# FINAL REGS IMPLEMENT CHANGES TO SOURCE-OF-INCOME RULES FOR INVENTORY SALES

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## INTRODUCTION

In late 2019, the I.R.S. proposed regulations modifying rules for determining the source of income from sales of inventory property produced by a taxpayer without and sold within the United States, or produced by the taxpayer within and sold without the United States.[1] A public hearing on the proposed regulations was held on June 2020, and final regulations were published in October.[2]

The regulations implement changes made by the Tax Cuts and Jobs Act[3] (the "T.C.J.A."), to Code §863(b). These regulations also provide guidance under Code §865(e)(2) regarding sales of inventory through a U.S. office or fixed place of business. The regulations resolve interpretative issues arising from the T.C.J.A. and have important international tax planning implications for cross-border sales of inventory by U.S. corporations in outbound transactions and non-U.S. corporations in inbound transactions.

This article proceeds in three parts. The first presents the sourcing rules for sales of inventory before the T.C.J.A. The second describes the changes implemented by the T.C.J.A. and the guidance offered by the I.R.S. in the published regulations. Finally, the third part details some of the consequences of these regulations for taxpayers.

## SOURCING RULES BEFORE THE T.C.J.A.

Code §865(a) generally sources income derived from the sale of goods to the residence of the taxpayer. However, Code §865(b) provides special sourcing rules for certain categories of sales, including sales of inventory property.

The Code distinguishes three types of inventory property sales and prescribes specific sourcing rules for each of them:

- Sales of purchased property, subject to sourcing rules under Code §§861(a)(6) and 862(a)(6);
- Sales of produced property, subject to sourcing rules under Code §863;
- Sales by nonresidents through a U.S. office, subject to sourcing rules under Code §865(e)(2) and (3).

1 REG-100956-19, issued December 30, 2019.

2 T.D. 9921 announced on October 19, 2020.

3 Pub. L. 115-97 (2017).

Of the three categories, the T.C.J.A. created uncertainty regarding the sale of produced inventory property sourced under Code §863 and the sale of inventory property through a U.S. office sourced under Code §865(e)(2).

**Sale of Produced Inventory Property Under Code §863**

*“Prior to the effective date of the T.C.J.A., Code § 863(b) and Treas. Reg. §1.863-3 provided a three-step analysis to determine the source of income resulting from Code §863 sales.”*

Prior to the effective date of the T.C.J.A., Code §863 focused on income from the sale of inventory produced in one location and sold in a different location. To illustrate, the property could have been produced wholly or partly within the U.S. and sold outside the U.S., or it could have been produced wholly or partly outside the U.S. and sold within the U.S. (“Code §863 Sales”). The source of gross income from Code §863 Sales was considered to be derived from sources partly within the U.S. and partly from sources outside the U.S.

Code § 863(b) and Treas. Reg. §1.863-3 provided a three-step analysis to determine the source of income resulting from Code §863 sales. The first step was to apportion gross income between the production function and the sales function, using one of the following three methods:

- **The 50/50 method.** Under this method, 50% of the gross income from Code §863 Sales could be allocated to production activity and 50% could be allocated to sales activity.[4] This method applied to all Code §863 Sales unless the taxpayer properly elected the independent factory price (“I.F.P.”) method or the books and records method for those sales.[5]

- **The I.F.P. method.** Under this method, a taxpayer could allocate its gross income based on the price at which the taxpayer regularly sold its inventory to wholly independent distributors or other selling concerns, provided that the taxpayer’s sales activities with respect to such sales were not significant.[6]

- **The books and records method.**[7] Under this method, a taxpayer could allocate its gross income from Code §863 Sales between production and sales activities based upon the taxpayer’s books of account.[8] The books and records method required prior approval from the District Director having audit responsibility over the taxpayer’s tax return. Anecdotally, this method is believed not to have been widely used. It required a taxpayer to “fully explain . . . the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.”[9]

The second step was to determine the source of production income and sales income.[10] The source of the former category of income looked to the place of production,[11] whereas the source of the latter looked to the place of sale.[12] Production

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4 Treas. Reg. § 1.863-3(b)(1), as in effect at the time.

