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by
Ray A. Knight
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by
Ray A. Knight†
Lee G. Knight*

I. INTRODUCTION

Unlike most countries, which tax on the basis of both citizenship and residency, the United States has created the potential for double taxation of U.S. citizens and resident aliens conducting business in a foreign country by subjecting them to U.S. tax on their worldwide income in addition to the foreign tax they must pay in the country in which they do business. To mitigate the effects of this double taxation, Congress enacted section 901 of the Internal Revenue Code ("Code") to allow taxpayers a credit against their U.S. tax liability for taxes paid to foreign countries. The source of income rules associated with section 901 are critical in calculating the amount of the foreign tax credit available. Although the sourcing rules do not themselves impose taxes, they serve as the basis for the application of the relevant rules that impose tax liability on both U.S. and foreign taxpayers, and thus play a crucial role in the taxation of international transactions.

In addition to a foreign tax credit, section 911 of the Code permits qualifying U.S. citizens and residents to exclude up to \$70,000 of foreign earned income, plus an additional amount based on their overseas housing expenses, from their U.S. gross income. This exclusion may serve to further mitigate the effects of double taxation. Although the original purpose of section 911's predecessor was to increase U.S. exports,¹ no export activity requirement was ever mandated. Accordingly, section 911 is available to any individual who can establish the required nexus with a foreign country.

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1. H.R. REP. NO. 1, 69th Cong., 1st Sess. 7 (1926).

Avoiding income tax is not automatic in either the United States or the foreign country where the taxpayer is working. The taxpayer must first qualify for the exclusions under section 911, for tax credits under section 901, and for any specific or general treaty exemption. This article summarizes the requirements of sections 901 and 911 and analyzes the changes implemented by the Tax Reform Act of 1986. It first discusses the Code's provisions for these exclusions, credits, and exemptions. Next, it provides a background discussion of the role of the sourcing rules in determining U.S. tax consequences of international transactions and describes the cases in which those rules apply with respect to the purchase and sale of personal property. The article then explains the seller's residence test, its exceptions under the new statute (after the Tax Reform Act of 1986), and related changes in the foreign tax credit. Finally, the article discusses the implications of the new tax law, and illustrates that, through careful tax planning, a taxpayer may continue to minimize his or her income tax.

II.

AVOIDING U.S. INCOME TAXES

A. Foreign Income Exclusion

Taxpayers who qualify for the benefits of section 911 are entitled to elect two exclusions—one applicable to foreign earned income and the other to foreign housing costs.² The foreign earned income exclusion is limited to an annual amount of \$80,000 per person for taxable years beginning in 1983 through 1986, and to \$70,000 thereafter;³ it is calculated on a daily basis.⁴ Consequently, if, for example, an individual only qualifies for the exclusion during twenty percent of 1988, the exclusion that year is limited to \$14,000.⁵ It should be noted that the per person limitation is applicable to income earned by each individual and not to amounts assigned under community property laws.⁶

The second exclusion under section 911 is for a "housing cost amount," which is the excess of reasonable housing expenses over a base housing amount.⁷ Housing expenses include rent or lease payments, the fair rental value of housing provided by an employer, utilities other than telephone expenses, insurance, nonrefundable fees paid to obtain a leasehold, rental payments for furniture and accessories, repair and maintenance expenses, and

2. I.R.C. § 911(a) (1982); Treas. Reg. § 1.911-1(a) (1985). Most state income tax laws also allow exclusions for foreign earned income. However, Alabama, Arkansas, California, Massachusetts, Mississippi, New Jersey, Pennsylvania, and South Carolina do not.

3. I.R.C. § 911(b)(2)(A) (Supp. III 1985 & Supp. V 1987).

4. I.R.C. § 911(b)(2)(A) (Supp. V 1987).

5. I.R.C. § 911(b)(2)(A), (B) (1982 & Supp. V 1987); Treas. Reg. § 1.911-3(d) (1985).

6. I.R.C. § 911(b)(2)(C) (1982); Treas. Reg. § 1.911-5(b) (1985).

7. I.R.C. § 911(c)(1) (1982); Treas. Reg. § 1.911-4(a) (1985). Reasonable housing expenses do not include expenses which are lavish or extravagant under the circumstances. I.R.C. § 911(c)(2) (1982 & Supp. V 1987); Treas. Reg. § 1.911-4(b)(4) (1985).

payments for residential parking.⁸ Housing expenses do not include the cost of a house or home improvements, the cost of furniture or accessories, payments for domestic labor, interest, taxes, or television subscription fees.⁹

The base housing amount is sixteen percent of the annual salary of a step 1, GS-14 U.S. government employee.¹⁰ For example, in 1987, this amount was equal to \$7,322 (or 16% × \$45,763). Like the annual limitation on the foreign earned income exclusion, this amount is calculated on a daily basis.¹¹ Thus, a taxpayer who qualified under section 911 for only three-fourths of the year would calculate the exclusion by subtracting \$5,492 (or 16% × \$45,763 × 75%) from housing expenses. In low cost-of-living countries, this exclusion may prove negligible, while in high-cost areas, such as Tokyo, it can bestow substantial benefits. Housing expenses paid in foreign currency must be converted into U.S. dollars to determine the housing cost amount. Thus, the housing cost amount will increase (decrease) as the foreign currency strengthens (weakens) against the dollar.

In addition to these individual limits, the two exclusions together are subject to an overall limitation equal to the taxpayer's foreign earned income.¹² Foreign earned income is all income earned from personal services performed outside the United States, including salaries, professional fees, reimbursements, and other compensatory payments.¹³ By statute, however, foreign earned income excludes amounts received as a pension or annuity, amounts paid to an employee of the U.S. government or its agencies, gross income received by the beneficiary of a nonexempt trust or nonqualified annuity, or amounts received more than one year following the end of the taxable year in which the income was earned.¹⁴

Consistent with tax law applicable to other tax-exempt income, no deduction, exclusion, or credit is allowed to the extent it relates to excludable

8. I.R.C. § 911(c)(2)(A)(i) (1982); Treas. Reg. § 1.911-4(b)(1) (1985).

9. I.R.C. § 911(c)(2)(A)(ii) (1982); Treas. Reg. § 1.911-4(b)(2) (1985). Housing expenses do not include any expenses allocable for housing in certain countries that are restricted by regulations adopted pursuant to the Trading With the Enemy Act (50 U.S.C. app. § 1 (1982)) or the International Emergency Economic Powers Act (50 U.S.C. § 1701 (1982)). I.R.C. § 911(d)(8)(A)(ii), (B) (Supp. V 1987). At the time the Tax Reform Act of 1986 was adopted, the following countries were restricted: Cuba, Kampuchea, Libya, North Korea, and Vietnam. S. REP. NO. 313, 99th Cong., 2d Sess. 388-89 (1986).

10. I.R.C. § 911(c)(1)(B) (1982); Treas. Reg. § 1.911-4(c) (1985).

11. I.R.C. § 911(c)(1)(B) (1982); Treas. Reg. § 1.911-4(c) (1985).

12. I.R.C. § 911(d)(7) (1982).

13. *Id.* § 911(b)(1)(A), (d)(2) (1982); Treas. Reg. § 1.911-3(a)(b) (1985); *Tobey v. Commissioner*, 60 T.C. 227 (1973), *acq.* 1979-1 C.B. 1; *Robida v. Commissioner*, 460 F.2d 1172, 1175 (9th Cir. 1972).

