Chapter 5 Deemed Subsidiaries

Contents:

5.1 Introduction

California Revenue & Taxation Code (R&TC) §25110 lists the entities to be included in the water's-edge combined report. Two of the entities required to be included in the water's-edge combined report are:

- Any controlled foreign corporation (CFC), as defined in Internal Revenue Code (IRC) §957, that has Subpart F income as defined in IRC §952. The income and apportionment factors of such corporation are included in the combined report based on the ratio of the total Subpart F income of such entity for the year to its current year earnings and profits (E&P).

- A foreign-nation bank, or a foreign-nation corporation, which has an average of less than 20 percent of its property, payroll, and sales located in the United States (US), is included in a water's-edge combined report only to the extent of its income derived from or attributable to sources within the US as determined by federal income tax laws.

  This provision is commonly referred to as the "deemed subsidiary rule" since a foreign corporation's US branch business operation is effectively equivalent to a US subsidiary of the foreign corporation.

The deemed subsidiary rules are found in R&TC §25110(a)(2)(A)(i).

Effective for taxable years beginning on or after January 1, 2006, Senate Bill (SB) 663, chaptered May 8, 2006, amended R&TC §25110(a) to clarify when a corporation has both US-sourced income and Subpart F income, it must include both sources of income in the water's-edge combined report. A CFC cannot exclude its "Subpart F" income from the water's-edge combined report, even if it is a California taxpayer or has income from a US source. (R&TC §25110(a)(2).)

The deemed subsidiary rule applies to:

- Banks – Regardless of the extent of the bank's activity in the US. (R&TC §§25110(a)(2)(A)(i) & 25110(a)(1)(B).)
- Non-banks – If they have less than 20 percent of their apportionment factors in the US. (R&TC §25110(a)(2)(A)(i).)

In general, to determine the amount of includible income in the combined report, banks and corporations are subject to the deemed subsidiary rules within the IRC. The federal method of taxing foreign corporations, and the rules for determining the geographic source of income, are quite different from the worldwide apportionment concept historically used by California.

The IRC divides income into two basic categories, income from US sources and income from foreign sources. The term "source" is a geographic concept that assigns income to a particular situs. The federal sourcing rules first look to the type of income involved, and then apply a specific set of rules to that type of income. Generally, the federal rules source income at the place where an activity occurred or where an asset is located.

The federal sourcing rules serve two primary purposes, to assist:

- US taxpayers in determining whether an item of income is to be treated as foreign-source income for purposes of the Foreign Tax Credit (FTC) limitation.

- Foreign persons in determining whether an item of income is from US sources and subject to federal tax.

Foreign corporations are, in general, subject to US tax only on their US-source income. Thus, for example, a Canadian corporation engaged in a trade or business in the US, but with business income from both the US and Canada, would be subject to US tax only on the income it derives in the US. In contrast, a US corporation is subject to US tax on its worldwide income, although it does get a FTC for foreign taxes paid on its foreign-source income.

US-source income of foreign corporations can generally be segregated into two categories. The first category is income attributable to a trade or business conducted in the US by a foreign corporation (so-called “effectively connected income” or ECI). The second category is income not connected with a trade or business conducted in the US, or non-effectively connected income (NECI). The most common type of NECI is passive investment income, such as interest, dividends, rents, and other fixed or determinable annual or periodical gains, profits, and income (FDAP Income).

The reason for the distinction between the two classes of income is that each class of income is taxed differently:

- NECI – Is subject to a flat-rate withholding tax on gross income for federal purposes. No deductions are allowed against such income in determining the tax liability. (See WEM 5.6.)
- ECI – Is taxable at the progressive tax rates incurred by domestic corporations, and deductions attributable to ECI are allowed in determining the corporation’s net federal taxable income. (See WEM 5.5.)

Foreign corporations are required to file Form 1120F if:

- The foreign corporation has ECI.
- The foreign corporation has only NECI and the full amount of tax was not paid through withholdings. No return is required if the foreign corporation was not engaged in a US trade or business, and the US tax liability for NECI is fully satisfied through withholding at source. (Treas. Reg. §1.6012-2(g)(2).)

Federal Form 1120F, filed by foreign corporations, is comparable to the federal Form 1120 filed by domestic corporations.

Any item of income or deduction, included in the water’s-edge combined report under the deemed subsidiary provisions, must be adjusted to reflect differences between state and federal law in the computation of net income. (California Code of Regulations (CCR) §25110(d)(2)(F).)

5.2 Income and Factors Subject to Inclusion in the Combined Report

Contents:

a. Important Regulation Changes

For taxable years beginning on or after January 1, 1992, CCR §25110(d)(2)(F) was amended to provide that entities subject to the deemed subsidiary provisions remain includible in the water's-edge combined report to the extent of their income effectively connected, or treated as effectively connected, with a US trade or business.

Tax Treaties – to the extent they limit the application of the IRC ECI provisions, are not considered.

NECI (e.g., dividend or interest) is excluded from the water's-edge combined report, unless such income arises from a contract or agreement solely for the avoidance of federal income tax or California franchise or income tax. In cases involving out-bound payments (e.g., royalties, fees, services), if material, IRC §482 may be considered. (See WEM 15.)

Under IRC §881(a) and §1442(a), the gross NECI is subject to federal withholding tax at a flat 30 percent rate, or a lower US tax treaty rate if available. In most instances, the tax withheld on NECI represents the recipient's total tax liability.

After this regulation amendment, there may be significant differences between the amounts of ECI reported for federal purposes and the amounts includible in the water's-edge combined report.

Example

> During 2006, Ideal Corporation, a corporation incorporated in Japan, filed federal Form 1120F claiming that it did not have taxable ECI as a result of the Japan-US tax treaty's permanent establishment rules. Ideal Corporation did have income effectively

connected, or treated as effectively connected with a US trade or business under the IRC. Such income, although not taxable for federal purposes because of the tax treaty provisions, would be treated as ECI for California purposes, and would be included in the water's-edge combined report.

b. Starting Point for Income and Apportionment Factor Determinations

As a general rule, the starting point for determining the income and apportionment factors included in a water's-edge combined report by an entity subject to the deemed subsidiary rules will be the amounts reflected on federal Form 1120F. The starting point for computing taxable income effectively connected with a US trade or business is found in the federal Form 1120F:

- Section II – "Taxable income before NOL deduction and special deductions."
- Section I, column b, provides the information for determining gross US-source NECI.
- Schedule L (Balance Sheet) and the amounts reflected on the branch's books and records would be a starting point for determining the deemed subsidiary's includible apportionment factors.

For many foreign corporations subject to the deemed subsidiary rules, the methodology for determining the amount of income and apportionment factors includible in the combined report will be the same as that used to determine net income before state adjustments and apportionment factors for the domestic members of the group. If the IRS is not auditing the foreign corporation, review the taxpayer's computation of the federal ECI as there may be issues of the allocation and apportionment of overhead expenses, the computation of interest expense allocable to the US activities, or the treatment of income as NECI instead of ECI. There may also be situations where the corporation has not filed the federal Form 1120F. In which case, the amount of federal taxable ECI and the includible apportionment factors must be determined by means of other sources.

There are various questions to consider if a foreign corporation has not filed a federal Form 1120F:

- Is the foreign corporation engaged in a US trade or business?

- Is the foreign corporation engaged in a US trade or business by virtue of its own activities, the activities of an affiliate, or the activity of an unrelated party, acting on its behalf?

- Does the foreign corporation have US source income and apportionment factor(s)?

- Does the foreign corporation have Subpart F income?

- Is there a potential pricing issue between the foreign corporation and its US affiliates?

The taxpayer may file a federal Form 1120F, which reports no ECI or fixed or determinable annual or periodical (FDAP) income. Information on the federal Form 1120F should indicate if the corporation is taking a return position that a US tax treaty modifies the IRC, thereby causing a reduction in the federal tax liability. If the corporation is taking such a position, you should refer to federal Form 8833, Treaty-Based Return Position Disclosure, which is required to be filed with the foreign corporation's federal Form 1120F.

Federal Form 8833 should disclose:

- The name of the treaty country
- The IRC provisions being modified by the treaty
- The name of the payor
- An explanation of treaty-based return position taken, including the nature and amount of the income items for which treaty benefit is claimed. (See Treas. Reg. §301.6114-1(b).)

c. Income Subject to Inclusion in the Combined Report

Certain corporations are included in the water's-edge combined report only to the extent of their income derived from, or attributable to, US sources as determined by federal income tax laws. CCR 25110(d)(2)(F) provides guidance on the actual computation of the income subject to inclusion in the water's-edge combined report for the relevant taxable year. Income of deemed subsidiaries includes income effectively connected, or treated as effectively connected, with a US trade or business.

A foreign corporation from:

- A treaty country must have a permanent establishment (PE) in the US before income effectively connected with a US trade or business will be considered ECI for federal income tax purposes. A foreign corporation may be engaged in a US trade or business and not have sufficient activities in the US to constitute a PE under the relevant tax treaty. In such situations, the foreign corporation's US activities would be immune from federal taxation under the applicable treaty.
- A non-treaty country needs only to be engaged in a US trade or business before its income is effectively connected, or treated as effectively connected, with a US trade or business and is subject to US income tax. It is important to note that the PE rule is irrelevant to ECI determinations for corporations from non-treaty countries.

Pursuant to CCR §25110(d)(2)(F)3, the deductions attributable to ECI are determined by the allocation and apportionment rules set forth in Treas. Reg. §1.861-8, §1.861-8T (other than interest expense) and §1.882-5 (interest expense). The amount of gross ECI less effectively connected deductions is the amount of taxable ECI includible in the water's-edge combined report. It is important to note that a deemed subsidiary can have negative income includible in the water's-edge combined report.

For California purposes, federal taxable ECI is the starting point for determining the income includible in the water's-edge combined report. If a corporation has not filed a federal return, this amount would have to be calculated from the books and records. Once this amount is determined, state adjustments may be required to reflect differences in the income computation for state and federal purposes because CCR §25110(d)(2)(F)4 requires that net income includible in the combined report must be determined pursuant to the R&TC. For example, adjustments must be made to add-back taxes measured by income, to compute depreciation using allowable California methods and asset lives, to compute the provision for the bad debt reserve using allowable California methods, to compute differences in basis in inventory or other property, etc. Finally (for taxable years beginning on or after January 1, 1992), ECI is included in the water's-edge combined report even if a US tax treaty precludes federal taxation. Accordingly, for a deemed subsidiary from a treaty country, a state adjustment may be needed to include any ECI that is not taxable for federal purposes.

Example

Island Corporation is a foreign corporation with less than 20 percent of the average of its apportionment factors in the US. Island Corporation has an effectively connected federal taxable loss of ($100,000), including an MACRS depreciation deduction of $200,000. The depreciation deduction using allowable California methods and lives is $75,000. A state depreciation adjustment of $125,000 ($200,000 - $75,000) is therefore required. As a result, Island Corporation's California taxable ECI of $25,000 is required to be included in the water's-edge combined report.

Example

Buzz Corporation, a Japanese Corporation, was engaged in the business of manufacturing and selling contact lenses. Buzz Corporation placed advertisements for its products in professional journals and periodicals sold in the US. As a result of this advertising, Buzz Corporation sold contact lenses to US customers. US customer orders were filled from inventory stored in warehouses rented by Buzz Corporation in San Francisco and New York City. Contact lenses were stored in these facilities to ensure prompt delivery to US customers on both the East and West coasts. Title to some of the goods passed to the customer in the US, and title to some of the goods passed outside the US.

Buzz Corporation's activities in the US are sufficient to constitute a US trade or business. However, the US-Japan tax treaty provides that these activities do not create a PE. Accordingly, the income effectively connected with Buzz Corporation's US trade or business would not be taxable for federal purposes because Buzz Corporation does not have a PE in the US. For California purposes, when title passes in the US, income from the sale of inventory is US-source income considered effectively connected with a US trade or business, and is includible in the water's-edge combined report. US tax treaties, to the extent they modify the federal ECI rules, are not followed for taxable years beginning on or after January 1, 1992. The sale of goods where title passed outside the US would be considered foreign-source income, and would only be considered ECI if the taxpayer had an office or fixed place of business in the US. Any foreign-source income from the sale of inventory, which is attributed to a foreign corporation's office or fixed place of business in the US would be US source income (See IRC §864(c)(4)(B)(iii) & Treas. Reg. §1.864-5(b)(3)).

Since Buzz Corporation self-reported federal ECI, the federal Form 8833, attached to the federal Form 1120F, can be used as a starting point for determining ECI includible in the water's-edge combined report. Buzz's books and records would also provide information essential in this inquiry.

It is important to note that the requirement to determine net income includible in the combined report pursuant to the R&TC does not override the basic ECI determination rules. The ECI includible in the water's-edge combined report must be determined under the federal rules before appropriate state adjustments are applied. It is also important to note that there can be significant differences in the amount of income includible in the water's-edge combined report as a result of the regulation changes that occurred effective for taxable years beginning on or after January 1, 1992. The effect of this regulation change is illustrated in the following examples.

Example

Craig Corporation, a Japanese corporation, is engaged in the business of manufacturing sake in Japan. During 1990, Craig Corporation shipped sake to California customers on a regular basis. The sake was stored for an average of 3 days in rented warehouse space at a San Francisco port facility before being delivered to California customers. Sales to California customers totaled $100 million during 1990. Pursuant to the terms of the US-Japan tax treaty, such activities are not sufficient to constitute a PE in the US. Since Craig Corporation does not have a PE and the taxable year began prior to January 1, 1992, there is no ECI includible in the water's-edge combined report.

Assuming Craig Corporation has made a water's-edge election for the 1990 taxable year, the combined report filed for 1990 by Craig Corporation would reflect no income subject to inclusion in the combined report even though Craig Corporation clearly has a taxable presence in California as a result of having inventory and rented warehouse space located in this state, and substantial California destination sales. Craig Corporation is still considered a California taxpayer, and it must file a return and pay at least the minimum franchise tax for 1990.

Example

> Assume the same facts as the above example, except that the activities in question occurred during 2003 instead of 1990. Pursuant to the terms of the US-Japan tax treaty, Craig Corporation's activities are still not sufficient to constitute a PE in the US. Accordingly, even if this income is effectively connected with a US trade or business under the IRC, it is not treated as taxable ECI for federal purposes because of the treaty PE rule. However, Craig Corporation's regular and continuous activities in the US do constitute a US trade or business. Accordingly, the income effectively connected with Craig Corporation's US trade or business is treated as ECI for California purposes, and is includible in the water's-edge combined report even if the US-Japan treaty precludes taxation at the federal level.
>
> In this situation, Craig Corporation may have filed a federal Form 1120F that does not reflect a net ECI computation because it is claiming immunity from taxation under the US-Japan tax treaty. Accordingly, Craig Corporation's ECI, applicable expenses, and apportionment factors includible in the water's-edge combined report must be determined from available books and records.

d. Factors Subject To Inclusion in the Combined Report

For purposes of applying the deemed subsidiary provisions, the US-located apportionment factors of a foreign corporation are determined using California's apportionment factor rules, subject to one very important modification. CCR §25110(d)(2)(F)6 provides that "*the terms property owned or rented and used during the taxable year, compensation paid during the taxable year, sales of the taxpayer during the taxable year, and other terms defining the numerator and denominator of any factor shall be construed on a basis consistent with the determination of its US located income*." In other words, only the apportionment factors related to the production of ECI will be subject to inclusion in the combined report.

Consider again the facts in the Example of Craig Corporation above applicable to taxable years beginning prior to January 1, 1992. Under California's standard apportionment factor rules, the rented warehouse space at the California port facility and any inventory located in California or in-transit at year-end to a California destination would normally be includible in the numerator of the property factor.

Similarly, the sales to California customers would normally be includible in the numerator of the sales factors. Under the deemed subsidiary rules, since Craig Corporation does not have a PE, and therefore has no ECI, there is no California apportionable income. As a result of having no income includible in the water's-edge combined report, there are also no apportionment factors subject to inclusion in the combined report since the apportionment factor rules must be construed in a manner consistent with the determination of Craig's income. If the deemed subsidiary has no includible income, it will have no includible apportionment factors.

The following example explains the determination of the apportionment factors under this rule.

Example

> Lanie B.V., a Netherlands Corporation, owns 100 percent of the stock in Lanie Corporation (Lanie), a domestic corporation. Lanie owns real property in California, and is a US Real Property Holding Corporation (USRPHC). Lanie B.V.'s stock interest in Lanie represents a US Real Property Interest (USRPI).
>
> Lanie B.V. sells the stock in Lanie to an unrelated foreign corporation. Pursuant to IRC §897(a)(1), the income from the sale is treated as effectively connected US-source gain from the sale of the underlying US real property for federal purposes, rather than as gain from the sale of stock. Accordingly, receipts from the sale would be assigned to the numerator and denominator of the sales factor in accordance with the rules for assigning receipts from the sale of real property, rather than using the rules for assigning receipts from intangible property.

e. Determination of Includible Factors

The includible apportionment factors are determined in accordance with the standard apportionment factor rules, except that the factors must be construed on the same basis as the deemed subsidiary's income included in the combined report.

1. Property Factor

The Uniform Division of Income for Tax Purposes Act (UDITPA) applies to the determination of property of a deemed subsidiary includible in the apportionment formula. The property that is subject to inclusion is the property that relates to the production of ECI includible in the water's-edge combined report. Property that relates to the production of income excluded from the combined report, such as inventory generating foreign-source income that is not considered ECI, and property that relates to NECI, is not includible in the apportionment factor.

If the taxpayer prepared a California Schedule R for the deemed subsidiary, verify whether the information reported on the Schedule R relates only to ECI or if it reflects all of the taxpayer's assets reflected on its US books. If the taxpayer did not prepare a Schedule R for the deemed subsidiary, then the instructions for the federal Form 1120F provide that the information included in the balance sheet may be limited to US assets and other assets effectively connected with its US trade or business. Use the federal Form 1120F, Schedule L (balance sheet) as a starting point for identifying assets associated with the generation of ECI included in the water's-edge combined report. Additional information may be required from the taxpayer's books and records, or from other information maintained by the taxpayer, to compute the deemed subsidiary's property factor.

Identifying assets included on the federal Form 1120F, Schedule L, that are generating US-source income may be difficult. This could be a significant issue for banks and financial corporations since intangible assets are included in the factor. It will also be difficult to identify assets generating ECI if the taxpayer is claiming that the income is immune from federal taxation because of an applicable tax treaty. If the deemed subsidiary is currently reporting NECI, or has a Schedule M-1 adjustment for book income, which is not included in its ECI computation, it may be determinable that some assets are not includible in the apportionment factor computation. Segregating the cost basis of those assets may prove to be cumbersome, but at least it will be apparent that such assets exist.

It may also be difficult to determine assets generating ECI if the taxpayer is reporting by taking a treaty-based return position. The cost basis and location of such assets may not be readily apparent. Determining the property includible in the apportionment formula may not be as easy as looking to the branch's books and records. It may be worth analyzing the taxpayer investment accounts to determine if there are any NECI assets on the books, especially for banks and financial corporations. If the income is not includible, the asset should be excluded from the apportionment formula.

Once the property subject to inclusion in the combined report is determined, the standard California rules will be used to assign the assets and capitalized rent expense to the numerator of the property factor.

2. Payroll Factor

The determination of total payroll subject to inclusion in the combined report is relatively straightforward. Total payroll will be those amounts included in the computation of net income includible in the combined report. This will include payroll attributable to ECI. The standard California rules will then be used to assign these amounts to the payroll factor numerator.

3. Sales Factor

The determination of total sales subject to inclusion in the combined report is relatively straightforward. The sales factor will include gross receipts, which give rise to ECI. As with the standard UDITPA rules, all intercompany receipts are excluded from the sales factor computation.

The characterization of an item of income will always be determined in a manner consistent with the determination of income for federal tax purposes. For example, a sale of stock, which is considered a disposition of a USRPI is treated as a sale of a real property interest for federal purposes, rather than as a sale of stock. Accordingly, the real property rules, rather than the intangible property rules, will be used to assign the receipt to the apportionment formula.

Once total receipts assignable to the sales factor denominator are determined, the standard California rules will apply to determine whether such amounts are includible in the sales factor numerator.

5.3 Federal Taxation of Foreign Corporations

Contents:

a. In General

For federal purposes, domestic corporations and foreign corporations are taxed differently. Domestic corporations (whether US owned or foreign owned) are taxed on their worldwide income at the rates provided by IRC §11 (graduated rates) or IRC §55 Alternative Minimum Tax (AMT). Foreign corporations are generally taxed by the US only on the portion of their income derived from economic activities having some nexus with the US.

The federal rules for determining the amount of a foreign corporation's income that is subject to US income taxes and the manner of taxing such income are highly technical. The operation of these rules relies on the US-sourcing rules found in IRC §§861-865. The general rule is that foreign corporations are taxable only on their US-source income. There is an exception to that rule for certain foreign-source income earned through a US office. Foreign corporations, which have no income from US sources, generally are not subject to US tax. The IRC also provides that under certain circumstances a foreign corporation's US-source income is not subject to US taxation.

As previously discussed, taxable US-source income of deemed subsidiaries can be segregated into two classes of income:

- The first class of income subject to taxation in the US is defined in IRC §881. IRC §881 applies to the following income that is received from sources within the US by a foreign corporation, but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the US:

    - Interest (other than original issue discount (OID)), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical (FDAP) gains, profits and income, and certain OID. (IRC §§881(a)(1) and (3).)

  - Certain limited kinds of capital gains, including gain from the disposal of timber, coal and domestic iron ore, and gain from the sale of intangible property, such as patents and copyrights, to the extent such gains are equivalent to royalty payments. (IRC §§881(a)(2) and (4).)

- The second class of income subject to taxation by the US is income effectively connected with a US trade or business (ECI). The federal rules for taxing ECI are set forth in IRC §882 and the regulations thereunder.

In general:

1. Foreign corporations engaged in a US trade or business that do not have a US office are:

   A. Taxed at graduated corporate rates (or at AMT rates) on their US-source net income effectively connected with their US trade or business. Note that a foreign corporation's FDAP income that is effectively connected with the foreign corporation's US trade or business is taxed at the graduated corporate rates in accordance with IRC §882.

