TAX REVIEW

No. 95

SOURCE AND CERTAIN OTHER JURISDICTIONAL LIMITATIONS IN LIGHT OF THE TAX REFORM ACT OF 1986

FRED FEINGOLD

May 18, 1987

Is there some jurisdictional limitation, albeit implied, on the ability of the United States to tax income of foreign persons? The issue rarely arises[1/] in part because the United States does not purport to tax income of a non-U.S. person that either does not arise in the United States or does not arise from a U.S. business activity. Of course, the United States does tax its citizens and residents and U.S. corporations on their world-wide income, generally without any limitation; however, that could hardly be considered to raise jurisdictional issues. Moreover, in the case of U.S. persons subject to tax on world-wide income, the United States unilaterally and by treaty cedes to the "source" country the primary right to impose a tax, with the United States retaining, in effect, through what has become a very complicated foreign tax credit mechanism, only a residual right to tax non-U.S. source income of U.S. persons.

The United States exercises tax jurisdiction over the income from a U.S. business activity of a foreign person by subjecting foreign persons who are (or are considered to be) engaged in a U.S. trade or busines to tax on the income which is or is considered to be attributable to such trade or business.[2/] While all such income might be classified as "U.S. source," historically the Code has not done so.[2a/] Because of this, certain income treated as foreign under the source rules, albeit attributable to U.S. business activities, would have escaped tax but for the special rules of Section 864(c)(4). The latter provision, in effect, provides that in certain limited cases income designated as foreign under the source rules may nevertheless be treated as "effectively connected" income[3/] subject to U.S. tax as U.S. business income of a foreign taxpayer engaged in a U.S. trade or business through an office or fixed place of business.[4/]

Thus, merely classifying business income as foreign under the source rules would not necessarily prevent the United States from exercising tax jurisdiction.[5/] On the other hand, the mere classification of certain types of income, including business income, as "U.S. source" may have the effect of subjecting such income to U.S. tax regardless of whether such income is factually related to any U.S. business activity.[6/] For example, gain from an unrelated sale by a nonresident alien individual, who is engaged in a U.S. trade or business (e.g., he performs services in the United States for a U.S. person), of a non-capital asset would be treated as U.S. business income if under the applicable source rules such gain is considered to be derived from U.S. sources.

The exercise of tax jurisdiction with respect to non-business income of a foreign person is also affected by its source classification: such income of a foreign person is subject to tax only if considered to be U.S. source and of a fixed or determinable annual or periodical nature.[7/]

In this connection, while it seems absolutely clear that a sovereign has the "right" to assert tax jurisdiction over income "arising" within its borders, it seems equally clear that an attempt to exert tax jurisdiction with respect to income that does not arise within the state would be suspect. Nor does it appear that a sovereign may "bootstrap" his position by designating income that arises somewhere else (under any acceptable standard) as having arisen in his state merely because his source rules say so. Thus, for example, designating interim or liquidating distributions paid by a foreign corporation with no U.S. income (business or non-business income) to a foreign shareholder as U.S. source income might well fail for lack of jurisdiction.[8/] Of course, the Code has no such rule. Rather, in order for dividends paid by a foreign corporation to a foreign taxpayer to be designated as a U.S. source dividend, a minimum amount (formerly 50% and now 25%) of the Company's income must have been effectively connected with the conduct of a U.S. trade or business for an applicable three year period.[9/] One need not be able to draw a line between that which is too low a threshold and that which is an acceptable one, to determine that both the old law and current law test would be acceptable even under the view expressed in the dissenting opinion in Frank W. Ross.

Consider the case of royalties, however. Royalties are considered to be derived from U.S. sources to the extent attributable to property used in the United States.[10/] There is no requirement that a royalty be paid by a person subject to U.S. tax jurisdiction or that the payor have any minimum portion of its income as U.S. source income, for the royalty to be designated as U.S. source.[11/] The only requirement is that the payment be for the "use" of property in the United States. Needless to say, the classification of royalties paid by a foreign person with little or no U.S. contacts to another foreign person as U.S. source merely because of the use in the United States (perhaps by a third party) of the intangible under license has raised eyebrows in certain cases.