14. I.R.C. § 911(b)(1)(B) (1982); Treas. Reg. § 1.911-3(c) (1985). Foreign earned income does not include any income from services rendered in certain countries that are restricted by regulations adopted pursuant to the Trading With the Enemy Act (50 U.S.C. app. § 1 (1982)) or the International Emergency Economic Powers Act (50 U.S.C. § 1701 (1982)). I.R.C. § 911(d)(8)(A)(i), (B) (Supp. V 1987). At the time the Tax Reform Act of 1986 was adopted, the following countries were restricted: Cuba, Kampuchea, Libya, North Korea, and Vietnam. S. REP. NO. 313, 99th Cong., 2d Sess. 388-89 (1986).

income.¹⁵ Thus, employee business expenses, IRA contributions, moving expenses, foreign tax credits, and child and dependency care credits are disallowed if they are related to foreign earned income excluded under section 911.¹⁶

Only qualified individuals can make a section 911 election. To be eligible, the taxpayer must have a tax home in a foreign country and must satisfy foreign residency or physical presence requirements. Specifically, the individual must be either (1) a U.S. citizen who is a bona fide resident of one or more foreign countries for an uninterrupted period that includes an entire taxable year, or (2) a U.S. citizen or U.S. resident who is physically present in one or more foreign countries for at least 330 days during any period of twelve consecutive months.¹⁷ Days spent in Cuba, Kampuchea, Libya, North Korea, or Vietnam cannot be used to satisfy either test.¹⁸

B. Foreign Tax Credit—Significance of the Source of Income Rules

1. U.S. Citizens and Resident Aliens

To illustrate the operation of the foreign tax credit, consider the following example:

Example. Assume a U.S. citizen earns \$100,000 of income in a foreign country subject to its tax at a rate of 20%, and an additional \$150,000 of income in the United States. Both amounts would be subject to a U.S. tax on worldwide income (assume it to be at a rate of 25%). This taxpayer would incur \$20,000 in foreign taxes and \$62,500 (\$250,000 times 25%) in U.S. taxes, making a total tax liability of \$82,500. To alleviate this double taxation, section 901 allows the taxpayer a credit against U.S. taxes for the \$20,000 paid in foreign taxes, thereby reducing U.S. taxes to \$42,500 and total taxes to \$62,500.

There are several limitations, however, on the availability of the foreign tax credit. First, in order to qualify for the tax credit, the foreign tax must come within the definition of income tax under U.S. law.¹⁹ Second, and more importantly, section 904(a) limits the credit to the amount of U.S. tax attributed to such foreign income. This limitation is calculated using the "overall

15. I.R.C. § 911(d)(6) (1982); Treas. Reg. § 1.911-6(a) (1985).

16. I.R.C. § 911(d)(6) (1982); Treas. Reg. § 1.911-6 (1985).

17. I.R.C. § 911(d)(1) (1982); Treas. Reg. § 1.911-2 (1985). Days spent in certain countries that are restricted by regulations adopted pursuant to the Trading With the Enemy Act (50 U.S.C. app. § 1 (1982)) or the International Emergency Economic Powers Act (50 U.S.C. § 1701 (1982)) cannot be used to satisfy either test. I.R.C. § 911(d)(8)(A)(iii), (B) (Supp. V 1987). At the time the Tax Reform Act of 1986 was adopted, the following countries were restricted: Cuba, Kampuchea, Libya, North Korea, and Vietnam. S. REP. NO. 313, 99th Cong., 2d Sess. 388-89 (1986).

18. I.R.C. § 911(d)(8)(A)(iii) (Supp. V 1987).

19. I.R.C. § 901(a), (b) (1982 & Supp. V 1987); Treas. Reg. § 1.901-1(b) (as amended in 1987). See also *New York & Honduras Rosario Mining Co. v. Commissioner*, 168 F.2d 745 (2d Cir. 1948); *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894 (3rd Cir. 1943); *Seatrains Lines, Inc. v. Commissioner*, 46 B.T.A. 1076 (1942).

limitation," under which all foreign income, even if earned in several countries, is treated as one unit. In general, the limitation is calculated by multiplying a fraction (the numerator of which is all foreign income determined under U.S. sourcing laws, and the denominator of which is all worldwide income) by the taxpayer's U.S. tentative tax before application of the applicable credit.²⁰ In the above example, the overall limitation would be $(\$100,000 / \$250,000) \times \$62,500 = \$25,000$.

The effect of the section 904(a) limitation is to ensure that the credit will be taken only against the U.S. tax that would be imposed on foreign income and not against the tax that would be imposed on income earned in the United States. In the above example, if the foreign tax rate were equal to the U.S. tax rate (twenty-five percent instead of twenty percent), making the foreign tax \$25,000 rather than \$20,000, a foreign tax credit for the full amount of \$25,000 would reduce U.S. tax liability to \$37,500. This is the same amount that would have been due on the \$150,000 of income derived from the United States had there been no foreign income at all.

However, if the foreign tax rate were fifty percent instead of twenty percent, a foreign tax of \$50,000 would be due. If this full amount were credited against U.S. tax, the U.S. tax liability would be \$12,500 (\$25,000 less than the U.S. tax that would be due on U.S. income of \$150,000 in the absence of foreign income). Allowing a full credit would thus permit the foreign tax credit to decrease U.S. government revenue from U.S. source income. Such a result is beyond the purpose of the foreign tax credit, which is limited to reducing U.S. taxation of foreign income in order to mitigate the potential for double taxation.

Use of the overall limitation, however, allows some taxpayers to receive a foreign tax credit for the entire amount of foreign taxes paid at a rate exceeding the applicable U.S. rate.²¹ Since the total of foreign income from all countries is treated as one unit for the purpose of computing the overall limitation,²² an averaging of all foreign tax rates occurs.²³ Consequently, the tax rates of foreign countries that exceed those of the United States can be offset by lower tax rates imposed by other foreign countries.

20. I.R.C. § 904(a) (Supp. V 1987). For certain categories of income, however, a separate limitation must be calculated. See I.R.C. § 904(d), (f) (1982 & Supp. V 1987). The Tax Reform Act of 1986 expanded these categories.

21. The highest marginal corporate tax rates for some of the major economic countries are as follows:

Japan	56%
Canada	52%
West Germany	56%
France	50%
United Kingdom	35%
United States	34%

22. I.R.C. § 904(a) (Supp. V 1987).

23. Section 904(c) provides some relief for taxpayers unable to take advantage of this averaging effect by allowing those with excess credits a two-year carryback and five-year carryover.

Example. Assume that the taxpayer in the previous example had earned \$50,000 of his \$100,000 of foreign income in a country that imposed a 50% tax rate and the other \$50,000 in a country with a 25% tax rate. The overall limitation would allow him a maximum foreign tax credit of \$25,000, although he incurred \$37,500 in foreign taxes, leaving him with \$12,500 of foreign taxes that cannot be credited. The taxpayer could have reduced the amount of foreign taxes that could not be credited (\$12,500) if he would have been able to earn the second \$50,000 in a country with a tax rate of 10% instead of 25%. The taxpayer would then have incurred only \$30,000 in foreign taxes but would have still received a credit of \$25,000, leaving \$5,000 in foreign taxes that could not be credited instead of \$12,500.