   B. Taxed at a flat 30 percent or lower US tax treaty rate on gross US-source income that is not effectively connected with the US trade or business (e.g., FDAP income which is not effectively connected with a US trade or business is taxed under IRC §881.)

2. Foreign corporations engaged in a US trade or business, which have a US office, are taxed the same as in item 1, except that under IRC §864(c)(4)(B), ECI may also include certain foreign-source income attributable to the US office. (Some tax treaty provisions may exempt foreign-source ECI from federal taxation. For taxable years beginning on or after January 1, 1992, such an exemption would not apply to any ECI determination for California purposes.)

b. Tax Treaties

The US has negotiated treaties with a number of foreign countries. The significance of these treaties cannot be overemphasized. Treaty provisions often grant more favorable tax consequences than are available under the IRC. For example, many treaties contain a provision that reduces or eliminates the 30 percent tax mandated by IRC §881. In addition, often treaty provisions override the IRC, although in some instances new federal legislation will specifically override existing treaty provisions.

US tax treaty provisions play a significant role in the determination of federal taxable ECI. If the deemed subsidiary is from a country with which the US has a treaty, ECI will not be subject to tax unless the deemed subsidiary has a permanent establishment (PE) in the US. The tax treaty should provide both a definition of PE and a list of the types of activities, which are not considered to create a PE. In general, a PE is a fixed place of business, such as an office or a place of management, through which the entity's business is wholly or partly carried on.

For taxable years beginning prior to January 1, 1992, the deemed subsidiary rules provide that provisions of US tax treaties are followed for California purposes to the extent they limit the application of the ECI provisions of the IRC. In situations where a deemed subsidiary has no ECI due to a US tax treaty overriding an IRC provision, the deemed subsidiary would not be included in the water's-edge combined report because it has no income or apportionment factors.

For taxable years beginning on or after January 1, 1992, the deemed subsidiary rules provide that provisions of US tax treaties are ignored for California purposes to the extent they limit the application of the ECI provisions of the IRC.

c. Federal Filing Requirements

Every foreign corporation, which is engaged in a US trade or business at any time during the year, or which has income which is subject to US income tax, must file a federal Form 1120F. A Form 1120F must be filed regardless of the amount of gross income or whether there is any taxable income. (Treas. Reg. §1.6012-2(g)(1).) Furthermore, federal Form 1120F must be filed even if the foreign corporation is claiming immunity from US taxation under an applicable US tax treaty.

Federal Form 1120F filed by foreign corporations is similar to the federal Form 1120 filed by domestic corporations. The major difference is that there are two additional sections on federal Form 1120F:

- Section I, reports US-source gross income not effectively connected with a US trade or business (NECI). No deductions are allowed against such income for federal purposes. Federal tax law subjects this income to a flat tax, withheld-at-source, equal to 30 percent of gross income. However, a treaty may substantially reduce or eliminate this withholding tax.

- Section II, equivalent to the Profit and Loss Statement, Balance Sheet, and Schedule M information of the federal Form 1120, reflects the foreign corporation's US trade or business activities.

- Section III, reports the branch profits tax. This is a tax imposed on the "dividend equivalent amount" and has no relevance for California purposes. A copy of federal Form 1120F is located in the Forms Appendix.

Federal return filing requirements are modified in some situations. A federal Form 1120F filing is not required when the tax is fully paid at the source (i.e., tax has been fully paid through withholding), and the foreign corporation has no ECI. Furthermore, if the foreign corporation has no taxable gross income for the year, it is not required to complete the federal Form 1120F schedules. However, it must attach a statement to the return indicating the nature and the amounts of income are being excluded from gross income.

If the foreign corporation takes a "return position" that any US tax treaty overrides or modifies any provision of the IRC, and thereby effects (or potentially effects) a reduction of tax, it must disclose this on the federal Form 8833, Treaty-Based Return Position Disclosure. The Form 8833 is attached to the federal Form 1120F (required since 1989.) Even if a return would not otherwise be required to be filed, a return must nevertheless be filed for purposes of making the required treaty-based disclosure. Such return needs to include only the corporation's name, address, identification number, and the disclosure, signed under penalty of perjury. A separate disclosure must be made for each treaty-based position taken. The disclosure requirement is waived in limited circumstances. The waiver does not generally apply to "return positions" relating to ECI. (See Treas. Reg. §301.6114-1.)

A copy of the Federal Form 8833 is located in the Forms Appendix.

The statement required to be attached to the federal Form 1120F must disclose the nature and amount of each income item for which the tax treaty benefit is claimed, an explanation of the position taken with a brief summary of the facts on which it is based, the specific tax treaty provision relied upon, and the IRC provision overridden or modified. Treas. Reg. §301.6712-1(a) imposes a penalty of $10,000 on corporations for each failure to comply with the return position disclosure requirement. IRC §6114 and the regulations thereunder contain more information on treaty-based return positions.

d. Income Effectively Connected with a US Trade or Business (ECI)

A foreign corporation engaged in a trade or business in the US is taxed under IRC §882 to the extent of its income effectively connected with its US trade or business. A foreign corporation can be engaged in a US trade or business even if it does not have an office or other fixed place of business in the US. If the foreign corporation does not have a US office or other fixed place of business, it is only taxed on its US-source income.

If the foreign corporation has a US office or other fixed place of business, it is taxed on its US-source income and on certain foreign-source ECI. For foreign-source income to be treated as ECI, it must be attributable to an office or other fixed place of business, which the foreign corporation has in the US at some time during the taxable year.

Under IRC §864(c)(4), only the following classes of foreign-source income can be treated as ECI:

- Rents or royalties for the use of or for the privilege of using intangible property, including copyrights, patents, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property. (IRC §864(c)(4)(B)(i), IRC §864(c)(5), Treas. Reg. §1.864-5(b)(1)(i)). This rule does not apply to:

- Foreign source rents or royalties paid for the use of, or the privilege of using, real property or tangible personal property located outside the US. (Treas. Reg. §1.864-5(b)(1)(iv))
- Foreign source royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the stock. (IRC §864(c)(4)(D)(i))

- Dividends, interest, or gains or (losses) from sales of stock or securities, derived in the active conduct of banking, financing or similar business within the US, or received by a corporation whose principal business is trading in stocks or securities for its own account. (IRC §864(c)(4)(B)(ii) & Treas. Reg. §1.864-5(b)(2)). This rule does not apply to:

  - Foreign source interest and dividends paid by a foreign corporation in which the taxpayer owns more than 50% of the stock (IRC §864(c)(4)(D)(i)) or
  - Foreign source income that is Subpart F income within the meaning of IRC §952(a). (IRC §864(c)(4)(D)(ii))

- Sale of personal property (i.e., inventory, depreciable personal property, and amortizable intangible personal property) through a US office. (IRC §864(c)(4)(B)(iii), IRC §865(e)(2)(A), Treas. Reg. §1.864-5(b)(1)(ii), & Treas. Reg. §1.864-5(b)(3)). This rule does not apply to:

  - Inventory sold for use or consumption outside the US, if an office of the taxpayer in a foreign country materially participated in the sale. (IRC §865(e)(2)(B))

No other types of foreign-source income may be considered ECI.

1. What Constitutes A US Trade or Business

The determination as to what constitutes a US trade or business is a question of fact. Case law has generally held that substantial, regular, or continuous activities and transactions, other than those of a passive nature, are characteristics of a trade or business. Whether a foreign corporation has sufficient contacts in the US by virtue of exercising the privilege of conducting activities within the US, and thereby enjoying the benefits and protection of US laws, so as to obligate it to help pay for those privileges and that protection, is an issue of fact. This is much the same as the test used by the states, including California (see

MATM 1100) for determining whether a corporation domiciled outside the state has sufficient contacts within the state to be subject to tax (i.e., whether the entity has “constitutional nexus.”)

The courts have held, for example, that the continuous sale of inventory in the US constitutes a US trade or business. Alternatively, if the sales are sporadic or immaterial, the courts have held that the corporation is not engaged in a US trade or business. (See *Commissioner v. Spermacet Whaling & Shipping Co., S/A* (1960) 281 F.2d 646; *Frank Handfield v. Commissioner* (1955) 23 T.C. 633; *W.C. Johnston v. Commissioner* (1955) 24 T.C. 920; *The Linen Thread Co Ltd.* (1950) 14 T.C. 725.) The activities of a dependent agent on behalf of the corporation are imputed to the corporation. Thus, a corporation is deemed to be engaged in a US trade or business, if an agent of the corporation is performing activities that would have caused the corporation to be engaged in a US trade or business if it had performed them itself. (Revenue Ruling 70-424, 1970-2 C.B. 150; *Frank Handfield v. Commissioner* (1955) 23 T.C. 633.) (For a discussion when an agent creates a permanent establishment in the US, see *The Taisei Fire & Marine Insurance Co., Ltd., et al., v. Commissioner* (1995) 104 T.C. 535; *InverWorld, Inc., et al., v. Commissioner* (1996) 71 TC Memo 1996-301, and Supplemental Memorandum Opinion (1997) TC Memo 1997-226.)

2. Determination of Federal ECI

Once it is established that a foreign corporation is engaged in a trade or business in the US, the next step is to determine its taxable ECI. If the foreign corporation is incorporated in a country which has a treaty with the US, its ECI is not taxed by the US unless it has a PE in the US, as defined by the applicable tax treaty. Therefore, the first step in determining taxable ECI is to determine whether a tax treaty applies. Determine if the foreign corporation reside in a country that has a tax treaty with the US. If it does, the next step is to review the applicable treaty to determine if its activities in the US are sufficient to create a PE.

If the corporation has a taxable presence in the US (either because it has a US trade or business or because it has a PE in the US), its income effectively connected with the US business must be determined. In most cases, this determination will be relatively straightforward as the income will clearly be income from the corporation’s trade or business. There will be situations, where the deemed subsidiaries will have investment income or extraordinary income that they believe is not related to their trade or business, and therefore should not be considered ECI.

IRC §864(c)(2) and Treas. Reg. §1.864-4(c) provide two tests to assist in determining whether or not FDAP income is effectively connected with a US trade or business:

- Asset-Use Test
- Business-Activities Test

The tests set forth in the regulations are the relevant standards to apply. Treas. Reg. §1.864-3(a) provides that administrative, judicial or other interpretations regarding the character of income made under the laws of any foreign country are not relevant to the determination of whether an item of income, gain, or loss is effectively connected with the conduct of a trade or business in the US.

The asset-use test looks to whether the income is derived from assets that are used in, or held for use, in the conduct of the taxpayer's US trade or business. The business-activities test looks to whether the business activities of the taxpayer in the US are a material factor in the generation of the income. These tests are discussed in greater detail in Chapter WEM 5.5(c). In applying the asset-use test or the business-activities test, Treas. Reg. §1.864-4(c)(4) provides that "due regard" will be given to how the taxpayer has handled the item on its books and records. The accounting test will not by itself, be controlling.

e. Income Not Effectively Connected with a US Trade or Business (NECI)

IRC §881 imposes a tax of 30 percent (or a lower tax treaty rate if available) on certain gross income from US-sources received by a foreign corporation. To be taxable under IRC §881, the US-source income received must meet certain criteria and must not be effectively connected with a US trade or business. (The taxability of ECI is governed by the provisions of IRC §882.) No deductions are allowed against US source NECI in determining the amount of tax due. Under IRC §1442, the payor of the income is the designated withholding agent and is required to withhold the tax from the payments made to the foreign person.

NECI subject to the tax under IRC §881 includes:

- Interest (other than OID as defined in IRC §1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other FDAP gains, profits, and income.

- Gains from the disposition of timber, coal or iron ore.

- OID accruing during the period in which the foreign corporation holds the obligation.

- Gains from the disposition of patents, copyrights, goodwill, and other like property if the gains are from payments which are contingent on the productivity, use, or disposition of the property sold or exchanged (i.e., the payments are equivalent to royalties).

US source NECI is not included in the water's-edge combined report unless the income arises from a transaction with related party for the purpose of avoiding federal or California tax. (CCR §25110(d)(2)(F)(1)(b))

5.4 SOURCES OF INCOME

Contents:

a. In General

R&TC §25110(a)(2)(A)(i) requires a corporation's income derived from or attributable to sources within the United States (US) to be determined by federal income tax laws. This section of the manual provides only a general introduction to this area of federal tax law. Additional research (resources such as international tax treatises, BNA Tax Management Portfolio, RIA, Lexis-Nexis) to address specific source of income issues is recommended. Flowcharts illustrating the federal sourcing rules by type of income are available for your reference at the end of Chapter 5.4.

To apply the federal source rules, an item of gross income must first be classified by type. Once identified by type, the rules governing the assignment of a particular type of receipt to a particular location are applied to determine the income source.

The IRC contains rules for six major classes of income. The classes of income, and the general rule for sourcing each class of income, are:

- Interest – Sourced to the residence of the debtor
- Dividends – Sourced to the country in which the payer is incorporated
- Personal services - Sourced to the location where the services were performed
- Rents and royalties - Sourced at the location where the underlying property is used or usable

- Income from the disposition of real property - Sourced where the property is located
- Income from the disposition of personal property - Sourced at the residence of the seller

There are many exceptions to these general rules. The source rules for each of the above types of income are found in IRC §§861-863 and 865. When an item of income is not classified within the statutory scheme or the regulation, courts have sourced the item by comparison and analogy with classes of income specified within the statutes. (*Howkins v. Commissioner* (1968) 49 T.C. 689; *Bank of America v. US* (Ct.Cl. 1982) 680 F.2d 142; *InverWorld, Inc. et al. v. Commissioner* (1996) TC Memo 1996-301.) To determine which class of income an item falls within or may be analogized to, the substance of the transaction must be determined. (*Karrer v. US* (1957) 152 F. Supp 66.)

b. Interest

Interest represents the amount paid for the use of money. For purposes of the US sourcing rules, the term "interest" includes all amounts treated as interest under IRC §483, and the regulations thereunder. It also includes original issue discount (OID), as defined in IRC §1232(b)(1). (Treas. Reg. §1.861-2(a)(4).) A general definition of what constitutes interest can also be found in Treas. Reg. §1.61-7.

1. General Rule

The source rules for interest income are set forth in IRC §§861(a)(1) and 862(a)(1). The general rule provides that interest from the US or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of noncorporate residents or domestic corporations are US-source income. Treas. Reg. §1.861-2(a)(1) provides that interest from any agency or instrumentality of the US (other than a US possession), and any state or political subdivision of such state also constitute US source income.

Simply stated, the source of interest income is generally the place where the person obligated to pay the debt resides. The method of making payments, or the location where the interest is paid, is immaterial. The courts have similarly held that the place of payment of the interest or the physical location of the securities is irrelevant for purposes of determining the source of interest. (*A.C. Monk & Co. v. Commissioner* (1948) 10 T.C. 77.)

Although IRC §861(a)(1) refers to "*interest on bonds, notes, and other interest bearing obligations*," it is well settled that the language includes all agreements to make interest payments, whether written or oral. The US Supreme Court held in *Helvering v. Stockholms Enskilda Bank* (1934) 293 US 84 that the words "*other interest-bearing obligations*" were not limited to a written interest-bearing obligation similar to a bond or a note, and that interest received on a US tax refund was therefore US-source income. The courts have similarly held that interest, received on deposits with a US resident are US-source income. In *InverWorld, Inc., et al., v. Commissioner* (1996) TC Memo 1996-301, the court had to determine whether the taxpayer was the true obligor of the debt to determine whether the taxpayer was obligated to withhold tax from the interest payments to its clients. The court determined, consistent with the finding in *Smith v. Commissioner* (1959) 33 T.C. 465 that the taxpayer was providing a service to its clients by pooling excess investment funds, which generated interest income. Accordingly, since the taxpayer did not have an economic interest in the pooled investments, the taxpayer was not obligated to withhold tax on the payments to its clients.

The source of interest income depends on the residence (or place of incorporation) of the debtor. Accordingly, it is necessary to determine both the identity of the true obligor of the debt instrument, and the residence of the debtor. As discussed in *InverWorld, Inc., et al., supra,* this is a facts and circumstance question requiring scrutiny of the underlying transactions and the debt instrument. Furthermore, if interest on the obligation of a US resident is paid by a nonresident acting in the nonresident's capacity as guarantor of the obligation of the resident, the interest will be treated as income from sources within the US since the US resident is the true obligor. (Treas. Reg. §1.861-2(a)(5).)

2. Exceptions to the General Rule

There is one major exception to the general rule that interest income is sourced to the residence of the debtor:

Interest paid on deposits with a foreign branch of a domestic corporation or a domestic partnership is considered foreign-source income if the branch is engaged in the commercial banking business at the time the interest is paid. (IRC §861(a)(1)(b).) Under Treas. Reg. §1.861-2(b)(5), it is not necessary for a domestic corporation or partnership to carry on a banking business in the US. Alternatively, interest paid by a foreign branch of a domestic corporation or a domestic partnership, which is not engaged in the banking business, constitutes US-source income.

c. Dividends

Dividends represent a distribution of assets to stockholders. To qualify as "dividend income" the distribution cannot exceed the total of accumulated and current-year earnings and profits (E&P). Distributions of assets in excess of E&P are treated as a return of capital with any excess being treated as capital gain income. Additional information on what constitutes a dividend can be found in IRC §316 and the regulations thereunder, and in Treas. Reg. §1.61-9 (See WEM 7).

The source rules for dividends income are generally found in IRC §861(a)(2) and §862(a)(2). As a general rule, dividends are sourced to the place of incorporation of the payer. Thus dividends received from a domestic corporation generally constitute US-source income. Dividends received from a Domestic International Sales Corporation (DISC), defined in IRC §992, are treated as foreign-source income to the extent they are attributable to qualified export receipts. Dividends paid by a Foreign Sales Corporation (FSC), defined in IRC §922, are considered foreign-source income under the general rule. (Note, with the exception of the IC-DISC, the FSC and DISC provisions have been repealed prior to tax year 2002).

If the dividend is received from a foreign corporation, the taxpayer generally applies one of two rules under IRC §861(a)(2)(B).

1. None of the dividends paid by a foreign corporation are considered US-source income, if less than 25 percent of the corporation's gross income from all sources for the three-year period prior to the dividend declaration is from income effectively connected with the corporation's conduct of a US trade or business. This test is done on an entity-by-entity basis.

2. If 25 percent or more of the corporation's gross income for the three-year period is income effectively connected with the corporation's US trade or business activities, then a portion of the dividend is deemed to be from US sources. The deemed US-source dividend is equal to the proportion of the corporation's income effectively connected with the US trade or business to gross income from all sources.

Example

Truffles A.G., a West German corporation engaged in the worldwide distribution of chocolate candies, was formed in 2003 and is owned by a West German citizen. Truffles has operated a chain of candy stores in the US since 2005. On December 31, 2009, Truffles A.G. declared a dividend of $500,000. During the three years immediately preceding the year in which the dividend was declared (i.e., 2006, 2007 and 2008) Truffles earned income of $400,000 that is effectively connected with its US trade or business, and $1,200,000 from foreign sources. Of the $500,000 dividend paid to the West German citizen, 25 percent ($400,000/$1,600,000), or $125,000, is deemed to be US-source income to Truffles' West German shareholder.

d. Services

Generally, compensation for labor or personal services is sourced at the place where the services are performed. (IRC §§861(a)(3) and 862(a)(3).) The place or time of payment, the residence of the payer, or the place where the contract was made is irrelevant in determining the source of the compensation.

If services are performed partly within and partly without the US and a specific amount is paid for the services performed within the US, then the amount specified as paid for the services performed in the US is considered US-source income. If a lump sum payment is made for services performed partly within and partly without the US, and there is no specific agreement as to the amount of pay attributable to the US, then a method that most correctly reflects the proper source of income based on the facts and circumstances of the particular case should be used to source the income from personal services. Any method of allocation is acceptable as long as it does not distort income. Allocation is most frequently based on a time basis, but other methods of allocation are acceptable based upon the facts and circumstances of the particular case.

Activities do not have to be performed by an individual to be considered income from personal services. A corporation or other entity is considered capable of rendering personal services through the actions of its employees.

Example

> Beta, a US firm, hired Alpha, a German corporation, to develop a custom engineering software program for use in Beta's business in the US. Alpha is paid a fee of $1,000,000 for its services over a period of eight months. Alpha's computer programmers devoted approximately 66 percent of their time in Germany developing the software program, and 33 percent of their time in the US installing the program and providing the necessary technical support and training for Beta. There was no specific agreement as to the amount paid for services performed within the US.
>
> If the service income is allocated based on time, 66 percent, or $660,000, would be considered foreign-source income. However, if Alpha can demonstrate that the services rendered in Germany were of greater value than those rendered in the US, more income could be allocated to Germany than would be allocated on a straight time basis.

Services rendered by a taxpayer's agent are deemed to be rendered by the taxpayer in the place where the agent renders the services. The courts have held it is the character of the services that determines whether they are personal services and not the fact that the taxpayer performs them in person. In *Le Beau Tours Inter-America, Inc. v. US* (2nd Cir. 1976) 547 F.2d 9, Cert. Den. (1977) 431 US 904, the taxpayer acted as a wholesale travel agent who arranged and marketed Latin American tour packages through retail travel agents in the US. The American customer would pay Le Beau the full retail price for the hotel and tour services, and Le Beau would then remit the amount less a commission to the local hotel or tour operator who actually provided the services. Le Beau maintained its US office in its parent company's office facility in New York. Its bookkeeping, and other clerical work, were performed by employees of the parent company. Le Beau paid its parent an annual lump sum for these services.

