



International Tax ADVISORY ■

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Sourcing the Source of Inventory Sales – Final Regulations Under Section 863(b)

The IRS released [final regulations](#) on September 29, 2020, addressing changes to the source-of-income rules applicable to sales of personal property, including inventory, made by the Tax Cuts and Jobs Act (TCJA) in 2017. These final regulations generally follow the [proposed regulations](#) released in December 2019 with some revisions.

Generally, under Section 865, income from the sale of personal property is sourced in the seller's country of residence. Income from inventory property is subject to an exception and is instead sourced under the general rules of Sections 861, 862, and 863. Under Section 861(a)(6), income from inventory purchased outside the U.S. and sold inside the U.S. (under the so-called "title passage" test) is U.S. source. Likewise, under Section 862(a)(6) income from inventory purchased inside the U.S. and sold outside the U.S. is foreign source (also under the title passage test).

The rules for inventory produced by the taxpayer, as opposed to purchased, are a bit different. Before the TCJA, Section 863(b)(2) provided that the source of income from sales of inventory produced within the U.S. and sold outside the U.S., or vice versa, (an "863(b) sale") was treated as partly U.S. source and partly foreign source. The TCJA amended Section 863(b) to say that income from 863(b) sales are sourced solely based on the location of production activities.

The final regulations followed the proposed regulations to modify the source rules for 863(b) sales consistent with the changes made to the Code by the TCJA. The final regulations further maintained the proposed regulations' position that when production activity takes place both within and without the U.S., income is sourced based on the relative average (beginning and end of year) adjusted basis of production assets located within and without the U.S. Such adjusted basis is to be measured using the alternative depreciation system under Section 168(g)(2) – bonus depreciation is not allowed because of its distortive effects.

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Additionally, the final regulations incorporate rules to determine when the taxpayer “produces” the inventory by reference to the principles of Treas. Reg. Section 1.954-3(a)(4). Under these principles, a taxpayer will be considered to have produced the inventory if it meets the substantial transformation test or the component part test (but not the substantial contribution test). The substantial transformation test requires that the property be substantially transformed by the taxpayer under a mechanical formula. The component part test is met if the property purchased by the taxpayer is used as a component part of the property that is sold by the taxpayer and the assembly or conversion of the component parts into the final product involves activities that are substantial in nature and generally are considered to constitute the manufacture, production, or construction of property.

Note that the revised Section 863(b) test causes issues with foreign distribution branches that sell inventory produced in the U.S. The distribution branch is likely to be taxed in the foreign country. While that income would generally fall within the foreign branch basket, there would be no foreign source income to support the foreign tax credit. The preamble to the final regulations clarifies that taxpayers may resort to treaty re-sourcing rules or competent authority to avoid double taxation. If tax treaties aren’t available, taxpayers may consider checking the box of foreign manufacturing subsidiaries (such as maquiladoras) to treat them as DREs. This would add foreign manufacturing assets to the numerator of the Section 863(b) test and add foreign source income.

A special rule under Section 865(e)(2) applies to sales of personal property, including inventory, by foreign residents attributable to an office or other fixed place of business maintained in the U.S. by a nonresident. Income from such sales is U.S. source to the extent attributable to the U.S. office or other fixed place of business except when the inventory is sold for use, disposition, or consumption outside the U.S. and a foreign office of the nonresident materially participated in the sale. This section applies “notwithstanding any other provision” of Sections 861 to 865, and the principles of Section 864(c)(5) apply to determine whether a nonresident has a U.S. office and whether a sale is attributable to that U.S. office.

The final regulations maintain the proposed regulations’ approach that income from sales of inventory properly produced outside the U.S. and sold through a U.S. office maintained by a nonresident must be sourced in the U.S. in part and is allocated using the 50/50 method by default (similar to the old 50% title passage / 50% location of assets test under Section 863(b)). Alternatively, if the taxpayer meets certain requirements, the books and records method can be used by election. The final regulations also expanded the rules cross-referenced for allocating and apportioning expenses to gross income effectively connected with the conduct of a trade or business in the U.S. to include Sections 882(c)(1) and 873(a). Note the inconsistency in that outbound taxpayers are required to use location of assets, whereas foreign taxpayers with foreign production assets are pushed into the 50/50. This inconsistency is because Section 865(e)(2) applies “notwithstanding any other provisions of this part.”

The final regulations apply to taxable years ending on or after December 23, 2019. Nonresidents may apply the final regulations for any taxable year beginning after December 31, 2017 and ending before December 23, 2019, as long as the nonresident and related persons apply them in their entirety and for all subsequent taxable years.

For more information, please contact [Sam Kaywood](#) at 404.881.7481 or [April McLeod](#) at 212.210.9487.

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Our tax team also joined our Intellectual Property Group for a webinar to discuss "[Tax and Litigation Implications of Intellectual Property Ownership & Licensing](#)."

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