The new source rule for interest adopts an approach which also ignores the amount of the contacts of a foreign corporate payor to the U.S. As most everyone knows, under prior law, and with certain exceptions, interest was considered to be sourced in the United States if the obligor was a U.S. resident. For this purpose, the term "U.S. resident" included all U.S. corporations and any partnership and any foreign corporation that engaged in a U.S. trade or business.[12/] However, unlike the case of a resident partnership, not all interest paid by so-called resident foreign corporations was considered to be from U.S. sources. Rather, before any such interest could be so treated, the foreign corporation had to meet a 50% income threshold,[13/] with a pro-rata portion being from U.S. sources if the income threshold was met. Also, under prior law, it did not matter how much of the interest paid by a resident foreign corporation or resident partnership was deductible for U.S. income tax purposes.[14/] Thus, for example, interest paid by a "nonresident partnership" would not be considered U.S. source even if all its partners were U.S. residents. Similarly, all interest paid by a foreign partnership, all of whose partners were foreign, that was engaged in a U.S. trade or business at some time during the year, would be U.S. source, regardless of whether any of the interest payments were deductible in the United States. If one considers that a foreign partnership such as a foreign law firm that performs services in the United States for even one day is engaged in a U.S. trade or business during the year, making all interest paid by such a partnership U.S. source, it is not too difficult to see why in many cases this rule was too harsh to enforce. Nevertheless it remains the law.

No less broad a source rule has now been adopted for interest paid by foreign corporations.

Section 884(f)(1)(A) provides that in the case of a foreign corporation engaged in a U.S. trade or business, any interest "paid by the U.S. trade or business of such foreign corporation" is treated for the purpose of imposing a tax on the foreign recipient thereof and for withholding purposes as if such interest were paid by a domestic corporation. The effect of such treatment is that under Section 861(a)(1) (as modified by the Tax Reform Act of 1986) such interest is U.S. source income, regardless of the proportion of income of the foreign corporation that was effectively connected with a U.S. trade or business and regardless of the portion of the interest paid which is deductible for U.S. tax purposes. This is a significant change from the prior law which established a 50% threshold before any interest paid by a foreign corporation could have been treated as from U.S. sources.[15/]

U.S. branches of foreign banks rarely met the 50% threshold and as a result generally were not required to withhold tax on interest paid to foreign lenders. Congress, apparently of the view that the 50% threshold provided an escape hatch for U.S. branches of large foreign corporations, considered reducing the threshold to as low as 10%. Banks lobbied for a 25% compromise but were successful in obtaining the 25% threshold only in the case of dividend payments. Consequently, in the case of interest, a threshold no longer exists. As under prior law, there is no requirement that interest be deductible for it to be considered from U.S. sources.

For interest to be covered by Section 884(f)(1)(A), it must be paid by the foreign corporation's U.S. trade or business. Presumably it is intended that the "paid" requirement will be met where the U.S. trade or business actually bears the interest expense, whether or not the interest is paid currently. However, a specific statement to this effect in the Regulations that are to be issued would be most welcomed.[15a]

The above assumes it can be determined that the foreign corporation's U.S. trade or business actually bears the interest expense. How will this be determined? To be sure, there will be clear cases where the U.S. trade or business actually maintains separate branch books and the rights of third parties are affected by whether an amount is reflected on such books. Suppose, however, separate branch books are not maintained or the rights of third parties are not affected by what is recorded on such books or the assets of the U.S. branch are not sufficient to support a borrowing of the branch, but the assets of the home office are sufficient?

Even where the interest paid by a foreign corporation is exempt from U.S. tax because of the portfolio interest rule, the bank deposit rule or by virtue of a tax treaty, the interpretation of Section 884(f)(1)(A) is not academic. The reason is that the amount of excess interest subject to tax under new Section 884(f)(1)(B) is the excess of the amount of interest allowed as a deduction to the foreign corporation for U.S. income tax purposes,[16/] over the amount of interest described in Section 884(f)(1)(A).

Excess interest is considered as having been received by the foreign corporation from its hypothetical wholly owned domestic subsidiary on the last day of such foreign corporation's taxable year and is considered to be from U.S. sources. The foreign corporation is subject to a tax of 30% (absent a specific exemption under the Code on a lower rate that may apply under a treaty) on the excess interest it is deemed to have received as if the interest were not effectively connected with the conduct of a U.S. trade or business by the foreign corporation.[17/]

Thus, a foreign corporation may be subject to the tax on excess interest even though it is in an overall loss position; there is no requirement that the interest expense giving rise to excess interest give rise to a current income tax benefit. The Conference Report clarifies that the tax due on excess interest is payable within the time prescribed for filing the foreign corporation's U.S. tax return (not including extensions),[18/] implying that withholding is not required.

Any interest of a foreign corporation that is neither paid by the trade or business in the United States of such foreign corporation nor is excess interest, is to be considered foreign source income. Thus, consistent with the law prior to its amendment by the Tax Reform Act of 1986, all interest paid by a foreign corporation that is not actually engaged in a U.S. trade or business will be considered to be from foreign sources regardless of the portion thereof that may be deductible because of a net election.[19/] However, any interest paid by the U.S. trade or business of the foreign corporation will be considered to be U.S. source interest income even if not deductible.