Le Beau contended that it received its income by making arrangements for hotel accommodations and ground services for overseas travelers. Thus, it asserted all its income was from foreign sources. The court held that Le Beau did not provide these services, it merely purchased them from foreign operators for its American clients. Le Beau's compensation was derived from facilitating and encouraging American travel, and its services consisted of planning, organizing and promoting its tours. To the extent these services were performed within the US, the income derived there from was income from US sources. The court held that it was irrelevant whether these services were performed by its own employees or by employees of its parent corporation. Thus, the value of all time spent by personnel of the parent company in performing services, such as administrative and clerical work in connection with the Latin American tours, was considered in determining the amount of income derived from US sources.

e. Rents and Royalties

IRC §861(a)(4) and §862(a)(4) provide the general rule that income received for the use of or for the privilege of using tangible or intangible property is sourced at the location where the property is used or usable. This rule applies to all types of real and tangible personal property, and to intangible property, including patents, copyrights, secret processes and formulas, goodwill, trademarks, franchises and other similar property. Payments received with respect to transfers of nonpatentable "know-how" are considered royalties. If the transfer involves a grant of an exclusive license, the transfer may be deemed a sale.

There are two issues associated with the payment for the use of property. It's important to correctly identify:

- Payment Characterization – The character of the payment received in connection with the use of the property.

- Property Use Location – The location where the property is being used.

1. Payment Characterization

Payments for the use of tangible real or personal property are easily characterized as rent. Similarly, payments for the use of intangible property are usually characterized as royalties. However, payments involving intangible property can represent royalties, compensation for services rendered, or proceeds from the sale of an asset.

The correct characterization of the payment can have significant US tax implications due to the different sourcing rules for royalties, services and the sale of property. In *Karrer v. US* (1957) 138 Ct.Cl. 385, 152 F. Supp. 66, the taxpayer, a nonresident alien, entered into agreements with a Swiss corporation, granting the Swiss corporation the commercial rights to use his inventions. The taxpayer was to be paid a percentage of the profits from the sale of the product. Under Swiss law, these were special employment contracts, under the terms of which all patents resulting from the taxpayer's inventions belonged to the Swiss corporation. The Swiss corporation granted its US subsidiary the exclusive right to use the patented process in the US. The US company paid a percentage of its sale proceeds directly to the taxpayer.

The taxpayer successfully argued that the payments received from the US Company were not royalties for the right to use the taxpayer's intangible assets (patents) in the US, but rather the payments were compensation for services performed outside the US for the Swiss parent. Since the services were performed outside the US, they were not taxable in the US. If, however, the payments received by the taxpayer had been held by the court to be royalties received for the use of intangible property in the US, the income would have been US source income subject to US taxes.

Whether income received is a royalty turns on whether the transferor has retained a substantial right to the transferred property. If the transferor retains any rights in the property being exploited or a continued participation in the transferees business, the payment is a royalty. If the exclusive rights to exploit the intangible property using a particular medium or in a specific location are not retained by the transferor and are transferred for the entire life of the copyright or patent, then the entire payment will be considered either income from personal services or proceeds from the sale of an intangible asset depending on the facts and circumstances.

2. Property Use Location

If the item in question has been characterized as either a rent or royalty payment, then it must be determined whether the property is rented or licensed for use within or without the US. The location where the property is rented or licensed for use is the determining factor as to the source of the payments received. The location of use must also be determined by looking to the location of use by the parties to the licensing agreement.

In *SDI Netherlands B.V., v. Commissioner* (1996) 107 T.C. 161, SDI Bermuda Ltd. (Bermuda), a subsidiary of SDI Ltd., owned the rights to certain commercial systems software. SDI Bermuda licensed the worldwide rights to the software to its affiliate, SDI Netherlands B.V. (BV), who in turned licensed the US rights to its subsidiary, SDI US (SDI). SDI made royalty payments to BV, which were exempt from withholding tax under the US-Netherlands treaty. BV then made royalty payments to Bermuda out of funds that included amounts received from SDI.

It was the IRS position that the payments by BV to Bermuda were US-source income to the extent royalties paid by BV were out of funds received from SDI since the amounts received from SDI were for the use of the license in the US. The court held that the licensing agreement between BV and Bermuda was separate and distinct from the licensing agreement between SDI and BV, and although the payments by SDI to BV constituted US-source income from the use of the intangible property in the US, the payments by BV to Bermuda did not. The court found support for its position in that the IRS position would cause a cascading royalty whereby multiple withholding taxes could be paid on the same royalty payment as it transferred up a chain of licensers.

It is important to note that the situs of the parties involved in the license or rental agreement is irrelevant. If the property is licensed or rented for use outside the US, then the amounts received as rents or royalties are not US-source income even if paid by a US company.

In Revenue Ruling 75-483, the IRS held that income received by a US corporation from the bareboat charter hire of a vessel to an unrelated US company, which used the vessel primarily to transport goods from Alaska to various other ports located within the US, constituted income within the US to the extent allocable to periods when the vessel was in a US port, and traveling within the US territorial waters. The rental income allocable to periods when the vessel was traveling outside the US territorial waters would be income from sources without the US. Such income would have been considered income from partially within and partially without the US if the vessel was transporting goods between the US and foreign ports. The legal situs of the boat was irrelevant.

Similarly, in *Wodehouse v. Commissioner* (4th Cir. 1949) 178 F.2d 987, the Court of Appeal, on remand from the US Supreme Court, held that royalty payments made by a US company to a nonresident alien for exclusive book rights in North America was income partly from within and partly from without the US since the North American rights included the rights to Canada. However, when income is generated from both within and without the US, the burden is on the taxpayer to prove the amount received for use of the property outside the US. If the taxpayer fails to carry that burden, the income will be allocated entirely to the US. In this particular case, the contract was silent on the value of the book rights to Canada. Since the taxpayer was unable to prove the value of the Canadian rights, all royalties received by the taxpayer were considered US-source income.

In *Molnar v. Commissioner* (2nd Cir. 1946) 156 F.2d 924, the taxpayer, a nonresident alien, received lump-sum payments for assigning the worldwide rights to certain movies to US companies. Although the income generated by the films was from sources partly within and partly without the US, no segregation of the lump-sum payments was made between the rights exercised in the US and those exercised worldwide. Further, the taxpayer was unable to submit any data, which could be used as a basis for allocating part of the payments to foreign use. As a result, the entire amount received was treated as US-source income.

3. Transactions Involving Computer Software after December 1, 1998

A computer program is defined as a set of statements or instructions to be used directly or indirectly in a computer to bring about a certain result, including any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program. Effective for transactions occurring pursuant to contracts entered into on or after December 1, 1998, special rules set forth in Treas. Reg. §1.861-18 must be applied for purposes of classifying transactions involving computer programs.

f. Disposition of a Real Property Interest

IRC §861(a)(5) provides that gains, profits, and income from the disposition of a US Real Property Interest (USRPI), as defined in IRC §897(c), are US-source income. Treas. Reg. §1.897-1(g) defines disposition as any transfer that would constitute a disposition by the transferor for any purpose of the IRC and regulations thereunder. IRC §862(a)(5) provides that gains, profits, and income from the sale or exchange of real property located without the US is foreign source income.

Income from the disposition of a real property interest is sourced to the location of the underlying property. USRPIs for these purposes include both direct and indirect ownership of real property. For example, the stock of a domestic corporation whose assets are predominantly US real property is a USRPI.

1. US Real Property Interest (USRPI)

USRPI, defined in IRC §897(c) and the regulations there under, is:

A. Any interest, other than an interest solely as a creditor, in real property located in the US or US Virgin Islands. IRC §897(c)(6)(A) defines the term “interest” in real property to include fee ownership, leaseholds, options to acquire real property, and options to acquire leaseholds of real property.

B. Any interest in a partnership, estate, or trust to the extent of the USRPI held by such entity.

C. Any interest, other than solely as a creditor, in any domestic corporation unless the taxpayer establishes that such corporation did not meet the definition of a US Real Property Holding Corporation (USRPHC) at any time during the shorter of the:

   i. Five-year period ending on the date of disposition of the interest.

   ii. Period after June 18, 1980, during which the taxpayer held the interest.

D. Treas. Reg. §1.897-1(c)(2) specifically excludes three categories of interest from the definition of a USRPI, an interest in a:

i. Domestically controlled Real Estate Investment Trust (REIT).

ii. Publicly traded corporation, if the taxpayer holds or has historically held (directly or indirectly) no more than 5 percent of the traded stock of the corporation. An interest in a publicly traded partnership or trust is treated as a publicly traded corporation.

iii. Corporation, which has disposed of its USRPI in a transaction in which the full amount of the gain was recognized.

The net effect of the above rules is that a domestic corporation, which meets the USRPHC test at any time remains a USRPHC for the ensuing five years, unless it disposes of its USRPI in a transaction in which the full amount of the gain is recognized for tax purposes. The IRC also provides that if a domestic corporation holds USRPI that ceases to meet the USRPI standard, such corporation will not be considered a USRPHC.

Example

> The sole asset of Corporation A, a US incorporated holding company, is stock in Corporation B, a US Corporation that owns US real estate. Corporation A and Corporation B are both considered a USRPHC. If corporation B disposes of its real estate in a fully taxable transaction, it ceases to be a USRPHC. Thus, the stock of Corporation B will cease to be considered a USRPI to Corporation A, and Corporation A will also cease to be considered a USRPHC.

2. Real Property Defined

Treas. Reg. §1.897-1(b) defines the term “real property” to include three categories of property:

- Land and unsevered natural products of the land
- Improvements
- Certain tangible personal property associated with the use of the real property

It should be noted that crops and timber cease to be real property at the time they are severed from the land. Ores, minerals and other natural deposits cease to be real property when they are extracted from the ground. An improvement is defined as a building and its structural components, and any other inherently permanent structure that is affixed to real property. Finally, personal property is considered associated with the use of a real property interest only if both the personal property and the real property are held by the same person or by a related person.

Under Treas. Reg. §1.897-1(b)(4), personal property is associated with the use of real property only if it falls into one of these four categories, property used:

- In mining, farming, and forestry
- To improve real property
- In lodging facility operations
- In the rental of a furnished office or a similar workspace

When associated personal property is sold, it is generally considered a disposition of USRPI. Treas. Reg. §1.897-1(b)(4)(ii) provides that an item of associated personal property will lose its status as USRPI, if the personal property either:

- Is disposed of more than a year before the real property with which it is associated is sold,
- Is disposed of more than a year after the real property with which it is associated is sold, or
- The real property is sold to buyers that are not related to the seller or to each other.

3. US Real Property Holding Corporation (USRPHC)

Under IRC §897(c)(2) and Treas. Reg. §1.897-2(b), a corporation is considered a USRPHC if the fair market value (FMV) of its USRPI on any applicable “determination date” equals 50 percent or more of the FMV of its total assets. The determination dates for testing whether a corporation is a USRPHC are generally the last day of the corporation’s tax year or any date on which it acquires or disposes of real property or a real property interest.

Treas. Reg. §1.897-2(c)(2) provides limitations with regard to the acquisitions and dispositions of property so that commonly occurring or de minimis transactions will not trigger a re-determination. For example, dispositions of inventory, disbursements of cash to meet regular operating needs or dispositions of business assets, not in excess of specified limitation amounts, will not trigger a re-determination. FMV is defined as gross value less purchase money mortgage against the property. The regulations provide an alternative to the FMV test. If the book value of the USRPI of a corporation is 25 percent or less of the book value of the total assets, it is presumed the corporation is not a USRPHC. This presumption is rebuttable.

For purposes of the 50 percent asset test, see Treas. Reg. §§1.897-2(d) and (e), which provide the list of assets that must be included in the total assets.

g. Sale or Exchange of Personal Property

Subject to many important exceptions, IRC §865(a) provides the general rule that income from the sale of personal property is sourced to the residence of the seller. If the seller of the personal property is a US resident, then the income from the sale of the property is generally sourced to the US. If the seller is a nonresident, then the income from the sale is generally sourced outside the US.

Although the seller's residence is the general rule for sourcing sales of personal property, there are only few situations where the general rule actually applies. Most income derived from the sale of personal property is sourced according to one of the exceptions to the general rule. The principal types of property excepted from the general rule are inventory, depreciable property, and intangible property.

1. Inventory Property

A. General Rule

Under IRC §865(b), income derived from the sale of inventory is generally sourced to the country in which the property is sold. This is somewhat similar to the California destination rule. Thus, if a taxpayer purchases inventory outside the US and sells it within the US, the profit is US-source income. Similarly, if a taxpayer purchases inventory within the US and sells it outside the US, the profit is considered foreign-source income. For purposes of this discussion, inventory includes stock in trade of the taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the end of the taxable year, or property held by the taxpayer is primarily for sale to customers in the ordinary course of his trade or business. (IRC §865(i)(1).)

B. Passage of Title

Treas. Reg. §1.861-7(c) provides that a sale of inventory occurs at the time and place where the seller's rights, title and interest in the property are transferred to the buyer. When legal title is retained by the seller, the sale is deemed to occur when the benefits and burdens of ownership pass to the buyer. This rule is referred to as the "passage of title" rule. Note that if the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the passage of title rule does not apply. In such cases the sale is treated as being concluded at the place where the substance of the sale occurred, as determined by the facts and circumstances of the particular case. All factors of the transaction, such as the place of negotiations and execution of the agreement, the location of the property, and place of payment will be considered in making this determination.

Case law has established that the time and place when title passes depends on the intention of the parties. Where the intention of the parties is not clearly stated, the courts have determined their intention by reference to the facts and circumstances surrounding the sale. One important fact considered by the courts in determining the place where title passed is the terms used in the trade contracts entered into by the parties. The most common terms used in trade contracts are free on board (FOB), Free Alongside (FAS), cost, insurance and freight (CIF), and cost and freight (C&F).

i. Free on Board (FOB) and Free Alongside (FAS)

When goods are shipped FOB or FAS, the seller delivers the goods to a designated point and the buyer pays the cost of delivery from the point the goods are delivered. The designated point can be the point of shipment, the point of destination, or any point in between. Title is presumed to pass from the seller to the buyer in the designated FOB or FAS location.

ii. Cost, Insurance, and Freight (CIF) and Cost and Freight (C&F)

When goods are shipped CIF, the seller places the goods aboard a common carrier, prepays the freight, procures proper insurance on the goods, delivers the bill of lading to the buyer, and collects a lump sum price. Under such contracts, title to the goods is presumed to pass from the seller to the buyer at the point of shipment, provided the seller has complied with the requirements set forth in the contract.

The primary difference between CIF and C&F contracts is that the seller does not buy the insurance for the buyer under a C&F contract. Other than that, C&F and CIF contracts create the same presumption as to passage of title. Title to the goods is presumed to pass from the seller to the buyer at the point of shipment, provided the seller has complied with the requirements set forth in the contract.

iii. Case Law

Ronrico Corporation

A good analysis of the passage of title rule is found in *Ronrico Corporation v. Commissioner* (1941) 44 B.T.A. 1130. Ronrico, a Puerto Rican corporation engaged in the manufacture of rum, entered into an exclusive marketing agreement with a US distributor. Upon receiving an order from the US distributor, Ronrico delivered the packaged goods to the common carrier designated by the distributor, prepaid the freight, and secured insurance covering the shipment. Ronrico then prepared an invoice showing prices, which covered insurance and freight and submitted the invoice, a copy of the bill of lading, and the insurance policy to the distributor. Unlike the typical CIF transaction, the bills of lading and insurance policies were made out in the name of Ronrico. Thus, leaving title to the goods with Ronrico until after shipment. Strictly considered, therefore, title did not pass until delivery of the bills of lading to the buyer in the US.

The court held that “the final acts essential to the sale, the shipment of the goods and the forwarding of the documents, took place in Puerto Rico.” It was there that the sale was made. The court found that when this type of dealing is followed only for the purpose of giving security to the seller, it does not prevent the passage of beneficial ownership and risk of loss to the buyer at the point of shipment.

Liggett Group

The Tax Court’s decision in *Liggett Group Inc. v. Commissioner* (1990) 58 T.C.M. (CCH) 1167 *action on decision*, 1991-03 (Feb. 11, 1991) also provides an interesting analysis of the passage of title rule. In *Liggett Group Inc.*, the court held that sales from a United Kingdom (UK) liquor manufacturer to a US distributor, followed by the immediate resale by the distributor to its US customers, produced foreign-source income to the distributor. The distributor never had physical possession of the product it sold to the US customers. Instead, the manufacturer shipped goods directly to the US customer FOB a designated ship located in the UK. The US customer bore the freight charges as well as any risk of loss or damage to the product during transit under the shipping contract. The UK manufacturer sent its invoice for the goods to the distributor and the distributor acquired and disposed of title to the goods at issue only momentarily. However, the court held that the transaction was sufficient to transfer rights, title and interest to the goods. Thus, it constituted a sale in the British Isles. Although the IRS did not appeal this decision, it did issue an Action on Decision, indicating that it did not acquiesce to the decision.

C. Income From Partly Within and Partly Without the US

While income derived from the sale of inventory is generally considered derived entirely in the country in which the property is sold, IRC §863(b) treats the following income from the sale or exchange of inventory property as derived partly from sources within and partly from sources without the US, inventory:

- Produced by the taxpayer within the US and sold outside the US
- Produced by the taxpayer outside the US and sold within the US (as opposed to inventory purchased by the taxpayer for resale)
- Purchased within a possession and sold within the US

Treasury adopted IRC §863 that provide the rules to source inventory income partly from within and partly from without the US. Due to changes made to the regulations, these rules differ for tax years beginning before and after December 30, 1996. In addition, effective for taxable years beginning on or after November 13, 1998, a set of new rules applies to income partly from sources within a possession of the US.

As a practical matter, these rules are aimed at determining the division between domestic and foreign source income from the sale of inventory by a US manufacturer. A foreign corporation will rarely be subject to these rules. The office-source rule attributes rules pertain to sales by a foreign corporation through a US office wholly to the US. In other words, the IRC precludes foreign persons from using the partly within and without rules to split income derived from the production and sale of inventory between the country of production and the country of sale if such sales are attributable to a US office.

Even if the sales are not attributable to a US office, it is unlikely that the within and without rule would ever be applied to a foreign corporation. A foreign-based manufacturer can easily arrange its transactions so that it does not have income partly from within and partly from without the US (i.e., it will sell its goods FOB shipping point so that title passes outside the US). If the transaction is structured properly (title to the inventory transfers offshore), the foreign manufacturer will not have inventory produced within a foreign country, and sold within the US. Accordingly, the foreign corporation would not be subject to these rules. Furthermore, a foreign corporation rarely manufactures inventory in the US, and sells it outside the US. To the extent foreign-based corporations engage in manufacturing in the US, they typically do so through US subsidiaries, and the inventory is usually sold to customers in the US.

Since the federal sourcing rules are generally relevant for California purposes only to the extent they are used to determine the US income of a foreign corporation, the special rules regarding income from inventory sales, which are considered to be from sources partly within and partly without the US, have limited application for California purposes.

Production/Manufacturing Activities. House Resolution 1 (H.R. 1), also referred to as the Tax Cuts and Jobs Act of 2017 (TCJA), amended IRC §863(b) to establish the source of income from sales of inventory to be determined solely on basis of production activities. For taxable years beginning prior to January 1, 2018, the federal rules use a mixed sourcing rule. In general, it sources 50 percent where inventory is produced and 50 percent where inventory is sold. For taxable years beginning after December 31, 2017, the new rule assigns receipts solely on production activities, where production takes place. IRC §863(b), as amended by the TCJA, will apply for California in the computation of ECI to be incuded in the water's-edge combined report (R&TC §25116).

2. Depreciable Personal Property

The rules regarding the source of income from the sale of depreciable personal property reflect a form of recapture. Gain, to the extent of depreciation allowed or allowable, is allocated within and without the US, based on the source of the depreciation deductions. Thus, such gain is allocated to US sources based on the ratio of US depreciation allowed or allowable with respect to the property to the total depreciation allowed or allowable. The remaining portion is sourced outside the US. For these purposes, depreciation includes all depreciation reflected in the adjusted basis of such property or other property (as in instances of carryover basis, such as tax-free exchanges) whether allowed to the taxpayer or to any other person. The term depreciation includes depreciation, amortization, or any other deduction allowable under any provision of the IRC, which treats an otherwise capital expenditure as a deductible expense. Any gain in excess of the amount of allowed or allowable depreciation deductions is sourced as if the property were inventory property. (IRC §865(c).)

Example

> Lucky Charters, a Bermuda corporation, owns a schooner that travels between the US and Bermuda. Lucky purchased the ship for $10 million and has claimed $3 million in depreciation, of which $1 million was depreciation claimed on its US tax return. Lucky sold the ship in Bermuda for $11 million. Of the $4 million gain, $1 million is US sourced [($1 million/$3 million) x $3 million.] The remaining $2 million gain attributable to depreciation claimed is foreign sourced, and the $1 million gain in excess of the depreciation is sourced in Bermuda, the place where title passed.

An exception to the above rules is provided for sales by a nonresident alien or a foreign corporation when the sales are attributable to its US office or fixed place of business. See the discussion in WEM 5.4(g)(4).

3. Intangible Personal Property

The source of income from the sale, exchange, or other disposition of intangible personal property depends on a number of factors. For these purposes, IRC §865(d)(2) defines intangible property as any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise or other similar property.

If the payments for the intangible property are contingent upon the sale, productivity, or use of the property, the payments are treated as royalties. Thus, such income would be sourced at the place where the property is used or usable. If the payments are not contingent on the productivity or use of the property, then the following rules apply:

- Gain, to the extent of amortization claimed, will be sourced in the same manner as the gain from the sale of depreciable personal property.

- The general residence of the seller rule applies to any gain in excess of amortization claimed. This is in contrast to the passage of title rule, which applies to the gain in excess of depreciation claimed on tangible personal property.

Separate rules exist to source intangible income from the sale of goodwill. IRC §865(d)(3) specifically provides that payments received for the sale of goodwill are sourced to the country in which such goodwill was generated. The statute, however, provides no guidance on how to determine where goodwill was generated. Additionally, under IRC §865(h)(2)(A), any gain from the sale of intangible property, which would be sourced to the US under the provisions of the IRC, but which is foreign sourced under a tax treaty, may at the election of the taxpayer be sourced outside the US.

Any gain from the liquidation of a corporation organized in a US possession, which generated more than 50 percent of its gross income for the preceding three-year period was received from the active conduct of a trade or business in the possession, is also considered foreign source income.

An exception to the above rules is provided for sales attributable to an office or fixed place of business.