5 Treas. Reg. § 1.863-3(e)(1), as in effect at the time.

6 Treas. Reg. § 1.863-3(b)(2)(i), as in effect at the time.

7 Treas. Reg. § 1.863-3(b), as in effect at the time.

8 Treas. Reg. § 1.863-3(b)(3), as in effect at the time.

9 Treas. Reg. §1.863-3(f)(2), as in effect at the time.

10 Treas. Reg. §1.863-3(c), as in effect at the time.

11 Treas. Reg. §1.863-3(c)(1), as in effect at the time.

12 Treas. Reg. §1.863-3(c)(2), as in effect at the time.

activity meant "an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory."[13] The only production activities taken into account were those conducted directly by the taxpayer. Activities by contract manufacturers were not taken into account. If production activity was carried on both within and outside the U.S., the source of income was apportioned under a formula that looked to the average adjusted basis of all production assets within and outside the U.S.[14]

$$\text{Income attributable to production activity} \times \frac{\text{Average adjusted basis of production assets located outside the U.S.}}{\text{Average adjusted basis of production assets located within and outside the U.S.}}$$

The source of the taxpayer's income that was attributable to sale activities was determined under the title passage rule, according to which a sale of inventory property occurred when and where title passed.[15]

The third and final step was to determine the taxable income by allocating and apportioning expenses, losses, and other deductions to the various classes of gross income from Code §863 Sales.[16] Expense was first allocated and apportioned between Code §863 Sales and other sales under Code §863(b), and the portion allocated or apportioned to Code §863 Sales was then apportioned between gross income from sources within and without the United States.

## Sale of Inventory Through a U.S. Office Under Code §865(e)(2)

Code §865(e)(2) addresses sales of inventory by a nonresident through a U.S. office. It provides the following:

Notwithstanding any other provisions of [Code §§861 to 865], if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced in the United States.

Under Code §865(e)(3), the principles of Code §864(c)(5) related to the computation of effectively connected income apply to determine whether a nonresident maintains a U.S. office and whether a sale is attributable to that office. In determining whether a nonresident alien individual or a foreign corporation has a U.S. office, Code §864(c)(5)(A) disregards an agent's office or other fixed place of business except when the following two facts exist with regard to the agent:

- The agent:
  - Has, and regularly exercises, the authority to negotiate and conclude contracts in the name of the individual or foreign corporation or
  - Has merchandise from which the agent regularly fills orders on behalf of the nonresident individual or foreign corporation, and
- The agent is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of its business.

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[13] Treas. Reg. §1.863-3(c)(1)(i)(A), as in effect at the time.

[14] Treas. Reg. §1.863-3(c)(1)(ii)(A), as in effect at the time.

[15] Treas. Reg. §§1.863-3(c)(2) & 1.861-7(c), as in effect at the time.

[16] Treas. Reg. § 1.863-3(d)., as in effect at the time.

Additionally, Code §864(c)(5)(B) does not attribute income, gain, or loss to a U.S. office unless the U.S. office is a material factor in the production of that income, gain, or loss, and the U.S. office regularly carries on activities that generate such income. In practice, for inventory produced outside the U.S. and sold through a U.S. office, the I.R.S. historically approved a 50-50 split between U.S. source and foreign source income in applying Code §865(e)(2) to such produced inventory.

Code §864(c)(5)(C) further provides that, with respect to certain sales of inventory involving a sale or exchange outside the U.S. and described in Code §864(c)(4)(B)(iii), the amount attributable to the office or fixed place of business cannot exceed the income that would otherwise have been U.S. source had the sale been made in the United States. Among other things, this rule ensures that taxable effectively connected income from the sale of inventory is computed in the same manner whether the sale generates foreign source effectively connected income or U.S. source effectively connected income.