But for the effect of this averaging, the taxpayer would not have the opportunity to use the total amount of foreign tax credit. Instead, separate limitations would be calculated for each country, resulting in a maximum allowable credit of \$12,500 for each. Thus, on income from the country imposing a ten percent rate, the taxpayer would only receive a \$5,000 foreign tax credit. This would leave \$7,500 of unused foreign tax credit that would not be available to offset the \$12,500 of foreign taxes paid in excess of the limitation in the country imposing the fifty percent tax rate. Therefore, averaging can permit a credit for the full amount of foreign taxes paid in a country imposing higher tax rates than the United States if there is enough unused credit from countries imposing lower rates to offset the foreign taxes paid in excess of the limitation.

For the taxpayer, the key to avoiding the impact of the overall limitation is to have as much income as possible in the numerator of the equation (i.e., as much income as possible treated as derived from foreign sources). U.S. law, however, determines the source of income,²⁴ and sometimes a taxpayer may pay foreign taxes on income that U.S. law does not consider income derived from foreign sources. This treatment precludes the placement of such income in the numerator of the equation used to compute the foreign tax credit, and thus results in double taxation. In order to increase the amount of allowable foreign tax credit, the taxpayer can minimize the impact of the limitation by generating what U.S. law deems foreign source income. In addition, to the extent the taxpayer does business in a foreign country imposing higher tax rates than those of the United States, he can further minimize the impact of the limitation by also doing business in foreign countries imposing lower tax rates.

2. *Nonresident Aliens and Foreign Corporations*

The sourcing rules provide the primary basis for the imposition of U.S. taxation on the income of foreigners. Nonresident alien individuals and foreign corporations are subject to U.S. tax on income derived from U.S. sources.²⁵ The extent of this tax will depend upon whether the foreigner is

24. I.R.C. §§ 861, 862 (1982 & Supp. V 1987).

25. I.R.C. §§ 871(a), 881(a) (Supp. V 1987).

engaged in a U.S. trade or business. The United States does not attempt to tax foreigners on income from sources outside the United States, except to the extent that they are engaged in a U.S. trade or business and have an office or other fixed place of business in the United States.²⁶ In such circumstances, U.S. tax on certain categories of foreign source income may be imposed.²⁷

In the absence of a U.S. trade or business, nonresident aliens and foreign corporations are taxed on all fixed or determinable income (including dividends, rents, and wages) from U.S. sources.²⁸ This income is taxed on a gross basis at a flat thirty percent rate imposed in the form of a withholding tax (no deductions allowed),²⁹ although treaties often provide for lower rates. "Fixed or determinable income" includes annual or periodic gain, profit, or income,³⁰ and is construed broadly to include even alimony,³¹ commissions,³² and gambling winnings.³³ Income that is not classified as fixed or determinable will escape U.S. taxation if the foreigner is not engaged in a U.S. trade or business. Gain from the sale or exchange of personal property (capital or non-capital) is not classified as fixed or determinable, and thus escapes U.S. taxation, except in the case of individuals who are present in the United States for 183 days or more in a taxable year.³⁴ In that case, such gains are taxed at a thirty percent rate.³⁵

If a nonresident alien or foreign corporation is engaged in a U.S. trade or business, other tax consequences will arise. For purposes of U.S. taxation, the trade or business may be actual or, in some situations, imputed.³⁶ The vagueness of the term "trade or business," however, makes ascertaining whether the taxpayer is engaged in an actual trade or business sometimes difficult. Section 864(b) defines a trade or business only by exclusion, specifying certain activities that do not constitute a trade or business. Whether a person is engaged in a trade or business within the United States depends on the facts and circumstances of each case.³⁷ The primary test is whether the

26. *Id.*

27. I.R.C. § 864(c)(4) (1982 & Supp. V 1987). See Treas. Reg. § 1.864-2(e) and the following cases for a discussion of the definition of "trade or business": *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (1959); *Linen Thread Co. v. Commissioner*, 14 T.C. 725 (1950); *European Naval Stores Co. v. Commissioner*, 11 T.C. 127 (1948).

28. I.R.C. §§ 871(a), 881(a) (Supp. V 1987).

29. I.R.C. §§ 871(a), 881(a) (Supp. V 1987).

30. *Id.*

31. *Id.*

32. Rev. Rul. 58-479, 1958-2 C.B. 60.

33. *Barba v. United States*, 2 Cl. Ct. 674 (1983).

34. I.R.C. § 871(a)(2) (Supp. V 1987).

35. *Id.*

36. The Code treats a foreigner as engaged in a trade or business, even in the absence of an actual trade or business, in three situations: (i) receipt of scholarship and fellowship grants (section 871(c)); (ii) exercise of an election to treat real property income as income connected with a U.S. business (section 871(d)); (iii) and disposition of a U.S. real property interest (section 897(a)(1)).

37. Treas. Reg. § 1.864-2(e) (as amended in 1975).

activities in question are "considerable, continuous, and regular" as opposed to "isolated" or "sporadic."³⁸

A nonresident individual or foreign corporation actually engaged in, or deemed to be engaged in, a trade or business within the United States will be taxed on all income "effectively connected" with the U.S. trade or business in the same manner as U.S. persons.³⁹ In general, section 864(c)(3) treats all income from U.S. sources automatically as "effectively connected" with a U.S. trade or business, whether it actually is or not.⁴⁰ However, income that is classified as "fixed or determinable," as well as capital gains, is treated as "effectively connected" only if it satisfies the requirements of either the "asset use" test or the "business activities" test.⁴¹ The asset use test asks whether the fixed or determinable income, capital gain, or loss, is derived from assets used in, or held for use in, the conduct of the taxpayer's trade or business.⁴² The business activities test asks whether the activities of the trade or business were a material factor in the realization of the fixed determinable income, capital gain, or loss.⁴³ Fixed or determinable income not "effectively connected" is taxed at a rate of thirty percent.⁴⁴ On the other hand, capital gains not "effectively connected" escape U.S. taxation, except in the case of individuals who are present in the United States for 183 days or more in a taxable year.⁴⁵ Foreign corporations escape taxation automatically.⁴⁶

Generally, section 864(c)(4) provides that no income, gain, or loss from sources outside the United States will be treated as effectively connected with the conduct of a trade or business within the United States, unless the foreign person maintains an office or other fixed place of business within the United States to which such gain or loss is attributable. "Effectively connected" foreign source income includes income derived from the sale or exchange of personal property held as inventory⁴⁷ occurring outside the United States but through a U.S. office or fixed place of business.⁴⁸ Such foreign income, however, will not be treated as "effectively connected" if: (1) the property is sold or exchanged for use, disposition, or consumption outside the United States, and (2) the taxpayer's office or other fixed place of business outside the United States materially participated in the sale or exchange.⁴⁹

38. See, e.g., *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959); *Linen Thread Co. v. Commissioner*, 14 T.C. 725, (1950); *European Naval Stores Co. v. Commissioner*, 11 T.C. 127 (1948).

39. I.R.C. § 871(b) (1982).

40. *Id.* § 864(c)(3).

41. I.R.C. § 864(c)(2) (1982 & Supp. V 1987).

42. I.R.C. § 864(c)(2)(A) (1982); Treas. Reg. § 1.864-4(c)(1)(i) (as amended in 1984). See notes 30-33 and accompanying text.

43. I.R.C. § 864(c)(2)(B) (1982); Treas. Reg. § 1.864-4(c)(i)(b) (as amended in 1984).

44. I.R.C. § 871(a)(1) (Supp. V 1987).

45. *Id.* § 871(a)(2).

46. *Id.* Section 871(a)(2) is limited to individuals.