4. Sales through an Office or Fixed Place of Business in the US

Special rules are provided for personal property sold through an office or fixed place of business in the US. Under IRC §865(e)(2), if a nonresident maintains an office or fixed place of business in the US, income from any sale of personal property attributable to such office is sourced in the US, regardless of where title passes. This rule does not apply to inventory sold for use or consumption outside the US, if an office of the taxpayer in a foreign country materially participated in the sale.

For purposes of sourcing such income, an office or other fixed place of business of an agent is disregarded, unless the agent meets both of the following conditions:

- Has the authority to negotiate and conclude contracts on behalf of the taxpayer and regularly exercises that authority or has a stock of merchandise from which he regularly fills orders on behalf of the taxpayer.

- Is not a general commission agent, broker, or other independent agent acting in the ordinary course of his business.

Income is attributable to that office only if the office is a material factor in the realization of the income and the income is realized in the ordinary course of the business carried on through that office. The activities are not considered to be a material factor unless they are an essential economic element in the realization of the income. Thus, for example, meetings in the US of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income.

Example

> Bernard Corporation manufactures industrial electrical generators in a foreign country. The generators require specialized installation and periodic maintenance, which only Bernard can provide. Bernard has an office in the US through which it sells generators for use in the US. The US office also provide for installation by the employees of the US office. In effect, the US office participates materially in the sales. Title to the generators sold through the US office passes outside the US. Accordingly, the sales made by the US office are US-source income even though title to the goods passed outside the US.

Example

> Bernard Corporation manufactures industrial electrical generators in a foreign country. The generators require specialized installation and periodic maintenance, which only Bernard can provide. Bernard has an office in the US through which it sells generators for use in other foreign countries (outside the US) under contracts, which provide for installation by the employees of the US office. Title to the generators sold through the US office passes outside the US. No other foreign office of Bernard participates materially in these sales. Accordingly, the sales made by the US office are US-source income even though title to the goods passed outside the US.

Example

> Same as Example above, except that the sale contracts provide that the installation and maintenance will be performed by Bernard's office in foreign country N. Since the inventory is sold for use outside the US and an office of Bernard performs significant services incident to the sales, which are necessary for their consummation, the income is foreign sourced even though the US office participates in the sale.

There are also special rules for US residents that maintain an office or fixed place of business in a foreign country. In general, income from sales of personal property attributable to such office is sourced outside the US if an income tax equal to at least 10 percent is actually paid on that income to a foreign country. A US resident is any individual who has a tax home in the US and any domestic corporation, trust or estate. Thus, a foreign corporation is not a US resident for purposes of these rules, regardless of how actively it is engaged in a US trade or business.

h. Transportation

IRC §863(c)(3) defines transportation income as any income earned in connection with the use, or hiring or leasing for use, of a vessel or aircraft as well as income from the performance of services directly related to the use of a vessel or aircraft. The term vessel or aircraft includes any container used in connection with a vessel or aircraft. The operation of a vessel on the high seas to transport cargo would be considered transportation income rather than income from ocean activities. If a trip begins and ends in the US, all transportation income is US-source income regardless of whether the freight is carried within or without the three-mile limit. Thus, if a vessel loads cargo in Alameda, California, and travels to Anchorage, Alaska, outside the three-mile limit, all income earned on the voyage is US-source income.

Income from transportation services carried on between points in the US and points outside the US is sourced partly within and partly without the US. In general, 50 percent of all transportation income (except personal services income related to the transportation income as discussed below) is considered US-source income if the trip begins in the US and ends in a foreign country or vice versa. For example, if a vessel loads cargo in Japan and travels to Long Beach, California, 50 percent of the income earned on the voyage is US-source income.

The personal services portion of transportation income is, with one exception, not subject to the 50 percent rule. The personal services portion is generally sourced where the services are performed. However, personal services income attributable to transportation, which begins in the US and ends in a possession of the US, or begins in a possession of the US and ends in the US, is subject to the 50 percent rule.

i. International Communications

IRC §863(e) provides the source rules and definition of the international communications income. International communications income includes all income derived from the transmission of communications or data between the US and any foreign country. Income derived from the transmission of international telephone calls via satellite would be considered international communications income rather than income from space activities. In the case of a US person, 50 percent of the international communications income is sourced in the US and 50 percent is sourced outside the US. In the case of a foreign person, international communications income is generally foreign sourced. However, if a foreign person maintains an office or other fixed place of business in the US, any international communications income attributable to such office is sourced in the US.

j. Space and Certain Ocean Activities

Under IRC §863(d), the source of any income derived from a space or ocean activity depends on who is deriving the income. If the income is derived by a US person, then the income is sourced in the US. If the income is derived by a person other than a US person, then it is sourced outside the US.

The term space or ocean activity is defined as any activity conducted in space and any activity conducted in water not within the jurisdiction (as recognized by the US) of any country or possession. The term includes any activity conducted in Antarctica. The term does not include any activity giving rise to transportation income, or any activity giving rise to international communications income.

The operation of a vessel on the high seas to transport cargo would be considered transportation income rather than income from ocean activities. Similarly, income derived from the transmission of international telephone calls via satellite would be considered international communications income rather that income from space activities.

Space or ocean activity generally includes the performance of services in space or on the high seas, and the leasing of equipment, such as satellites or deep-sea diving bells for use on or beneath the ocean or in space. Deep-sea mining outside the jurisdiction of any country is an example of ocean activity, as is the licensing of technology for use on or beneath the ocean or in space.

k. Natural Resources

Income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, is sourced within and without the US in the same manner as inventory produced within the US and sold outside the US, or inventory produced in a foreign country and sold within the US.

1. Taxable Years Beginning Prior To January 1, 1997

In *Phillips Petroleum Co. v. Commissioner* (1991) 97 T.C. 30, affd. (10th Cir. 1995) 96-1 USTC 50006, the tax court held that Treas. Reg. §1.863-1(b)(1), which interpreted IRC §863(b), was invalid. This regulation had treated income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber located in the US differently than mixed-source income from the manufacture and sale of personal property. The regulation had provided that this income was "ordinarily" US-source income, regardless of whether the products are sold within or without the US. Conversely, income from the ownership or operation of such property located in a foreign country was sourced to the country where the property is located. The regulation did not treat income from cross-border natural resource transactions as mixed-source income.

The tax court held that Treas. Reg. §1.863-1(b)(1) was invalid because its general rule, which sourced all of the income to one location, was inconsistent with IRC §863(b), which provides for mixed-source income when cross-border transactions are involved. To the extent the regulation conflicted with the mixed-sourced income provisions of the statute, the regulation was held to be invalid. Having held that the income should be allocated within and without the US, it was uncontested that Treas. Reg. §1.863-3(b) governed the apportionment of mixed source income within and without the US.

2. Taxable Years Beginning After December 31, 1996

As a result of the decision in *Phillips Petroleum Co.,* new regulations were issued effective for taxable years beginning after December 31, 1996, to determine the source of income from natural resources. These rules are less favorable than the basic IRC §863(b) rules for inventory sales because they do not allow for the sourcing of all gross income under the 50/50 method. Rather, a priority allocation to the location of the natural resource is used based on the application of one of three methods.

A. Sourcing Income under the Export Terminal Rule

Under the export terminal rule, sales of natural resources are first allocated to the export terminal based on the fair market value of the natural resource immediately prior to export. The source of gross receipts equal to FMV of the product at the export terminal will be sourced to the location where the farm, mine, well, deposit, or uncut timber is located. The source of the excess of the sales price over the FMV of the natural resource at the export terminal depends on whether the taxpayer engages in further production activities.

If further production activities occur outside the US, the excess of the sales price over the FMV of the product at the export terminal is then sourced using, either the 50/50 method, the Independent Factory Price (IFP) method, or the Books and Records method. (For examples of the methods, see Treas. Reg. §1.863-3(b)(1) for the 50/50 method; Treas. Reg. §1.863-3(b)(2) for the IFP method; and Treas. Reg. §1.863-3(b)(3) for the Books and Records method.)

If no further production activities are undertaken, the excess of the sales price over the value at the export terminal is sourced to the country where the sale takes place.

If further production activities take place in the country where the natural resources are located, the excess of the sales price over the FMV of the product, immediately prior to additional production, is sourced using either the 50/50 method, the IFP method, or the Books and Records method. The FMV of the product at the point where additional production takes place is still sourced to the location where the farm, mine, well, deposit, or uncut timber is located.

If the 50/50 method is used, only productions assets used in the additional production activities are taken into account. Furthermore, only production activities conducted directly by the taxpayer are considered.

B. Sourcing Expenses under the Export Terminal Rule

Expenses related to income from natural resources are allocated and apportioned using the rules under Treas. Reg. §§1.861-8 through 1.861-14T. Accordingly, expenses incurred up to the point of the export terminal would be allocated to the receipts sourced to the location where they were farmed, mined, deposited, cut or drilled based on the export terminal rule. The excess of the FMV over the export terminal value would be allocated expenses under the more traditional sourcing rules under Treas. Reg. §§1.861-8 through 1.861-14T.

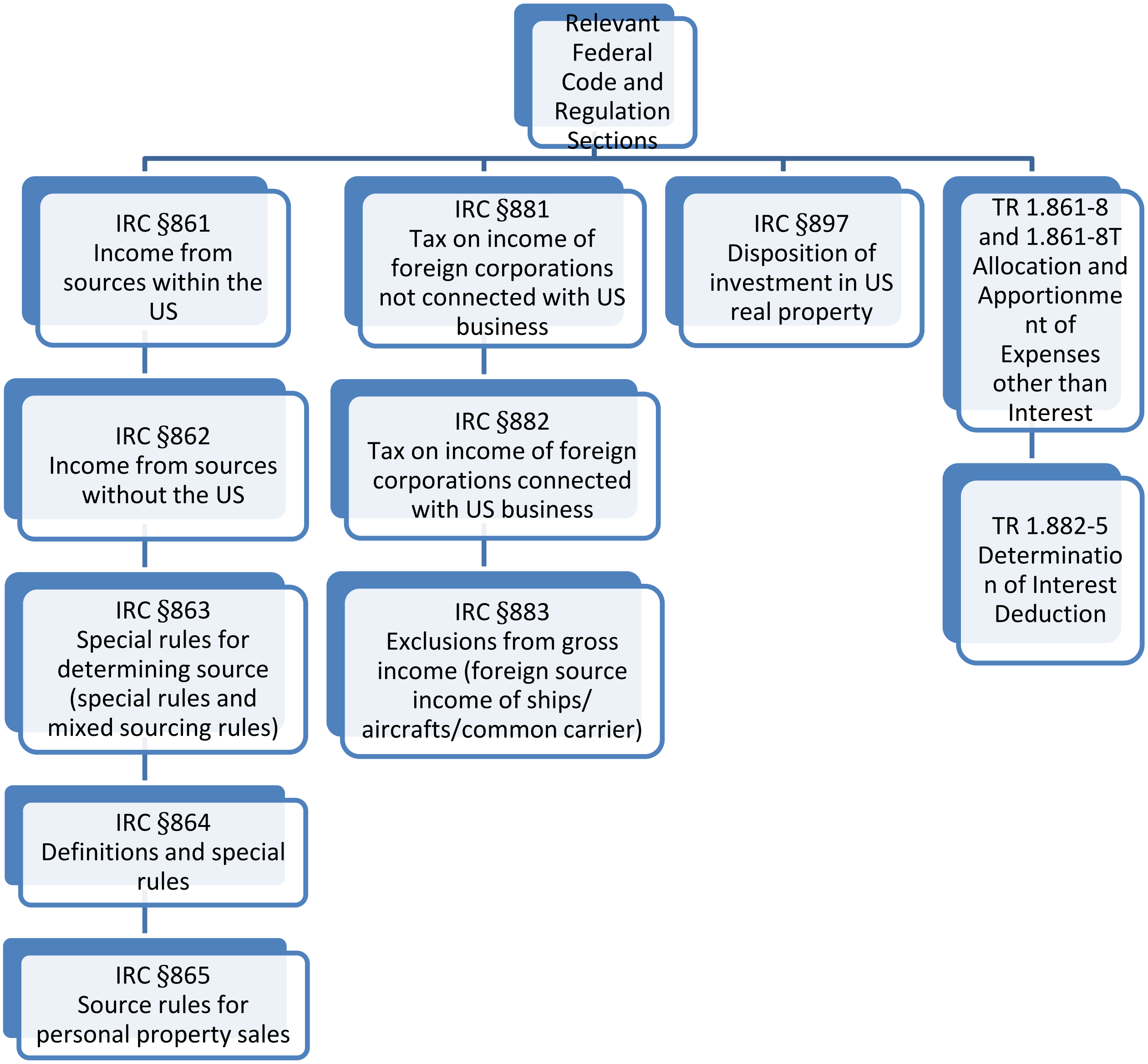
C. Tax Return Disclosure

Effective for taxable years beginning on or after January 1, 1997, taxpayers are required to attach a statement to their return disclosing the methodology used to determine the FMV of the natural resource at the export terminal, and to explain any additional production activities performed by the taxpayer. This is in addition to any other information that the taxpayer is required to provide under Treas. Reg. §1.863-3.

3. Definitions

IRC §638 provides that, for purposes of applying IRC §§861(a)(3) and 862(a)(3), in the case of the performance of personal services with respect to mines, oil and gas wells, and other natural deposits, the term “United States” includes the seabed and subsoil adjacent to the US territorial waters. Thus, for example, drilling operations conducted on the US continental shelf would be considered located in the US.

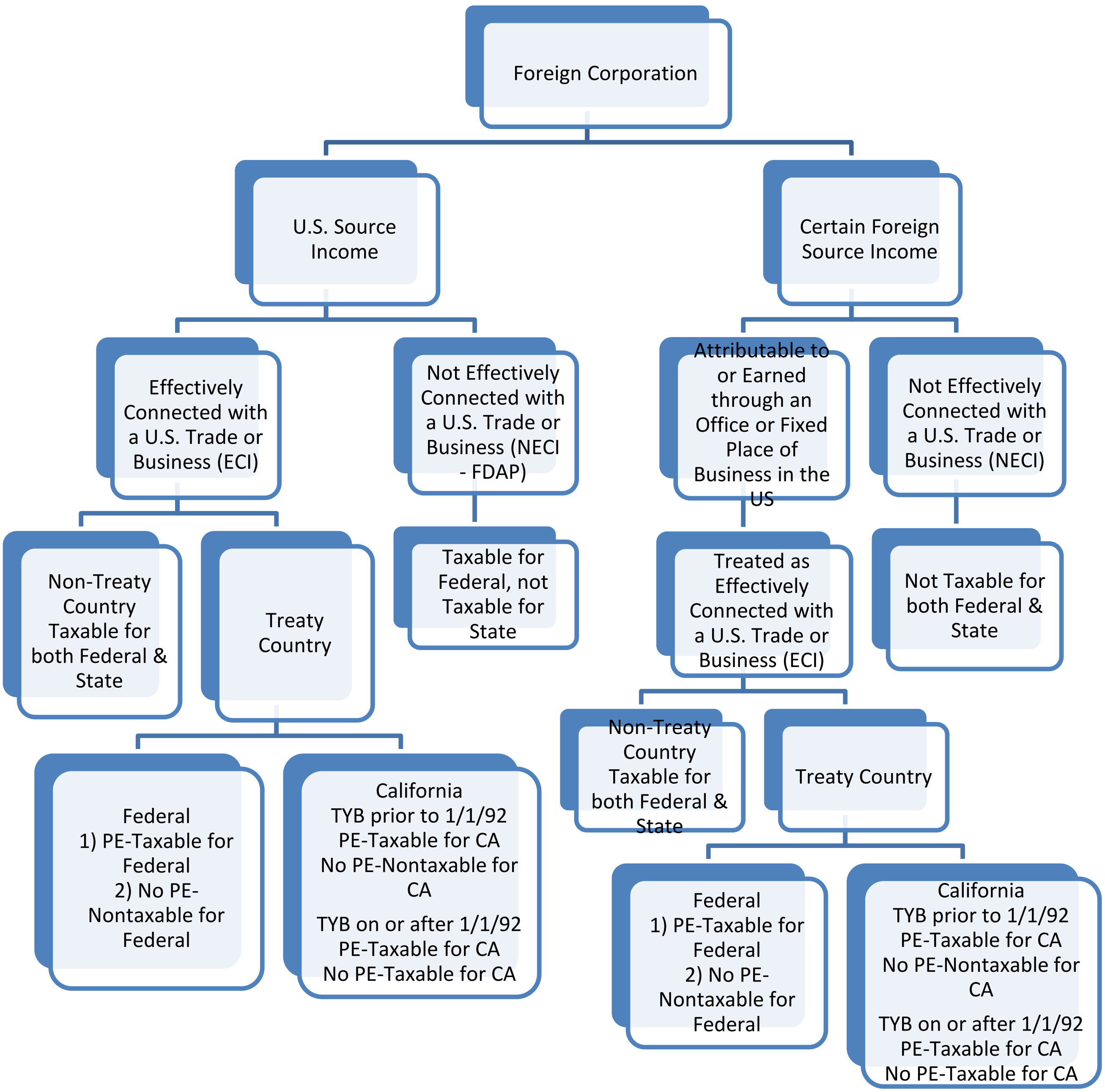
FLOW CHART – RELEVANT FEDERAL CODE AND REGULATION SECTIONS



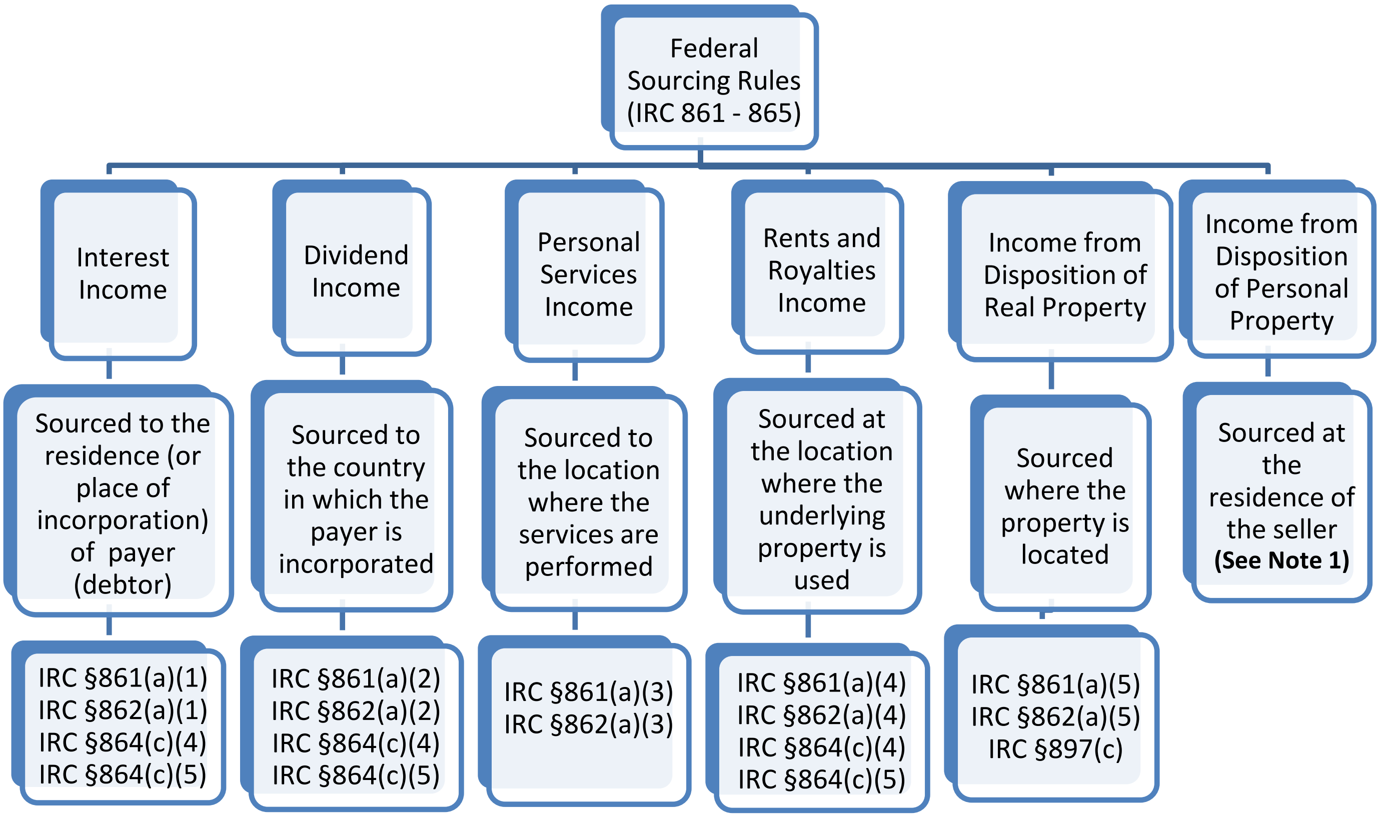
IRC §863 special rules are in reference to transportation income, space or ocean activities, and international communications income.

IRC §864 defines terms (i.e., US trade or business, ECI, office or fixed place of business in the US, etc.) and addresses the special rules for certain foreign source income (i.e., interest, dividends, royalties, and sales of personal property) that is treated as effectively connected with a US trade or business if it is attributable to or earned through an office or fixed place of business in the US.

