

US: Source-of-income rules modified by proposed regulations implementing TCJA changes

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The United States (US) Treasury Department has released proposed regulations ([REG-100956-19](#)) concerning the sourcing of income from sales of personal property (including inventory). The proposed regulations primarily address amended Internal Revenue Code¹ Section 863(b), which sources income from the sale of inventory produced by a taxpayer based on the location of production activities with respect to the inventory.

Proposed regulations were also issued under Section 865(e)(2), concerning the US-source treatment of certain income from personal property sales by nonresidents that are attributable to a US office or fixed place of business (US Office). Finally, the proposed regulations would also update and clarify existing provisions under Section 864, concerning the treatment of certain income from property sales as effectively connected with a US trade or business (ECI).

The proposed regulations would apply generally to tax years ending on or after 23 December 2019. Subject to certain limitations, however, taxpayers can elect to apply the proposed regulations to prior tax years.

Overview of general sourcing rules applicable to sales of personal property

Subject to various exceptions, Section 865(a) generally sources income from the sale of personal property based on the seller's residence. Different rules apply to sales of inventory property, depending on whether the taxpayer purchased or produced the inventory, and to sales of depreciable personal property.

Under Section 861(a)(6), income from the sale in the US of inventory purchased outside the US is treated as US source; under Section 862(a)(6), income from the sale outside the US of inventory purchased in the US is treated as foreign source. The location of the sale is generally determined based on where title to the inventory passes from the seller to the buyer.

Under Section 863(b)(2), as amended by the *Tax Cuts and Jobs Act*, Pub. L. 115-97 (2017) (TCJA), income from the sale of inventory produced (in whole or in part) by the taxpayer in the US and sold outside the US (or vice-versa) is allocated and apportioned between US and foreign sources solely based on the production activities with respect to the property (an 863(b)(2) Sale). Before the TCJA, Section 863(b)(2) sourced income from 863(b)(2) Sales partly as US and partly as foreign but did not specify a method for determining the amount sourced as foreign or US. Treas. Reg. Section 1.863-3 provided three methods for making this determination: the 50/50 method, the independent factory price method (IFP), and the book and records method. Each method generally attributed the gross income from 863(b)(2) Sales to the taxpayer's production activity and sales activity with respect to the inventory and then applied different rules to determine the source of the gross income attributed to the production activity versus sales activity. The source of the gross income attributed to production activity was generally determined based on a ratio of the relative average adjusted basis of the production assets located inside and outside the US to the total adjusted basis of the production assets.

Under Section 865(e)(2), which applies "notwithstanding any other provision" of Sections 861 to 865 of the Code, if a nonresident maintains a US Office, income from all sales of personal property (including inventory) attributable to the US Office is treated as US source (an 865(e)(2) Sale). An 865(e)(2) Sale does not, however, include the sale of inventory for use, disposition or consumption outside the US if a foreign office of the nonresident materially participates in the sale.

The principles of Section 864(c)(5) apply to determine whether a nonresident has a US Office and whether a sale is attributable to the US Office.

In determining whether a nonresident alien individual or a foreign corporation has a US Office, Section 864(c)(5)(A) disregards an agent's office or other fixed place of business unless the agent (i) has, and regularly exercises, the authority to negotiate and conclude contracts in the name of the individual or foreign corporation or has merchandise from which the agent regularly fills orders on behalf of that individual or foreign corporation, and (ii) is not a general commission agent, broker or other agent of independent status acting in the ordinary course of his business.

Section 864(c)(5)(B) does not attribute income, gain, or loss to a US Office unless the US Office is a material factor in the production of that income, gain, or loss, and the US Office regularly carries on the type of activities from which that income, gain, or loss is derived. The Preamble to the proposed regulations describes this provision as a threshold requirement for determining whether any income can be attributed to a US Office.

Finally, under Section 864(c)(5)(C), the income, gain or loss that is attributable to a US Office is the income, gain, or loss property allocable to the US Office. For sales or exchanges of personal property outside the US but through the US Office, however, the income from the sale that is treated as attributable to the US Office shall not exceed the income that would be US source if the sale or exchange were made in the US.

Proposed regulations for sourcing gross income from Section 863(b)(2) sales

Subject to new regulations proposed under Section 865(e)(2) (discussed next), the proposed regulations under Section 863(b)(2) (Prop. Reg. Section 1.863-3) would replace the three methods in Treas. Reg. Section 1.863-3 with a single method based solely on the location of the taxpayer's production activities with respect to the 863(b)(2) Sale. If the taxpayer's production activities were located both inside and outside the US, the gross income from the 863(b)(2) Sale would continue to be treated as US source and foreign source based on the adjusted basis of the production assets.