47. See I.R.C. § 1221(1) (1982). See also *infra* note 85 and accompanying text.

48. I.R.C. § 864(c)(4)(B) (Supp. V 1987).

49. *Id.* § 864(c)(4)(B) (as applied by the rules in § 864(c)(5) (1982)).

Since the sourcing rules provide the primary mechanism for the U.S. taxation of foreigners, the planning of international transactions must take these rules into account. The sourcing rules provide an opportunity for foreign taxpayers to control U.S. tax consequences to the extent they can characterize their income as having been earned outside the United States.

III. THE INADEQUACY OF PRIOR LAW

The approach of prior law to the question of foreign tax credits created the potential for U.S. citizens and residents to minimize their U.S. tax liability by manipulating the passage of title test⁵⁰ to characterize income as foreign source income and thereby increase the allowable foreign tax credit. As described above,⁵¹ when the foreign tax rate is higher than the U.S. tax rate on that income, the U.S. taxpayer will have paid foreign taxes that cannot be credited because of the overall limitation. However, a prudent U.S. taxpayer will credit the excess foreign tax by generating foreign source income in countries imposing no tax or a lower rate of tax than that imposed by the United States. This adjustment is possible because the tax rates of all foreign countries imposing tax are averaged under the overall limitation. Under prior law, the source of income from the purchase and sale of personal property was the place of sale as stated by the parties.⁵² Therefore, parties could easily adjust their foreign source income to come within the overall limitation by characterizing income from the purchase and sale of personal property as being from particular foreign sources.

A. *Prior Law*

Under prior law, the place of sale of personal property determined the source of income.⁵³ The rule applied only to sales or transfers of personal property and not to real property.⁵⁴ For the sourcing rules, the Code treats personal property held by foreigners as real property in two situations: (1) when personal property is associated with the use of real property, i.e., furnishings, movable walls, and other personal property used in connection with a U.S. real property interest;⁵⁵ and (2) when the property consists of interests in domestic corporations that are U.S. real property holding corporations (as defined in section 897(c)(2)).⁵⁶

In addition to the personalty requirement, a "sale" must have occurred. A sale generally consists of a transfer of all rights, title, and interest in and to

50. See *infra* note 64 and accompanying text.

51. See *supra* pp. 8-11.

52. See *infra* notes 53-59 and accompanying text.

53. I.R.C. §§ 861(a)(6), 862(a)(6) (1982).

54. See Treas. Reg. § 1.861-7 (1957).

55. I.R.C. § 897(c)(6)(B) (1982).

56. *Id.* § 897(1)(A).

the property from the seller to the purchaser.⁵⁷ Taxpayers who transfer intangible personal property, however, are confronted with a question as to whether the transfer is a sale or a license arrangement. In distinguishing the purchase and sale of intangibles from their licensure, courts ask whether the property transferred was perpetual and whether the use was exclusive as to a certain territory or field.⁵⁸ A sale is not converted into a license by the sellers' retention of title, for the purposes of bringing an infringement suit, provided that the transferee also enjoys the power; nor is it by the seller's retention of the right of termination as a contractual remedy for bankruptcy or breach.⁵⁹ Gain from the purchase and sale of intangible property that is not effectively connected⁶⁰ with the conduct of a U.S. trade or business by a nonresident alien or foreign corporation is, however, treated as gain from a license for purposes of determining whether such gain was from U.S. sources in certain situations.⁶¹ These situations include gain for any taxable year from the purchase and sale of intangibles to the extent that the gain resulted from payments which were contingent on the productivity, use, or disposition of the property.⁶² If more than fifty percent of the gain for any taxable year from the sale or exchange of the property resulted from contingent payments, all gain from the sale is treated as from contingent payments.⁶³

B. Determining the Place of Sale Under Prior Law

Under prior law, the courts determined the place of sale by using a passage of title test. According to U.S. Treasury Regulations ("Regulations") section 1.861-7(c), title generally passes at the following time and place:

A sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.⁶⁴

Courts interpreting the regulation held that the passage of title test was satisfied when: (1) title was transferred, and (2) risk of loss passed from seller

57. Treas. Reg. § 1.861-7(c) (1957); see U.C.C. §§ 2-106, 2-401 Comment 1 (1978).

58. See, e.g., Rev. Rul. 71-564, 1971-2 C.B. 179; Rev. Rul. 64-56, 1964-1 C.B. 133.

59. Rev. Rul. 71-564, 1971-2 C.B. 179; Rev. Rul. 64-56, 1964-1 C.B. 133.

60. See *supra* notes 47-49 and accompanying text.

61. I.R.C. § 871(e)(2) (1982).

62. *Id.*

63. *Id.* § 871(e)(1).

64. Treas. Reg. § 1.861-7(c) (1957).

to purchaser⁶⁵—a position not in strict adherence to the regulation. When the parties expressly stated their intentions in the contract, the courts accepted the designation for the source of income rule and disregarded evidence of any other intention (e.g., shipping terms, place of destination, and place of payment).⁶⁶ The courts considered other evidence only if they found that the parties' expressed intent was clearly inconsistent with their true intent, as revealed by their actions.⁶⁷ In the absence of an express contractual provision, the courts applied state sales law concerning passage of title and risk of loss.⁶⁸

The Internal Revenue Service ("Service") repeatedly tried to apply an exception for tax avoidance provided in the Regulations so that it could examine the substance of the transaction.⁶⁹ For instance, the Service would contend that passage of title was formally delayed for the primary purpose of avoiding taxes.⁷⁰ With one exception,⁷¹ however the courts consistently rejected the Service's attempt to apply the tax avoidance exception on the ground that tax avoidance in itself is permissible as long as the corporation's actions do not constitute a sham without any commercial purpose.⁷² The courts narrowly applied the tax avoidance exception because some commercially reasonable basis to pass title outside the U.S. usually exists (e.g., for insurance purposes, for purposes of risk of loss, or to protect the seller against the bankruptcy of the buyer).

In the absence of an expressed intention in the contract, the courts applied several presumptions based on state sales law concerning when title and risk of loss pass in determining the place of passage of title.⁷³ As a result, even when the parties did not expressly state in the contract the place of passage of title, they could structure the transaction in accordance with state sales law principles and, in effect, choose the place of sale.⁷⁴ However, the

65. *Commissioner v. Hammond Organ Export Corp.*, 327 F.2d 964 (7th Cir. 1964); *Barber-Greene Americas, Inc. v. Commissioner*, 35 T.C. 365 (1960).

66. *See, e.g., A.P. Green Export Co. v. U.S.*, 284 F.2d 384 (Ct. Cl. 1960); *Barber-Greene Americas, Inc. v. Commissioner*, 35 T.C. 365 (1960).

67. *Amtorg Trading Corp. v. Higgins*, 150 F.2d 536 (2d Cir. 1945).

68. *Kates Holding Co. v. Commissioner*, 79 T.C. 700 (1982); *Miami Purchasing Service Corp. v. Commissioner*, 76 T.C. 818 (1981).

69. *Treas. Reg. § 1.861-7(c)* (1957). Once tax avoidance is shown as a primary purpose, the "substance of the transaction" test may be applied. In some situations the courts and IRS look through the form to find the "substance" of a transaction in order to find out what was "in fact" done rather than what is "claimed" to have been done.

70. *See, e.g., A.P. Green Co. v. U.S.*, 284 F.2d 384 (Ct. Cl. 1960).

71. *Philipp Bros. Inter-Continent Corp. v. United States*, Civ. 147-174 (S.D.N.Y. May 18, 1966).