FLOWCHART - U.S. VERSUS FOREIGN SOURCE ECI AND NECI



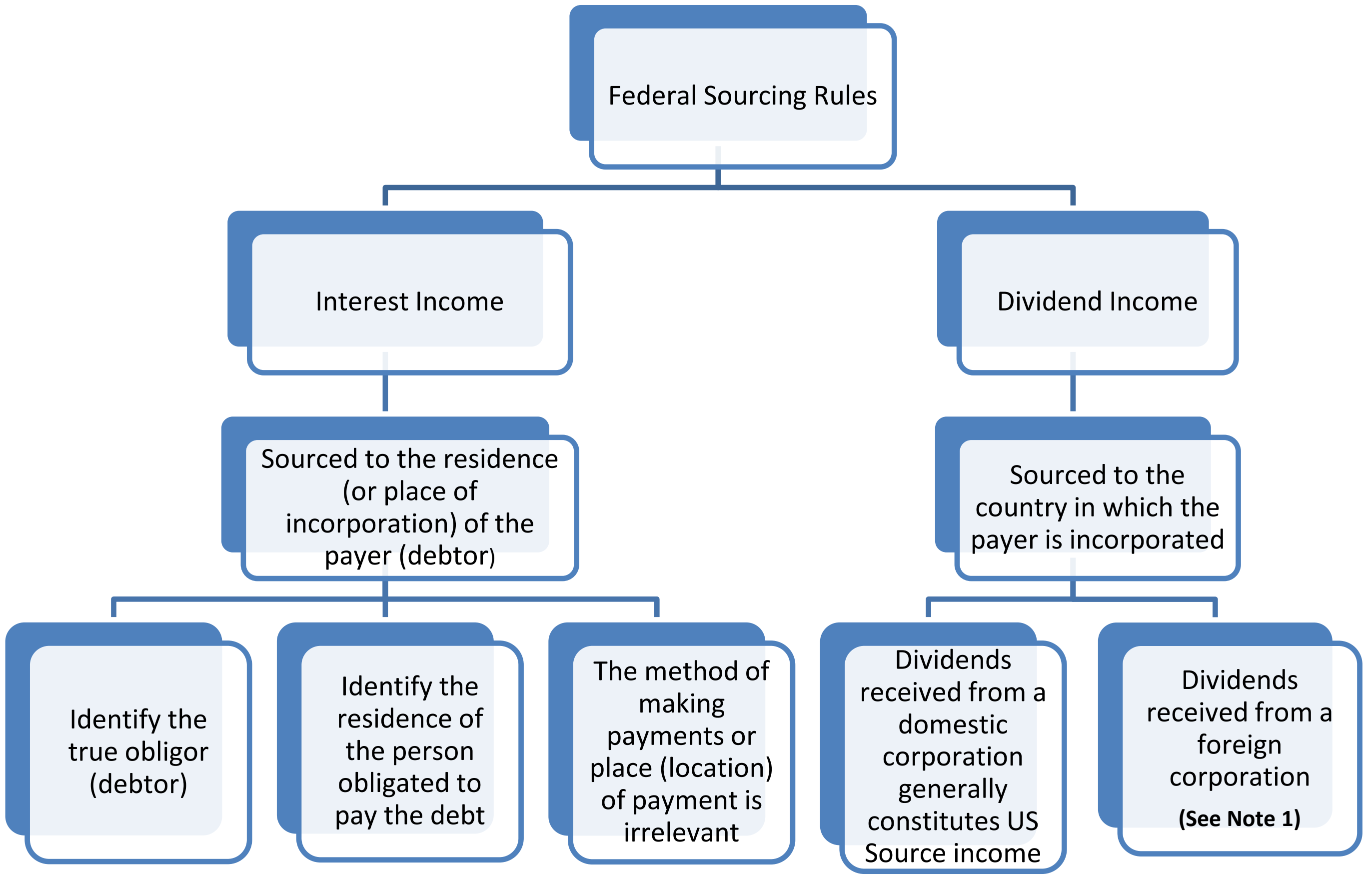
FLOW CHART – APPLICATION OF FEDERAL SOURCING RULES
GENERAL RULES



Note 1:
Keep in mind that the general rule of sourcing income from the disposition of personal property at the residence of the seller is really the exception.

Income from Sale of Personal Property:
IRC §861(a)(6)
IRC §862(a)(6)
IRC §863(b)(2) and IRC § 863(b)(3)
IRC §864(c)(4) and IRC §864(c)(5)
IRC §865(a) thru IRC §865(e)

FLOW CHART – APPLICATION OF FEDERAL SOURCING RULES
INCOME FROM INTEREST AND DIVIDENDS



General rule - Interest income: Interest Income is sourced to the residence (or place of incorporation) of the payer (debtor). The general rule provides that interest from the US or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of non-corporate residents or domestic corporations are US-source income. Treas. Reg. §1.861-2(a)(1) provides that interest from any agency or instrumentality of the US (other than a US possession), and any state or political subdivision of such state also constitute US source income. (IRC §861(a)(1) and §862(a)(1).)

Exception to the general rule for interest income: Interest paid on deposits with a foreign branch of a domestic corporation or partnership is considered foreign-source income if the branch is engaged in the commercial banking business at the time the interest is paid. IRC §861(a)(1)(A).

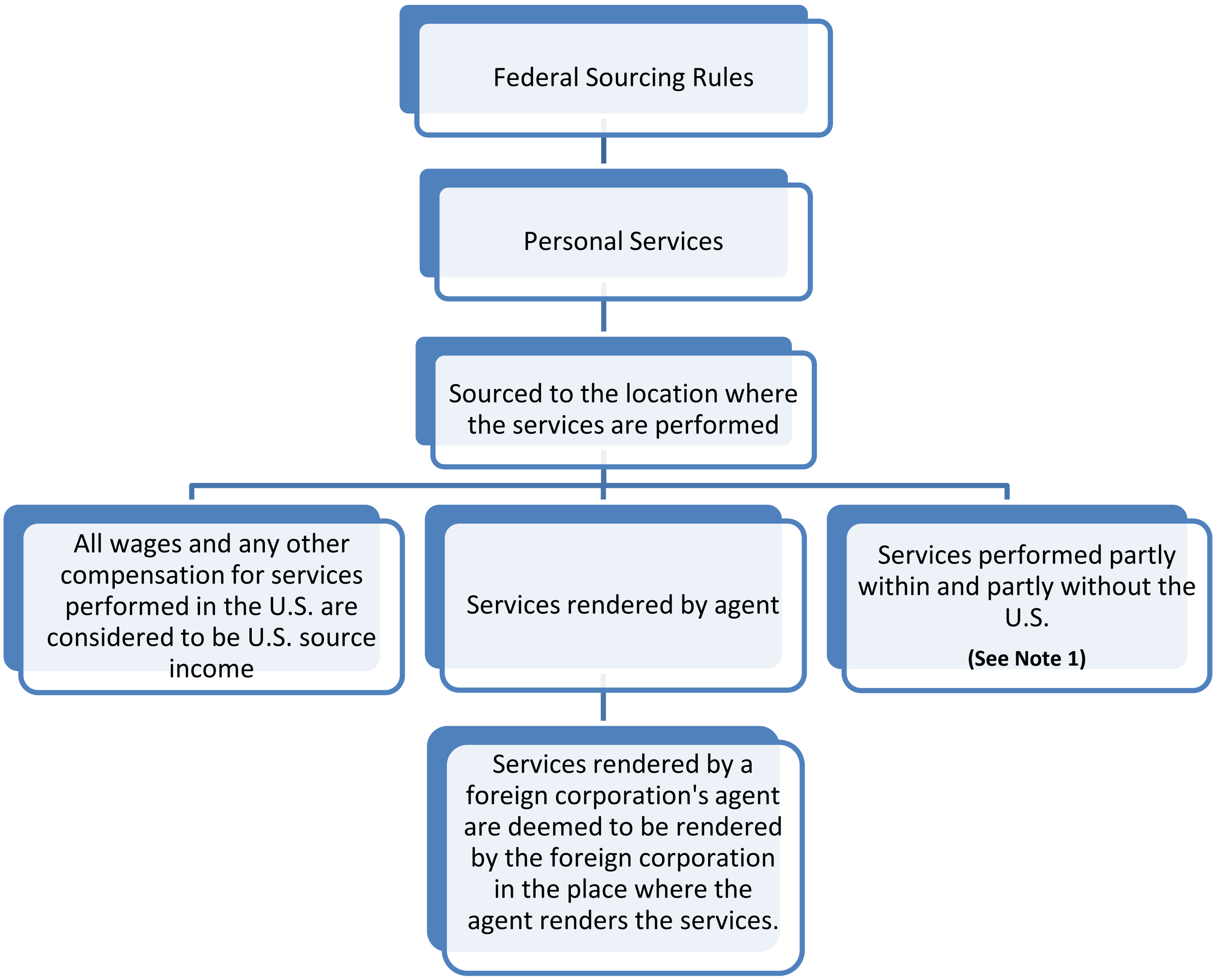
General rule - Dividend income: Dividend income is sourced to the country in which the payer is incorporated. To qualify as “dividend income” the distribution cannot exceed the total of accumulated and current-year earnings and profits (E&P). Distributions in excess of E&P are treated as a return of capital with any excess being treated as capital gain income. (IRC §861(a)(2) and §862(a)(2).)

Note 1: The taxpayer will apply one of two rules if the dividend is received from a foreign corporation:

1. None of the dividends paid by a foreign corporation are considered US-source income if less than 25% of the corporation's gross income from all sources for the three-year period prior to the dividend declaration is from income effectively connected with a US trade or business.

2. If 25% or more of the foreign corporation's gross income for the three-year period prior to the dividend declaration is from income effectively connected with a US trade or business, then a portion of the dividend is deemed to be from US sources. The deemed US-source dividend is equal to the proportion of the corporation's income effectively connected with the US trade or business to gross income from all sources.

FLOW CHART – APPLICATION OF FEDERAL SOURCING RULES INCOME FROM PERSONAL SERVICES



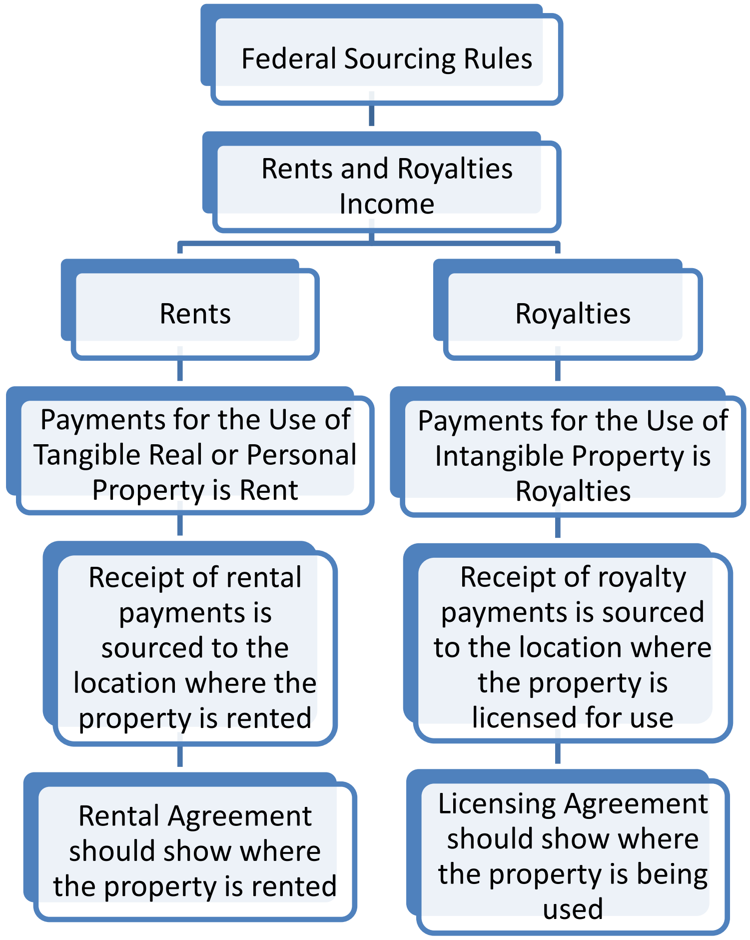
General rule - Personal services income: Generally, compensation for labor or personal services is sourced at the place where the services are performed. The place or time of payment, the residence of the payer, or the place where the contract was made is irrelevant in determining the source of the compensation. (IRC §861(a)(3) and §862(a)(3).)

Note 1: Services performed partly within and partly without the U.S.

- If services are performed partly within and partly without the US and a specific amount is paid for the services performed within the US, then the amount specified as paid for the services performed in the US is considered US-source income.

- If a lump sum payment is made for services performed partly within and partly without the US, and there is no specific agreement as to the amount of pay attributable to the US, then a reasonable method based on the facts and circumstances of the case should be used to source the income from personal services. An allocation based on time (time-basis rule) is reasonable, but other methods of allocation are acceptable as long as it does not distort income.

FLOW CHART – APPLICATION OF FEDERAL SOURCING RULES RENTS & ROYALTIES INCOME

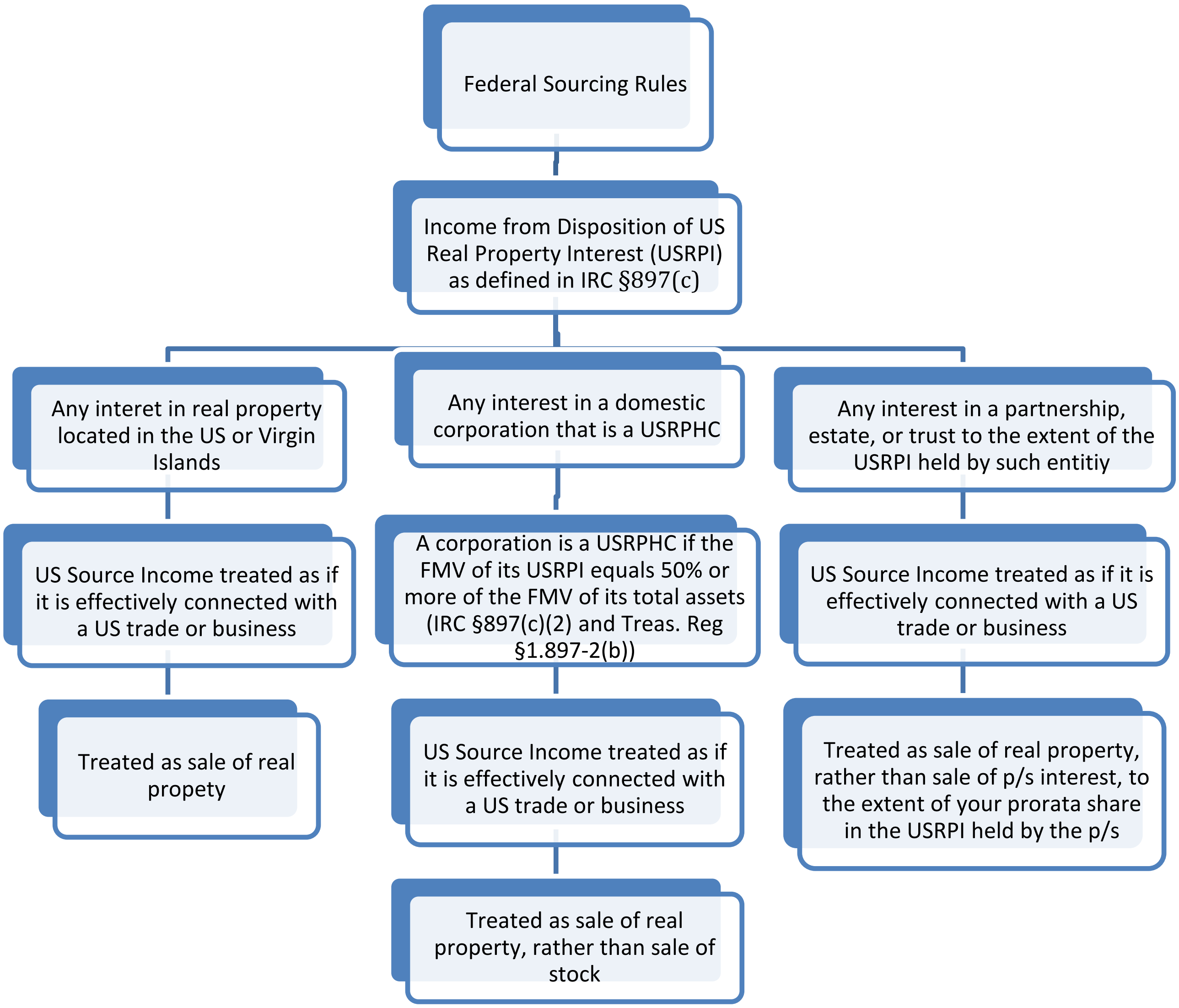


General rule - Rents and royalties income: Income received for the use or privilege of using tangible or intangible property is sourced at the location where the property is used or usable. This rule applies to all types of real and tangible personal property, and to intangible property, including patents, copyrights, secret processes and formulas, goodwill, trademarks, franchises and other similar property. (IRC §861(a)(4) and §862(a)(4).)

A foreign corporation, which derives income from US real estate, but is not engaged in sufficient activities to be considered engaged in a US trade or business, may elect to treat US real property income as effectively connected with a US trade or business under IRC §882(d). The election will apply to all income derived from the passive holding of real property located in the US. If this election is not made, the question of when the rental of US real estate is a trade or business is an examination issue. Recently, the courts have generally looked to the level of the taxpayer's activity and whether the taxpayer is actively involved with the real estate investment. Rental income with little activity, such as a triple net lease, would not generally be considered a US trade or business. As a practical matter, most corporations will have an IRC §882(d) election in effect to treat income from real property as income effectively connected with a US trade or business (ECI) to obtain the benefit of deductions, e.g., depreciation, interest, property taxes, etc.

A foreign corporation's foreign source income from rents or royalties is treated as effectively connected with a US trade or business if such income is attributable to or earned through an office or fixed place of business in the US. Such income is foreign source ECI wholly assigned to the US. This rule does not apply to rents or royalties paid for the use of, or the privilege of using, real property or tangible personal property located outside the US (IRC §864(c)(4)(B)(i), IRC §864(c)(5), Treas. Reg. §1.864-5(b)(1)(i), and Treas. Reg. §1.864-5(b)(1)(iv)).

FLOW CHART – APPLICATION OF FEDERAL SOURCING RULES INCOME FROM DISPOSTION OF REAL PROPERTY



USRPI = US Real Property Interest
USRPHC = US Real Property Holding Corporation

Gain or (loss) from the sale or other disposition of real property interest is sourced to the location of the underlying property *(IRC §861(a)(5), §862(a)(5), & Reg. §1.861-6)*. Gain or (loss) from the sale or other disposition of US Real Property Interest (USRPI):

- Is US Source Income (IRC §861(a)(5))
- Is treated as if it is effectively connected with a US trade or business, regardless of whether it actually is (IRC §897(a))
- Is treated as a sale of real property rather than a sale of stock

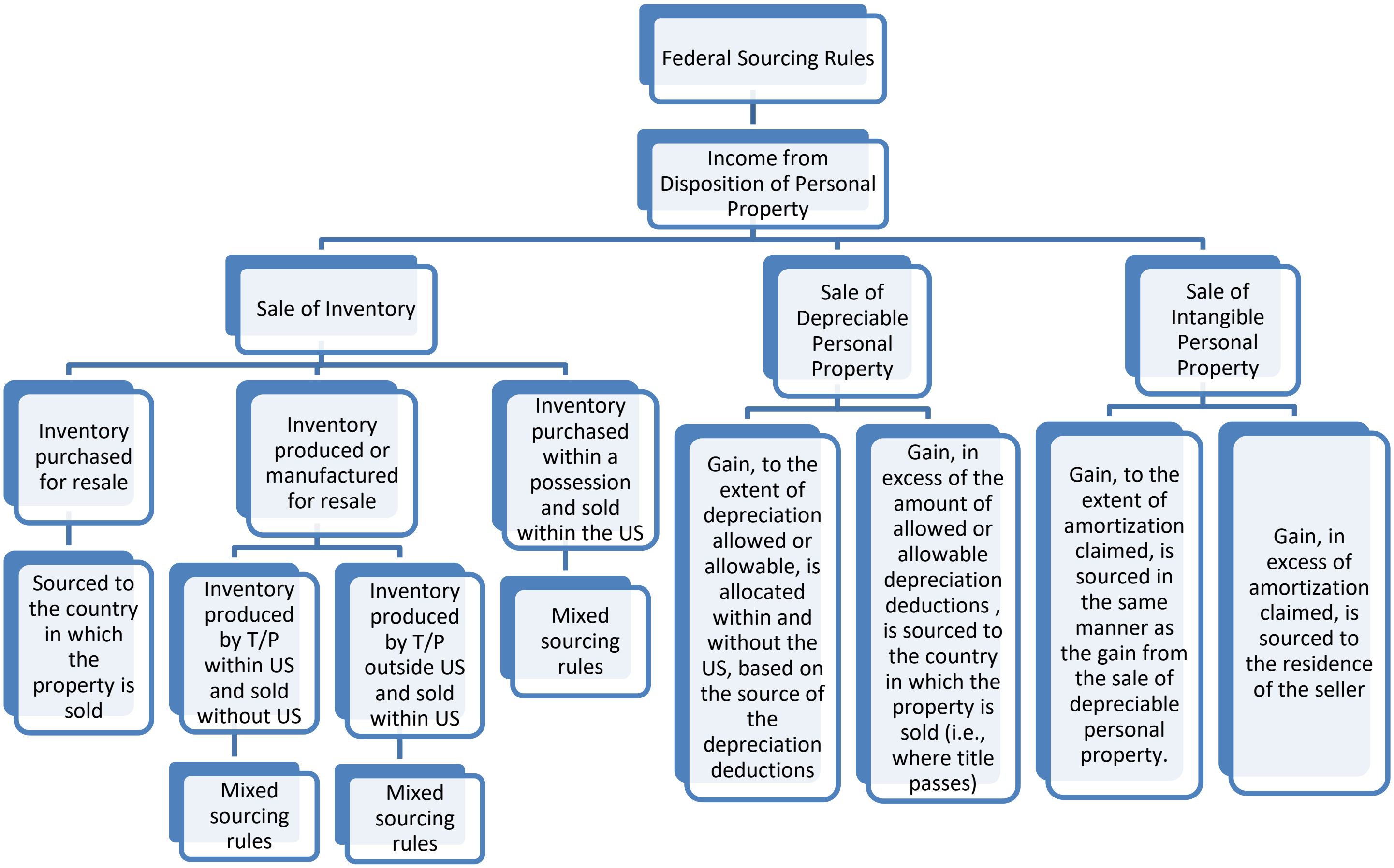
Thus, a foreign corporation is taxed on such income pursuant to IRC §882 as US source ECI.