In considering problems which may arise in the application of the above rules, it would be helpful to keep in mind that, for purposes of the imposition of second level taxes, the U.S. trade or business of the foreign corporation is to be treated as a domestic subsidiary.[20/] As so regarded, interest expense of the U.S. trade or business should be treated in the same manner as interest expense of an actual U.S. corporation.[21/] Consistent with this principle, only the portion of the interest paid by the fictional U.S. subsidiary which is deductible under the interest allocation rules should be treated as U.S. source income.[22/] Indeed, any interest paid in excess of the amount deductible is, in effect, treated as not having been incurred by a U.S.

trade or business. However, for purposes of the U.S. source rules, all interest paid by the U.S. trade or business is to be treated as interest paid by a U.S. corporation. So much for consistency.

The source rules relating to gain from the sale of personal property[23/] have also been changed considerably with certain jurisdictional implications. Under prior law, apart from the special rules applicable to contingent payments for intangibles and sales of property produced by the taxpayer,[24/] amounts properly characterized as gain from the sale of personal property were generally considered to be sourced at the place of sale with that place generally determined by reference to the place where the seller's right, title and interest to the property passed from seller to buyer (the so-called "title passage" rule).[25/] Since passage of title could often be arranged to occur at the most convenient place from the tax viewpoint, this rule often permitted foreign taxpayers the choice of being subject to U.S. jurisdiction with respect to gain on the property being sold. To be sure, the applicable regulations have long provided that the mere arrangement of the passage of title at a place for the principal purpose of tax avoidance is not to be given effect; in such circumstances, the sale will be deemed to occur at the place where its substance occurred, taking into account the place of negotiations, place of execution of the agreement, the location of the property and the place of payment.[26/] Notwithstanding the in terrorem effect of the language of the cited regulation, taxpayers generally were able to become comfortable with the conclusion that their sale will be deemed to have occurred where title passed as long as there was some contact with that place; and if title passed outside the United States, taxpayers were willing to assume that any gain was foreign source.[27/]

As has been noted, whether gain was U.S. or foreign source was of considerable significance given the restraint of the United States in exerting tax jurisdiction over foreign source income of a foreign person. Under prior law, apart from tax treaty considerations, for a foreign taxpayer to have been subject to U.S. tax on foreign source gain, he would have to be engaged in either a banking or financial business, a licensing business or a business involving exporting inventory. In addition, he would have had to maintain an office or other fixed place of business in the United States and the U.S. office or fixed place of business would have had to materially participate in the realization of the income. In addition, in the case of foreign sales of inventory which was sold for use, consumption, or disposition outside the United States, an office or fixed place of business of the taxpayer outside of the

United States must have not materially participated in the sale.28/ Thus, gains from sales outside of the United States of depreciable personal property used by a foreign taxpayer in a U.S. trade or business or portfolio assets of a taxpayer not in a financial industry would, in general, never have been subject to U.S. tax. Moreover, even assuming the foreign taxpayer's foreign gain was taxable under the above rules (e.g., because it constituted inventory sold through a U.S. office), tax could have been avoided if the taxpayer were entitled to the benefits of a treaty that precluded the U.S. from taxing "foreign" source income.29/

Under the new rules, foreign source gains of a foreign person will never be subject to U.S. tax.30/ However, gains attributable to a U.S. office or fixed place of business will now be designated "U.S. source," except in the case where a foreign office of the taxpayer materially participates in the sale and the property sold is inventory and is for use or consumption outside the United States. As a result, all gains which were "foreign source" but subject to U.S. tax under prior law will still be subject to tax but will now be designated "U.S. source."31/ In addition, any other personalty gain which is attributable to a U.S. office or fixed place of business of a foreign person will also be U.S. source gain. Of course, merely designating such gain "U.S. source" does not subject it to U.S. tax.

It, generally, must also be "effectively connected" gain.[32/] Residents of treaty countries also generally will be subject to U.S. tax on such gains because treaties do not exempt such gains from U.S. tax.[33/]

If a foreign taxpayer does not have a U.S. office or fixed place of business or the sale is not made through any such office or fixed place of business, the source of the gain from the sale of personal property will be determined under the following rules:

(a) Gains and losses on inventory purchased and sold by the taxpayer will be sourced generally under the title passage rule of prior law.[34/] If title passes in the United States, such gain will be from U.S. sources; in other cases, subject to the in terrorem language of the regulations, the gain will be foreign source income.

(b) Gain on inventory produced by the taxpayers in one country and sold in another will be allocated between the two countries, generally one-half to each.[35/]

(c) Gain from the sale of depreciable personal property will be allocated between the portion of such gain equal to previously allowed or allowable depreciation adjustments and the gain, in excess of depreciation, if any. The gain in excess of depreciation will be sourced under the rules for inventory discussed above.[36/] The portion of the gain attributable to depreciation recapture will be sourced in the United States to the extent of the proportion of the depreciation adjustments which were allowable for the purpose of determining U.S. taxable income.[37] Thus, for example, assume a foreign person were to sell depreciable equipment used in its trade or business for $1,100, that the sale took place outside the United States and that no U.S. office participated in the sale. Further assume the equipment had an original cost of $1,000, and an adjusted basis of $100. Finally, assume that 70% of the depreciation was allocable to U.S. taxable income.

