**SOURCE OF INCOME RULES**

1. Importance of Source Rules
   1. U.S. Persons
      1. The U.S. taxes U.S. persons on all of their income
      2. Sourcing can have a significant effect, however, on the computation of a U.S. person’s *foreign tax credit limitation*, which equals the portion of the pre-credit U.S. tax that is attributable to foreign-source income. The limitation establishes a ceiling on the amount of foreign taxes that can offset U.S. taxes. It is designed to prevent U.S. persons operating in high-tax foreign countries from offsetting those higher foreign taxes against the U.S. tax on domestic income
      3. Foreign Tax Credit Limitation = Pre-credit U.S. tax x (Foreign-source taxable income / Worldwide taxable income)
      4. When a U.S. person’s creditable foreign taxes are *less* than the limitation, the cost of paying foreign income taxes is entirely offset by the U.S. tax savings associated w/ the credit. Therefore, foreign taxes do n/ represent an out-of-pocket tax cost for the U.S. person
      5. In contrast, when a U.S. person’s creditable foreign taxes *exceed* the limitation, the noncreditable foreign income taxes *increase* the U.S. person’s total tax burden beyond what it would have been if only the U.S. had taxed the foreign-source income
      6. Example: USAco, a domestic corporation, has taxable income of $ 1,000, all of which is attributable to a foreign branch operation. The U.S. tax rate is 35%
      7. Case 1: **When a U.S. person’s creditable foreign taxes are *less* than the limitation**: If USAco’s foreign branch is subject to foreign taxation at a 30% rate, USAco can claim a credit for the entire $ 300 of foreign taxes paid, as follows:
         1. Foreign tax credit limitation = $ 350 x ($ 1,000 / $ 1,000) = $ 350
         2. U.S. Tax Return
            1. Taxable income: $ 1,000
            2. Tax rate: 35%
            3. Pre-credit tax: $ 350
            4. Foreign tax credit: - $ 300
            5. U.S. tax: $ 50
         3. Foreign Tax Return
            1. Taxable income: $ 1,000
            2. Tax rate: 30%
            3. Foreign tax: $ 300
         4. The total tax burden on USAco’s foreign profits is $ 350 [$ 50 U.S. tax (+) $ 300 foreign tax]
      8. Case 2: **When a U.S. person’s creditable foreign taxes *exceed* the limitation**: The foreign tax credit limitation equals the U.S. tax of $ 350 on USAco’s foreign source income. If USAco’s branch is subject to foreign taxation at a 40% rate, the foreign tax credit limitation will prevent USAco from claiming a credit for $ 50 of the $ 400 of foreign taxes paid
         1. U.S. Tax Return
            1. Taxable income: $ 1,000
            2. Tax rate: 35%
            3. Pre-credit tax: $ 350
            4. Foreign tax credit: - $ 350
            5. U.S. tax: $ 0
         2. Foreign tax return
            1. Taxable income: $ 1,000
            2. Tax rate: 40%
            3. Foreign tax: $ 400
         3. Foreign taxation now increases the total tax burden on USAco’s foreign profits from $ 350 to $ 400, resulting in a $ 50 out-of-pocket tax costs
      9. Just b/c an item of income is taxed in a foreign country doesn’t mean that under the U.S. sourcing rules it is foreign source income. Conversely, there can be a situation where no income is subject to foreign tax but under the U.S. rules, it is treated as foreign source income. We’re talking about the U.S. sourcing rules. N/ talking about whether the income is subject to tax in a foreign country. We’re going to assume that it’s taxed in a foreign country. The issue is whether the income is foreign source income or whether it’s U.S.-source income. Very important for U.S. persons doing business abroad to understand the sourcing rules. But it’s also very important for foreign persons who operate in the U.S. We have a two-prong system for taxing foreign persons
   2. Foreign Persons
      1. The source rules play a more prominent role in the taxation of foreign persons, since they effectively define the boundaries of U.S. taxation
      2. The U.S. taxes the gross amount of a foreign person’s U.S.-source nonbusiness income at a flat rate of 30%
      3. The U.S. also taxes foreign persons at graduated rates on the net amount of income effectively connected w/ the conduct of a U.S. trade or business
      4. The U.S. generally exempts the foreign-source income of foreign persons
2. Source Rules for Gross Income
   1. The overriding policy behind these sourcing rules is to source the income where the economic activity occurs
   2. Examples
      1. Number 1
         1. Facts: NRA owns Banana Corp. Banana Corp. pays a dividend that is U.S. source income. NRA incurs withholding
      2. Number 2
         1. NRA buys and sells widgets in Lexington, KY. Is it U.S. source income? If it’s n/ U.S. source income, NRA doesn’t have to pay tax
         2. Overriding policy: Source income where the economic activity occurs
         3. Analysis: It’s U.S. source income
   3. Step 1: Determine the applicable statutory category
      1. The source rules for gross income are organized by categories of income, such as interest, dividends, personal services income, rentals, royalties, and gains from the disposition of property
      2. General Rules for Sourcing Gross Income:

|  |  |  |
| --- | --- | --- |
| **Type of income** | **U.S.-source income if:** | **Foreign-source income if:** |
| Interest income | D/or is a U.S. resident or a domestic corp. | D/or is a foreign resident or a foreign corp. |
| Dividends | Payer is a domestic corp. | Payer is a foreign corp. |
| Personal Services Income | Services are performed in the U.S. | Services are performed abroad |
| Rentals and royalties | Property is *used* in U.S. | Property is *used* abroad |
| Gain on sale of *real* property | Property is *located* in U.S. | Property is *located* abroad |
| Gain on sale of inventory *purchased* for resale | Title passes in U.S. | Title passes abroad |
| Gain on sale of inventory *manufactured* by TP | Allocated between U.S. and foreign sources using the 50-50 method | Allocated between U.S. and foreign sources using the 50-50 method |
| Gain on sale of securities | Seller is a U.S. resident | Seller is a foreign resident |
| Gain on sale of depreciable property | Title passes in U.S. | Title passes abroad |
| Gain on sale of patents and other intangibles | Seller is a U.S. resident | Seller is a foreign resident |