Exceptions to USRPI:

- Domestically controlled REIT(less than 50% owned by foreign persons)
- Publically traded corporation or partnership that is 5% or less owned.

Important Note: California does not conform to IRC §897(a) in treating the source of such income as deemed ECI.

FLOWCHART – APPLICATION OF FEDERAL SOURCING RULES INCOME FROM DISPOSTION OF PERSONAL PROPERTY



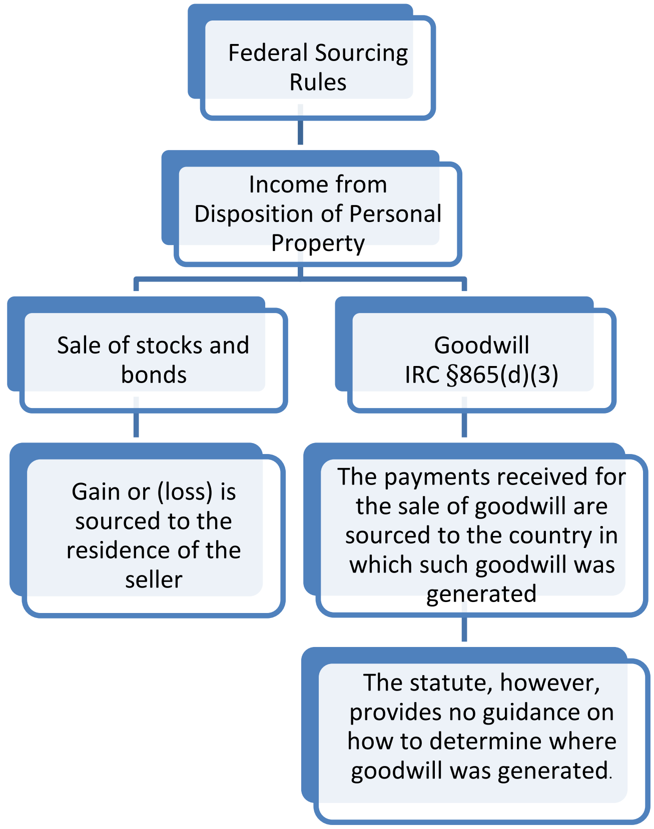
General rule: Income from the sale of personal property is sourced at the residence of the seller (IRC §865(a)). Although the seller's residence is the general rule for sourcing sales of personal property, there are only few situations where the general rule actually applies. Most income derived from the sale of personal property is sourced according to one of the exceptions to the general rule. The principal types of property excepted from the general rule are inventory, depreciable personal property, and intangible personal property. In reference to this flowchart, gains from the sale or exchange of intangible personal property refer to intangible personal property subject to amortization such as patents, copyrights, secret processes and formulas, trademarks, trade brands, franchises, and other like property. (IRC §861(a)(6), IRC §862(a)(6), & IRC §865(a) thru §865(d).)

Inventory purchased for resale: If a taxpayer purchases inventory outside the US and sells it within the US, the profit is US-source income. Similarly, if a taxpayer purchases inventory within the US and sells it outside the US, the profit is considered foreign-source income. Treas. Reg. §1.861-7(c) provides that a sale of inventory occurs at the time and place where the seller's rights, title, and interest in the property are transferred to the buyer. This rule is referred to as the "passage of title" rule. Other factors of the transaction, such as the place of negotiations and execution of the agreement, the location of the property, place of payment, etc. is irrelevant.

Inventory produced or manufactured for resale: IRC §863(b) treats the income from the sale or exchange of inventory produced or manufactured for resale as derived from sources partly within and partly without the US (i.e., mixed sourcing rules). The 50/50 split method applies unless another method is elected. Once an allocation method is used, the method must be used in later tax years unless IRS consents to a change.

A foreign corporation's foreign source income from the sale of personal property (i.e., inventory, tangible personal property, and intangible personal property) is treated as effectively connected with a US trade or business if such income is attributable to or earned through an office or fixed place of business in the US. Such income is foreign source ECI wholly assigned to the US. This rule does not apply to inventory sold for use or consumption outside the US, If an office of the taxpayer in a foreign country materially participated in the sale ((IRC §864(c)(4)(B), IRC §864(c)(5), IRC §865(e)(2), Treas. Reg. §1.864-5(b)(1)(ii), & Treas. Reg. §1.864-5(b)(3)).

FLOW CHART – APPLICATION OF FEDERAL SOURCING RULES INCOME FROM DISPOSTION OF PERSONAL PROPERTY



Exception to the general rule for sale of stocks and bonds (IRC §865(f)): If a U.S. resident (i.e., U.S. citizen or resident alien or domestic corporation, estate, or trust) sells the stock of an affiliated foreign corporation, the gain is foreign source if:

- The foreign corporation is an affiliate of the seller within the meaning of IRC §1504(a) (i.e., the seller owns 80% of the stock of the affiliate);
- The sale occurs in a foreign country in which the affiliate is engaged in the active conduct of a trade or business; and
- The foreign affiliate has derived more than 50% of its gross income during the three-year period preceding the sale from conducting such business in the foreign country.

A foreign corporation's foreign source income from dividends, interest, or gains or (losses) from sales of stocks or securities, derived in the active conduct of banking, financing, or similar business within the U.S., or received by a corporation whose principal business is trading in stocks or securities for its own account is treated as effectively connected with a US trade or business if such income is attributable to or earned through an office or fixed place of business in the U.S. Such income is foreign source

ECI wholly assigned to the U.S. (IRC §864(c)(4)(B)(ii) and Treas. Reg. §1.864-5(b)(2)).

- Exception: Foreign source interest, dividends, or royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the stock are not treated as ECI; or 2) Foreign source income that is Subpart F income within the meaning of IRC §952(a) is not treated as ECI. (IRC §864(c)(4)(D).)

5.5 Effectively Connected Income (ECI)

Contents:

a. Trade or Business Defined

Once it has been determined that a foreign corporation has US-source income, it must be determined whether the foreign corporation has a trade or business in the US to be taxed under IRC §882(a). This determination drives how the US source income is taxed. Federal net income effectively connected with a US trade or business is subject to the same progressive tax rates as a domestic corporation. Gross noneffectively connected income (NECI) is subject to a flat 30 percent US withholding tax (or a lower tax treaty rate if applicable).

IRC §864(b) provides that a trade or business within the US includes the performance of personal services within the US at any time during the year, but excludes the following activities:

1. Performance of personal services for a foreign employer by a nonresident alien individual temporarily in the US for not more than 90 days during the year. This rule applies only if the individual's compensation for such services does not exceed $3,000.

2. Trading in stocks, securities or commodities, regardless of who effects the transactions (the taxpayer or an independent broker, agent, custodian or commission agent). In other words, an investor or dealer in stock, securities or commodities generally is not considered to be engaged in a US trade or business regardless of the amount and scope of trading involved.

   To be excluded, Treas. Reg. §1.864-2(c) provides that one of the following conditions must be met:

   A. Trading in stocks and securities through an *independent* US broker is excluded, *unless* the foreign corporation maintains a

US office through which, or by the direction of which, trades are affected.

B. Trading for the foreign corporation's own account is excluded whether the trading is done by the foreign corporation or through an agent, *unless* the foreign corporation is:

   i. A dealer in securities.

   ii. A foreign corporation whose principal business is trading in securities for its own account, if the foreign corporation's principal office is in the US.

Treas. Reg. §1.864-2(c)(2)(iii) provides guidelines for determining whether a foreign corporation's principal office is in the US. Generally, the activities (other than trading in stocks or securities) of the US office are compared with those of the foreign office. If the corporation carries on most of its investment activities in the US, but maintains its general business office in a foreign country, then it will not usually be treated as engaged in a US trade or business.

Neither the IRC nor the Treas. Reg. provides guidance on what constitutes a "trade or business," and court cases in this area are limited. *InverWorld Inc. et al., v. Commissioner* (1996) TC Memo 1996-301; Supplemental Memorandum Opinion, (1997) TC Memo 1997-226, is one of the most detailed US Tax Court decision issued discussing whether a foreign corporation is engaged in a US trade or business. In this case, the tax court determined that the taxpayer, a foreign corporation, was conducting a US trade or business through the activities of its subsidiary. The subsidiary had an office in San Antonio, Texas, and was conducting various administrative, investment, and trading functions in the US on the taxpayer's behalf. The court determined that the subsidiary was acting as the taxpayer's dependent agent, and the activities and office of the subsidiary in the US were attributed to the taxpayer since the agent had the authority to negotiate and conclude contracts in the name of the taxpayer. In addition, it regularly exercised that authority.

Once it was determined that the taxpayer had an office or other fixed place of business in the US as a result of the attribution of the activities and office of the subsidiary to the taxpayer, the court then concluded that the taxpayer was conducting a US trade or business since the statutory exemptions for "trading through an independent broker" and "trading for the taxpayer's own account" did not apply.

The facts in this case made it difficult to argue with the conclusion that the subsidiary was acting as an agent of the parent, that the subsidiary was conducting significant business activities in the US on behalf of the parent, and thus, the parent was engaged in a US business.

As noted in WEM 5.3, the determination of what constitutes a US trade or business is a question of fact. The courts have held that substantial, regular, or continuous activities in the US are characteristics of a US trade or business. A foreign partner of a partnership engaged in a US trade or business will be considered engaged in a US trade or business as a result of the attribution of the partnership's activities to the partner.

It is important to note that the foreign corporation is considered engaged in a US trade or business for the entire taxable year if it is so engaged at any time during the taxable year. Below are several examples of whether or not a foreign corporation is conducting a US trade or business based on the treasury regulations and relevant court decisions.

Example

> Parker Corporation, a foreign corporation, purchases and sells household equipment through a sales office in the US. Guide Corporation is engaged in a trade or business in the US by virtue of its sales activity in the US.

Example

> ACME PLC, a United Kingdom (UK) corporation, opens an office in the US to promote sales of British goods. The US employees, consisting of salespersons and general clerks, are empowered only to run the office, to arrange for the appointment of distributing agents for merchandise offered by ACME, and to solicit orders. These employees do not have the authority to negotiate and conclude contracts for ACME, nor do they have a stock of merchandise from which to fill orders on ACME's behalf. Any negotiations entered into are under the instruction of the head office in the UK and subject to its approval as to any decision reached. The only independent authority the employees have is in the appointment of ACME's US distributors. However, the head office retains the right to approve or disapprove the selection of distributors.

ACME is engaged in a trade or business in the US. Regular and continuous activity by a foreign corporation's employees in pursuing the business of the foreign corporation constitutes a trade or business.

Example

Truckee SA, an Argentine corporation, purchased goods in the US for sale to customers in Argentina and negotiated the sale of goods to the Argentine customers in Argentina. Truckee has an employee in the US, who inspects the goods, solicits orders, makes purchases, and ensures that the goods are placed in warehouses and aboard ships. The corporation maintains a bank account in the US to provide funds for the employee to purchase goods and pay expenses. The employee has an office in the US where suppliers contact him and the address of the office is used on documents involved in the transactions. The goods are shipped free on board (FOB) New York. The customer pays all shipping expenses and makes its own marine insurance arrangements.

Truckee SA, is engaged in a US trade or business. The numerous and varied activities of the employee in the US on the corporation's behalf constitutes a trade or business. Since title to, and beneficial ownership of, the goods passed in New York, income from the sales to the Argentine customers is considered US-source ECI. (*United States v. Balanovski* (2nd Cir. 1956) 236 F.2d 298.)

It is not necessary that the foreign corporation itself be directly engaged in regular and continuous activity in the US for it to be considered engaged in a US trade or business. If an agent of the foreign corporation engages in activities that would have caused the corporation to be engaged in a US trade or business if it had performed them itself, then the foreign corporation is deemed to be engaged in a US trade or business as a result of the agent's activities on its behalf. (*Helvering v. Boekman* (1939) 107 F.2d 388; *The Taisei Fire and Marine Insurance Co. Ltd., v. Commissioner* (1995) 104 T.C. 535.)

Example

Shellit Co., a UK corporation, and Gadget Inc., a US corporation, enter into an agreement under which Shellit conveys to Gadget the sole agency for the sales of its products in the US. Gadget agrees not to sell the same kind of products for any other company without the express permission of Shellit. Gadget also agrees not to sell to any of Shellit's competitors and not to take a financial interest in any competitor. Gadget assumes the full responsibility for the sales of Shellit's products and acts as guarantor. However, Shellit agrees to share equally with Gadget any loss incurred up to a specified amount. Under the agreement, Gadget is to receive a commission based on a percentage of the selling price of the products.

This arrangement is one of an ordinary principal and agent relationship through which Shellit carries on its activities in the US, and Shellit is thus engaged in a US trade or business. (Revenue Ruling 70-424, 1970-2 C.B. 150.)

1. Election to Treat US Real Property as Effectively Connected With a US Trade or Business

A foreign corporation, which derives income from US real estate, but is not engaged in sufficient activities to be considered engaged in a US trade or business, may elect to treat US real property income as effectively connected with a US trade or business under IRC §882(d). Pursuant to Treas. Reg. §1.871-10, if this election is made, the income is taxable under IRC §882 even though the taxpayer is not engaged in a US trade of business. Once made, the election remains in effect for all subsequent years, and applies with respect to all income derived from the passive holding of real property located in the US, including rents or royalties from mines, wells, or other natural deposits. The election, may however, be revoked with the consent of the Commissioner with respect to any taxable year. The regulations provide more information on how to make or revoke such an election.

If this election is not made, the question of when the rental of US real estate is a trade or business is an examination issue. Recently, the courts have generally looked to the level of the taxpayer's activity and whether the taxpayer is actively involved with the real estate investment. Rental income with little activity, such as a triple net lease, would not generally be considered a US trade or business.

For both federal and state purposes, the question of whether income derived from US real property is connected with a US trade or business is important. For federal purposes, if the income is considered ECI, deductions such as interest, depreciation and taxes will be allowed against the income in determining the foreign corporation's tax liability at the same progressive rates paid by domestic corporations. If, the taxpayer does not elect to treat the income derived from US real property as ECI, and the activities are not sufficient to be considered a US trade or business, then the income will generally be considered NECI. It would be taxable for federal purposes on a gross basis at the 30 percent (or a lower tax treaty rate) withholding rate with no benefit of deductions from related expenses such as interest, property taxes or insurance.

For state purposes, income from US real property is included in the water's-edge combined report, net of expenses, if the property generates ECI. The income from US real property is excluded from the water's-edge combined report if it is NECI. Accordingly, it would make a difference for California purposes whether the taxpayer made an IRC §882(d) election to treat the income from the US real property as ECI.

2. Special Rules for ECI Characterization

Two special ECI rules are worthy of mention at this point:

- First, pursuant to IRC §864(c)(3), once it has been established that a foreign corporation is engaged in a US trade or business, all income from sources within the US (other than income, gain, or loss to which IRC §864(c)(2) applies) is treated as ECI. (See Treas. Reg. §§1.864-4(a) and (b) for a detailed explanation and examples of this rule.)

- Second, under IRC §864(c)(6), the deferral of taxation of ECI for tax purposes does not change the character of the income even if it is received in a year when the taxpayer is not engaged in a US trade or business. If any property ceases to be used or held for use in connection with the conduct of a US business and is disposed of within 10 years after cessation of such activities, the gain is treated as ECI. The removal of property from the US is a constructive sale at the time of removal if an actual sale occurs within 10 years. (IRC §864(c)(7).)

Example

Middleman Ltd., a UK corporation, is engaged in the business of buying and reselling high-performance sports cars in the US on the installment basis. Middleman has $12.5 million of net income from its US operations, of which $10 million is deferred under the installment method. At year-end, Middleman ceases its US

> operations. In the current year, Middleman receives net income of $8.5 million from the installment contracts entered into in the prior year. The $8.5 million is taxable as ECI of Middleman in the current year even though Middleman is no longer engaged in a trade or business in the US.

Example

> Same facts as in the Example above. During the current year Middleman distributes its US inventory to its UK shareholders and sells other items of office equipment. Any gain recognized on the distribution to the shareholders and the sale of the office equipment is taxable as ECI of Middleman in the current year even though Middleman is not engaged in a US trade or business during that taxable year.

Note that the above deferred income rule is in sharp contrast to the rules in effect for taxable years prior to 1987. Under prior federal law, a foreign corporation had to be engaged in a US trade or business in the year the income was recognized for the income to be considered ECI. The above law change should be kept in mind when reading Treas. Reg. §1.864-3 and §1.864-4, as the federal regulations have not yet been updated and still reflect prior law.

b. Impact of Tax Treaties

For taxable years beginning on or after January 1, 1992, California does not follow the provisions of US tax treaties, to the extent they limit the application of the ECI provisions of the IRC. (CCR §25110(d)(2)(F)1a.)

Tax treaties only impact the determination of ECI for foreign corporations incorporated in foreign countries with which the US has a treaty in effect. If a foreign corporation is from a country with which the US has an income tax treaty, then it must have a PE in the US before income effectively connected with a US trade or business can be taxed for federal purposes. Tax treaties require that income be effectively connected with a permanent establishment, not just a US trade or business, for the income to be subject to tax. If the foreign corporation is not from a treaty country, then the income effectively connected with its US trade or business will be taxed for federal purposes without consideration of tax treaty PE rules. Additionally, some tax treaties may override certain IRC income-sourcing rules, or preclude the treatment of foreign-source income as ECI.

1. In General

The primary purpose of tax treaties is to eliminate international double taxation resulting from overlapping taxing powers using different rules to tax the same income. Tax treaty provisions are negotiated between the two countries involved, and take into account the special taxing rules of each country so as to eliminate double taxation problems to the extent possible. Tax treaties also provide for the exchange of information between the two countries involved in order to prevent tax evasion.

California is not a party to US tax treaties. We are unable to obtain any documentation or information from the IRS if the information was obtained under treaty provisions. Furthermore, California is not bound by the provisions of US tax treaties (except to the extent they limit the determination of ECI for taxable years beginning prior to January 1, 1992.)

Although treaties are negotiated on a bilateral basis between the two governments involved, the US does have a model income tax treaty, which it uses as a starting point for its negotiations with other countries. The Council of the Organization for Economic Cooperation and Development (OECD), of which the US is a member country, has also issued a model income tax treaty. The provisions of the US model treaty and the OECD model treaty are very similar. US treaties signed since 1963 generally follow the models. As is the case with the IRC provisions, taxpayers and the government may disagree as to the correct interpretation of treaty provisions. In interpreting treaties to resolve these differences, the US courts look to legislative history (such as State Department Reports, Treasury Department Technical Explanations, and Senate Foreign Relations Committee Hearings.) The IRS also issues revenue rulings, revenue procedures, letter rulings, technical advice memoranda, etc., dealing with the interpretation of treaty provisions.

The text of treaties and the Treasury Department Technical Explanation are published in the Cumulative Bulletin for the year in which the treaty was ratified. Cumulative Bulletins should be available in a number of places, the Central Office libraries, in local law libraries, or through other services such as Lexis®-Nexis® and RIA. “Income

Taxation of Foreign Related Transactions” contains copies of all US income tax treaties.

2. Interaction between Tax Treaties and the IRC

IRC §894 provides that the IRC is to be applied to any taxpayer with due regard to tax treaties that apply to the taxpayer. IRC §7852(d) provides that, in general, tax treaties and the IRC have equal status, neither having preferential status by reason of being a treaty or law. The section does have a savings clause for 1954 treaties. No provision of the IRC, which was in effect as of August 16, 1954, applies in any case where its application would be contrary to any tax treaty obligation in effect on August 16, 1954.

Although IRC §7852(d) provides that tax treaty and IRC provisions have equal status, except with respect to IRC and treaty provisions in effect on August 16, 1954, there are instances where an IRC section, the Public Law enacting a particular IRC section, or the Committee Reports will specifically state whether the Code or the treaty takes precedence. Congress has the power to enact statutes, which override previously negotiated treaties. (See Revenue Ruling 80-223, 1980-2 C.B. 217.) For example, the Foreign Investment in US Real Property Tax Act of 1980 (FIRPTA), which enacted the provisions relating to treatment of gain on the disposition of US real property interests, overrode conflicting tax treaties.

Similarly, the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and its Conference Committee Report provide that certain international tax provisions enacted by the 1986 Tax Reform Act do not apply to the extent they conflict with any treaty in effect on October 22, 1986. Certain other 86 Act amendments, relating to the foreign tax credit computation, do apply notwithstanding any conflicting treaty in effect on October 22, 1986.

The impact of the TAMRA provisions on IRC sections, which are relevant for California water's-edge purposes, is set forth below:

A. If a foreign corporation maintains an office in the US, income from any sale of personal property attributable to such office is sourced in the US unless the property is inventory sold for use outside the US and a foreign office of the corporation materially participated in the sale. TAMRA provided that if a treaty in effect on October 22, 1986, conflicts with this source rule, then the treaty prevails.

B. Income from transportation services carried on between points in and outside of the US is generally considered 50 percent from US sources and 50 percent from foreign sources. TAMRA provided that if a treaty in effect on October 22, 1986, exempts the income, then the treaty would prevail except for Foreign Tax Credit (FTC) purposes.

C. Interest income received from a so-called 80-20 corporation is considered foreign source income if the 80-20 corporation meets the active foreign business test. Dividends received from a domestic corporation, including an 80-20 corporation, are considered US-source income. (Note that prior to the 1986 Act amendments, interest and dividends paid by an 80-20 corporation were always considered foreign-source income.) TAMRA provided that if such income were foreign source under a tax treaty in effect on October 22, 1986, the treaty would prevail except for FTC purposes.

D. A portion of dividends received from a foreign corporation is considered US-source income if at least 25 percent of the foreign corporation's gross income during a base period is connected with the corporation's US business. TAMRA provided that if a treaty in effect on October 22, 1986, conflicts with this source rule, then the treaty prevails.

E. Gain from the sale of business property received in a year in which the corporation is no longer engaged in a US business retains its character as ECI. Many treaties follow the prior statutory rule requiring that the corporation be engaged in a US business in the year in which the income is recognized. TAMRA provided that if a treaty in effect on October 22, 1986, conflicts with the new ECI rule, then the treaty prevails.