To account for taxpayers' ability to immediately deduct under Section 168(k) the cost of qualifying property (which is available only for certain property used in the US), the proposed regulations would determine the adjusted basis of

production assets located in the US under Section 168(g)(2)'s alternative depreciation system (ADS), which applies to determine the adjusted basis of production assets located outside the US, thus creating parity. Determining the adjusted basis of all production assets in this manner would prevent a disproportionate amount of gross income from 863(b)(2) Sales being sourced as foreign. After the gross income from 863(b)(2) is allocated and apportioned between US and foreign sources, the proposed regulations would require taxpayers to apply the regulations under Section 861 to properly allocate and apportion deductions between US- and foreign-source gross income from Section 863(b)(2) Sales.

Proposed regulations for sourcing gross income from Section 865(e)(2) sales

The proposed regulations “clarify the scope and application of” Section 865(e)(2) to determine the amount of gross income from 865(e)(2) Sales treated as US source. If a nonresident maintains a US Office, the proposed regulations would treat an amount of the gross income from any sale of personal property (including inventory property) attributable to that US Office as US source. Consistent with the statute, however, this general rule would not apply to gross income from any sale of inventory that is sold for use, disposition, or consumption outside the US if the nonresident’s office or other fixed place of business in a foreign country materially participated in the sale. Prop. Reg. Section 1.864-6(b)(3) would determine whether a foreign office materially participated in the sale and whether the inventory was destined for foreign use.

Thus, consistent with the statute, the following must be determined for any tax year of a nonresident:

- ▶ Whether the nonresident has a US Office
- ▶ Whether any sale of personal property is attributable to that US Office
- ▶ The amount of the gross income from those sales that is treated as US source

The principles of Section 864(c)(5)(A) would apply to determine whether the nonresident has a US Office, and the principles of Section 864(c)(5)(B), as prescribed in Prop. Reg. Section 1.864-6(b) and (c), would apply to determine whether a sale of personal property is attributable to that US Office. Finally, subject to special rules applicable to inventory and depreciable personal property, the proposed regulations would determine the amount of income, gain, or loss from the sale of personal property attributable to a US Office under Prop. Reg. Section 1.864-6(c)(1).

For income from the sale of depreciable personal property, the amount of gain not in excess of depreciation deductions that is allocable to a nonresident’s US Office is limited to the amount that would be generally attributable to US depreciation deductions under Section 865(c); if the gain exceeded prior US and non-US depreciation deductions, it would be sourced as if the sold property were inventory.

Prop. Reg. Section 1.865-3(d) would treat all income from an 865(e)(2) Sale of purchased inventory as US source. In contrast, two methods are available for determining the source of gross income from an 865(e)(2) Sale of produced inventory. Under the default method, 50% of a nonresident’s gross income from a Section 865(e)(2) Sale of produced inventory would be properly allocable to the US Office and treated as US source. The remaining 50% of gross income would be allocated or apportioned under Section 863(b) based on the location of the nonresident’s production activities under Prop. Reg. Section 1.863-3 (relative adjusted basis of production assets within and outside the US). Thus, for inventory produced entirely outside the US, under this 50/50 method, 50% of the gross income would be US source and 50% would be foreign source.

In lieu of this proposed 50/50 method, the proposed regulations would also allow the nonresident to elect to allocate its gross income from 865(e)(2) Sales of produced inventory under a “books and records” method. A taxpayer electing the books and records method must indicate in a statement attached to its tax return that it elects to apply this method, and must prepare and maintain certain records, including an explanation of how the allocation clearly reflects the taxpayer’s income from production and sales activities under the principles of Section 482. For this purpose, Section 482 principles apply as if the US Office were a separate taxpayer from the nonresident (even if payments are not made between the US Office and other offices of the nonresident taxpayer’s other offices). The gross income from the 865(e)(2) Sales allocable to sales activity under this books and records method would be treated as properly allocable to US Office and the gross income allocable to production activities would be sourced based on the location of the production assets with respect to the inventory in accordance with Prop. Reg. Section 1.863-3. The proposed regulations would not, however, change the amount of a nonresident taxpayer’s business profits that are attributable to a US permanent establishment under a US tax treaty.