Under prior law, the entire $1,000 gain would be considered foreign source income under the title passage rule and would be computed as follows:

Amount realized	$1,100
Basis	(100)
Gain	$1,000

Under the new provision, $630 of the $1,000 gain would be treated as U.S. source, determined as follows:

Gain from previous depreciation	$ 900
U.S. proportion of depreciation	70%
U.S. source gain from depreciation recapture	$ 630

and $370 would be treated as foreign source determined as follows:

Gain from previous depreciation	$ 900
Foreign proportion of depreciation	30%
Foreign source gain from depreciation recapture	$ 270
Gain in excess of all depreiation:	
$1,000	
(900)	
	$ 100
Total foreign source gain	$ 370

If, in the above illustration, the equipment were sold in the United States, an additional $100 of the gain would be U.S. source, but $270 of the gain would continue to be foreign source computed as follows:

U.S. source gain from previous depreciation	$630
Gain in excess of all depreciation:	
$1,000	
(900)	
	100
Total U.S. source gain	$730

Gain from previous depreciation	$900
Foreign source portion of depreciation	30%
Foreign source gain	$270

This should be compared with the result under prior law in which, in the case of a sale in the United

States, the entire $1,000 gain would have been U.S. source gain.

If in either of the above illustrations, the sale were made through the U.S. office of the foreign person, the entire gain would be considered to be from U.S. sources.

(d) Gain from the sale of intangibles other than goodwill is to be sourced, to the extent of any contingent payments, under the royalty source rule[38/] (i.e., source follows place of use); and to the extent of any fixed payments, the source is to be determined either under the depreciable property rule noted above or the residual rule noted below, depending on whether the property is depreciable property.[39/]

(e) Gain attributable to goodwill is to be sourced where the "goodwill was generated."[40/]

(f) All other gains (residual gains), principally gains on stocks and bonds are, in general, to be sourced in the country of "residence" of the taxpayer.[41/] Thus, for example, gain from the sale of stock of a U.S. corporation that is not a U.S. real property holding corporation, realized by a nonresident is to be considered foreign source unless such sale is attributable to a U.S. office or fixed place of business.[42/] It is unclear whether this would also be the result in the case of gain realized by a shareholder on the liquidation of a company.[43/]

It makes considerable difference whether the person realizing the gain is regarded as a U.S. resident.44/ Significantly, for purposes of these provisions, the term "U.S. resident" may not mean the same as such term means under U.S. internal law or under an applicable fiscal domicile provision of a treaty. To be sure, U.S. corporations are, and foreign corporations are not, considered U.S. residents for this purpose.45/ An individual is treated as a U.S. resident if his "tax home" is in the United States.46/ A U.S. citizen and a resident alien may be regarded as a nonresident under these rules. Similarly, a nonresident alien may be regarded as a resident under the above rules if his tax home is in the United States. However, the effect of treatment of a resident of a treaty country as a U.S. resident for source rule purposes may be very limited.47/

Partnerships that are created under the laws of the United States48/ are regarded as resident for source purposes, whereas partnerships created under non-U.S. law, for example, Canadian law, are regarded as nonresident.49/ Similarly, trusts which are taxed as U.S. resident trusts are considered to be resident whereas trusts taxed as nonresidents are treated similarly for source purposes.50/ Thus, it would appear that a Canadian partnership will be considered to realize foreign source income on residual gain (unless such gain is attributable to a U.S. office).

A U.S. resident partner of such partnership would appear to obtain foreign source gain with respect to his distributive share of such gain[51/] (unless, perhaps, if the partnership were to be treated as an aggregate for this purpose).[51a/] Similarly, a Canadian partner of a U.S. partnership would be treated as realizing U.S. source gain on the residual gains of the partnership.[52/]

As noted, the new source rules may, in certain limited cases, expand the scope of the U.S. taxing jurisdiction over foreign persons by broadening the category of income considered to be U.S. source and subject to U.S. tax. For example, it was possible under old law for gain from the sale of business property other than inventory to avoid U.S. tax even if the gain were attributable to a U.S. permanent establishment simply by selling the property outside the United States. It was also possible to avoid U.S. tax on gain from portfolio assets, even when those assets represented the U.S. branch's working capital, simply by selling those assets outside the United States, e.g., on a foreign stock exchange. Moreover, it was even possible to avoid tax on the sale of inventory by utilizing a third country corporation resident in a country having a treaty with the United States that exempted from tax all "foreign source" income.[53/] The new provision would tax gain in these cases. Moreover, treaties generally would not bar the United States from taxing such gain if it represented business profits of a U.S. permanent establishment or were realized from the sale of property forming part of the business property of a U.S. permanent establishment.[54]