TAMRA and its Conference Committee Report also provide guidance with respect to any unidentified conflicts between tax treaty and IRC provisions. The Committee Report states that except as otherwise provided in the 1986 Reform Act and TAMRA, the provisions of the 1986 Act override any treaty provision in effect on October 22, 1986 (the date of 1986 Act's enactment). (See S. Rep No 100-445, 100th Congress, 2d Session.) These rules only impact the California water's-edge combined report for taxable years beginning prior to January 1, 1992.

3. Permanent Establishment (PE) Rules

Under the IRC, foreign corporations engaged in a US trade or business are taxable on their net ECI at the normal graduated rates applicable to domestic corporations. However, if the foreign corporation engaged in a US trade or business is from a country that has a tax treaty with the US in effect, the foreign corporation will only be subject to US tax on ECI if it has a PE in the US.

When dealing with a foreign corporation from a treaty country, not only must it be determined whether the corporation has US trade or business activities, but also it must be determined whether the deemed subsidiary's activities rise to the level of a PE as defined in the applicable tax treaty. If the activities do, then the foreign corporation can be taxed on its income effectively connected to the US trade or business.

In general, a foreign corporation does not have a PE in the US unless it is actively involved in continuous business activities in the US. A foreign corporation may be taxed if it has a PE in the US at any time during the year, even if the PE does not exist at the time a particular income item is earned. Since taxpayers who are claiming immunity from US tax by virtue of the PE rules of a treaty must file a federal Form 1120F, disclosing the basis for their "return position," it will usually be obvious when a foreign corporation is taking the position that its activities in the US do not create a PE in the US. (This assumes, of course, that the corporation complies with the federal Form 1120F filing requirements and that, if filed, a copy is available to California.)

Since specific treaty provisions will vary from treaty-to-treaty, the rules of the specific treaty involved must be reviewed to determine if the taxpayer's return position is valid. There are some general concepts regarding the level of presence in the US required to constitute a PE, which are common to all treaties.

Generally, there are three tests for determining if a corporation has a permanent establisment:

- Asset Test - It looks to which kinds of assets, such as a branch, office, or factory, maintained by the foreign corporation in the US, will constitute a PE.

- Agency Test - It looks to the extent to which the activities carried on by an agent, partner, or subsidiary of the foreign corporation will constitute a PE even if the corporation itself does not maintain a place of business in the US.

- Activity Test - It looks to the types of specified minimal activities, such as storing, delivering, or purchasing goods in the US, which the foreign corporation may engage in without being considered as having a PE.

The following review of the PE provisions contained in the 2006 US model income tax treaty will help to demonstrate how the above rules are put to use. The 2006 Model replaces the 1996 Model, and is drawn from a number of sources including the 1981 Model, the 1995 OECD Model treaty, the 1996 Model, existing US income tax treaties, recent experience negotiating US tax treaties, current US income tax laws and policies, and comments received from interested parties such as tax practitioners. Only recently negotiated US treaties would reflect the 2006 model treaty language and provisions.

Article 5 of the 2006 US-model income tax treaty contains the following rules for determining if an enterprise has a permanent establishment:

A. For purposes of this Convention, the term "PE" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

B. The term PE specifically includes:

    i. Place of management (this criterion was not in the 1981 model treaty)
    ii. Branch
    iii. Office
    iv. Factory
    v. Workshop
    vi. Mine, an oil or gas well, a quarry, or any other place of extraction of natural resources

C. A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or development of natural resources, constitutes a PE only if it lasts more than 12 months (the 1981 model treaty specified 24 months.)

D. Notwithstanding the preceding provisions of this Article, the term “PE” shall be deemed not to include the use or maintenance of:

   i. Facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise.
   ii. Stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery.
   iii. Stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise.
   iv. Fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise.
   v. Fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.
   vi. Fixed place of business solely for any combination of the activities mentioned in subparagraphs i. to v. above.

E. Notwithstanding the provisions of paragraphs A and B, where a person, other than an agent of independent status to whom paragraph F applies, is acting on behalf of an enterprise, and habitually exercises in a contracting state an authority to conclude contracts that are binding on the enterprise, that enterprise shall be deemed to have a PE in that state with respect to any activities that the person undertakes for the enterprise. This is unless the activities of such person are limited to those mentioned in paragraph D. If exercised through a fixed place of business, it would not make this fixed place of business a PE under the provisions of that paragraph.

F. An enterprise shall not be deemed to have a PE in a contracting state merely because it carries on business in that state through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business as independent agents.

G. The fact that a company that is a resident of a contracting state controls or is controlled by a company that is a resident of the other contracting state, or that carries on business in that other state (whether through a PE or otherwise), shall not constitute either company a PE of the other.

As can be seen, all three tests are present in the model treaty. Paragraphs A, B and C establish an asset test, under which a branch, office, factory, etc., is considered a PE. Paragraph E establishes an agency test, under which a business carried on by other than an independent agent on the corporation's behalf constitutes a PE. Paragraphs D and F establish an activity test, under which certain activities do not constitute a PE.

The following examples demonstrate the tax implications of the PE rules.

Example

Soto Co. Ltd., a Japanese corporation, is engaged in the business of manufacturing and selling electronic equipment. Soto places advertisements for its products in periodicals sold in the US. As a result of such advertisements, Soto frequently makes sales of its products to US customers. To fill its orders from US customers, Soto rents a warehouse in the Los Angeles Foreign Trade Zone in which it stores a stock of its electronic equipment to enable quick delivery to its customers. Title to the goods passes to the US customer upon its receipt of the goods.

Under the IRC and relevant case law, the activities of Soto in the US are sufficient to constitute a US trade or business. Further, gain from the sale of the inventory is US-source income since title to the goods passes in the US. Under the IRC, this income would be considered US-source income effectively connected with Soto’s US trade or business activities. Pursuant to the Japan treaty, however, the types of activities conducted by Soto in the US are specifically deemed not to constitute a PE in the US.

As a result of the treaty provisions, Soto is not subject to US income tax on the income realized from the sale of its inventory in the US because Soto does not have a PE in the US.

For California purposes, Soto’s US-source income and its US-located apportionment factors would not be subject to inclusion in a water’s-edge combined report for taxable years beginning before January 1, 1992. For taxable years beginning on or after January 1, 1992, California does not follow US tax treaties in determining ECI. Accordingly, Soto's net income from the sale of inventory in the US would be considered US-source income effectively connected with a US trade or business, which is includible in the water's-edge combined report for taxable years beginning on or after January 1, 1992. Soto's effectively connected apportionment factors would also be included in the water's-edge combined report for such taxable years.

Example

> Assume the same facts as in the example above, except that Soto is incorporated in Brazil, a country with which the US does not have a tax treaty. Because its activities are not exempted by a tax treaty, Soto's income from the sale of inventory in the US is considered effectively connected to a US trade or business and would be subject to US income tax for all taxable years.

Note that as a practical matter, it is unlikely that a corporation from a non-treaty country would engage in the types of activities, which would subject it to US tax. US taxes could easily be avoided, for example, by simply shipping the goods to the US customers directly from the foreign country and having title pass at the point of shipment outside the US. Thus, although the corporation would still be engaged in a US trade or business by reason of its continuous sales activities in the US, all of its income would be foreign-source income. As noted previously, unless a corporation has an office in the US, it is only taxable on its US-source income.

For California purposes, the provisions of US treaties are followed only to the extent they limit the application of the federal ECI rules for taxable years beginning prior to January 1, 1992. This rule determines whether the foreign corporation has any income or apportionment factors includible in its California return regardless of whether it files on a separate or combined report basis. US tax treaty provisions have no other application for purposes of determining the source of a foreign corporation's income (e.g., US or foreign source), or for determining whether a foreign corporation has sufficient constitutional nexus in California to subject it to California tax. In other words, even though a foreign corporation has no ECI pursuant to a US tax treaty, and therefore has no income or factors subject to inclusion in a waters-edge combined report, it may nonetheless still be considered a California taxpayer by virtue of its activities carried on in

California. Accordingly, the foreign corporation will remain subject to at least the minimum franchise tax as a result of its activities in California.

c. Determination of ECI

Once it has been established that a foreign corporation is engaged in a US trade or business, or that it has a PE if it is from a tax treaty country, its income effectively connected with the US trade or business or PE must be determined. The determination of gross income effectively connected with the US trade or business will usually be fairly straightforward. There will be situations where a question will arise as to whether income from investments or extraordinary activities should be considered ECI or NECI.

In general, Treas. Reg. §1.864-4(c) provides an asset-use test and a business-activities test for determining whether such income is effectively connected with a US trade or business.

- The asset-use test asks the question: Are the assets used or held for use in a trade or business in the US?

- The business-activities test asks the question: Are the activities of the trade or business in the US a material factor in the realization of the income?

In applying the asset-use test or the business-activity test, the regulations provide that “due regard” will be given to how the taxpayer has handled the item on its books and records. However, the accounting test is not in and of itself the sole determining factor. Income may or may not be considered ECI irrespective of how it was recorded for book purposes. The regulations also provide that consideration is to be given to whether the accounting treatment meets Generally Accepted Accounting Principles standards for the particular trade or business, and whether the accounting treatment for the item is consistent from year-to-year.

1. Asset-Use Test

The asset-use test is primarily useful when income, gain, or loss of a passive type (e.g., interest, dividends) is derived from US sources by a foreign corporation that is not engaged in business activities that normally give rise directly to such income, gain, or loss (such as a foreign corporation engaged in manufacturing or selling goods in the

US). Treas. Reg. §1.864-4(c)(2) sets forth the rules and examples for applying the asset-use test.

2. Business-Activities Test

The business-activities test ordinarily applies when it is necessary to make a determination with respect to income which, even though generally of the passive investment type, arises directly from the active conduct of the foreign corporation's US trade or business. The business-activities test is of primary significance, for example, where gain is derived from the disposition of capital assets in the active conduct of a business by an investment company, where royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, where interest or dividends are received by a dealer in stocks or securities, or where service fees are derived in the active conduct of a servicing business. Treas. Reg. §1.864-4(c)(3) provides the detailed explanation and examples of the business-activities test.

3. Banks and Financials – Special Rules

Treas. Reg. §1.864-4(c)(5) provides the special rules that apply to banks and financial corporations for purposes of determining if income from stocks and securities is effectively connected with the conduct of their banking, financing, or similar business activities in the US. Banks and financial corporations do use the asset-use test and the business-activity test to determine whether income other than from stocks and securities is effectively connected with their US trade or business.

A. Banking or Financial Activities Defined

Although the definition of financial activities for federal ECI purposes is very similar to California's definition of financial activities, there are some important differences. For purposes of applying the ECI provisions, a foreign corporation is considered engaged in the active conduct of a banking, financing or similar business in the US, if at some time during the year the corporation is engaged in business in the US and the US activities of the business consist of any one or more of the following activities carried on in transactions with persons located within or without the US:

- Receiving public deposits of funds
- Making personal, mortgage, industrial or other loans to the public

- Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances or other evidences of indebtedness
- Issuing letters of credit to the public and negotiating drafts drawn thereunder
- Providing trust services to the public
- Financing foreign exchange transactions for the public

A foreign corporation, which acts merely as a financial vehicle for borrowing funds for its parent corporation or any other related person, is not considered to be engaged in the active conduct of a banking, financing or similar business in the US. Thus, unlike the California rules, the federal rules do not consider a "captive financial" subsidiary as being engaged in the financing business.

To determine if a foreign corporation is engaged in the banking or financing business in the US, the character of the business actually carried on during the year in the US is the deciding factor, although consideration is given to the fact that the corporation is subjected to the banking and credit laws of a foreign country.

It is important to note the above federal definition of US banking or financial activities applies for California purposes only for purposes of determining the amount of taxable ECI. The California definition of bank and financial activities still applies for purposes of determining if the entity is subject to the financial tax rate, and whether CCR §25137-4 applies.

B. Effective Connection of Income from Stocks or Securities Associated With a Banking or Financing Business

Any US-source dividends or interest from stocks or securities, or any US-source gain or loss from the disposition of stocks or securities, which are capital assets, earned by a foreign corporation engaged in the active conduct of a banking, financing, or similar business are treated as ECI:

- If the stocks or securities giving rise to the income are attributable to the US office, and either:

    - Were acquired in the course of making loans to the public, in the course of distributing such stocks or securities to the public, or for the purpose of satisfying reserve or other similar requirements established by US banking authorities.

- Consist of securities which are payable on demand or with a maturity date not exceeding one year, or are issued by the US or any agency or instrumentality of the US.

A stock or security is considered to have been acquired in the course of making loans to the public if, for example, the stock or security was acquired as additional consideration for making the loan or the stock or security was acquired by foreclosure upon a bona fide default of the loan.

In addition to the income from securities, which meet the requirements above to be considered ECI, the treasury regulations provide that a portion of the interest or gain/loss from the disposition of securities, which do not meet the above tests, is also considered ECI.

The portion of interest or gain or loss from the disposition of such securities considered ECI is determined by the following formula:

		10%
		Over
US source interest Income or gain/loss from disposition of such securities	X	the ratio of book value of securities to total assets of branch office (the ratio based is on monthly average of such assets)

Note that this formula is applied to US-source interest, gains and losses. The portion of the interest, gains and losses that the formula determines not to be ECI is still US-source income. It is NECI and would not be included in the water's-edge combined report.

Stocks or securities are defined as any bill note, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase any of these items.

In addition to the above rules, receipts from stocks or securities will only be attributed to a US office if the office actively and materially participates in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security. However, the US office need not have been the only active participant in arranging the acquisition of the stock or security.

A stock or security is not deemed to be attributable to a US office merely because the office conducts one or more of the following activities:

- Collects or accounts for the income from the stocks or securities.
- Exercises general supervision over the people soliciting, negotiating, or carrying on other activities required to arrange the acquisition of the stock or security.
- Performs clerical functions incidental to the acquisition of the stocks or securities.
- Exercises final approval over the execution of the acquisition of the stocks or securities.
- Holds the stock or securities in the US or records the stock or securities on its books as having been acquired by the office or for its account.

Treas. Reg. §1.864-4(c)(5)(vii) provides examples to illustrate the above rules.

d. Foreign-Source ECI

A foreign corporation engaged in a US trade or business at any time during the year may be subject to US tax on certain classes of foreign-source income, which are treated as ECI under the IRC. For all taxable years, CCR §25110(d)(2)(F) provides that foreign-source income, which is treated as ECI is deemed to be derived from or attributable to sources within the US, and as such, is included in the water's-edge combined report. For taxable years beginning on or after January 1, 1992, provisions of US tax treaties, to the extent they limit the application of the ECI provisions of the IRC, are not followed in making the determination whether the foreign-source income is treated as effectively connected with a US trade or business.

Under IRC §864(c)(4) and Treas. Reg. §1.864-5, foreign source income may be considered ECI if the:

1. Foreign corporation has a US office or other fixed place of business in the US to which the income in question is attributable; and

2. Foreign-source income consists of:

A. Rents or royalties for the use of or for the privilege of using intangible property, including copyrights, patents, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property. (IRC §864(c)(4)(B)(i), IRC §864(c)(5), Treas. Reg. §1.864-5(b)(1)(i).) This rule does not apply to:

- Foreign source rents or royalties paid for the use of, or the privilege of using, real property or tangible personal property located outside the US. (Treas. Reg. §1.864-5(b)(1)(iv).)
- Foreign source royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the stock. (IRC §864(c)(4)(D)(i).)

B. Dividends, interest, or gains or (losses) from sales of stocks or securities, derived in the active conduct of banking, financing or similar business within the US, or received by a corporation whose principal business is trading in stocks or securities for its own account. (IRC §864(c)(4)(B)(ii) & Treas. Reg. §1.864-5(b)(2).) This rule does not apply to:

- Foreign source interest and dividends paid by a foreign corporation in which the taxpayer owns more than 50% of the stock (IRC §864(c)(4)(D)(i)), or
- Foreign source income that is Subpart F income within the meaning of IRC §952(a). (IRC §864(c)(4)(D)(ii).)

C. Sale of personal property (i.e., inventory, depreciable personal property, and amortizable intangible personal property) through a US office. (IRC §864(c)(4)(B)(iii), IRC §865(e)(2)(A), Treas. Reg. §1.864-5(b)(1)(ii), & Treas. Reg. §1.864-5(b)(3).) This rule does not apply to:

- Inventory sold for use or consumption outside the US, if an office of the taxpayer in a foreign country materially participated in the sale. (IRC §865(e)(2)(B) & Treas. Reg. §1.864-6(b)(3)(i).)

No other types of foreign-source income may be considered ECI.

1. Office or Other Fixed Place of Business

For purposes of determining whether foreign-source income will be treated as ECI, the foreign corporation must have an office or other fixed place of business in the US. Under Treas. Reg. §1.864-7, an office or other fixed place of business is a fixed facility through which the foreign corporation engages in a trade or business in the US. This would include a factory; a store or other sales outlet; a workshop; or a mine or other place of extraction of natural resources. A fixed facility may be considered an office or other fixed place of business whether or not the facility is continuously used by the foreign corporation.

In determining whether a foreign corporation has an office or other fixed place of business in the US, due regard is given to the facts and circumstances of each case, particularly to the nature of the corporation's business and the physical facilities actually required to conduct the business. The law of a foreign country is not controlling in determining whether a foreign corporation has an office or other fixed place of business in the US.

Use of another person's office or other fixed place of business will not cause a foreign corporation to meet the office requirement if its business activities through that office are relatively sporadic or infrequent. Furthermore, a foreign corporation is not considered to have an office or other fixed place of business merely because a person controlling it has an office or other fixed place of business in the US from which general supervision and control over the policies of the foreign corporation are exercised.

The US office or other fixed place of business of a dependent agent (i.e., someone who is not a general commission agent or other independent agent acting in the ordinary course of his business) may be considered in determining whether a foreign corporation has an office or other fixed place of business in the US only if the agent has:

- Authority to negotiate and conclude contracts in the name of the foreign corporation, and regularly exercises that authority.

- A stock of merchandise belonging to the foreign corporation from which order are regularly filled on behalf of the foreign corporation.

Thus, for example, if a domestic corporation regularly negotiates and concludes contracts in the name of a foreign affiliate or maintains a stock of inventory from which it regularly fills orders on behalf of the foreign affiliate, the office or other fixed place of business of the domestic corporation is treated as the office of the foreign corporation unless the domestic corporation is an independent agent.

The office of an independent agent is not treated as an office of his principal regardless of whether the agent has authority to negotiate and conclude contracts for the principal or maintains a stock of inventory for filling orders on behalf of the principal. An independent agent means a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business. An independent agent can be related to the foreign corporation. *Taisei Fire and Marine Insurance Co., Ltd. et al.,v. Commissioner (1995) 104 T.C. 535* contains a discussion on when a US agent creates a PE in the US on behalf of its principal.

The above “agent” limitation does not apply if an employee of the foreign corporation, in the ordinary course of his duties, regularly carries on the business of his employer through a fixed facility in the US. Such facility is considered an office of the employer even if the employee doesn't have the authority to negotiate and conclude contracts or have a stock of inventory for filling orders.

2. Income Attribution

Once it has been determined that an office or other fixed place of business exists in the US, the next step is to determine whether there is any foreign-source income of the foreign corporation attributable to that office. Foreign-source income is considered attributable to the US office if the office is a material factor in the realization of the income and if the income is realized in the ordinary course of the trade or business carried on through that office. The office must be an essential economic element in the realization of the income in question. It is not necessary that the US activities be a major factor in the realization of the income. In addition, a US office may be a material factor in the realization of the income even though the office is not in existence in the US when the income is actually realized. If the US office is a material factor in the realization of the income, then the amount of income which is considered allocable to the US office or other fixed place of business shall not exceed the amount which would be treated as income sources within the US if the taxpayer had sold the goods or merchandise in the US.

Treas. Reg. §1.864-6(b) discusses the application of the material factor test to each of the three classes of foreign-source income, which may be considered ECI. Any foreign-source income, which is considered ECI is deemed derived from or attributable to US sources, and is included in the water's-edge combined report.

e. Disposition of A US Real Property Interest

IRC §897 provides that foreign corporations are subject to US tax on gains from the disposition of US Real Property Interests (USRPI). Gain or loss realized from the disposition of a USRPI is treated as if it is effectively connected with a US trade or business. Thus, a foreign corporation is taxed on such income pursuant to IRC §882 regardless of whether the foreign corporation is actually engaged in a US trade or business. As a practical matter, most corporations will have an IRC §882(d) election in effect to treat income from real property as income effectively connected with a US trade or business to obtain the benefit of deductions, e.g., depreciation, interest, property taxes, etc.

The provisions of IRC §897 (commonly referred to as FIRPTA, the Foreign Investment in US Real Property Tax Act, which enacted the IRC §897 provisions) generally apply to dispositions of a USRPI after June 18, 1980. While the details of FIRPTA are very complex, the basic concept is fairly straightforward. The purpose of FIRPTA is to tax foreign persons on the dispositions of both their direct interests in US real property and their indirect interests in USRPI's held in corporate form (stock.)

For all taxable years, ECI is included in the water's-edge combined report. ECI includes income, which is effectively connected or treated as ECI under the IRC. Since US tax treaties cannot override the FIRPTA provisions, gain or loss from the disposition of a USRPI, will always be treated as ECI for federal purposes. . For California, it is not automatically deemed ECI, but becomes an examination issue since we do not conform to IRC §897(a). However, any periodic income attributable to the USRPI, which is treated as ECI, as a result of an IRC §882(d) election, would be included in a water's-edge combined report.

There are some significant differences between federal and California law with respect to whether a gain realized on the disposition of a USRPI is to be recognized for tax purposes. These differences are discussed briefly below.

For FIRPTA purposes, a disposition is any transfer of a USRPI if the transfer is considered a disposition under the IRC and the Treas. Reg. Thus, dispositions include not only a sale, but also transactions such as redemptions, transfers in reorganizations, contributions to capital, and liquidating or nonliquidating distributions.