* + 1. This determination is sometimes ambiguous! The same item of income may be allocated between U.S. and foreign sources differently, depending on how it is categorized
       1. Example # 1:
          1. Facts: TP is an orchestra conductor. A U.S. record company hired *TP to conduct various songs* at a recording session that *took place in the U.S.* TP was compensated based on a percentage of the sales of the recording, which is owned by the record company. Most of the *record sales took place outside the U.S.*
          2. Rules: Personal services income is sourced on the basis of **where the services were performed**. Royalty income is sourced on the basis of **where the intangible is *used***
          3. Analysis: TP’s income is entirely U.S.-source income if it is classified as personal services income b/c TP conducted all of the songs in the U.S. However, it is mainly foreign-source income if it is classified as royalty income b/c most of the record sales took place outside the U.S.
       2. Example # 2
          1. Facts: Professor’s publisher asks him to write a book on transfer pricing. Publisher sends Misey to the Netherlands to write this book. He is paid $ x for each book sold. Misey is going to write the 2,000 page manuscript on a typewriter
          2. Issue: What is the source of Misey’s income?
          3. Analysis: Three possibilities. First, a royalty. That will be U.S. source income if the book is sold in the U.S. Second, personal services income (i.e., if publisher pays Misey for writing the book). B/c Misey is performing that service in the Netherlands, a foreign country, it will be foreign-service income. Third, Misey is providing his publisher w/ 2,000 pages of paper. But that is tangible personal property. Maybe that would fall under the tangible personal property rules which are sourced from TP’s tax home (here, that would be the Netherlands, where Misey wrote the book)
  1. Step 2: Apply the applicable source rule to classify the item of income as either U.S. or foreign-source
  2. Interest Income
     1. Interest income is sourced by the residence of the debtor
     2. Interest income is U.S.-source income if the payer is:
        1. A domestic corp., or
        2. U.S. resident
           1. The following TPs are considered to be U.S. residents:

Individuals who, at the time the interest is paid, are residents of the U.S.;

Domestic corporations;

Domestic partnerships which at any time during the taxable year were engaged in a U.S. trade or business; and

Foreign corporations or foreign partnerships which at any time during the taxable year were engaged in a U.S. trade or business

* + 1. Interest income is foreign-source income if the payer is:
       1. A foreign corp., or
       2. Nonresident
    2. Examples
       1. Slide 7 (view it)
       2. Professor loans $ 100 to his deadbeat brother-in-law Voldemort at a family reunion in Roanoke, VA. Voldemort is German. Professor says, “Pay me back on Dec. 31.” On Dec. 31, professor was at his wife’s parents’ home in Roanoke, VA. Voldemort pays professor back. Although professor lent Voldemort the money while he was in the U.S. and although Voldemort repaid professor in the U.S., it is still foreign-source income. Income is sourced by the residence of the debtor
       3. Slide 8 (view it)
       4. Slide 11
       5. USAco, a domestic corp., is a retailer of women’s apparel. Five years ago, USAco opened a retail store in London, which was structured as an unincorporated branch. USAco financed the store through a $ 10 million loan from a UK bank. The loan is being repaid out of the profits of the London retail store. Thus, the acquisition, use, and repayment of funds all occurred abroad. Nevertheless, under the residence-of-debtor source rule, the interest that USAco pays to the UK bank is U.S.-source income b/c *USAco is a domestic corp.*

$ 10 million loan

U.S.

Foreign

Interest and principal payments

U.K. Bank

* + 1. Exceptions to the general rules for sourcing interest income
       1. Look-through rule: Congress enacted an exception that looks beyond the debtor’s residence to determine whether a domestic corp. is distributing earnings that were derived *predominantly* from foreign sources
          1. Rule applies to a domestic corp. or a resident alien who, during the preceding **three** taxable years, derived **80% or more of its gross income from the active conduct of a foreign business**
          2. If the payer of interest meets the 80% test, *all* of the interest income is reclassified as foreign-source income
          3. Exception: Unless the recipient is a related-person
          4. Example: Assume that USAco consistently derives 80% or more of its gross income from sales made at its U.K. store. B/c USAco now meets the 80% active foreign-business test, all of the interest USAco pays to the unrelated U.K. bank is foreign-source
       2. Interest paid by a foreign corp. that is at least 50% owned by *U.S. persons* is **U.S.-source income** to the extent the interest payment is attributable to income that the foreign corp. derived from U.S. sources. This exception applies only for purposes of computing the foreign tax credit limitation of a U.S. shareholder or other related person of the U.S.-owned foreign corp. It’s designed to prevent U.S. persons from artificially increasing their foreign tax credit limitation by routing U.S. source income through a U.S.-owned foreign corp.
          1. What happens if the U.S. individual wholly owns ForCo? ForCo is the U.S. individual’s wholly owned foreign subsidiary. Couldn’t the U.S. individual manufacture some foreign source income by lending ForCo money and getting a stream of foreign source interest income? Even though ForCo may have nothing to do w/ the foreign country except be incorporated there. In that situation, if a U.S. individual owns ForCo and lends ForCo money, ForCo is treated as providing *U.S.-source* interest income for purposes of the foreign tax credit limitation.
          2. If a U.S. individual lends money to its wholly-owned foreign corporation, the interest paid by the foreign corporation is treated as U.S.-source income
       3. Interest received from deposits made w/ a foreign branch of a domestic corporation engaged in commercial banking is treated as foreign-source income
          1. See slide 9
          2. Twist on Slide 9: What if NRA deposits money w/ the foreign branch? Is NRA subject to withholding on that income? No
  1. Dividend income
     1. Dividends are U.S.-source income if the payer is a domestic corp.
     2. Dividends are foreign-source income if the payer is a foreign corp.
     3. Examples
        1. U.S. person owns 10% of USCo, a U.S. corporation. U.S. person receives a dividend. That is a U.S.-source dividend
        2. U.S. person owns 10% of UKco, a foreign corp. UKco pays U.S. person a dividend. In that situation, it is foreign-source income
     4. Exception to the general rule for sourcing dividend income
        1. Look-through rule
           1. Look-through rule: Applies to a foreign corp. if, during the preceding three taxable years, 25% or more of its gross income was effectively *connected* w/ the conduct of a *U.S. trade or business*
           2. If a foreign corp. meets the 25% test, the **U.S. source-portion**equals:

Amount of dividend (x) (Gross income that was connected w/ a U.S. trade/business during three-year test period / Foreign corporation’s total gross income for that period)

* + - * 1. Example: UKco earns $ 1,000,000, all of which is foreign-source income. In that situation, that dividend is all foreign-source income
        2. Example: What happens if UKco earns $ 1,000,000 and $ 200,000 (or 20%) is U.S.-source income? That dividend is all foreign-source income
        3. Example: UKco earns $ 1,000,000 of income, $ 250,000 (25%) of which is U.S.-source income. We’ve hit the magic threshold of 25%. In that situation, 25% of any dividend that UKco pays to U.S. individual is U.S.-source income. The remaining 75% is foreign-source income by reason of UKco’s foreign corporation status. If $ 400K of $ 1M was U.S.-source income, then 40% of any dividend paid by UKco is U.S.-source income and 60% is foreign-source income
        4. Example: What happens if all $ 1,000,000 of income is U.S.-source income? Then all of the dividend – 100% -- is U.S.-source income
  1. Personal Services Income
     1. Key issue: Where were the services performed?
        1. Compensation for personal services performed in the *U.S.* is **U.S.-source income**
        2. Compensation for personal services performed *abroad* is **foreign source income**
     2. Personal services income includes:
        1. Salaries,
        2. Wages,
        3. Fees, and
        4. Commissions
     3. Example
        1. Slide 15
     4. De minimis rule:
        1. Income of a nonresident alien is re-characterized as **foreign-source income** if:
           1. The alien’s income is *attributable to U.S. services*;
           2. The nonresident alien is present in the U.S. for 90 days or less during the taxable year;
           3. The nonresident alien receives no more than $ 3K for his U.S. services; and
           4. The nonresident alien works as an employee or under K for either:

A foreign person who is n/ engaged in a U.S. trade or business, or

The foreign office of a U.S. person

* + - 1. This exception allows nonresident aliens to make short business trips to the U.S. free of U.S. taxes
      2. Example: Slide 16
    1. Allocation issue
       1. N/ every item of income is clear-cut – i.e., all earned in the U.S. or all earned abroad. There will be situations where part of it is earned in the U.S. and part of it is earned abroad
       2. For example, an allocation issue arises when TP is paid a lump-sum amount, such as an *annual salary*, for services performed both within and without the U.S. In these situations, the lump-sum amount is apportioned between U.S.- and foreign-source income, typically on the basis of the relative number of days worked in the U.S. and abroad
       3. Example: T lived and worked in the U.S. throughout the current year, except for a ten-week foreign business trip. There are a total of 250 working days (or 50 weeks) in a year b/c two weeks are set aside for vacation. T received an annual salary of $ 100K for a total of 250 working days, including the 50 days spent working abroad.
          1. Issue # 1: What is the foreign-source component of T’s $ 100K salary?

50 days working abroad / 250 total working days = 1/5

$ 100K (x) 1/5 = $ 20K. $ 20K of T’s salary is foreign-source income

* + - * 1. Issue # 2: What is T’s U.S.-source income?

$ 100K (-) $ 20K = $ 80K

* + - 1. Ultimate case in the allocation w/ respect to days in sourcing of personal services income
         1. Facts: Stemkowsky is a Canadian born hockey player who played for the Rangers in the ‘70s. 360 days in a year b/c each month is 30 days. Stemkowsky was in the U.S. for 230 days during the season. B/c the Rangers played some games in Toronto against the Maple Leafs and in Montreal against the Canadians, he spent ten days during the season in Canada. His NHL contract said that when he reported to training camp, he had to report in “good shape.” Stemkowsky worked out regularly in the off-season
         2. Stemkowsky’s argument: The 120 days in the off-season that Stemkowsky spent in Canada should have counted in the allocation.
         3. IRS argument: The only days that Stemkowsky spent in Canada according to the terms of the K were the ten days that he spent in Montreal or Toronto
         4. Held: Tax court ruled in favor of the IRS. The fact that Stemkowsky was n/ paid during the off-season was important. The language, “must report in shape” was n/ significant b/c if someone didn’t show up in shape, they would still be paid