The more modern U.S. tax conventions generally provide that to the extent gain may be taxed in the United States in accordance with the Convention, such gain is considered to arise in the United States for the purpose of applying the foreign tax credit rules.[55/] Notwithstanding this, there may be situations where double taxation can occur. Consider the case of a U.S. branch of a Canadian company selling inventory in a third country, but through a U.S. fixed place of business. Under the new rules, gain from such sales will be U.S. source and, therefore, the Canadian company could not use a foreign tax credit in the United States for any taxes imposed by the third country on the gain. If instead, a U.S. company were to make the sale, gain would be considered foreign source because the title passage rule was retained for U.S. corporations exporting abroad, regardless of the locations of their fixed places of business.[56/] Thus, a U.S. company which exports inventory abroad with title passing abroad receives foreign source income which increases the availability of the foreign tax credit.

The title passage rule for U.S. residents was retained specifically by Congress to help U.S. companies exporting abroad.[57/] In the Senate version of the bill, foreign companies would have been permitted to treat such income as foreign source for purposes of the foreign tax credit allowed to nonresidents on effectively connected income.[58/] This provision was changed during the Conference without explanation because, apparently, the United States was unwilling to cede primary taxing jurisdiction to a third country in such cases. It is unclear how this disparity would fare under the nondiscrimination provisions of tax treaties to which the United States is a party.

Under the Tax Reform Act of 1986, the U.S. Treasury Department is required to conclude a study of the effect of the title passage rule on the source rule for sales of inventory property and report to Congress by September 30, 1987. However, bills were recently introduced in both Houses to delay this study until September 30, 1988.[59/] It remains to be seen whether Congress will change this rule in the future.

While not directly relevant to the topic at hand, it is difficult to resist comment on new Sections 865(f) and 865(e)(1). Those provisions provide limited exceptions to the source rule for residual gains. As noted earlier, the source of residual gains is, in general, determined by reference to the residence of the seller. Thus, under the general rule, if a U.S. corporation were to sell shares of a foreign affiliate, gain would be U.S. source, regardless of any other rule. Two exceptions are provided to this rule. Under the first exception, which is unlikely to apply in most cases, a U.S. resident may obtain foreign source gain if the sale occurred through a foreign office of the seller and an income tax at least equal to 10% is paid to a foreign country with respect to such income.[60/]

If the foreign affiliate sold is actually engaged in the active conduct of a trade or business in a foreign country and the sale occurs in the foreign country where the foreign affiliate derived more than 50% of its gross income for a three year period ending with the affiliate's year ending immediately preceding the year of sale, then gain on the sale will be foreign source.[61/] A simple illustration will indicate how limited this exception is likely to be in practice. Consider the case of a U.S. corporation selling five foreign affiliates to one buyer in one transaction each incorporated and actively engaged in a business in a different foreign country. For obvious reasons it is unlikely that the rule will be helpful in that case.

New sections 864(c)(6) and (7) present interesting issues where they interact with the section 865 source rules discussed above. As noted above, under prior law the income of a foreign taxpayer could be subjected to tax as effectively connected with a U.S. trade or business only if the taxpayer was engaged in a U.S. trade or business in the year such income was required to be taken into account by the taxpayer.[62/] Except for income or gain from the disposition of a U.S. real property interest, if the foreign taxpayer was not engaged in a U.S. trade or business in the year U.S. source income was required to be taken into account, such income would be taxed, if at all, at flat rates; this was true even though such income may have arisen out of a trade or business conducted in the United States in a prior taxable year.[63/]

Congress became concerned with the application of this rule under U.S. internal law in the following two common situations:[64/]

First, if a nonresident alien performed services in the United States in Year 1, he was generally considered to be engaged in a trade or business in the United States in Year 1 and the compensation he received for such services in Year 1 was treated as effectively connected with a U.S. trade or business, taxable at graduated rates.[65/] If he received compensation for the Year 1 services in Year 2 and was not otherwise engaged in a U.S. trade or business in Year 2, then Year 2 compensation would be treated as not effectively connected with a U.S. trade or business and would be taxed at a 30 percent rate.[66/]

Second, if a nonresident alien or foreign corporation wound up a U.S. business and sold the business assets in return for an installment note, gain recognized in years subsequent to the year of sale would not constitute effectively connected income because no U.S. trade or business would exist in such subsequent years. The gain on the business assets which was recognized in the subsequent years (other than the gain on real estate) would not be subject to any U.S. tax.[67/]

New section 864(c)(6) provides that the income or gain of a nonresident alien or foreign corporation which is attributable to another taxable year is to be treated as effectively connected with a U.S. trade or business if it would have been treated as effectively connected with a U.S. trade or business had it been taken into account in the other taxable year. As a result, the deferral of income described in the above two situations no longer changes the character of the income from effectively connected to non-effectively connected.