Additional proposed rules

1. Possession/territory sales

Current regulations on income partly from sources within a territory of the US (under Treas. Reg. Section 1.863-3(f)) would be replaced by Prop. Reg. Section 1.863-3(e). The proposed regulations do not provide specific rules for the sale of inventory produced (in whole or in part) by the taxpayer within the US and sold within a US territory, or vice versa; instead, they cross-reference the general sourcing rules provided by Prop. Reg. Section 1.863-3(c). In addition, Prop. Reg. Section 1.863-3(e) would modify the rule for sourcing gross income derived from the purchase of personal property within a US territory and its sale within the US under Section 863(b)(3), removing the books and records method, and instead requiring this income to be sourced based solely upon the taxpayer's business activity.

2. Sales of inventory by certain nonresident alien individuals

The proposed regulations also address circumstances involving nonresident alien individuals who have a tax home in the US under Section 865(g)(1), and whose inventory sales would not be subject to Section 865(e)(2) because they would not be "nonresidents" under Section 865(g)(1)(B). According to the Preamble, Treasury and the Internal Revenue Service have determined that Section 864(c)(4)(B)(iii) – which generally is only relevant to certain foreign individuals with a substantial presence in the US – should apply to treat income from these individuals' inventory sales as effectively connected income to the same extent as if Section 865(e)(2) did apply, depending on whether the inventory was purchased abroad or produced abroad. The proposed regulations thus would require a nonresident alien with a tax home in the US to determine the amount of income from the sale of goods or merchandise that is properly attributable to the individual's US Office under Prop. Reg. Section 1.865-3(d).

3. Space and ocean activity

The proposed regulations would also modify current sourcing rules for income derived from the sale of taxpayer-produced inventory that is produced or sold in space or international water. To conform with post-TCJA Section 863(b)(2), income from the sale of this property would no longer be subject to the 50/50 method whereby half of the income would be allocable to production activity and the other half to sales activity. Instead, these sales would now solely be allocated on the basis of the production activity related to the property.

Once this allocation occurs, the existing rules for sourcing of income based on where production occurs would continue to apply (see Treas. Reg. 1.863-8(b)(3)(ii)(B), (C)).

4. Natural resources

The proposed regulations also provide conforming modifications to the regulations for allocating or apportioning income from the sale of natural resources, which can be a subset of inventory, removing the prior "export terminal" provisions and replacing them with general rules basing the allocation and apportionment of income on the location of the farm, mine, oil or gas well, etc. from which the natural resource is derived. The proposed regulations also provide rules that take into account any additional production activities related to the natural resource.

Implications

Section 863(b)(2), as amended by the TCJA, applies to tax years beginning after 31 December 2017. Accordingly, the Treasury regulations under former Section 863(b)(2) were deadwood and the replacement of the methods available under those regulations was anticipated. In contrast, the proposal to determine the adjusted bases of US-based production assets using ADS might require taxpayers to revisit their sourcing projections. Although taxpayers had noted the imbalance caused by amended Section 168(k), some had hoped that Treasury would conclude that the effect – generally, more foreign-source income – had been intended. Further, the proposed regulations continue to use the adjusted basis of production assets as a proxy for production activity to allocate gross income from 863(b)(2) Sales between US and foreign production assets. Self-created intangibles, including formulas and processes used in manufacturing, are not taken into account for this purpose, a result that could be significant.

The proposed regulations applicable to 865(e)(2) Sales will be important for nonresidents selling inventory property through a US Office by providing that at least 50% of the gross income from those sales is US source. With the amendment of Section 863(b)(2) to source income based solely on production activity, many nonresidents were anticipating that change to also affect the sourcing of gross income from 865(e)(2) Sales. However, Treasury views the policy underlying Section 865(e)(2), which applies notwithstanding any other provision of Sections 861 to 865 of the Code, as sourcing gross income from 865(e)(2) Sales based on the location of the economic activity giving rise to the income.

According to Treasury, this policy is unaffected by the scope and application of post-TCJA Section 863(b)(2), in part because (i) it views Section 865(e)(2) as a further restriction on the source rule of Section 863(b)(2), and (ii) the TCJA did not alter the wording of Section 865(e)(2). Before the release of the proposed regulations, however, the relevant statutory provisions were subject to different interpretations. Nonetheless, because the proposed regulations would be

effective for tax years ending on or after 23 December 2019, calendar-year taxpayers should immediately determine the impact of the proposed regulations on their sourcing projections. In addition, the proposed rules for sourcing gain on the sale of certain depreciable property may be beneficial for some nonresidents, e.g., sale of leased property that was used outside the US.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated.

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