72. *See, e.g., Commissioner v. Hammond Organ Export Corp.*, 327 F.2d 964 (7th Cir. 1964); *A.P. Green Co. v. U.S.*, 284 F.2d 384 (Ct. Cl. 1960); *Barber-Greene Americas, Inc. v. Commissioner*, 35 T.C. 365 (1960).

73. *Kates Holding Co. v. Commissioner*, 79 T.C. 700 (1982); *Miami Purchasing Service Corp. v. Commissioner* 76 T.C. 818 (1982).

74. *See, e.g., U.S. v. Balanovski*, 236 F.2d 298 (2d Cir. 1956).

complexity of state sales law concerning risk of loss often trapped the unwary, leading to complex litigation and frustrated business expectations.⁷⁵

C. *Avoiding U.S. Tax Under Prior Law*

The prior structure of the source of income rules created a strong incentive for the taxpayer to pass title outside the United States in order to generate foreign source income in countries imposing no or low taxes. In this manner, unused foreign tax credits could be available to offset excess foreign taxes imposed by high tax rate jurisdictions that otherwise could not be credited. This practice was further encouraged by the fact that many foreign countries do not tax income based on mere passage of title within the country.⁷⁶ In short, U.S. taxpayers were allowed to reduce their U.S. tax on their income derived from U.S. sources by artificially increasing the amount of foreign taxes that could be credited against U.S. tax.

Under prior law, taxpayers were also able to manipulate the sourcing rules to maximize their foreign tax credit with respect to depreciable property. To increase their foreign tax credit, taxpayers could use a depreciation deduction to reduce their U.S. income and then, by selling the property abroad, use the gain attributable to the recapture of the depreciation to increase foreign income.

In addition, nonresident aliens and foreign corporations were able—with an exception for inventory property⁷⁷—to avoid U.S. income tax altogether by passing title outside the United States. Nonresident aliens and foreign corporations subject to U.S. tax could reduce their tax liability by taking depreciation deductions to reduce their U.S. taxable income and then selling the property abroad to avoid U.S. taxation on gain from recapture of the deductions. Thus, the taxpayers received the benefits of the deduction to reduce their U.S. taxes and avoided the costs of being taxed on the gain from the recapture of the depreciation deductions.

IV.

TAX REFORM ACT OF 1986

A. *Seller's Residence Rule*

After many years of criticism of the passage of title test Congress in the Tax Reform Act of 1986 changed the sourcing rule with respect to the purchase and sale of personal property and related provisions in the foreign tax credit. Under new section 865(a), the source of income derived from the sale of personal property is the seller's residence, with certain exceptions.⁷⁸

75. See *Miami Purchasing Service Corp. v. Commissioner*, 76 T.C. 818 (1982).

76. See President Reagan's Tax Proposals to the Congress for Fairness, Growth and Simplicity, 21 WEEKLY COMP. PRES. DOC. 707 (May 29, 1985).

77. I.R.C. § 864(c)(4)(B)(iii) (1982).

78. I.R.C. § 865(a) (Supp. V 1987).

The new law provides specific rules for determining the seller's residency. Section 865(g)(1)(A)(i) defines a U.S. resident as any individual who has a tax home in the United States. Section 911(d)(3) defines tax home as the home of an individual for purposes of section 162(a)(2) (relating to travel expenses while away from home). An individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the United States.⁷⁹

An exception exists for citizens and residents of the United States (within the meaning of section 7701(a)(30)) who maintain tax homes in foreign countries. These individuals will not be treated as residents of the United States "with respect to any sale of personal property unless an income tax equal to at least ten percent of the gain derived from such sale is actually paid to such foreign country with respect to that gain."⁸⁰ The legislative intent is to preclude a U.S. citizen or resident alien from maintaining a tax home in another country and generating foreign source income, unless that person actually pays at least ten percent tax on the income from such sale to a foreign country.⁸¹

The term "U.S. resident" also includes "any corporation, partnership, trust, or estate which is a U.S. person."⁸² Section 7701(a)(30) defines a U.S. person as any of the following:

- (1) A citizen or resident of the United States;
- (2) A domestic partnership;
- (3) A domestic corporation; or
- (4) An estate or trust (other than a foreign estate or foreign trust), within the meaning of section 7701(a)(31).

A domestic corporation or partnership is one that is created or organized in the United States; a foreign corporation or partnership is one that is not domestic.⁸³ New section 865(g)(1)(B) defines nonresident as any person other than a U.S. resident.

B. Exceptions To Seller's Residence Rule

While the new law provides that the source of income from the purchase and sale of personal property is the seller's residence, it has five categories of personal property exceptions: (i) inventory, (ii) depreciable property, (iii) intangibles, (iv) stock of an affiliate, and (v) any other type of property sale whose income is attributed to an office located outside the country of the seller's residence.

79. I.R.C. § 911(d)(3) (1982).

80. I.R.C. § 865(g)(2) (Supp. V 1987).

81. S. REP. NO. 313, 99th Cong., 2d Sess. 331 (1986).

82. I.R.C. § 865(g)(1)(A)(ii) (Supp. V 1987).

83. A domestic corporation or partnership is one that is created or organized in the United States. I.R.C. § 7701(a)(4) (1982).

1. Inventory Property

Section 865(h)(1) defines "inventory property" as personal property described in section 1221(1). Section 1221 describes inventory as (1) stock in the trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or (2) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.⁸⁴ Income from the purchase and sale of inventory will continue to be sourced according to the passage of title test contained in the prior law.⁸⁵ The bill passed by the U.S. House of Representatives had proposed that income from the purchase and sale of inventory property be sourced based on the seller's residence (unless certain requirements were met).⁸⁶ Congress ultimately rejected this approach out of a concern that it would create competitive difficulties for U.S. businesses engaged in international commerce and would thereby exacerbate already severe trade deficit problems.⁸⁷ However, Congress directed the Treasury Department to study the effect of the prior law's passage of title rule in light of the Tax Reform Act's lower tax rates and Congress' trade concerns.⁸⁸

2. Depreciable Personal Property

The new law's second exception to the seller's residence test is for depreciable personal property. Section 865(c)(4)(A) defines "depreciable personal property" as "any personal property if the adjusted basis of such property includes depreciation adjustments." Section 865(c)(4)(B) defines "depreciation adjustments" as adjustments reflected in the adjusted basis of any property on account of depreciation deductions, whether allowed with respect to such property or other property and to the taxpayer or to any other person. "Depreciation deductions" are defined as "any deductions for depreciation or amortization or any other deduction allowable under any provision of this chapter which treats an otherwise capital expenditure as a deductible expense."⁸⁹

Section 865(c)(1) allocates gain (not in excess of the depreciation adjustment) from the sale of depreciable personal property between sources in the United States and sources outside the United States by: (1) determining the proportion that the U.S. depreciation adjustments with respect to the personal property bear to the total depreciation adjustments and treating that proportion of the gain as sourced in the United States, and (2) treating the remaining portion of the gain as sourced outside the United States.⁹⁰

84. I.R.C. § 1221(1) (1982).

85. I.R.C. § 865(b) (Supp. V 1987). Section 865(b) refers to sections 861(a)(6), 862(a)(6), and 863(a)(6) which retain the passage of title rules of prior law.