F 120 days off-season / 10 days in-season

U.S. 230 days in-season

* + - 1. The need to allocate compensation between U.S. and foreign sources also can arise w/ respect to payments from a defined benefit plan
  1. Rental and Royalty Income
     1. Rental and Royalty income is sourced by where the underlying property is used
        1. Rentals and royalties are **U.S.-source income** if the property is located or used in the U.S.
        2. Rentals and royalties are **foreign-source income** if the property is located or used abroad
     2. The place of use of personal property may be both w/in and w/o the U.S., in which case TP must apportion the rental income between U.S. and foreign source
     3. Rents
        1. Payments for the use of tangible property
           1. Tangible property can be mobile. Professor might rent a car and drive it to Canada. That car is driven in Canada as well as in the U.S. Income should be apportioned between U.S.-source and foreign-source, based on the respective miles driven in each country
           2. Tangible property can be immobile (i.e., big piece of equipment). In the hypothetical below, the lessee uses the equipment in the U.S. Therefore, it is U.S.-source income. But what if the equipment was used abroad? It would be foreign-source income
        2. Rents for real estate
           1. Where is the property located? Where the real estate is situated
           2. Example: Prof earns rents from an apartment building that he owns in Atlanta, GA. That is U.S.-source income. If prof. earns rents from a ski condo in Whistler, BC, that is foreign-source income
     4. Royalty income
        1. Payments for intangible property are sourced by where the property is used
        2. Slides 20-22
  2. Income from the disposition of property
     1. Real property is sourced by the situs of the real estate
        1. A gain on the sale or exchange of a U.S.-real property interest is U.S.-source income
           1. Example: If a U.S. individual sells U.S. real estate to a nonresident alien, that is U.S.-source income b/c the real estate is located in the U.S.
           2. Example: A gain on the sale of a U.S. office building to foreign investors is U.S.-source income, even if all of the related sale activities take place abroad
        2. A gain on the sale or exchange of real property located abroad is foreign-source income
           1. Example: A U.S. individual sells a villa in Monaco to a nonresident alien. That is foreign-source income b/c the villa is n/ located in the U.S.
        3. A U.S. real property interest includes the following types of interests located w/in the U.S. or the U.S. Virgin Islands:
           1. Land,
           2. Buildings,
           3. Mines,
           4. Wells,
           5. Growing crops and timber, and

What happens if TP sells farmland on which there is a growing crop? If the crop is still on the land, it’s considered part of the real estate and sourced by where the real estate is located

If the crop is sold in a severed state, the personal property rules apply. Personal property is sourced by the residence of the *seller*. If TP sells the crop separately, then the personal property rules apply

* + - * 1. Personal property associated w/ the use of real property (i.e., mining and farming equipment)
    1. Personal Property
       1. General rule:
          1. A gain on the sale of personal property is **U.S.-source income** if TP is a U.S. resident
          2. A gain on the sale of personal property is **foreign-source income** if TP is a nonresident
       2. Personal property includes:
          1. Stocks and securities,
          2. Inventories,
          3. Machinery and equipment, and
          4. Intangibles

i.e., patents, trademarks, and copyrights

* + - 1. Example
         1. T, a citizen and resident of Ireland, sells at a gain 100 shares of USAco, a U.S. utility company whose shares are traded on the NYSE. Even though USAco is a domestic corporation that conducts business operations only w/in the U.S., T’s gain is nevertheless treated as **foreign-source income** b/c T is the seller and he is a nonresident
         2. Bridgestone Japan sells all of its shares of Bridgestone Firestone U.S. What is the source of the income? It’s foreign source income. As a foreign person, Bridgestone Japan doesn’t pay any U.S. tax. However, Bridgestone Japan does pay Japanese tax
      2. What is the definition of residence for sales of personal property?
         1. It’s where TP’s tax home is located
         2. An individual’s tax home is his *principal place of business*
         3. Gain realized by a U.S. citizen or resident alien is treated as **foreign-source income** if:

U.S. citizen or resident alien has a *foreign* tax home, and

The foreign country taxes that gain at a rate of 10% or more

* + - * 1. Example: Professor gets a job working in London and sells his baseball card collection to Hans. B/c professor’s tax home is England and England’s tax rate is greater than 10%, the gain realized on the sale of his baseball card collection is foreign-source income
        2. Exception: Gain realized is still treated as **U.S.-source** income, even if TP has a foreign tax home, if that gain is NOT subject to foreign tax at a rate of 10% or more
  1. Income from the sale of inventories
     1. **Exceptions that eat up the general rule of sourcing the sale of personal property to the residence of the taxpayer**
     2. Inventory includes personal property (and n/ real property) that is held by TP primarily for sale to customers in the ordinary course of business
     3. Developing an accurate, yet simple, source rule for income from the sale of inventories is difficult, given the complex nature of the underlying income-producing activities
     4. Congress addressed these complexities by promulgating separate source rules for inventory purchased for resale, as opposed to inventory manufactured by TP
     5. Inventory *purchased* for resale
        1. Gross income from the sale of inventory that TP purchases for resale is sourced on the basis of **where the sale occurs**
        2. Therefore, such income is U.S.-source income if the sale occurs w/in the U.S. Such income is foreign-source income if the sale occurs abroad
        3. Place of sale: Where title to the goods passes from the seller to the buyer. When determining where title passes, you’re looking at the ultimate sale to the customer
        4. Example



* + - * 1. USCo purchases widgets and sells them to foreign customers. Where does title pass? If title passes abroad, it’s foreign-source income. If title passes in the U.S., it’s U.S.-source income. Look at the shipping terms of the K. If it’s F.O.B. shipping point, then it’s U.S.-source income. If it’s destination point, then title passes abroad
      1. Example
         1. Facts: USAco, a domestic corp., is an independent broker that *purchases* used commercial aircraft from U.S. airlines for resale abroad. During the current year, USAco purchased 20 planes from a regional airline based in Texas and then resold the planes to a German airline. The German airline first learned about USAco’s services at a trade show held in Las Vegas, NV. The sales agreement between USAco and the German airline was negotiated and signed in Florida. Title to the airplanes passed in Germany upon delivery at the Frankfurt airport
         2. Analysis: Even though all of the selling activities, including solicitation, negotiation, and closing, took place w/in the U.S., the entire profit from the sale of the airplanes is foreign-source income b/c title passed abroad
      2. Exception to title passage rule:
         1. Applies to both inventory *purchased* for resale and inventory *manufactured* by TP
         2. Prevents nonresidents from avoiding U.S. tax by passing title abroad on sales to U.S. customers
         3. Income from such sales is treated as **U.S.-source income** if:

A foreign resident maintains an office or other fixed base in the U.S., and

U.S. office is a material factor in making the sale and regularly engages in these types of sales activities

Even if:

