9 October 2020
Global Tax Alert

US: Final regulations add clarifications and revisions to source-of-income rules

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Executive summary

United States (US) final regulations (T.D. 9921) on sourcing income from sales of personal property, including inventory (the Final Regulations), generally retain the basic approach of proposed regulations that were released in December 2019 to address changes made to Internal Revenue Code[1] Section 863(b)(2) by the *Tax Cuts and Jobs Act* (2017) (REG-100956-19) (the Proposed Regulations).[2] The Final Regulations also revise the Proposed Regulations' guidance on sourcing income from sales of personal property under Section 865(e)(2), as well as other provisions of former Treas. Reg. Sections 1.863-3 and 1.864-5 (the Prior Regulations) that were not amended by the Proposed Regulations. This Tax Alert discusses the Final Regulations in light of these changes.

Detailed discussion

Summary of relevant statutory provisions

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

Building a better working world

Before the *Tax Cuts and Jobs Act*, Pub. L. 115-97 (2017) (TCJA), Section 863(b)(2) sourced 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, (an 863(b)(2) Sale) partly as US and partly as foreign but did not specify a method for determining the amount sourced as foreign or US. The Prior Regulations provided three methods for making this determination: the 50/50 method, the independent factory price method (IFP), and the book-and-records method. These rules provide different methods for determining the amount of gross income that is from 863(b)(2) Sales and attributable to the taxpayer's production activity and sales activity with respect to the inventory. They also apply different rules to determine the source of the gross income attributable to the production activity versus sales activity. The source of the gross income attributable to production activity was generally 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. The TCJA amended Section 863(b)(2), which now allocates and apportions income from 863(b)(2) Sales between US and foreign sources solely based on the production activities with respect to the property.

If a nonresident maintains a US office or fixed place of business (US Office), Section 865(e)(2) treats income from all sales of personal property (including inventory) attributable to the US Office (an 865(e)(2) Sale) as US source. Section 865(e)(2) applies "notwithstanding any other provision" of Sections 861 to 865. 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.

Section 864(c) provides the general rules for determining whether income is treated as effectively connected with the conduct of a trade or business within the United States (ECI). Nonresidents engaged in a trade or business within the US are generally subject to US net basis taxation on income that is ECI.

Generally, under Section 864(c), only US-source income of a nonresident is determined to be ECI. Section 864(c)(4)(B), however, sets forth special rules that treat certain foreign-source income as ECI if a nonresident has a US Office to which the income is attributable, including income from certain sales of inventory. Section 864(c)(5) provides rules to determine whether a nonresident has a US Office and whether a sale is attributable to the US Office.

Final regulations governing Section 863(b)(2) sales

Rules for determining the location or existence of production activity

Subject to the rules under Treas. Reg. Section 1.865-3, the Final Regulations allocate and apportion all income, gain or loss derived from an 863(b)(2) Sale between US and foreign sources based solely on the taxpayer's production activities with respect to the inventory. This treatment is consistent with Section 863(b)(2) and the Proposed Regulations.

The Final Regulations add a new rule in Treas. Reg. Section 1.863-3(c)(1)(i) that incorporates the principles of Treas. Reg. Section 1.954-3(a)(4) to determine whether a taxpayer's activity qualifies as a production activity. These principles do not include, however, the rules regarding a "substantial contribution to the manufacturing of personal property" under Treas. Reg. Section 1.954-3(a)(4)(iv).

Treas. Reg. Section 1.954-3 provides rules for determining the foreign base company sales income of a controlled foreign corporation (CFC) for purposes of Subpart F of the Code. Treas. Reg. Section 1.954-3(a)(4) specifies that foreign base company sales income does not include income from the sale of personal property manufactured, produced or constructed by the CFC itself (the Manufacturing Exception). Specifically, a CFC is generally eligible for the Manufacturing Exception if one of the following tests is satisfied:

- The property is substantially transformed by the CFC (the Substantial Transformation Test)
- The property purchased by the CFC is used as a component part of the property that is sold and the assembly or conversion of the component parts into the final product involves activities that are substantial in nature and generally considered to constitute the manufacture, production or construction of property (the Component Part Test)
- The property is manufactured, produced or constructed by another party, but the CFC makes a substantial contribution through the activities of its employees to the manufacture, production or construction of the property (the Substantial Contribution Test)

In the Preamble to the Final Regulations (the Preamble), the Internal Revenue Service (IRS) and Treasury note that the Final Regulations do not incorporate the Substantial Contribution Test because "there is no clear metric for quantifying production arising from substantial contribution activities" for determining the place of production.