86. H.R. 3838, 99th Cong. 1st Sess. § 611(a) (1985) (amending I.R.C. § 865(b)).

87. S. REP. NO. 313, 99th Cong., 2d Sess. 329-30 (1986).

88. H.R. REP. NO. 841, 99th Cong., 2d Sess. 596 (1986).

89. I.R.C. § 865(c)(4)(c) (Supp. V 1987).

90. *Id.* § 865 (c)(1).

The term "U.S. depreciation adjustments" means the portion of the depreciation adjustments to the adjusted basis of the property which are attributable to the depreciation deductions allowable in computing taxable income from sources in the United States.⁹¹ Thus, the place where prior depreciation adjustments with respect to the property are allocated determines the source of income where the property is sold (to the extent of the amount of such prior deductions). If, however, in any taxable year the property is "predominantly" used in the United States or outside the United States, the depreciation deductions allowable for the year are treated as having been allocated to income from sources in the place of predominant use, except for property described in section 48(a)(2)(B).⁹² Because of this automatic allocation rule, the source of income from gain (not in excess of allowable depreciation adjustments) realized upon a purchase and sale of property that was predominantly used in one country will be such country regardless of whether the taxpayer claimed depreciation deductions there. Gain in excess of allowable depreciation adjustments is sourced as though it were inventory, according to the passage of title test.⁹³

91. *Id.* § 865(c)(3)(A).

92. I.R.C. §§ 865(c)(3)(B), 48(a)(2)(B) (1982 & Supp. V 1987).

93. I.R.C. § 865(c)(2) (Supp. V 1987).

The Internal Revenue Code provides for a deduction for the consumption of the cost of an asset through depreciation or cost recovery. I.R.C. § 167(a), 168 (1982 & Supp. V 1987). A write-off of the cost (or other adjusted basis) of a tangible business asset is known as depreciation or cost recovery. A write-off for income tax purposes is not allowed when an asset lacks a determinable useful life, as for example, land or goodwill, or when it is not business use property. Thus, the depreciation or cost recovery deduction provides a reasonable allowance for the exhaustion, wear and tear, and obsolescence of business property and property held for the production of income (e.g., rental property held by an investor).

On the other hand, depreciable or cost recovery property may be subject to "recapture" of the depreciation or cost recovery allowances upon sale or other disposition of the property according to sections 1245, I.R.C. § 1245 (1982 & Supp. V 1987), or 1250, I.R.C. § 1250 (1982 & Supp. V 1987). Section 1245 was enacted to prevent taxpayers from receiving the dual benefits of depreciation deductions that offset ordinary income plus long-term capital gain treatment under section 1231 on the disposition of the depreciable or cost recovery property. Section 1245 applies primarily to non-real estate property and requires that gain recognized be treated as ordinary income (i.e., included in gross income) to the extent of depreciation taken on the property disposed of. Section 1245 provides, in general, that the portion of recognized gain from the sale or other disposition of section 1245 property that represents depreciation or cost recovery (including immediate expensing under section 179, and the 50 percent basis reduction associated with the investment tax credit) is "recaptured" as ordinary income. Any remaining gain after subtracting the amount recaptured as ordinary income will usually be section 1231 gain. Section 1245 does not apply if property is disposed of at a loss.

Section 1250 was enacted in 1964 for depreciable real property and has been revised many times. The provision prevents taxpayers from receiving the benefits of both accelerated depreciation or cost recovery deductions (i.e., large deductible amounts in the early years of an asset's life) and subsequent long-term capital gain treatment upon the sale of real property. If straight-line depreciation is used, section 1250 does not apply. Nor does section 1250 apply if the real property is sold at a loss. Section 1250 as originally enacted required recapture of a percentage of the "additional depreciation" deducted by the taxpayer. "Additional depreciation" is the excess of accelerated depreciation actually deducted over depreciation that would have been deductible if the straight-line method had been used. Post-1969 additional depreciation on nonresidential real property is subject to 100 percent recapture.

3. *Intangibles*

The third exception to the seller's residence test is for intangibles. Section 865(d)(2) defines "intangibles" as "any patent, copyright, secret process or formula, goodwill, trademark, trade brand or other like property." In the case of any purchase and sale of intangible property, the seller's residence test will apply only to the extent that payment and consideration for the sale are "not contingent on the productivity, use, or disposition of the intangibles."⁹⁴ To the extent the payments are contingent, their source will be determined as if such payments were royalties under sections 861 and 863. The new law provides a special rule for goodwill. Section 865(d)(3) treats payments in consideration for the purchase and sale of goodwill as being from sources in the country in which the goodwill was generated.

The new provision simplifies the sourcing of payments for the purchase and sale of goodwill. It also obviates the difficulty of determining whether the transfer of an intangible is a sale or license, since all payments that are contingent will be treated as relating to a license and those noncontingent as relating to a sale.

4. *Sale of Stock of an Affiliate*

The fourth exception relates to the sale of stock of an affiliate by a U.S. resident. The term "affiliate" means a member of the same affiliated group within the meaning of section 1504(a) without regard to section 1504(b).⁹⁵ Any gain from sale of stock of an affiliate by a U.S. resident is sourced outside the United States if the U.S. resident: (1) sells stock in an affiliate that is a foreign corporation engaged in the active conduct of a trade or business, and (2) the sale occurs in the foreign country in which the affiliate derived more than fifty percent of its gross income for the three-year period ending with the close of the affiliate's taxable year immediately preceding the year during which the sale occurred.⁹⁶

5. *Office Outside the Seller's Country of Residence*

The new law provides further exceptions for residents conducting business through an office outside the United States and for nonresidents conducting business through an office or other fixed place of business inside the United States. In the case of U.S. residents, section 865(e)(1) deems income from the purchase and sale of personal property other than inventory, depreciable personal property, intangible personal property, or stock of an affiliate, as sourced outside the United States when two conditions are satisfied. First, the taxpayer must have an office or other fixed place of business outside the

94. *Id.* § 865(d)(1)(A).

95. *Id.* § 865(h)(4).

96. *Id.* § 865(f).

United States to which such income is attributable.⁹⁷ Second, the U.S. resident must actually pay to the foreign country an income tax with respect to such income equal to at least ten percent.⁹⁸ When these two conditions are met, income from the purchase and sale of personal property, such as bonds, financial instruments, and stocks (other than those of an affiliate) will be sourced outside the United States.⁹⁹

This approach, rather than the seller's residence test, was adopted because it was feared that too strict an application of the seller's residence test might result in treating income that properly should be deemed foreign source as U.S. source.¹⁰⁰ For example, when significant business activity is conducted abroad—evidenced by a fixed place of business—and such country collects a tax of at ten percent on the income, the resulting income will be treated as sourced from the foreign country, regardless of the seller's residence.¹⁰¹

When a nonresident maintains an office or other fixed place of business in the United States, income from the purchase and sale of personal property (including inventory property) attributable to the office or other fixed place of business is generally sourced in the United States.¹⁰² If, however, (1) the income is derived from inventory property which is sold for use, disposition, or consumption outside the United States, and (2) an office or other fixed place of business of the nonresident outside the United States materially participated in the sale, such income is sourced outside the United States.¹⁰³ This rule reflects congressional concern that foreigners conducting substantial business activities in the United States frequently escaped U.S. taxation on the income derived from the activities through the use of the old title passage rule.¹⁰⁴

The principles of section 864(c)(5) apply to these exceptions in determining whether a nonresident taxpayer has an office or other fixed place of business and whether a sale is attributable to it.¹⁰⁵ Under these principles, an office or other fixed place of business of an agent of the taxpayer is disregarded unless the agent has and regularly exercises substantial authority on behalf of the taxpayer and is not merely a general agent.¹⁰⁶ Also, income is attributed to an office of that taxpayer if the office is a material factor in the production of the income and regularly carries on activities of the type from which the income was derived.¹⁰⁷

97. *Id.* § 865(e)(1)(A).

