



International Tax ADVISORY ■

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What's Your Source? Proposed Regulations on Sourcing Inventory Sales

The Tax Cuts and Jobs Act (TCJA) dispensed with the title passage rule for sales of produced inventory. Section 863(b) now provides that sales of produced inventory are sourced solely based on the place of production. In regulations proposed in late December 2019 ([REG-100956-19](#)), the IRS elaborates on sourcing sales of produced inventory consistent with the statutory change. More interestingly, the proposed regulations outline new rules for sourcing income from nonresidents' sales of personal property attributable to a place of business in the U.S. and modify the rules to determine whether foreign source income is effectively connected with a U.S. business (ECI). While somewhat iterative, due to coordination of distinct provisions, the proposed regulations are largely helpful and taxpayer-friendly guidance.

Background

The Code provides various rules for sourcing income from sales of purchased inventory (Section 861), produced inventory (Section 863), personal property generally (Section 865), and sales attributable to a U.S. or foreign office.

Before its amendment by the TCJA, Section 863(b) provided that gains from the sale of inventory produced in the U.S. but sold outside the U.S., and vice versa, would be treated partly as U.S. source and partly as foreign source income, typically on a 50-50 basis. Now, the place of production determines source for sales of produced inventory.

Section 865 generally provides that gain from the sale of personal property by a U.S. resident (as specially defined) is U.S. source income, while similar gain of a nonresident is foreign source income. For this purpose, a U.S. resident includes a domestic corporation, a U.S. citizen or resident individual with no foreign tax home, and a nonresident individual with a U.S. tax home. There are various exceptions to the general rule for inventory, depreciable property, intangibles, and stock of affiliates.

Section 865(e)(2) provides that a nonresident's gain from the sale of personal property (including inventory) attributable to a U.S. office or fixed place of business will be U.S. source income. In contrast, income from the sale of inventory for use, disposition, or consumption outside the U.S. will be foreign source if an office in a foreign country materially participated in the sale. The principles of Section 864 apply to determine whether a taxpayer has a U.S. office or fixed place of business, whether a sale is attributable to such office or place of business, and whether foreign source inventory sales by a nonresident are ECI.

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Proposed Regulations

For *produced* inventory, the proposed regulations would amend existing regulations to allocate sales income solely based on the place of production, consistent with Section 863(b) post-TCJA. If a taxpayer has inventory production activities inside and outside the U.S., existing regulations would source income based on the relative average adjusted basis of production assets located inside and outside the U.S.

A more interesting aspect of the newly proposed rules involves the application of Section 865(e)(2) to the sale of inventory produced abroad by a nonresident taxpayer and sold through a U.S. office. According to the preamble, the IRS is concerned that taxpayers could take the position that post-TCJA Section 863(b) overrides Section 865(e)(2) for sales of produced inventory. The IRS believes that Section 865(e)(2) must be given effect, despite the change to Section 863(b), in light of the former's introductory language: "notwithstanding any other provisions of this part" (where Section 863 is included in the relevant "part" of the Code).

For inventory *produced* abroad and sold through a U.S. office, the IRS thinks that the relevant statutory provisions operate to set a limit on the sales income determined to be U.S. source—rather than mandating that all income attributable to the U.S. office be U.S. source. The preamble specifically notes that the TCJA did not change Section 865(e)(2) and that the IRS historically approved, in practice, a 50-50 split between U.S. source and foreign source in applying Section 865(e)(2) to such produced inventory. (By contrast, all income from the sale of inventory *purchased* abroad but sold through a U.S. office would be U.S. source, attributable to the U.S. office, and ECI.)

Based on this interpretation, the proposed regulations under Section 865(e)(2) provide separate rules for sales of personal property through a U.S. office and for sales of inventory. And within the inventory rules, there is further distinction between produced and purchased inventory. For *produced* inventory, the proposed rules prescribe a 50-50 split between U.S. source and foreign source (unless a taxpayer elects a books-and-records-based method). For *purchased* inventory, all sales income attributable to a U.S. office would be U.S. source. In either case, any U.S. source income would generally be ECI under Section 864(c)(3).

The IRS also points out the apparent overlap of Section 865(e)(2) with Section 864(c)(4)(B)(iii). (Foreign source sales are ECI under Section 864(c)(4)(B)(iii) if they are attributable to a U.S. office or fixed place of business.) When Section 865(e)(2) was added by the Tax Reform Act of 1986, the same legislation eliminated Section 864(c)(4)(B)(iii). However, the provision was added back by the Technical and Miscellaneous Revenue Act of 1988 to "ensure that foreign persons who have a substantial presence in the United States, who may be treated as U.S. residents for source rule purposes but as nonresidents for general purposes, are taxed on income derived from sales of inventory property." (Due to the specific definitions in Section 865, a nonresident individual, within the meaning of Section 7701(b) for general income tax purposes, may nonetheless be a "resident" for Section 865 purposes if the individual has a U.S. tax home.)

The proposed regulations provide that, when both Section 864(c)(4)(B)(iii) and Section 865(e)(2) apply, Section 865(e)(2) takes precedence. However, Section 864(c)(4)(B)(iii) would apply to treat foreign source inventory sales as ECI in the case of a nonresident individual treated as a Section 865 "resident," since such an individual would not be subject to Section 865(e)(2) on its terms. Further, the income from the sale of inventory by such nonresident individuals would be taxable as ECI to the same extent as if such inventory sales were governed by Section 865(e)(2), depending on whether the inventory was produced abroad or purchased abroad.

For foreign taxpayers who are subject to U.S. income tax treaties, the IRS states that the proposed regulations would not affect the amount of profits attributable to a permanent establishment.

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