Whether the new provision succeeds in subjecting the deemed effectively connected income to tax at graduated rates is another matter. Sections 871(b)(1) and 882(a)(1) subject nonresident alien individuals and foreign corporations, respectively, to tax at graduated rates on their effectively connected income, but only where they are "engaged in a trade or business within the United States during the taxable year." In every other instance in the Internal Revenue Code where income is deemed to be effectively connected, the Code further provides that the taxpayer is deemed to be engaged in a trade or business within the United States during that taxable year, thereby enabling tax to be imposed at graduated rates on such income.[68/] No language of the new section 864(c)(6) deems the taxpayer to be engaged in a trade or business within the United States during the taxable year in which the deemed effectively connected income must be taken into account. This raises the question whether section 864(c)(6) changes the tax result in the above two examples. Thus, absent a "technical correction," it could be argued that the new provision merely codifies the rule of the current regulations to the effect that income effectively connected with the conduct of a U.S. trade or business in Year 1 will generally be greated as effectively connected for a subsequent taxable year <u>provided</u> the taxpayer is engaged in any trade or business in the subsequent year.[69/] Under such a reading, taxation at graduated rates would apply only where the taxpayer is in fact engaged in a U.S. trade or business in the year the income is required to be taken into account. Since it is unlikely that this result was intended, we should expect to see a technical correction.

As noted above, section 864(c)(6) applies to a deferral of income from a transaction that occurred during a year when the taxpayer was engaged in a U.S. trade or business; it does not apply to income arising from a transaction that was put off until a year when the taxpayer is no longer engaged in a U.S. trade or business. New section 864(c)(7) was enacted to deal with the latter case. Under section 864(c)(7), if property which was at any time used or held for use in connection with the conduct of a trade or business is sold within 10 years of the cessation of such use ~~the U.S. property,~~ 70/ any income or gain from the sale or exchange is treated as effectively connected if it would have been treated as effectively connected with the conduct of the U.S. trade or business had it been sold immediately prior to the cessation of the use in such U.S. trade or business.

Like section 864(c)(6), this other new provision, section 864(c)(7), lacks any language deeming the nonresident alien or foreign corporation to be engaged in a U.S. trade or business in the year that the deemed effectively connected income is taken into account. Thus, absent a technical amendment, there is some doubt that such deemed effectively connected income would be subject to tax under sections 871(b)(1) or 882(a)(1).

The new source rules applicable to income from sales of personal property discussed above do not interact well with the above provisions. For example, under new section 865, a nonresident's sale of a trademark for a fixed sum gives rise to effectively connected income if the nonresident engages in a U.S. trade or business through a U.S. office or other fixed place of business and such office or other fixed place of business materially participates in the sale of the trademark. If a trademark formerly used in a terminated U.S. trade or business is sold by a nonresident's foreign offfice within 10 years of the cessation of the U.S. business, then for purposes of determining whether the income is effectively connected, section 864(c)(7) would deem the sale to have occurred immediately before the cessation of the U.S. trade or business (at a time when, presumably, the U.S. office or fixed place of business still existed). Unless section 864(c)(7) could also be read to deem the U.S. office to have materially participated in the hypothetical sale, however, section 865 would not treat the income as U.S. source or effectively connected. Consequently, unless section 864(c)(7) could be read to deem the U.S. office to have materially participated in the hypothetical sale, no U.S. tax would be imposed on the actual sale of the trademark. There currently is nothing in the language of section 864(c)(7) which would require the U.S. office to be deemed to have participated in any hypothetical sale under that section. While Congress' intentions as to the application of section 864(c)(7) in this case are unclear, the Joint Committee's General Explanation of the Tax Reform Act of 1986 indicates someone thought of the issue.[71]

Notably, neither of the new provisions under section 864(c) purports to apply to losses. Thus, for example, if property which had been used in a U.S. trade or business were sold a year after the U.S. trade or business ceased, any loss resulting from the sale would not be treated as effectively connected.

While the new provisions under section 864(c) apply to taxable years beginning after December 31, 1986,[72] in some respects the provisions may be retroactive; for example, installment sale gain recognized in 1987 may be treated as effectively connected income even though the property out of which the gain arose was sold in 1984.

FOOTNOTES

1. Cf., Frank W. Ross v. Comm., 44 BTA 1 (1941) (dissenting opinion); Rev. Rul. 80-362, 1980-2 C.B. 208.

2. IRC §§864(c)(1), 871(b)(1), 871(d), 882(a)(1), 882(d) and 897(a). Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1986 (the "Code") and all references to the "Blue Book" are to The Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Cong., P.L. 99-514).