98. *Id.* § 865(e)(1)(B).

99. *Id.* § 865(e)(1)(A).

100. S. REP. NO. 314, 99th Cong., 2d Sess. 329-31 (1986).

101. *Id.* at 330.

102. I.R.C. § 865(e)(2)(A) (Supp. V 1987).

103. *Id.* § 865(e)(2)(B).

104. S. REP. NO. 314, 99th Cong., 2d Sess. 330 (1986).

105. I.R.C. § 865(e)(3) (Supp. V 1987).

106. I.R.C. § 864(c)(5)(A) (1982).

107. *Id.* § 864(c)(5)(B) (1982).

6. *Sale of Stock of Foreign Corporation*

The new law also clarifies that income derived from the sale by a U.S. shareholder of stock in a controlled foreign corporation, which section 1248(a) treats as a dividend, is sourced pursuant to the sourcing rules applicable to dividends, rather than those governing the sale of personal property.¹⁰⁸

C. *Limitation of Income Categories*

The 1986 Tax Reform Act made other changes in the foreign tax credit. Although the overall limitation is retained, the taxpayer's ability to use unused foreign tax credits by averaging tax rates imposed by different foreign countries is limited because separate limitations must be computed for nine categories of income.¹⁰⁹ As a result, averaging is permitted only within each category. Therefore, taxpayers may find it difficult to use the sourcing rules to maximize their ability to take advantage of unused credits by generating foreign income available for averaging under the overall limitation. This difficulty results from the fact that, to be averaged, such foreign income will need to be within the same category as the income creating the excess foreign tax.

The nine categories of income under section 904(d)(1) are as follows:

- (1) passive income;
- (2) high withholding tax interest;
- (3) financial services income;
- (4) shipping income;
- (5) dividends from each noncontrolled section 902 corporation;
- (6) dividends from a domestic international sales corporation (DISC) or former DISC (as defined in section 992(a)) to the extent they are treated as a foreign source;
- (7) taxable income attributable to foreign trade income (within the meaning of section 923(b));
- (8) distributions from a foreign sales corporation (FSC) or former FSC out of earnings and profits attributable to foreign trade income or qualified interest and carrying charges (as defined in section 245(c)); and
- (9) income other than those types described in the preceding categories.

1. *Passive Income*

"Passive income" means any income that will be foreign personal holding company income under section 954(c).¹¹⁰ Therefore, dividends, interest, royalties and rents (excluding rents and royalties which are earned in the active conduct of a trade or business), annuities, commodities transactions

108. I.R.C. § 904(g) (Supp. V 1987); see I.R.C. §§ 865(e)(2)(B)(ii), 951(a)(1)(A) (1982 & Supp. V 1987). In general, the source of dividend or interest income is the residence of the payer. See I.R.C. §§ 861(a)(1), (2); 862(a)(1), (2) (Supp. V 1987).

109. I.R.C. § 904(d)(1) (Supp. V 1987).

110. I.R.C. § 904(d)(2)(A) (Supp. V 1987).

(the excess of gains over losses), foreign currency gains (the excess over foreign currency losses due to changes in exchange rates on or after the booking date and before the payment date), any income equivalent to interest, foreign personal holding company income, and income from qualified electing funds are all treated as passive income.¹¹¹ However, "passive income" does not include any export financing interest, any high-taxed income, and any foreign oil and gas extraction income (as defined in section 907(c)).¹¹²

2. High Withholding Tax Interest

"High withholding tax interest" means any interest if (1) the interest is subject to the withholding tax of a foreign country or a possession of the United States, and (2) the rate of the withholding tax is at least five percent.¹¹³ "High withholding tax interest," however, does not include export financing interest.

3. Financial Services Income

"Financial services income" means income (other than passive income) which is (1) earned in the active conduct of a banking, financing, or similar business, or earned by an insurance company from the ordinary and necessary investment of unearned premiums or reserves, or (2) insurance income from any country (as defined in section 953(a)).¹¹⁴ Financial services income does not include export financing interest or high withholding tax interest.¹¹⁵

4. Shipping Income

"Shipping income" means any income which can qualify as foreign base company shipping income (as defined in section 954(f)).¹¹⁶

5. Noncontrolled Section 902 Corporation

"Noncontrolled section 902 corporation" means any foreign corporation where the taxpayer owns ten percent or more of the voting stock of the foreign corporation (under section 902(a)).¹¹⁷

D. Exceptions to the Definition of Passive Income

One reason for the increase in the number of limitation baskets is the policy that a taxpayer generally should not be allowed to average low-taxed income with high-taxed income. The passive income basket is designed to

111. *Id.* § 954(c).

112. *Id.* § 904(d)(2)(A)(iii).

113. *Id.* § 904(d)(2)(B)(i).

114. *Id.* § 904(d)(2)(C)(i).

115. *Id.* § 904(d)(2)(C)(iii), (iv).

116. *Id.* § 904(d)(2)(D).

117. *Id.* § 904(d)(2)(E).

include—to the greatest extent possible—only those types of low-taxed income that could easily be earned in different countries or in the United States.¹¹⁸ To maximize the effect of this policy, there are several exceptions to the definition of passive income defined in the Code. These exceptions apply to all types of passive income.¹¹⁹

1. Income Described in Another Basket

Passive income does not include income described in any other basket.¹²⁰ This is consistent with the general policy that the passive income basket is a “catch-all” basket for low-taxed income. Passive income includes only those types of income that are perceived to be (1) unrelated to business activities of the U.S. taxpayer, (2) related to investments that “easily” can be made in or moved between foreign jurisdictions, and (3) easily manipulable as to source.

2. High-taxed Income

“High-taxed income” means any passive income if the total amount of (1) foreign taxes on the income, and (2) deemed foreign taxes on the income under sections 902 or 960 exceeds an amount representing the highest marginal U.S. tax rate times the income (after considering any deemed dividends received under section 78).¹²¹

3. Export Financing Interest

“Export financing interest” means any interest derived from financing the sale of property (or other disposition) for use or consumption outside the United States if the property is (1) manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person (e.g., controlled foreign corporation), and (2) fifty percent or less of the fair market value of the property is attributable to products imported into the United States.¹²²

V.

IMPLICATIONS OF THE NEW LAW

A. Elimination of Tax Avoidance

A principal objective of the changes made by the Tax Reform Act of 1986 was to minimize the potential that existed under prior law for taxpayer manipulation of the sourcing rules and foreign tax credit in order to avoid

118. Joint Comm. on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 863 (Comm. Print 1987).

119. I.R.C. § 904 (d)(2)(A).

120. I.R.C. § 904 (d) (2) (A) (iii) (I).

121. *Id.* § 904(d)(2)(F).

122. *Id.* § 904(d)(2)(G).

U.S. taxes. Whereas prior law provided the parties to a transaction with total flexibility to avoid U.S. taxes by designating the place of passage of title, the new law provides a rigid rule that, with certain exceptions, fixes the place of sale as the residence of the seller. Thus, the new law should eliminate much of the tax avoidance that was facilitated by the prior law.