The seller’s residence is foreign,

Title passes abroad, and

Goods are manufactured abroad

* + - * 1. Example

Facts: FORco is a foreign company located in Mexico. It manufactures widgets at its plant in Mexico. FORco has a branch sales office in the U.S. and a warehouse in the U.S. FORco’s branch office sells widgets throughout North America. FORco’s branch office sells widgets to a Mexican customer. Title passes in Mexico

Issue: Is that income foreign-source income? No

Analysis: Although FORco is a foreign manufacturer, it maintains a branch office in the U.S. Second, FORco’s branch sales office was a material factor in making the sale of widgets to the Mexican customer. Therefore, this income is treated as **U.S.-source income**, notwithstanding the fact that the widgets were manufactured outside of the U.S., that the customer was Mexican, and that title passes in Mexico

* + 1. Inventory *manufactured* by TP
       1. Income from the sale of inventory that TP produces is apportioned between U.S. and foreign-source income using the 50-50 method
       2. Under the 50-50 method, a U.S. manufacturer apportions 50% of the gross income from export sales based on a sales factor and the other 50% based on a property factor
          1. **Sales factor** = (Gross amount of export sales that are classified as foreign using title passage rule) / (Gross amount of *all* export sales)
          2. **Property factor** = (Average adjusted basis of TP’s production assets located abroad) / (Average adjusted basis of TP’s production assets everywhere)

Production assets include tangible and intangible assets owned by TP and directly used to produce inventory sold abroad (e.g., factory building, machinery and equipment, and patents)

* + - * 1. **FSI = (1/2 of gross profit is sourced by where title passes when title passes abroad) (+) (1/2 of gross profit is sourced by the percent of manufacturing assets located abroad)**
      1. Examples of 50-50 method
         1. A U.S. manufacturer passes title abroad. The 50-50 method will allocate half of the manufacturer’s gross income from export sales to foreign-source income and the other half will be allocated to U.S.-source income. This is the best we can do for a U.S. manufacturer b/c the manufacturing assets are located in the U.S. This is why so many U.S. manufacturing companies want to avoid foreign taxation on their export sales. They realize that limitation is going to restrict their foreign tax credit



* + - * 1. Suppose on these sales that gross profit is $ 150. And title passes abroad.

Step 1: Calculate foreign-source income

How much is foreign-source income based on where title passes? ½ ($ 150) or $ 75 is foreign-source income b/c title passed abroad

How much is foreign-source income based on the location of manufacturing? None, b/c all of USCo’s manufacturing assets are located in the U.S., n/ abroad

Total foreign-source income is $ 75

Step 2: Calculate U.S.-source income

$ 150 (-) $ 75 = $ 75

Note: Under the 50-50 rule, there can be situations where all of the income is U.S.-source and none of it is foreign-source if title does NOT pass abroad. As such, make sure that you include a clause stating “title passes abroad” in the sales K

* + - * 1. Facts: USAco, a domestic corporation, manufactures computers at its U.S. plant at a cost of $ 1,200/unit. USAco markets its computers in Canada through a branch sales office located in Montreal. During the year, USAco sold 1,000 computers through its Canadian branch at a price of $ 2,000/unit. Therefore, USAco realized gross income of $ 800,000 [1,000 units x ($ 2,000 sales price (-) $ 1,200 cost of goods sold)] from its Canadian sales. *USAco passed title abroad on all of its Canadian sales*. *USAco has no production assets located abroad*, whereas the average value of its U.S. production assets is $ 5 million
        2. Issue: How much income is apportioned to foreign-source income?
        3. Analysis: The sales factor apportions $ 400K of income to foreign earnings b/c title passed abroad in Canada [50% x $ 800K x ($ 2 million of foreign export sales / $ 2 million of total export sales)]. The property factor apportions no income to foreign sources b/c all of USAco’s manufacturing assets are located in the U.S. Thus, USAco has $ 0 of foreign production assets
        4. Therefore, the foreign-source portion of USAco’s export gross income is $ 400K and the remaining $ 400K is U.S.-source income
      1. Example when title passes in the U.S.
         1. Assume the same U.S. manufacturing company. If title passes in the U.S., *all* of the income will be U.S.-source income b/c n/ only does title pass in the U.S., but all of USCo’s manufacturing assets are located in the U.S.
  1. Distributive share of Income from a Pass-through Entity
     1. In the case of partnerships and S corporations, the source of income is usually determined at the entity level and that source characterization carries over to the partners or shareholders in their distributive shares of income. The income is going to flow-through the S Corp.
     2. Example
        1. 60 % of the income is foreign-source and 40% is U.S.-source. Larry, Curly, and Mo, the three U.S. individuals that own the S Corp., will get income in that 60-40 percentage