2a. Cf., Restatement of the Foreign Relations Law of the United States (Revised) Tentative Draft No. 2. §412(1)(c), articulating the principle that, with respect to income of foreign persons, a state has jurisdiction only to tax income derived from property located within its territory.

3. Certain amendments have been made to Section 864(c)(4) to conform to the rules which now treat as U.S. source gain certain types of personalty gain of a foreign person attributable to a U.S. office of a trade or business which had been treated as effectively connected

foreign source gain under prior law. As noted below, additional clean-up drafting may still be required.

4. The foreign source label is convenient for foreign tax credit considerations. See IRC §906; <u>but cf.</u> discussion, <u>infra</u> at 20.

Unless

5. A tax treaty ~~must~~ exempt foreign source income from U.S. taxation. See, <u>e.g.</u>, U.S.-Netherlands (as applicable to the Netherlands Antilles), Article III(1); U.S.-Switzerland, Article III(1)(a), Rev. Rul. 74-63, 1974-1 C.B. 375 and discussion <u>infra</u>.

6. IRC §864(c)(3) (containing the residual or "force of attraction" category of income).

7. IRC §§871(a), 881(a).

8. In <u>Frank W. Ross</u>, <u>supra</u> n. 1, more than 50% of the gross income of the foreign corporation was derived from the United States.

9. IRC §861(a)(2)(B). If the test is met, a pro-rata portion of the dividend will be considered U.S. source.

10. IRC §861(a)(4); Reg. §1.861-5.

11. See Rev. Rul. 80-362, *supra* n. 1.

12. Reg. §1.861-2(a).

13. Section 861(a)(1)(D), Internal Revenue Code of 1954, ("IRC of 1954").

14. See Reg. §1.882-5.

15. See Section 861(a)(1)(C), IRC of 1954.

15a. Though the Blue Book, at 1046, states that: "Regulations are to also address the application of the branch level interest tax in cases where the payment of interest comes after the deduction and vice-versa ...," in the very next sentence it is stated that the regulations are to ensure this tax is only collected once.

16. Reg. §1.882-5.

17. Section 881(a); H. Rep. No. 841, 99th Cong., 2d Sess., II-648 (1986) (Conference Report). The Conference Report contemplates that Regulations will prescribe

rules that may treat excess interest as having been incurred on each type of external borrowing by the foreign corporation. Id. at II-649. See also Blue Book at 1042. As so treated, all or a portion thereof may be exempt from the 30% tax pursuant to a specific Code provision. See Sections 871(h) and 871(i)(2)(A).

18. Conference Report, supra note 17 at II-648.

19. See Sections 861(a)(1) and 884(f)(1). Cf. Section 884(f)(2) (defining effectively connected income for purposes of Section 884(f) as including income treated as effectively connected).

20. Conference Report, supra note 17 at II-648.

21. But, of course, the revised "80:20" rule of Section 861(a)(1)(B), IRC of 1954, is not to apply to the fictional U.S. corporation, whereas it could apply to an actual U.S. corporation.

22. See Blue Book at 1037. Cf. U.S.-Japan, Article 6(2).

23. Gain from certain specified types of personal property are covered by special rules. They include gain from

the sale of "U.S. real property interests" (section 861(a)(5)), foreign exchange gains and losses (section 988(a)(3)) and in certain cases gain from the disposition by a U.S. person of intangibles in a tax-free rollover transaction (section 367(d)(2)).

24. Under prior law, if the taxpayer sold personal property in one country but produced that property in another country, the regulations generally required that one-half the gain was to be sourced at the place where the property was sold and one-half at the place where the property was produced. Reg. §1.863-2(b)(3), Example (2). The new law limits this allocation to inventory only. In the case of sales of intangibles, prior law required that any fixed amount paid therefor was to be sourced under the rules generally applicable to sales of personal property and any contingent amount was to be treated as a royalty (and sourced at the place of use). Internal Revenue Code of 1954 sections 861(a)(6); 862(a)(6); 861(a)(4); 862(a)(4); 871(e)(2). Under a special rule, if contingent payments exceeded fixed payments for a year, all payments were considered to be contingent. Section 871(e), Internal Revenue Code of 1954. The latter rule no longer exists.

25. Reg. §1.861-7(c).

26. Id.

27. Cf., LTR 7502281430A, February 28, 1975. [For commercial reasons, title passed at a point on the boundary between the U.S. and a contiguous country. Because title did not pass over the boundary, gain was U.S. source, not non-U.S. source.]

28. Section 864(c)(4)(B) and 5, IRC of 1954.

29. Supra, n. 5.

30. Section 864(c)(4)(B) still contains references to foreign source gains which may be attributable to a U.S. fixed place of business and subject to U.S. tax. This is no longer correct. Once gains are deemed attributable to a U.S. fixed place of business they become U.S. source under section 865. See section 865(e)(2).