Under the new law, U.S. residents will find it more difficult to manipulate their tax liability by maximizing their foreign tax credit. In the past, taxpayers could easily increase their available credits by generating foreign income through the sale of property and passing title outside the United States, even when most of the sales activities occurred in the United States. Taxpayers having excess foreign tax that could not be credited because of the overall limitation had the incentive to generate foreign sales income in countries where little or no tax is imposed. Such foreign income created unused credit that could be used to offset unrelated foreign taxes. For this reason, much income characterized as foreign sourced was in reality derived from a U.S. source, resulting in a reduction of U.S. tax revenue on income derived from the United States. Even when the income was actually foreign sourced, this practice artificially increased the amount of foreign taxes imposed by a country using a higher rate than the United States that were eligible for the credit.

To curtail this potential for manipulation of tax liability, the new law reduces the ability of U.S. residents to characterize their sales income as foreign source because, unless an exception applies, the seller's residence test requires all income to be sourced in the United States. Exceptions will be difficult to achieve (aside from inventory transactions) in the absence of legitimate, significant economic activities in a foreign country that is not merely a tax haven.¹²³ U.S. residents will be able to qualify only certain types of income derived from the purchase and sale of personal property as from foreign sources.¹²⁴ Also, such income must be attributed to an office in a foreign country, and a tax of at least ten percent must actually be paid to the foreign country on the income in order to qualify.¹²⁵

In addition, the potential to use foreign sourcing to increase the available credit is reduced because foreign source income can increase the foreign tax credit only if the U.S. income is within the category of income that created the excess foreign tax.¹²⁶ The new provisions will more closely fulfill the goal of the foreign tax credit—decreasing double taxation by reducing U.S. tax that would be imposed on foreign income but not that which would be imposed on income derived from the United States.

The new law also reduces the incentive under prior law for taxpayers to allocate as many depreciation deductions as possible to income earned in the

123. See S. REP. NO. 313, 99th Cong., 2d Sess. 330-31 (1986).

124. I.R.C. § 865(e)(1) (Supp. V 1987).

125. *Id.*

126. *Id.* § 904(d)(1).

United States and then sell the depreciable property that had generated these deductions in a foreign country. This procedure now will be of no avail because any gain attributed to deductions taken in the United States will be subject to recapture in the United States, regardless of where the property is sold.¹²⁷

The ability to manipulate the sourcing rules and the foreign tax credit existing under prior law to decrease U.S. taxation will survive to some extent, however, because the passage of title test will still apply to both inventory and excess gain from the purchase and sale of depreciable property.¹²⁸ Thus, taxpayers will still enjoy the flexibility existing under prior law to qualify income from these two categories as foreign source income, when in reality such income arises from U.S. sources. Passage of title in foreign tax havens to reduce U.S. tax will remain attractive for these two categories of income since the requirement that the foreign country impose a tax on the income of at least ten percent will not apply.¹²⁹ In these two categories of income, taxpayers will continue to be able to generate foreign source income, thereby increasing available unused foreign tax credits that can offset unrelated foreign taxes in excess of the limitation, provided it is within the same category of income that created the excess tax.

Under the new law, taxpayers can also generate foreign source income to offset excess foreign tax by selling stocks (other than those of an affiliate), bonds or other financial instruments in a foreign country, provided they (1) do so through an office that they maintain there, and (2) pay tax there at a tax rate that is less than that of the United States but at least ten percent of the income from the sale.¹³⁰ Although the new law continues to allow some manipulation of the foreign sourcing rules, these possibilities are somewhat diminished by the lowering of tax rates in the new law. As a result, taxpayers will experience greater difficulty finding countries with tax rates below those of the United States.

B. Potential for Double Taxation

While the new law limits to a greater extent the potential for tax avoidance, it will have the corresponding effect of enlarging the potential for double taxation. That is, the new lower tax rates — which will be lower than those in most foreign countries — will result more frequently in the taxpayer incurring foreign tax in excess of the overall limitation. In addition, by requiring computation of separate limitations for each of nine categories of income, the new foreign tax credit provision will exacerbate the problem of double taxation by limiting the ability of taxpayers to take advantage of unused credits to offset foreign taxes paid in excess of the limitation.

127. *Id.* § 865(c).

128. *Id.* § 865(b), (c)(2).

129. *Id.* § 865(e)(1)(B).

130. *Id.* § 865(e)(1).

The new law will also limit taxpayers' ability to generate foreign source income to qualify for the foreign tax credit because it requires substantial economic activity in a foreign country that is not a tax haven. Many taxpayers will be unable to satisfy this requirement, yet will incur foreign tax on income that will not be considered as being from foreign sources under U.S. law. While Congress attempted to eliminate one kind of inequity (i.e., the manipulation of the sourcing rules to avoid taxation), it may have produced another kind of inequity—saddling taxpayers with more double taxation. While the extent of the former type of inequity may be difficult to assess, it can be anticipated that disgruntled taxpayers subjected to the latter inequity will not hesitate to bring their plight to the attention of Congress and thus produce pressure for reform in the opposite direction.

The new law will also increase the U.S. taxation of foreigners with an office in the United States. All income attributed to such an office will generally be sourced in the United States.¹³¹ However, two types of transactions are exempt from this rule: (1) any sale of inventory property which is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the taxpayer outside the United States materially participated in the sale, and (2) any amount is included in gross income under section 951(a)(1)(A).¹³² In addition, foreigners will be unable to avoid recapture on assets for which they previously took depreciation deductions against their U.S. income.¹³³ Foreigners will be able to avoid U.S. tax only in the case of inventory sold outside the United States through an office in a foreign country that materially participates in the sale.¹³⁴ In contrast, prior law allowed foreigners to avoid U.S. tax by merely passing title outside the United States.¹³⁵ The new law will substantially curtail tax avoidance by foreigners who do business through an office in the United States.

While perhaps increasing U.S. tax revenues, these new provisions may result in inequitable taxation of foreigners, providing a disincentive for foreigners to conduct business in the United States and possibly compelling them to increase prices. On the other hand, the new lower U.S. tax rates relative to other countries may substantially mitigate this added tax burden to foreigners. The isolated impact of the new provisions on the U.S. economy, on the balance of payments problem, and on the availability of consumer choices is difficult to predict in light of the relatively weak dollar.

131. *Id.* § 865(e)(2)(A).

132. *Id.* § 865(e)(2)(B).

133. *Id.* § 865(c).

134. *Id.* § 865(e)(2)(B).

135. I.R.C. § 862(a)(6) (1982); *see id.* § 861(a)(6).

VI.

CONCLUSION

Since the new sourcing requirements generally depend solely on the seller's residence (with limited exceptions), predictability and certainty will be enhanced. The place of the seller's residence is fixed and definite and is not subject to change through occurrences outside the control of the seller. As a result, businessmen will know whether income will be deemed U.S. source or foreign source income without the necessity of relying upon contractual terms or the vagaries of states sales law. This certainty and predictability will decrease the cost of doing business, particularly by decreasing the risk and expense of litigation in this regard, and will also facilitate the realization of business expectations. While the new law's limitation of prior flexibility diminishes the potential for taxpayer manipulation of transactions, it comes at the expense of greater potential for double taxation.

Inequities exist under the approaches of both the prior law and the new law. Each approach has certain advantages and corresponding disadvantages. Only time will allow an assessment of the wisdom of Congress' actions. In the mean time, taxpayers must have a working knowledge of the rules to tax plan under the sourcing rules and the foreign tax credit. With this working knowledge, taxpayers will continue to enjoy some flexibility that existed under prior law.