*"... the place of production solely determines the source for sales of produced inventory."*

## CHANGES IMPLEMENTED BY THE T.C.J.A. AND THE FINAL REGULATIONS REGARDING SOURCE RULES FOR INCOME FROM THE PRODUCTION OF INVENTORY

The T.C.J.A. added the following sentence to the flush language of Code §863(b):

> Gains, profits, and income from the sale or exchange of inventory property described in paragraph (2) shall be allocated and apportioned between sources within and without the United States solely on the basis of the production activities with respect to the property.

Hence, the place of production solely determines the source for sales of produced inventory. This change gave rise to three distinct issues, addressed by the proposed regulations:

- The move to a single factor rule to determine source of income;
- The overlap of Code §863(b) and Code §865(e)(2) for a nonresident's foreign-source income attributable to a U.S. office;
- The applicability of Code §864(c)(5)(C)(iii) for purposes of Code §865(e)(2).

### The Move to a Single Factor Rule to Determine Source of Income

To reflect the changes made by the T.C.J.A., the final regulations remove the three apportionment methods of Treas. Reg. § 1.863-3(b). In their place, the final regulations reiterate the flush language of Code §863 by providing that income from Code §863 Sales is sourced "solely on the basis of the production activities with respect to the inventory."[17]

Where production activity takes place within the U.S. and outside the U.S., the final regulations adopt several rules to avoid inappropriate computations that increase foreign source production activity:

[17] Treas. Reg. §1.863-3(b).

- The first is an anti-abuse rule to ensure that *de minimis* activity outside the U.S. does not affect the source of the income. This is achieved by reference to production activity as defined in the Foreign Base Company Sales rules that appear in Treas. Reg. §954-3(a)(4), which specifically eliminates packaging, repackaging, labeling, or minor assembly operations.[18]

- The second eliminates the consideration of any activity that constitutes a "substantial contribution to the manufacturing of personal property" under Treas. Reg. §1.954-3(a)(4)(iv).[19]

- Third, when there is production activity both within and without the United States, the ability of a taxpayer in the U.S. to write down the cost of qualifying property under Code §168(k) is expressly eliminated. Instead, the final regulations mandate use of the alternative depreciation system ("A.D.S.") of Code §168(g)(2) when computing the adjusted cost basis of production assets in the U.S. and outside the U.S.[20] The basis of both U.S. and non-U.S. production assets should thus be measured consistently on a straight-line method over the same recovery period.

- Lastly, the final regulations adopt a general anti-abuse rule ("G.A.A.R.") to prevent a corporate group from artificially skewing the computation of the amount of production activity apportioned to the U.S.[21] The G.A.A.R. rule has broad application. It can be used to neutralize any plan, such as a plan in which domestic production assets are acquired by a related partnership rather than the taxpayer if a principal purpose of the plan is a reduction in income subject to tax under Code §863.

## The Overlap of Code §§863(b) and 865(e)(2)

The amendment to Code §863(b) under the T.C.J.A. raised several questions as to the scope and application of Code §865(e)(2) to determine the amount of gross income from sales of inventory through a U.S. office. Code §865(e)(2) applies notwithstanding any other provisions in Code §§861 through 865. Consequently, the statute may be read as overriding Code §863(b), where Code §863 Sales of a nonresident are attributable to an office or another fixed place of business in the United States. In this case, all inventory income from Code §863 Sales—*i.e.*, both production and sales income—attributable to a U.S. office would automatically be treated as U.S. source income. On the other hand, Code §865(e)(3) limits the scope of Code §865(e)(2) by providing that the principles of Code §864(c)(5) apply in determining whether a taxpayer has a U.S. office and whether a sale is attributable to that office. More specifically, Code §864(c)(5)(C) limits the amount of "income, gain, or loss" from sales that meet the "material factor" threshold of Code §864(c)(5) to the amount of income "properly allocable" to the office in the United States.

