from the sale of purchased inventory and 50% of the income from the sale of foreign manufactured inventory will be resourced as U.S. source income (subject to an exception for sales to foreign customers through a foreign office that materially participates in the sale).

ENDNOTES

[1] Code Secs. 901 and 904. The deduction for foreign-derived intangible income provided by Code Sec. 250(a)(1)(A) is available for both U.S. source and foreign source sales income derived from foreign customers. Proposed Reg. §1.250(b)-4. *See* Yoder, *The Proposed FDII Regulations: Sale of Products to Foreign Customers*, 48 Tax Mgmt. Int'l J. 352 (June 14, 2019).

[2] Code Secs. 864 and 882.

[3] The Tax Cuts and Jobs Act, P.L. 115-97 (Dec. 22, 2017).

[4] Code Sec. 861(a)(6).

[5] Code Sec. 862(a)(6). *See* Reg. §1.861-7(a).

[6] Reg. §1.864-7(c). The place where inventory is purchased or where the customer is located are not factors in determining the source of income from the sale of inventory. *Carding Gill, Ltd.*, 38 BTA 669, 672, Dec. 10,442 (1938).

[7] The Treasury and IRS published proposed regulations that would provide that the sale of a copyrighted article transferred through electronic medium would be deemed to occur at the location of the download or installation (or the location of the customer). Proposed Reg. §1.861-18(f)(2)(ii); *see* REG-130700-14, 84 FR 40,317 (Aug. 9, 2019).

[8] If the documents do not provide for when title and risk of loss pass to a buyer, the courts will look to the delivery terms and commercial law for determining where title and risk of loss pass to the buyer, *e.g.*, the Uniform Commercial Code or the International Chamber of Commerce Incoterms. *See Kates Holding Co., Inc.*, 79 TC 700, Dec. 39,460 (1982); *Liggett Group, Inc.*, 79 TCM 1167 (1990).

[9] *See, e.g., A.P. Green Export Co.*, CtCls, 61-1 ustc ¶9103 284 F2d 383, 151 CtCls 628; *Barber-Green Americas, Inc.*, 35 TC 365, Dec. 24,475 (1960); *Pfaudler Inter-American Corp.*, CA-2, 64-1 ustc ¶9405, 330 F2d 471, *aff'g*, 22 TCM 506, Dec. 26,071(M), TC Memo. 1963-109; *Otis Elevator Co.*, CtCls, 66-1 ustc ¶9244, 356 F2d 157, 174 CtCls 357.

[10] Code Sec. 863(b).

[11] Reg. §1.863-3(b)(1).

[12] Reg. §1.863-3(b)(2) and (3).

[13] The TCJA added the following sentence at the end of Code Sec. 863(b): "Gains, profits, and income from the sale or exchange of inventory [produced (in whole or in part) by the taxpayer] shall be allocated and apportioned between sources within and without the United States solely on the basis of the production activities with respect to the property."

[14] REG-100956-19, 84 FR 71,836 (Dec. 30, 2019). The regulations are proposed to generally apply to taxable years ending on or after December 23, 2019.

[15] The current regulations define "production activity" as an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. *See* Reg. §1.863-3(c)(1)(i)(A).

[16] Reg. §1.863-3(c)(1).

[17] Reg. §1.863-3(c)(1)(i)(B).

[18] Reg. §1.863-3(c)(1)(ii)(A). The proposed regulations would determine the basis of U.S. production assets by reference to the alternative depreciation system under Code Sec. 168(g)(2). Proposed Reg. §1.863-3(c)(2)(ii).

[19] *See* Proposed Reg. §1.1501-13(c)(7)(ii)(N), *Ex.* 14 (applies matching principles to determine the source of income with respect to a transaction between members of a consolidated group).

[20] Code Sec. 865(e)(2)(A).

[21] Code Secs. 882(a)(1) and 864(c)(4). As a general rule, foreign source income from the sale of inventory is not treated as effectively connected with the conduct of a trade or business in the United States. Code Sec. 864(c)(4)(A). *See* Reg. §1.864-2(e) (U.S. trade or business determined based on the facts and circumstances).

[22] Reg. §1.864-7(b)(1).

[23] Code Sec. 864(c)(5)(A); Reg. §1.864-7(d)(1).

[24] Code Sec. 864(c)(5)(B).

[25] Reg. §1.864-6(b)(1).

[26] Reg. §1.864-6(b)(2)(iii).

[27] *See* Reg. §1.864-6(c)(2) (specifically referencing Code Sec. 863(b)(2), and examples rely on the sourcing rules in Code Secs. 861 and 863). The proposed regulations would revise this regulation to limit the scope of its application to certain nonresident alien individuals, and remove the cross-references to Code Secs. 861 through 863). Proposed Reg. §1.864-6(c)(2).

[28] Proposed Reg. §1.865-3(d)(3). *See* Code Sec. 864(c)(3) (income from sources within the United States treated as effectively connected income).

[29] Proposed Reg. §1.865-3(d)(2)(i). A taxpayer may elect to determine the amount of gross income from the sale of foreign manufactured inventory that is allocable to sales activities and production activities based on an optional books and records method. Proposed Reg. §1.865-3(d)(2)(ii).

[30] *See* Code Secs. 864(c)(3) and 882(a); *see also* Code Sec. 884(a) (branch profits tax). *Cf.*, Code Sec. 952(b) (Subpart F income does not include any item of income from sources within the United States that is effectively connected with the conduct of a trade or business within the United States); Code Sec. 951A(c)(2)(A)(i)(I) (tested income does not include an item of income described in Code Sec. 952(b)); Yoder, *The Interplay Between Subpart F and the Effectively Connected Income Rules*, 45 Tax Mgmt. Int'l J. 625 (Oct. 14, 2016).

[31] The preamble to the proposed regulations acknowledges that under U.S. income tax treaties the business profits of foreign treaty residents may be taxable in the United States only if the profits are attributable to a permanent establishment in the United States. It states that, "[w]ith respect to taxpayers entitled to the benefits of an income tax treaty, the amount of profits attributable to a U.S. permanent establishment will not be affected by the regulations." 84 FR at 71,849.

[32] Code Sec. 865(e)(2)(B).

[33] Proposed Reg. §1.965-3(b).