31. Section 865(e)(2).

32. Sections 881, 871(a)(2). Section 864(c)(2); Reg. §1.864-4(c)(2)(i The Senate Report states that once income is U.S. source

because it is "attributable" to a U.S. fixed place of business it will be effectively connected under the general rules. S. Rep. No. 313, 99th Cong., 2nd Sess., at 332. While this would generally be true under the "force of attraction" rule of section 864(c)(3), it would not be the result in the case of sales of capital assets because of the requirement under section 864(c)(2) that the gain must meet either the "asset use" or "material income producing factor" tests. Cf., Reg. §1.864-5(a), last sentence.

33. See, e.g., U.S. Treasury 1981 Proposed Model Income Tax Convention, Article 7(1); U.S.-Canada, Article 7(1).

34. IRC §865(b).

35. Id.

36. Section 865(c)(2).

37. Section 865(c)(1)

38. Section 865(d)(1)(B).

39. Section 865(d)(1)(A); Blue Book at 920, fn. 2.

40. Section 865(d)(3).

41. Section 865(a).

42. _Cf_. section 877.

43. _Cf. Hay v. Comm._, 2 TC 460 (1943); _aff'd_ 145 F.2d 1001 (4th Cir. 1944) (holding on the facts of that case that gain on the liquidation of a U.S. corporation to be U.S. source gain).

44. The source rules described above, which are applicable to income of nonresidents that are _not attributable_ to a U.S. fixed place of business, generally apply to U.S. residents whether or not the income is attributable to a U.S. fixed place of business.

45. Section 865(g)(1)(A)(ii).

46. Section 865(g)(1)(A)(i). See also, §1.911-2(b). The statute does not require that the taxpayer establish that he has a tax home outside the United States or that he have a tax home at all in order to be a non-

resident for this purpose. It merely states that if his tax home is in the United States he will be a U.S. resident. Occasionally, an individual will have no tax home. An example would be a travelling salesman who lived in hotels wherever he went. George Harvey James v. U.S., 308 F.2nd 204 (9th Cir. 1962). If, however, the taxpayer has his principal place of business in the United States, his tax home will be in the United States. For this purpose, if the taxpayer has his principal place of business outside the United States, even if his abode is in the United States, he does not have a U.S. tax home, and he is not a "resident" for purposes of these source rules. One can have a "tax home" in the United States and be a "resident" for purposes of these source rules and not be a resident subject to tax on world-wide income.

47. In the absence of a U.S. permanent establishment, gains otherwise subject to U.S. tax will generally be exempt. See, e.g., U.S.-U.K., Article 7(1); U.S.-Canada, Article XIII(4) of the Canada-U.S. Treaty.

48. For example, pursuant to the Uniform Limited Partnership Act of a state.

49. Section 865(g)(1)(B).

50. *Id*.

51. Section 702(b); *Foster v. U.S.*, 329 F.2d 717 (2nd Cir. 1964).

51a. Regulations may treat a foreign partnership as a U.S. resident to the extent its partners are U.S. persons. Blue Book at 923. But *cf*. discussion, *supra*, p. 6.

52. Section 865(a)(1). The special exception of section 865(e)(1) would probably not apply even if the sale were attributable to a foreign office of the partnership since the partnership is not likely to incur a foreign tax.

53. *Supra*, n. 5.

54. See, e.g., U.S.-Canada, Articles VII and XIII(2).

55. See, e.g., U.S.-Canada, Article XXIV(3)(a); U.S.-U.K., Article 23(3).

56. *Supra*, n. 44.

57. S. Rep. 313, 99th Cong., 2nd Sess. at 329.

58. Section 911, H.R. 3838, 99th Cong., 2nd Sess.

59. H.R. 1654, 100th Cong., 1st Sess.; S. 817, 100th Cong., 1st Sess.

60. Section 865(e)(1)(A).

61. Section 865(f).

62. Supra, n. 2.

63. Reg. §§1.871-8(c) and 1.882-1(c).

64. H. Rep. No. 426, 99th Cong., 1st Sess., 436; S. Rep. No. 313, 99th Cong., 2d Sess., 408.

65. Sections 864(b) and (c) and 871(b).

66. Section 871(a)(1)(A).

67. Reg. §1.871-8(c)(2) (Example (2)).

68. Sections 871(d), 882(d) and (e), and 897(a).

69. See n. 63, _supra_. But _cf_. Blue Book at 1049.

70. _Cf_. U.S.-Canada, Article XIII(2).

71. The Blue Book, at 1049, implies such a deemed sale through a U.S. office.

72. Tax Reform Act of 1986, section 1242(c).