The Final Regulations do not modify the rule in Treas. Reg. Section 1.863-3(c)(1)(i)(A) of the Prior Regulations (redesignated in the Final Regulations as Treas. Reg. Section 1.863-3(c)(1)(i)), which takes into account only those "production activities" that are "conducted directly by the taxpayer." Similarly, the Final Regulations retain the rule in Treas. Reg. Section 1.863-3(c)(1)(i)(B) of the Prior Regulations (redesignated in the Final Regulations as Treas. Reg. Section 1.863-3(c)(1)(ii)), which defines "production assets" as those "owned directly by the taxpayer [and] directly used by the taxpayer to produce inventory." Thus, the Final Regulations, only take into account the activities directly conducted by and assets directly owned by the taxpayer for purposes of allocating and apportioning income with respect to an 863(b)(2) Sale; the rules for determining the location or existence of production activity do not include activities or assets of related parties or unrelated agents. The Preamble indicates, however, that the IRS and Treasury may consider other approaches to determining the location or existence of production activity as part of a more comprehensive review of the sourcing rules (for purposes of both 863-3 and 865-3) in a future notice of proposed rulemaking.

Measuring the adjusted basis of production assets

If the taxpayer's production activities are located both inside and outside the US, the Final Regulations source the gross income from an 863(b)(2) Sale based on the adjusted basis of the production assets. For this purpose, the Final Regulations retain the rules in the Proposed Regulations requiring taxpayers to measure the adjusted basis of production assets located in the US under Section 168(g)(2)'s alternative depreciation system (ADS), despite comments urging the IRS and Treasury to implement different rules. The Preamble notes that the use of ADS for measuring the adjusted basis of assets is necessary to prevent the TCJA's modification to Section 168(k) (which allows accelerated depreciation for certain property used in the US) from inappropriately skewing the apportionment formula in favor of foreign-source income.

The Final Regulations further clarify how to determine the adjusted basis of production assets. Specifically, the Final Regulations require the adjusted basis of production assets for a tax year to be determined by averaging the bases of the assets at the beginning and end of the year, except when a change during the year would cause the average to "materially distort" the calculation for sourcing of income attributable to production activity. The Final Regulations indicate that a material distortion in the calculation of the split between US and foreign production activities may occur in the event of a major acquisition or disposition of assets, such as a later-year disposition of substantially all of a corporation's US production assets. In the event of material distortion, the average adjusted basis is determined "upon a more appropriate basis that is weighted to reasonably reflect the period for which the assets are held by the taxpayer during the [tax] year." The Preamble notes that the Final Regulations use concepts from Treas. Reg. Section 1.861-9(g)(2)(i)(A) to explain when a change might "materially distort" the calculation.

Anti-abuse rules

The Proposed Regulations eliminated Treas. Reg. Section 1.863-3(c)(2) of the Prior Regulations, which presumed the place of sale of inventory property to be in the US, even if title passed outside the US, if a taxpayer wholly produced the inventory in the US and sold it for use, consumption or disposition in the US. A comment to the Proposed Regulations recommended including a rule similar to "prior" Treas. Reg. Section 1.863-3(c)(2) in the Final Regulations and expanding it to inventory produced in the US that is acquired by a related party and resold for use, consumption or disposition in the US, with title passing outside the US. Absent such a rule, the comment observed, the related party would generate foreign-source income because the title passes outside the US, notwithstanding the fact that the inventory was produced and ultimately sold for use, consumption or disposition in the US. The IRS and Treasury declined to adopt this comment, noting in the Preamble that the broad anti-abuse rule of Treas. Reg. Section 1.861-7(c) may already address this kind of related-party arrangement.

The Proposed Regulations did not revise a separate anti-abuse rule in Treas. Reg. Section 1.863-3(c)(1)(iii) (within the Prior Regulations). The Final Regulations modify this anti-abuse rule (renumbered as Treas. Reg. Section 1.863-3(c)(3)) to apply to transactions "inconsistent with the purpose of Treas. Reg. Section 1.863-3(b) or (c)," which provide rules for determining the income source based on the taxpayer's production activities. If this anti-abuse rule applies, the IRS may make appropriate adjustments so that the source of the taxpayer's gross income "more clearly reflects the location of production activity." The revisions include an example illustrating that a taxpayer may be subject to the anti-abuse rule if a related partnership (or a subsidiary of a related partnership) acquires

domestic production assets with a principal purpose of reducing its US tax liability by treating inventory sale income as subject to Section 862(a)(6) rather than Section 863(b).