Before the T.C.J.A., the I.R.S. interpreted the amount properly allocable to the U.S. office as the amount reflecting sales activity rather than production activity. It is therefore a lesser amount of income than would be allocated under a literal reading of Code §865(e)(2) (*i.e.*, the entire amount of income). This seemed in turn to indicate that Code §865(e)(2) did not sweepingly override Code §863(b).

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18 Treas. Reg. §1.954- 3(a)(4)(iii).

19 Treas. Reg. §§1.863-3(c)(1)(i) and 1.865- 3(d)(2).

20 Treas. Reg. §1.863-3(c)(2)(ii)

21 Treas. Reg. §1.563-3(c)(3).

This approach is retained in the final regulations. Treas. Reg. §1.865-3 applies only if a nonresident maintains an office or other fixed place of business in the United States to which a sale of personal property is attributable.[22] Otherwise, the source of the income, gain, or loss from the sale will be determined under other applicable provisions of section 865, such as section 865(b) through (d).

When an office exists in the U.S., the final regulations retain rules for determining the portion of gross income from sales and production activities that are attributable to the office.[23] The 50/50 method remains the default method in the final regulations. because it is viewed to be an appropriate and administrable way to apply Code §865(e)(2).[24] As in the proposed regulations, the final regulations allow nonresidents to elect a books and records method that would more precisely reflect gross income from both sales and production activities in the U.S., provided the nonresidents meet certain requirements for maintaining their books of account. However, once a taxpayer demonstrates the ability to use books of account to determine U.S. source gross income under the books and records method, it must continue to apply the books and records method until revoked. Moreover, the election to use the books and records method may not be revoked without the consent of the I.R.S. for any taxable year beginning within 48 months of the end of the taxable year in which the election is first made.

## The Applicability of Code §864(c)(5)(C)(iii) for Purposes of Code §865(e)(2)

Code §864(c)(5)(C)(iii) imposes a limitation on income from sales outside of the United States made through an office or other fixed place of business in the United States: this income "shall not exceed the income that would be derived from sources within the United States if the sale or exchange were made in the United States." This special limitation appears to cap the amount of income from sales of inventory outside the United States that can be attributable to the U.S. office by the amount that would be U.S. source under the rules of Code §863(b). This is based on the assumption that the sale is made in the United States. Without application of Code §865(e)(2)(A), which treats the income from such foreign sales domestic income, the U.S. would not have the primary right to impose tax on the resulting income. Consequently, U.S. tax on such income could be offset by a foreign tax credit. Under the approach of the regulations, that is no longer the case.

But if income from the sale of inventory produced by a taxpayer is now sourced solely based on production activity under Code §863(b), is the rule in Code §865(e)(2)(A) overridden? If the answer is yes, none of the income would be allocable to a U.S. office under Code §865(e)(2).

The regulations disagree with this interpretation. As explained above, the I.R.S. believes that it is appropriate to maintain apportionment between production and sales activity when a foreign taxpayer maintains a U.S. office that materially participates in sales of inventory produced outside of the United States, even though such apportionment is no longer necessary under the general sourcing rule of Code §863(b). Under this view, Code §865(e)(2) applies notwithstanding any other provisions of Code §s 861 through 865, because the T.C.J.A. did not amend Code §865(e)(2) when it amended Code §863.

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22 Treas. Reg. §1.863-3(b).

23 Treas. Reg. §1.865-3(d).

24 Treas. Reg. §1.865-3(d)(2)(i).

## IMPLICATIONS OF THE FINAL REGULATIONS

### Effective Dates of Final Regulations

Wiggle room exists as to the effective date of the proposed and final regulations. The proposed regulations were proposed to apply to taxable years ending on or after December 23, 2019, although taxpayers and their related parties could generally apply the rules in their entirety for taxable years beginning after December 31, 2017, and ending before December 23, 2019.