1. Source rules for deductions
   1. Sourcing a TP’s gross income will be sufficient in some situations. For example, there is no need to source the deductions of a foreign person whose only connection to the U.S. is as a passive investor deriving U.S.-source nonbusiness income, since such income is taxed on a gross basis through a flat rate withholding tax
   2. In other cases, the operative tax attribute is net taxable income, which necessitates the sourcing of items of both gross income and deduction
      1. Example: A foreign corp. w/ a branch office in the U.S. is taxed on the net amount of income effectively connected w/ the conduct of that U.S. trade or business
      2. In computing taxable income from sources w/in (or w/o) the U.S., TP is allowed :
         1. Deductions for expenses and losses *directly related to either U.S.- or foreign-source gross income*; and
         2. A ratable portion of expenses and losses that are n/ definitely related to any specific item of gross income
      3. TP makes these determinations through a two-step process referred to as “allocation and apportionment”
      4. Example
         1. Facts: USCo has two sources of income: (1) $ 1 million of K R&D and (2) $ 500K from the sale of widgets. W/ respect to the K R&D, USCo pays $ 500K in salaries to the guys in the white lab coats. W/ respect to widget sales, USCo pays commissions of $ 200K
         2. Analysis: The salaries should be allocated against the $ 1 million of contract R&D. Therefore, there is $ 500K of net income on the R&D ($ 1 million (-) $ 500K). And the $ 200K commission should be allocated against the $ 500K of widget sales. Therefore, there should be a net income of $ 300K from the sale of widgets. How about the rent? The regulations give you a lot of opportunity to figure out how to apportion that $ 100K of rent. You could apportion 1/3 of the rent to the widget sales and 2/3 to the contract R&D. Or you could do it based on the contribution of profit
         3. In international arena, the key is allocation and apportionment
   3. Allocation
      1. Step 1 in sourcing a deduction: Allocate it to a related income-producing activity or class of gross income
      2. Examples of potential classes of gross income:
         1. Compensation for services (including fees and commissions),
         2. Gross income derived from business,
         3. Gains derived from dealings in property,
         4. Interest,
         5. Rents,
         6. Royalties,
         7. Dividends
      3. A deduction is related, and therefore allocable, to a class of gross income if it is incurred as a result of the activity or property from which the gross income is derived
      4. Although most deductions are definitely related to a specific class of gross income, some deductions are related to all gross income
         1. Examples include overhead, general and administrative, and supervisory expenses
      5. It’s n/ always as easy as it seems
   4. Apportionment
      1. Step 2 in sourcing a deduction: Apportion the deduction w/in that class between U.S.- and foreign-source gross income
      2. This is accomplished by using an apportionment base that reflects, to a reasonably close extent, the factual relationship between the deduction and the gross income
      3. Examples of potential apportionment bases include:
         1. Gross income,
         2. Gross sales,
         3. Units sold,
         4. Cost of goods sold,
         5. Profit contributions,
         6. Expenses incurred,
         7. Assets used,
         8. Salaries paid,
         9. Space utilized, and
         10. Time spent
      4. **The relationship between deductions and U.S. and foreign operations often is ambiguous**. For example, a U.S. exporter should apportion its marketing expenses between U.S. and foreign sources based upon the relative amounts of marketing resources expended to generate U.S., as opposed to foreign, assets. However, often it is unclear which, if any, of the apportionment bases, such as unit sales, gross sales, or gross margin, accurately reflects this relation
      5. If the mix of products sold in the U.S. differs from the mix of products sold abroad, the use of different apportionment bases will lead to *different* results
         1. Facts: USAco is a domestic corp. that sells its products both in the U.S. and abroad. During the current year, USAco had $ 20 million of sales and a gross profit of $ 10 million. *USAco incurred $ 2 million of selling, general, and administrative (SG&A) expenses*. USAco’s $ 20 million of sales included $ 12 million of foreign sales and $ 8 million of domestic sales. USAco has $ 1 million of SG&A expenses that it has to allocate between U.S. and foreign income
         2. Issue 1: What if USAco uses *gross profit* as an apportionment base?
            1. Analysis: USAco’s gross profit of $ 10 million was split 50-50 between U.S. and foreign sources. Thus, if USAco used gross profit as an apportionment base, it would apportion $ 1 million of SG&A expenses to foreign-source income [50% x $ 2 million of SG&A expenses]
            2. Therefore, $1 million of SG&A expenses would be apportioned to U.S.-source income
         3. Issue 2: What if USAco uses *gross sales* as an apportionment base?
            1. Analysis: If USAco uses gross sales as an apportionment base, then $ 1.2 million of SG&A expenses would be apportioned to foreign-source income [($ 12 million of foreign sales / $ 20 million of total sales) x $ 2 million of SG&A expenses]
            2. Therefore, $ 800K of SG&A expenses would be apportioned to U.S.-source income
         4. Keep in mind, you want foreign-source income to be as **large** as possible and U.S.-source income to be as **low** as possible b/c U.S.-source income is generally taxed at a higher rate. In that case, which method would you choose? The gross-profit method. That way only $ 1 million of SG&A expenses, as compared to $ 1.2 million, is allocated against foreign-source income. When allocate on the basis of gross sales, $ 200K more of SG&A expenses is allocated against foreign-source income, reducing the amount of expenses that can be allocated against U.S.-source income to $ 800K.
      6. The selection of an apportionment base is also impacted by the amount of time that an employee devotes to foreign operations as opposed to domestic operations
         1. Facts: The facts are the same, except now assume that USAco’s SG&A expenses of $ 2 million consist of the president’s salary of $ 500K, the sales manager’s salary of $ 200K, and other SG&A expenses of $ 1.3 million. Also assume that USAco’s president and sales manager maintain time records which indicate that the **president** devoted *30% of her time to foreign operations* and 70% to domestic operations, while the **sales manager** devoted *40% of her time to foreign operations* and 60% to domestic operations
         2. Analysis: USAco should now apportion the salaries of the president and sales manager on the basis of **time spent** and apportion the other SG&A expenses on the basis of **gross profit**. Therefore, USAco apportions to foreign-source income $ 150K of the president’s salary [30% x $ 500K], $ 80K of the sales manager’s salary [40% x $ 200K], and $ 650K of the remaining SG&A expenses [50% x $ 1.3 M], for a total of $ 880K of SG&A expenses apportioned to foreign-source income
   5. Specialized Apportionment Rules
      1. Interest expense
         1. All income-producing activities require some degree of funding and a TP often has considerable *flexibility* as to the source and use of funds
         2. Example: A multinational corp. could use the proceeds from a second mortgage on a U.S. factory to acquire an office building located abroad
         3. Interest relates to money. And b/c money is fungible, interest expense is assumed to relate to *all* of TP’s activities and property, regardless of the specific purpose of the borrowing. Therefore, interest expense is allocated to *all* of TP’s gross income
         4. Interest expense is allocated based on assets
            1. Interest expense is apportioned between U.S.- and foreign-source income using the relative value of U.S. and foreign assets as an apportionment base
            2. Example: If 20% of TP’s assets are *foreign* in nature, then that TP must apportion 20% of its interest expense to foreign-source income
            3. An asset is characterized as **U.S.** or **foreign** based upon *whether the asset* ***produces*** *U.S. or foreign-source income*
            4. Example: Inventory is characterized as a **foreign asset** to the extent that inventory sales give rise to *foreign-source income*
            5. TP may elect to apportion interest expense on the basis of:

The average adjusted basis amounts at the beginning and the end of the year, or

The FMV of the assets

* + - 1. Apportioning interest expense on the basis of average adjusted basis amounts – How pre-2009 rules screw up TPs
         1. Facts: USP, a domestic corp., owns all of the stock of FSub, a foreign corp. USP has a basis of $ 2K in its U.S. operating assets and a basis of $ 1K in its shares of FSub. FSub has foreign operating assets w/ a basis of $ 1.2 M as well as $ 400 of debt, on which FSub pays $ 40 of interest expense.
         2. Point: The interest expense apportionment rules screw up U.S. taxpayers more than anything else. The full amount of FSub’s $ 40 of interest expense is effectively allocated against USP’s foreign-source income when it is distributed upstream as a dividend to USP. How does that happen? The interest expense reduces FSub’s earnings and profits and ultimately any dividends that FSub pays to USP by $ 40. That $ 40 of interest expense is n/ interest expense of U.S. Parent. U.S. Parent can have its own interest expense. And if it does, that is what would get apportioned under these fungibility rules
      2. Example of how USP’s interest expense gets apportioned and how USP’s foreign-source taxable income is understated due to the asymmetric treatment of the interest expense incurred by USP and FSub
         1. The facts are the same as in the above example, except this time USP now has $ 600 of debt, on which its pays $ 60 of interest expense. USP’s basis in its FSub stock is $ 1,000, n/ $ 1 million.
         2. Under the pre-2009 basis rules, USP apportions **$ 40** of interest expense to **U.S.-source income** [($ 2,000 basis in U.S. operating assets / $ 3,000 total basis) x $ 60 interest expense], and **$ 20** of interest expense to **foreign-source income** [($ 1,000 basis in FSub shares / $ 3,000 total basis) x $ 60 interest expense]
         3. Thus, any *foreign-source* dividend income derived by USP from FSub is reduced by the full amount of FSub’s $ 40 in interest expense, as well as $ 20 (or one-third) of USP’s interest expense.
      3. Congress recognized this inequity. To address this issue, Congress created a new system in the code (864(f)). 864(f) creates a situation where USP can’t allocate any more interest expense than FSub had earned on a worldwide consolidated basis. Worldwide consolidation is n/ something that is normally done in international tax. In the government’s interest to increase revenue, every time they need to raise revenue, the gov’t defers enactment of that provision.
    1. Research and Development Expenditures
       1. Any research and development expenditures incurred *solely to meet legal requirements imposed by a jurisdiction* (U.S. or foreign) are allocated to **that jurisdiction**
       2. Research and development expenditures n/ incurred solely to meet legal requirements are:
          1. Apportioned between U.S. and foreign-source income using the sales apportionment method, or
          2. If TP so elects, an optional gross income apportionment method
       3. Overriding theme: There is a lot of flexibility w/ respect to expense apportionment. You can use gross profit to apportion in one year and then sales to apportion in another year
       4. Apportionment Priority of Research and Development Expenditures

|  |  |
| --- | --- |
|  | APPORTIONMENT POLICY |
| Step 1 | R&D expenditures incurred solely to meet legal requirements imposed by a jurisdiction (U.S. or foreign) are allocated to that jurisdiction |
| Step 2 | Apportion half of the remaining R&D expenses to U.S. or foreign-source income if R&D activities are conducted either in the U.S. or abroad |
| Step 3 | Other 50% of R&D expenditures is apportioned between U.S. and foreign sources using sales or gross income as an apportionment base |

1. PROBLEMS

Engco – U.S.

U.S.

Foreign

$ 5 million gross profit on Can. sales

Engine Sale Customers

* 1. 3-1: Engco, a domestic corp., sells industrial engines to customers in the U.S. and Canada. All engines are sold F.O.B. *place of destination*. Engco earns $ 5 million of gross profit on the Canadian sales. W/o considering any allocations of expenses, what is Engco’s **gross foreign-source income** if:
     1. Engco *manufactures* the engines at its manufacturing facility in Orange County, CA?
        1. If Engco is a manufacturer, apply the 50-50 rule
        2. Go to inventory rules. Is it purchased inventory? No, it’s manufactured inventory b/c Engco is manufacturing these engines in Orange County, CA. Apply the 50-50 rule
        3. Half of $ 5 million ($ 2.5 M) is sourced by where the manufacturing assets are located. What percent of these manufacturing assets is located abroad? 0%. They are all located in Orange County. This is U.S.-source income
        4. Is title passing abroad? Yes, F.O.B. destination point. Half of $ 5 million ($ 2.5 M). 100% of title passes abroad on these sales
        5. Under 50-50 rule, $ 2.5 M is foreign-source income
     2. Engco *purchases* the engines from a U.S. supplier located in East Palo Alto, CA?
        1. This is purchased inventory. Does the 50-50 rule apply? No. Instead, it is done based on where title passes. Here, title passes abroad in Canada. All $ 5 M is foreign-source income
     3. How would your answers to (a) and (b) change if all the engines were sold F.O.B. *shipping point*?
        1. Would be identical in (a) and (b). It would all be U.S.-source income b/c shipping point means that title passes in the U.S.
        2. In part (a), all of the manufacturing assets are located in the U.S. and title passes in the U.S. It’s all U.S.-source income
        3. For purchased inventory, it’s all U.S.-source income b/c title passed in the U.S.
  2. 3-2: Pursco is a domestic corp. that *purchases* scientific equipment for world-wide distribution. During the current year, Pursco earns $ 100 million of sales, has a gross profit of $ 40 million, and incurs $ 30 million of SG&A expenses, for taxable income of $ 10 million. Pursco’s sales include $ 20 million of sales to foreign customers. The gross profit on these foreign sales is $ 10 million. Pursco transferred title abroad on all these foreign sales and, therefore, *the entire $ 10 million of gross profit is classified as foreign-source income*. A time management survey was recently completed and indicated that employees devote 90% of their time to the company’s domestic operations and 10% to foreign operations. Compensation expenses account for $ 20 million of the $ 30 million of total SG&A expenses. Compute Pursco’s net foreign-source income under the following independent assumptions

$ 80 million sales

$ 30 million gross profit

$ 30 million S, G & A

Pursco – U.S.