Application of tax treaties to avoid double taxation

A comment to the Proposed Regulations expressed concern that the regulations governing 863(b)(2) Sales could potentially result in double taxation to US taxpayers engaged in business operations through a permanent establishment. The Final Regulations do not include any rule preventing or mitigating double taxation. The Preamble clarifies, however, that the Final Regulations governing 863(b)(2) Sales do not affect a taxpayer's ability to rely on treaty provisions to mitigate or relieve double taxation, and that taxpayers may ask the competent authority for assistance under a mutual procedure article of an applicable income tax treaty when double taxation arises.

Final regulations governing Section 865(e)(2) sales

Source of income from Section 865(e)(2) sale of purchased inventory

As noted previously, an 865(e)(2) Sale is a sale of personal property (including inventory) attributable to the US Office of a nonresident but does not 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. Generally, the Final Regulations retain the rules of the Proposed Regulations for purposes of determining the source of income from 865(e)(2) Sales and provide different sourcing rules for the sales of inventory property depending on whether the taxpayer purchased or produced the inventory sold. Consistent with Section 862(e)(2) and the Proposed Regulations, the Final Regulations treat all income from an 865(e)(2) Sale of purchased inventory as US source.

Two methods for determining the source of income from Section 865(e)(2) sale of produced inventory — 50/50 default method or elective books and records method

For an 865(e)(2) Sale of produced inventory, the Final Regulations clarify what constitutes a production activity for this purpose. Specifically, similar to Treas. Reg. Section 1.863-3(c)(1)(i), Treas. Reg. Section 1.865-3(d)(2) now defines the term "produced" to include created, fabricated, manufactured, extracted, processed, cured and aged, as determined under the principles of Treas. Reg. Section 1.954-3(a)(4), but excluding the Substantial Contribution Test.

Consistent with the Proposed Regulations, the Final Regulations include two methods 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 an 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 based on the location of the nonresident's production activities as determined under Treas. Reg. Section 1.863-3. Thus, for inventory produced entirely outside the US, 50% of the gross income would be US source under this 50/50 method, and 50% would be foreign source. In lieu of this proposed 50/50 method, the Final Regulations continue to allow the nonresident to elect to allocate its gross income from 865(e)(2) Sales of produced inventory under a books-and-records method.

Mechanics of the books-and-records election

As noted, the 50/50 method continues to be the default method for allocating income from an 865(e)(2) Sale of produced inventory, and the Final Regulations continue to permit taxpayers to elect the books-and-records method, if the required records are kept (including an explanation of how the allocation reflects the arm's-length principles of Section 482). Once a taxpayer elects to use the books-and records method, however, the election continues until revoked. Moreover, an election cannot be revoked without IRS consent for any tax year beginning within 48 months of the last day of the tax year for which the election was made.

The Preamble notes that this limitation is appropriate when a nonresident has elected to use a books-and-records method because it prevents the nonresident from returning to the "less precise" 50/50 method solely to obtain a better tax result. Requiring the election to remain in effect until revoked, the Preamble adds, also reduces the risk that taxpayers will inadvertently fail to include the election with their Federal income tax return.

Determining source of taxable income

For determining the source of taxable income, Prop. Reg. Section 1.865-3(e) includes a cross-reference to Treas. Reg. Sections 1.882-4 and -5, which provide rules for allocating and apportioning expenses to income effectively connected with the conduct of a trade or business in the US. However, the cross-referenced regulations apply only to foreign corporations and do not cover nonresident alien individuals who are also subject to Treas. Reg. Section 1.865-3.

Therefore, the Final Regulations replace these cross-references with cross-references to Section 882(c)(1), which governs allocation and apportionment of expenses to gross income of a foreign corporation, and Section 873(a), which governs allocation and apportionment of expenses to gross income, gain, or loss of a nonresident alien individual.

Sales of inventory by certain nonresident alien individuals

The Final Regulations revise a rule that was not addressed by the Proposed Regulations. Specifically, consistent with Section 864(c)(4)(B), Treas. Reg. Section 1.864-5 of the Prior Regulations generally considers foreign-source income of a nonresident, including income from certain sales of inventory, to be ECI if the nonresident has a US Office to which the income is attributable. The Final Regulations add a sentence to Treas. Reg. Section 1.864-5(a) clarifying that Treas. Reg. Section 1.865-3(d) applies to determine the source of income, gain or loss from the sale of personal property (including inventory property) attributable to a US Office of nonresidents within the meaning of Section 865(g)(1)(B). The term "nonresident" is defined in Section 865(g)(1)(B) as "any person other than a United States resident." The term "United States resident" includes a nonresident alien who has a "tax home" in the US under Section 911(d)(3).