The final regulations generally apply to taxable years ending on or after December 23, 2019. Taxpayers may choose to apply the final regulations for any taxable year beginning after December 31, 2017, and ending before December 23, 2019, provided that the taxpayer and all persons that are related to the taxpayer within the meaning of section 267 or 70 apply the final regulations in their entirety and, once applied, the taxpayer and all such related persons continue to apply the final regulations in their entirety for all subsequent taxable years.[25]

Alternatively, taxpayers may rely on the proposed regulations for any taxable year beginning after December 31, 2017, and ending on or before December 31, 2020 provided that the taxpayer and all persons that are related to the taxpayer rely on the proposed regulations in their entirety and provided that the taxpayer and all such persons have not applied the final regulations to any preceding year.

### Manufacturers of Inventory Property

Given that the T.C.J.A. amendment to Code §863(b) applies to tax years beginning after December 31, 2017, the removal of the apportionment methods available under the current Code §863(b) regulations was expected.

*"Wiggle room exists as to the effective date of the proposed and final regulations."*

In comparison, the computation of adjusted basis of U.S.-located production assets using the A.D.S. method may be a surprise to nonresident taxpayers who believed that the T.C.J.A. should be read as a unified whole, including Code §§863(b) and §168(k).[26]

The burden of maintaining multiple asset books cannot be overstated. According to Fox Rothschild LLP, taxpayers may have to maintain as many as four sets of depreciation schedules covering various provisions of the Code and financial accounting reporting.[27]

### Nonresidents Selling Inventory Property Through a U.S. Office

The proposed regulations require sourcing of Code §863 Sales based solely on the location of production activities, consistent with the amended Code §863(b). However, this does not mean that sales are necessarily foreign source if the production activities are entirely outside the United States. Under Code §865(e)(2), a portion of this income can be characterized as U.S. source income if the nonresident maintains

25 See section 7805(b)(7).

26 US: Source-of-Income Rules Modified by Proposed Regulations Implementing T.C.J.A. Changes, EY (Jan. 9, 2020).

27 Fox Rothschild LLP, comment. on Notice of Proposed Rulemaking: Proposed Amendments to Regulation Code §1.863-3 on Source of Income from Certain Sales of Personal Property, at 7 (Feb. 28, 2020).

a U.S. office, and if such U.S. office is a material factor in generating the income. As a result, in order to avoid U.S source income under the proposed regulations, a nonresident must establish that it does not have a U.S. office or place or business or, if it does, that such U.S. office is not a material factor in generating the income. Of course, if personnel in the U.S. receive compensation that is directly tied to sales, the ability to avoid U.S. source income is likely remote.

**Individuals Operating a Business as a Sole Proprietorship/Pass-Through**

The proposed regulations also raise questions in the context of Code §199A. Code §199A provides a deduction to owners of sole proprietorships, partnerships, S corporations, and some trusts and estates in connection the operation of a qualified trade or business. Subject to certain limitations, the Code §199A deduction generally equals 20% of the individual's qualified business income ("Q.B.I.").[28] Q.B.I. arises from qualified items of income, gain, loss and deduction in a qualified trade or business. Code §199A(c)(3)(A) further provides that whether the income arises in a qualified business is determined under concepts developed under Code §864(c) related to nonresident persons and income that is effectively connected to the conduct of a trade or business in the U.S. Thus, whether an individual is a U.S. resident or a nonresident, noncitizen, the tax return preparer must be familiar with the concepts of Code §864.

## CONCLUSION

The final regulations issued under Code §s 863(b) and 865(e)(2) provide necessary guidance on the changes implemented by the T.C.J.A. The application of the new rules may change the amount of U.S. and foreign source income for certain taxpayers, who must be particularly attentive to the implications of the proposed regulations.

[28] Code § 199A(a)(1).

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