U.S.

Foreign

$ 20 million sales

$ 10 million gross profit

* + 1. Pursco determines the amount of SG&A expenses allocable to foreign-source income using *gross profit as an apportionment base*
       1. $ 30 million of SG&A expenses is allocated between U.S. and foreign gross profit using gross profit as an allocation base to determine net foreign source income
       2. Start w/ $ 10 million of gross profit. What percent of the $ 30 million is allocable to foreign gross profit based on gross profit? There is a total of $ 40 million of gross profits -- $ 30 million in the U.S. and $ 10 million abroad. $ 10 million foreign gross profit / $ 40 million of total gross profit = ¼ or 25%. [$ 10 million foreign source gross profit (-) (.25 x $ 30 million of SG&A expenses)] = $ 2.5 million. That is foreign source income when SG&A expenses are allocated based on gross profit
    2. Pursco determines the amount of SG&A expenses allocable to foreign-source income using *sales as an apportionment base*
       1. Must evaluate options to get the best result for your client! There is a total of $ 100 million of sales, 20% of which occurred abroad [($ 20 million in foreign sales / $ 100 million in total sales)]. $ 10 million foreign source gross profit (-) (20% x $ 30 million SG&A). $ 10 million foreign source gross profit (-) $ 6 million = $ 4 million, which is net foreign source income. Do we prefer to apportion based on gross profit, as in (a), or on sales percentage in (b)? We want to do it based on the sales percentage b/c that gives us more net foreign source income
    3. Pursco determines the amount of SG&A expenses allocable to foreign-source income using *time as an apportionment base* for the compensation component of SG&A and *gross profit* as an apportionment base for all other SG&A expenses
       1. SG&A expenses = $ 30 million
       2. What amount of $ 30 million of SG&A is compensation?
          1. Compensation expenses account for $ 20 million of the $ 30 million of total SG&A expenses
          2. $ 10 million is non-compensation oriented SG&A expenses
       3. Employees devote 90% of their time to the company’s domestic operations and 10% to foreign operations
       4. We’re going to use gross profit as an apportionment base for the non-compensation oriented SG&A expenses. And we’re going to use time as an apportionment base for the compensation portion of SG&A expenses
       5. $ 10 million is the non-compensation oriented SG&A expenses. Remember that the percentage of foreign gross profit to total gross profit is ($ 10 million / $ 40 million) or ¼ (25%). .25 x $ 10 million = $ 2.5 million. $ 10 million (-) [(.25 x $ 10 million)] = $ 10 million (-) $ 2.5 million = $ 7.5 million
       6. $ 20 million is the compensation oriented SG&A expenses. Employees devote 10% of their time to foreign operations. .1 x $ 20 million of compensation oriented SG&A = $ 2 million
       7. $ 10 million (-) $ 2.5 million (-) $ 2 million = $ 5.5 million of foreign source income
       8. Is that better than (a)? Yes. Is that better than (b)? Yes. That gives us more foreign-source income and a greater foreign tax credit limitation
    4. Pursco determines the amount of SG&A expenses allocable to foreign-source income using time as an apportionment base for the compensation component of SG&A and *sales as an apportionment base for all other SG&A expenses*
       1. Pursco wants to use sales as an apportionment base for the non-compensation oriented SG&A expenses
       2. Pursco then wants to use time for the compensation oriented SG&A expenses
       3. $ 10 million is our foreign source gross profit.
       4. $ 10 million is the non-compensation oriented SG&A expenses. Remember that 20% of Pursco’s total sales occurred abroad [($ 20 million in foreign sales / $ 100 million in total sales)]. $ 10 million foreign source gross profit (-) (20% x $ 10 million SG&A). $ 10 million foreign source gross profit (-) $ 2 million = $ 8 million
       5. $ 20 million is the compensation oriented SG&A expenses. Employees devote 10% of their time to foreign operations. .1 x $ 20 million of compensation oriented SG&A expenses = $ 2 million
       6. $ 8 million (-) $ 2 million = $ 6 million of foreign-source income
  1. 3-3: Boris is an internationally-renowned tennis player. Boris receives $ 1 million from Coke, a U.S. soft-drink company, to wear Coke’s logo on his tennis shirt in the Wimbledon final, which is televised world-wide. What is the source of the $ 1 million? Why?
     1. Must figure out what is the classification of the income. Is Boris receiving the $ 1M for personal services (i.e., wearing patch while he is playing tennis)? Or is the classification of income a royalty? What’s the royalty? Isn’t Boris associating his image (i.e., his face and body playing tennis) w/ Coke?
     2. Think of the sourcing ramifications
        1. If it is classified as compensation for personal services, Boris is performing them in Wimbledon at center court. That is a foreign country and thus, foreign-source income
        2. What if it’s royalty income? Boris is associating his image w/ the Coke patch. It would be part foreign-source income and part U.S.-source income. How do people see Boris’ image on T.V.?
     3. Should be treated as royalty and sourced as **U.S.-source income** based on the number of television sets watching in the U.S. as compared to the number of television sets watching outside the U.S. b/c that is where Boris’ intellectual property (i.e., his image) was *being used*