The Final Regulations retain the rule in Prop. Reg. Section 1.864-6(c)(2). Consistent with the Proposed Regulations, the Final Regulations require a nonresident alien individual with a tax home in the US to determine the amount of income from the sale of goods or merchandise that is properly allocable to the individual's US Office under Treas. Reg. Section 1.865-3(d).

Effective dates of the final regulations

The IRS and Treasury rejected a comment requesting that the Final Regulations apply to tax years ending after 31 December 2019, because some taxpayers have consistently relied on the Prior Regulations for many years. Thus, the Final Regulations preserve the retroactive applicability date of the Proposed Regulations.

In general, the Final Regulations apply to tax years ending on or after 23 December 2019 — the date that the Proposed Regulations were filed with the Federal Register. However, a taxpayer and all related persons (within the meaning of Section 267 or 707) may apply the Final Regulations in their entirety for any tax year beginning after 31 December 2017, and ending before 23 December 2019, so long as the taxpayer and all related persons apply the Final Regulations in their entirety for all tax years thereafter. The Preamble also allows taxpayers to rely on the Proposed Regulations in their entirety for all tax years beginning after 31 December 2017 and ending on or before 29 September 2020 (the release date of Final Regulations) if the taxpayer and all related persons (within the meaning of Section 267 or 707) rely on the Proposed Regulations in their entirety and have not applied the Final Regulations to any preceding tax year.

Implications

The Final Regulations make several changes to the Proposed Regulations that taxpayers may not have anticipated. For example, taxpayers considering whether to elect the books-and-records method should note the limitation on the ability to revoke the election, and the impact on the sourcing of income from subsequent years' operations. Taxpayers should evaluate the scope of the anti-abuse rules generally; the revised anti-abuse rule of Treas. Reg. Section 1.863-3(c)(3)) is of particular note to taxpayers that may have sold domestic production assets to a related partnership or a subsidiary of a related partnership. Taxpayers should also consider the rules of Treas. Reg. Section 1.954-3(a)(4) to determine whether their activities constitute production activities within the meaning of the Final Regulations.

The Preamble acknowledges some commenters' concerns that the allocation and apportionment rules may not accurately reflect the ambit of a taxpayer's "production activities," as they use only the relative adjusted basis of production assets within and outside of the US, the rules. The Preamble also acknowledges comments noting that treating income from the sale of inventory produced in whole or in part in the US as US-source income may limit a US taxpayer's ability to use foreign tax credits. While these comments were not adopted in the Final Regulations, the Preamble notes that a "more comprehensive review of the sourcing rules for production activity" may be considered in future proposed regulations, for purposes of both Treas. Reg. Sections 1.863-3 and 1.865-3. It also requests comments on approaches for determining the location or existence of production activity. Accordingly, taxpayers should monitor future developments and consider (or continue) engaging in the comment process.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. For discussion of the proposed regulations, see EY Global Tax Alert, *US: Source-of-income rules modified by proposed regulations implementing TCJA changes*, dated 9 January 2020.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax Services

- Craig Hillier, *Americas ITTS Director – Americas, Boston* craig.hillier@ey.com
- Jose Murillo, *National Tax ITTS Leader - Washington DC* jose.murillo@ey.com
- Arlene Fitzpatrick, *Washington DC* arlene.fitzpatrick@ey.com
- Julia Tonkovich, *Washington DC* julia.m.tonkovich@ey.com
- Anna Voortman, *Chicago* anna.voortman@ey.com
- Leo Naughton, *New York* leo.naughton@ey.com
- Anna Moss, *Washington DC* anna.moss@ey.com

International Tax and Transaction Services

Global ITTS Leader, **Jeffrey Michalak,** *Detroit*

Global Transfer Pricing Leader, **Luis Coronado,** *Singapore*

ITTS Director, Americas, **Craig Hillier,** *Boston*

ITTS NTD Leader, **Jose Murillo,** *Washington, DC*

Transfer Pricing Leader, Americas, **Tracee Fultz,** *New York*

ITTS Markets Leader, Americas, **Laynie Pavio,** *San Jose, CA*

ITTS Regional Contacts, Ernst & Young LLP (US)

West
Sadler Nelson, *San Jose, CA*

East
Colleen O'Neill, *New York*

Central
Aaron Topol, *Atlanta*

Financial Services
Chris J Housman, *New York*

Canada – Ernst & Young LLP (Canada)
Warren Pashkowich, *Calgary*

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