For example, distributions received by a foreign shareholder from a US Real Property Holding Corporation (USRPHC) are treated as a disposition of a USRPI by the foreign corporation if the distribution is treated as a:

- Sale or exchange of stock under IRC §301(c)(3)(A)
- Stock redemption pursuant to IRC §302(a)
- Complete liquidation pursuant to IRC §331(a)

Each of these transactions involves an actual or constructive sale or exchange of the USRPHC stock by the foreign shareholder. These transactions are taxable events for both federal and state purposes.

For federal purposes, FIRPTA contains a number of special rules, which restrict a foreign corporation's right to make use of the normal tax nonrecognition provisions.

California has not conformed to IRC §897. However, California CCR §25110((d)(2)(F)(1) follows the US source income determination as provided in IRC §861 – §865. IRC 861(a)(5) provides that the gain or loss from the disposition of USRPI (as defined in IRC §897(c)) is US source income. As such, for California purposes, the gain or loss from the disposition of USRPI is US source income. Such income or loss is not treated as deemed ECI under §897(a), but instead becomes an examination issue since California does not conform to IRC §897(a). It is necessary to determine that the foreign corporation that generated the gain or loss form the disposition of USRPI is engaged in a US trade or business in order to include such gain or loss in the water's-edge combined report. Furthermore, there may be federal / state differences where gain has been recognized for federal purposes under IRC §897, but no gain is required to be recognized for California purposes. In such cases, obviously, the gain is not includible in the water's-edge combined report.

1. FIRPTA Nonrecognition Override Provisions

The FIRPTA nonrecognition override provisions are found in IRC §897(d) and §897(e). IRC §897(d) sets forth the general rule that if a foreign corporation distributes a USRPI (including a distribution in redemption or liquidation) to its shareholders, the foreign corporation must recognize gain (but not loss) on the distribution to the extent the fair market value (FMV) of the property exceeds the corporation's basis in the property. A statutory exception to this rule is provided. Gain will not be required to be recognized under IRC §897(d) if the following three conditions are met:

- At the time of receipt of the distributed USRPI, the recipient would be subject to US tax on a subsequent disposition of the USRPI.

- The recipient's basis in the USRPI is not greater than the adjusted basis of the property before the distribution, increased by the amount of any gain recognized by the distributing foreign corporation upon distribution (i.e., the foreign corporation's "inside" basis in the property cannot be less than the shareholder's "outside" basis in the stock of the foreign corporation).

- The distributing foreign corporation complies with certain filing requirements set forth in the regulations. In general, the foreign transferor must file an income tax return for the year of the distribution even if a nonrecognition provision will be applicable and no US tax is due. The return must describe the USRPI, identify the recipient of the USRPI, and contain a declaration signed by the recipient that it will treat any subsequent disposition of the USRPI as a disposition that is subject to US tax, regardless of any intervening change in circumstances.

IRC §897(e) and Treas. Reg. §1.897-6T(a)(1) provide that a nonrecognition provision of the IRC (e.g., IRC §§332, 351, 354, 355, 361, 1031, 1033, 1034, 1036) will only apply to exchanges when the disposing foreign corporation receives another USRPI which, immediately following the exchange, would be subject to US tax upon its disposition, and the transferor complies with the filing requirements set forth in Treas. Reg. §1.897-5T(d)(1)(iii).

Treas. Reg. §1.897-5T and §1.897-6T, issued in 1988, contain a detailed analysis of the taxability of corporate distributions under

FIRPTA. They discuss and provide numerous examples of the various types of dispositions that will, or will not, be free of US tax:

- Treas. Reg. §1.897-5T principally covers distributions under IRC §897(d),
- Treas. Reg. §1.897-5T(b) covers distributions by domestic corporations
- Treas. Reg. §1.897-5T(c) covers distributions by foreign corporations.
- Treas. Reg. §1.897-6T covers the nonrecognition rules of IRC §897(e).

As a result of California's non-conformity to IRC §897, the FIRPTA non-recognition override provisions do not apply to California. Since these rules do not apply for California purposes, they will not be discussed in great detail in this section. They are briefly discussed in order to note the types of situations where gain recognized and reported on the federal return may not be taxable for California purposes.

Some of the more important FIRPTA nonrecognition over-ride provisions, which do not apply for California purposes include:

- Gain is generally required to be recognized by a foreign corporation on the transfer of a USRPI to a foreign corporation if the transfer is made as paid-in surplus or as a contribution to capital to the extent of the FMV of the property transferred exceeds the adjusted basis plus the amount of any gain recognized by the transferor.

- A foreign corporation that distributes stock in a USRPHC in an IRC §355 distribution must recognize gain on the distribution to the extent that the FMV of the distributed stock exceeds the distributing corporation's adjusted basis in the stock. The gain recognized is limited, however, to the amount by which the basis of the stock in the hands of the distributee exceeds the distributing corporation's basis in the stock (i.e., to the extent "outside" basis exceeds "inside" basis). In addition, the distributee's basis in the stock is determined under the otherwise applicable provisions of IRC §358. (In other words, the distributee's basis in the stock is not increased for any gain recognized by the distributing foreign corporation.)

- A foreign corporation that distributes to its shareholders stock in a USRPHC that it received under an IRC §§368 "C", "D" or "F" reorganization must recognize gain on the distribution to the extent the FMV of the stock exceeds the distributing corporation's basis in the stock. As is the case with IRC §355 distributions, the gain recognized is limited to the amount by which the basis of the stock in the hands of the distributee exceeds the distributing corporation's basis in the stock. The distributee's basis in the stock is determined under the provisions of IRC §358.

- If a domestic corporation (stock in which is treated as a USRPI) makes an IRC §355 distribution of stock in a domestic or foreign corporation that is not a USRPHC to a foreign person, the foreign person is considered as having exchanged part of the stock of the domestic corporation (that is a USRPI) for stock that is not a USRPI. As a result, the distributee has not met the USRPI for USRPI exception of IRC §897(e), and the gain on the distribution would be subject to US tax.

2. IRC §897(i) Election

Any foreign corporation may make an election to be treated as a domestic corporation for purposes of IRC §897, if at the time of the election:

- The corporation owns a USRPI.
- Under any tax treaty obligation, the foreign corporation is entitled to nondiscriminatory treatment with respect to the USRPI.
- The conditions and disclosure requirements set forth in Treas. Reg. §1.897-3(c) are met.

In general, Treas. Reg. §1.897-(c) provides that the corporation must provide a statement indicating it is making the election, the US tax treaty under which it is seeking nondiscriminatory treatment, and a description of the USRPI, including its adjusted basis and FMV.

A foreign corporation, which makes the election, effectively becomes a USRPHC and any disposition of its stock by its foreign shareholders will be considered a disposition of a USRPI. The IRC §897(i) election is the exclusive remedy for any person claiming discriminatory treatment under a US tax treaty obligation. If the election is not properly made, the tax treaty's nondiscrimination provisions will not apply.

There are valid reasons why a foreign corporation would elect to be treated as a USRPHC. By doing so, to some extent, a foreign corporation can avoid the FIRPTA nonrecognition over-ride provisions by making the “i” election. Since the enactment of the 1986 Act, however, the significance of the “i” election has been reduced. Prior to the 1986 Act, one of the most significant differences between a US and a foreign corporation was the availability of tax-free liquidation treatment under IRC §337. A foreign corporation could not get tax-free IRC §337 treatment on the sale of its USRPI. The “i” election allowed foreign corporations from tax treaty countries to alleviate this “discriminatory” treatment between domestic and foreign corporations.

The “i” election continues to work to allow foreign corporations to receive nonrecognition treatment on certain liquidations, reorganizations, and IRC §355 distributions, which would otherwise be taxable under the FIRPTA nonrecognition override provisions. Refer to the examples in Treas. Reg. §§1.897-5T(b)(3)(iv)(B), 1.897-5T(c)(4) and 1.897-6T.

Since the FIRPTA nonrecognition override provisions are not applicable for California purposes, a foreign corporation does not benefit from the “i” election for California purposes. Under the IRC provisions, a foreign corporation, which has made the election, is considered a USRPHC (and thus a USRPI.) They will also be considered a USRPI for California purposes. Any gain recognized under California law on the disposition of such stock is therefore subject to inclusion in the water’s-edge combined report if such income is effectively connected with a US trade or business.

3. Withholding Requirements

IRC §1445 and Treas. Reg. §1.1445-1(b)(1) require that every transferee of a USRPI deduct and withhold a tax of 10 percent of the amount realized by the foreign transferor on the disposition. The transferee is obligated to withhold even if the transaction will not generate taxable gain to the transferor. The transferor of the USRPI is required to file a return and pay whatever tax may still be due, using the withheld amount as a credit (as compared to the filing exemption granted to a foreign corporation if its only income is FDAP income and any tax due has been fully withheld at source).

California has a very similar withholding requirement. The assessment and collection of the California withholding tax is handled by the Withhold at Source Unit. The presence of a federal or state withholding certificate within the California return may reveal an IRC

§897 sale or exchange that is includible in the water's-edge combined report as ECI.

f. IRC §883 Exclusions

IRC §883 provides that certain items of income of a foreign corporation are not included in gross income and are exempt from US tax. CCR §25110(d)(2)(F)(1)(a) provides that income excluded from US federal income tax pursuant to the provisions of IRC §883 will also be excluded from income in a water's-edge combined report.

The IRC §883 exclusion applies to the following types of income:

1. Income from the international operation of ships and aircraft by foreign corporations, if the country in which the corporation is organized grants an equivalent exemption to US corporations. Revenue Ruling 89-42, 1989-1 C.B. 234, provides a listing of countries that provide an equivalent exemption. Revenue Ruling 91-12, 1991-1 C.B. 473, provides guidance on how to claim the exemption under IRC §883. The exemption does not apply to any foreign corporation. If 50 percent or more of the foreign corporation's stock is owned by individuals, who are not residents of a foreign country meeting the equivalent exemption requirement. Attribution rules apply in determining if the 50 percent rule is met. The 50 percent rule does not apply to corporations whose stock is publicly traded in the US or in a foreign country, which meets the equivalent exemption. Finally, the exemption does not apply to any controlled foreign corporation as that term is defined for Subpart F purposes.

2. Income from payments by a common carrier for the temporary use, not expected to exceed 90 days in any one year, of railroad rolling stock owned by a foreign corporation if the country in which the corporation is organized grants an equivalent exemption to US corporations.

3. Income derived from the ownership or operation of a communications satellite system by a foreign entity designated by a foreign government to participate in such ownership or operation is exempt if the US participates in the system pursuant to the Communications Satellite Act of 1962.

For purposes of determining the amount of ECI of a foreign corporation, which is subject to inclusion in the water's-edge combined report, the federal rules for determining what income qualifies for the exemption and the federal method of excluding IRC §883 income from the gross income computation will apply. In other words, none of the income or any of the related factors is includible in the water's-edge combined report, if the requirements of IRC §883 are met.

5.6 NONEFFECTIVELY CONNECTED INCOME (NECI)

Contents:

a. NECI

R&TC §25110(a)(4) requires a water's-edge taxpayer to include a foreign corporation in a combined report to the extent the foreign corporation has income derived from or attributable to sources within the US. Income of the foreign corporation shall be limited to and determined from the books of account maintained by the corporation with respect to its activities conducted within the US. Any US-source NECI is excluded from the water's-edge combined report.

1. In General

IRC §881 imposes a flat tax of 30 percent (or a lower tax treaty rate if applicable) on certain gross income from US sources received by a foreign corporation. To be taxable under IRC §881, the US source income received must meet the criteria listed below. The amount received must:

A. Be described in IRC §881(a) and the regulations thereunder.

B. Constitute gross income under the IRC. In other words, receipts that are excluded from gross income under the IRC are not taxable under IRC §881. For example, state and local bond interest excluded from gross income under IRC §103(a) would not be taxable to a foreign corporation.

C. Be derived from US sources.

D. Not be effectively connected with the conduct of a trade or business in the US. Income effectively connected with a US trade or business is taxed under IRC §882, rather than IRC §881.

E. Not be exempted from the 30 percent withholding tax under the IRC.

No deductions are allowed in determining the foreign corporation's taxable income subject to the IRC §881 tax. (See Treas. Reg. §1.881-2(a)(3).) If the foreign corporation is from a treaty country, the tax is often reduced to a lower applicable tax treaty rate.

IRC §1442 requires a person who makes a payment to a foreign corporation of certain types of US source income, including both fixed or determinable annual or periodical (FDAP) income and other income taxable under IRC §881, to withhold 30 percent from the payment and remit it to the IRS. Tax that is withheld from a payment to a foreign corporation under IRC §1442 may be credited against the foreign corporation's US tax liability under IRC §§33 and 1462.

The payer of the income is the designated withholding agent for the foreign corporation. For federal purposes, the withholding agent will file federal Form 1042 reporting the amount of gross income paid, the amount of taxes withheld, and the number of federal Forms 1042-S filed. Federal Form 1042-S is provided to the income recipient. It reflects the type and gross amount of income received, and the name of the payer. Federal Form 1042-S should be attached to any federal tax return filed by the income recipient (e.g., federal Form 1120F).

If a foreign corporation's US tax liability is entirely satisfied by withholding at source and it is at no time during the taxable year engaged in a US trade or business, the corporation is not required to file a US return. However, under IRC §882(c)(2), a foreign corporation must file a return to receive the benefit of the deductions and credits allowed to it.

2. Types of Income Subject to IRC §881 Tax

IRC §881 tax applies to the following types of income:

- FDAP Income
- IRC §631 Gains
- Original Issue Discount (OID)
- Gains From The Sale of Intangible Personal Property

A. FDAP Income

IRC §881(a)(1) refers to certain types of income as "fixed or determinable annual or periodical" (FDAP) income.

Interest Income

IRC §881(a)(1) provides that if interest income from US sources is not effectively connected with the conduct of a US trade or business, then it is FDAP income subject to the flat withholding tax on gross income. OID is excluded from this definition of FDAP income. However, certain OID is subject to the flat withholding tax under IRC §881(a)(3) upon the sale or exchange of the OID obligation. Prior to January 1, 2001, interest included interest on certain deferred payments as provided in IRC §483, and the regulations thereunder. (See Treas. Reg. §1.1441-2(a)(1) (1999).)

Dividend Income

Dividend income from US sources that is not effectively connected with a US trade or business is FDAP income. A dividend is a distribution of current or accumulated earnings and profits (E&P). It is important to note that the withholding tax is paid on the gross amount received by the foreign corporation. A dividend would include any money received plus the fair market value (FMV) of other property, but would not include any return of capital.

Miscellaneous Income

In addition to interest and dividend, IRC §881(a)(1) also enumerates rents, salaries, wages, premiums, annuities, compensations, remunerations and emoluments as FDAP income. Other types of income can constitute FDAP income as well, such as fixed or determinable annual or periodical gains, profits, or income. For example, royalties, including royalties for the use of patents, copyrights, secret processes and formulas, and other like property. (See Treas. Reg. §1.1441-2(b) for the description of FDAP income.)

B. IRC §631 Gains

Gains described in IRC §§ 631(b) and 631(c), from the sale of timber, coal, and iron ore, which were held for more than one year and in which the owner retains an economic interest, are income subject to the flat tax of 30 percent.

C. Original Issue Discount

Certain OID received on the sale or exchange of bonds or other evidences of indebtedness is also income subject to the 30 percent flat tax under IRC §881. OID is defined in IRC §1273(a) as the excess of the stated redemption price at maturity over the issue price at which the bond or other evidence of indebtedness was originally sold.

The amount taxable to the foreign corporation under IRC §881 is when a:

- Payment on an OID obligation, the amount of the OID accrued on the obligation while the foreign corporation held the obligation that has not previously been subject to tax.

- Sale or exchange of an OID obligation, the amount of the OID accrued while the foreign corporation held the obligation, but only to the extent that the foreign corporation has not previously recognized the OID in income.

D. Gains from the Sale of Intangible Personal Property

Gains realized by a foreign corporation from the sale or exchange of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, or of any interest in such property, are income subject to the flat 30 percent tax under IRC §881, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged.

3. Income That Is Not FDAP

FDAP does not include gains realized from the sale or other disposition of real or personal property. FDAP does not include any other income that the IRS may determine, in published guidance (see Treas. Reg. §601.601(d)(2)), is not FDAP income. However, any interest income received from an installment obligation from the gain on the sale of real or personal property that is not otherwise subject to US tax would be taxed as FDAP interest under IRC §881(a).

In addition, the following types of income have been held not to constitute FDAP income:

- Income from hedging transactions. (Income Tax Ruling, I.T. 3137, 1937-2 C.B. 164.)
- “Boot” dividends received as part of a corporate reorganization. (Income Tax Ruling, I.T. 3781, 1946-1 C.B. 119.)

- Capital gains dividends received from a regulated investment company. (Revenue Ruling (RR) 69-244, 1969-1 C.B. 215.)
- Premiums for the insurance of US risks by a foreign insurer. (RR 80-222, 1980-2 C.B. 211; modified by RR 89-91, 1989-2 C.B. 129.)
- Return of capital.

To the extent a corporate payer is unable to distinguish between a payment, which is a dividend distribution or a return of capital, the entire distribution remains subject to withholding. The payee can request a refund for any overpayment. (Revenue Ruling 72-87, 1972-1 C.B. 274.)

b. Exception for Certain Guam and Virgin Islands Corporations

A corporation created or organized in Guam, American Samoa, the Northern Mariana Islands, or the Virgin Islands, or created or organized under the law of any such US possession will not be treated as a foreign corporation, and will not be subject to the IRC §881 tax for any taxable year if:

- Less than 25 percent of the stock value is beneficially owned by foreign persons.

- At least 65 percent of the gross income of the corporation is effectively connected with the conduct of a trade or business in the possession or the US for the three-year period ending with the close of the taxable year of such corporation.

- No substantial part of the income of the corporation is used to satisfy obligations to persons who are not bona fide residents of the possession or the US.

If the foreign corporation was not in existence during a portion of the three-year test period, then the test period will be limited to the portion of the three-year period that the foreign corporation was in existence.

c. Income Exempt From IRC §881 Tax

1. Portfolio Interest

For obligations issued after July 18, 1984, certain US-source “portfolio” interest received by foreign corporations, which is not effectively connected with the conduct of a US trade or business, is exempt from the tax imposed by IRC §881. Portfolio interest means any interest, including OID, which would otherwise be taxable under IRC §881(a) except for this exemption, and which is either interest paid on:

- Unregistered obligations described in IRC §163(f)(2)(B).

- Registered obligations with respect to which the US withholding agent has received a statement that the beneficial owner of the obligation is not a US person.

Qualifying portfolio debt may be in either registered or bearer form. In general, qualifying obligations must meet certain standards, as discussed here.

A. Bearer Obligations

A bearer obligation must be "foreign targeted." A foreign targeted obligation is one that is sold under arrangements designed to ensure that the obligations will be originally issued to a foreign person, provides that interest on the obligation is payable only outside the US, and is issued after July 18, 1984. A bearer obligation is a bond, debenture, promissory note, or other similar instrument, which belongs to the person who has possession.

B. Registered Obligations

Registered obligations must be issued after July 18, 1984, and must either:

i. Be targeted to foreign markets.

ii. If not targeted to foreign markets, the withholding agent (payer) must get a statement from the owner of the obligations signed under penalty of perjury that certifies that the owner is not a US person. The statement must give the owner's full name and address.

Registered obligations are instruments registered with the issuer so that they can be transferred only by surrender of the old instrument to the new holder or issuance of a new instrument to the new holder or instruments, which may only be transferred through a book entry system maintained by the issuer.

Portfolio interest does not include:

i. Any interest paid on an obligation to any person who owns ten percent or more of the total combined voting power of all classes of voting stock of the corporation, or ten percent or more of the capital or profits interests in the partnership.

ii. Any interest paid to a Controlled Foreign Corporation (CFC) by a related person. Interest received by a CFC from an unrelated person may be eligible for exemption from the IRC §881 tax, but the interest will be includible in the income of the US shareholders under IRC §951, without regard to the de minimis rule in IRC §954(b)(3), the high tax exception in IRC §954(b)(4), or the exception from foreign personal holding company income for interest received from certain related persons. CFC has the same meaning as that is found in IRC §957(a).

iii. Certain contingent interest received by a foreign corporation after December 31, 1993. Contingent interest is defined in IRC §871(h)(4) as any interest that is determined by reference to the:

   a. Sale, receipt or other cash flow of the debtor or a related person
   b. Income or profit of the debtor or a related person
   c. Change in the value of property of the debtor or related person
   d. Dividend, partnership distribution or similar payment made by the debtor or a related person

Refer to Notice 94-39, 1994-1 C.B. 350, for more information on the contingent interest exception to the portfolio interest withholding tax exemption.

2. Other Interest and Dividends

IRC §881(d) also exempts from IRC §881 tax the following:

A. Interests on deposits, if it is not effectively connected to the conduct of a US trade or business.

B. A percentage of any dividend paid by a domestic corporation, if at least 80 percent of its gross income is foreign-source income earned from the active conduct of a trade or business in a foreign country or possession. The exempt percentage is the ratio of foreign-source gross income during the testing period to total gross income during the testing period. The testing period is the three-year period ending with the close of the taxable year of the corporation preceding the payment.

C. Income derived by a foreign central bank of issue from bankers acceptance.

For purposes of this discussion, the term deposits means amounts which are deposits with persons carrying on a banking business, deposits with savings institutions chartered as savings and loans, or similar associations under federal or state law, and amounts held by an insurance company under an agreement to pay interest thereon.

5.7 Allocation and Apportionment of Deductions against ECI

Contents:

a. Introduction

1. In General

R&TC §25110(a)(2)(A)(i) provides that the ***source*** of income of a deemed subsidiary included in the water's-edge combined report is determined under federal tax law. In computing the net income included in the water's-edge combined report, deductions attributable to includible effectively connected income (ECI) are determined using the allocation and apportionment rules set forth in:

- Treas. Reg. §§1.861-8, 1.861-8T – For deductions other than interest expense
- Treas. Reg. §1.882-5 – For interest expense

CCR §25110(d)(2)(F)4 requires appropriate state adjustments be made in determining the California taxable income to be included in the water's-edge combined report.

2. Federal Rules

A foreign corporation engaged in a trade or business in the United States (US) is allowed deductions against its ECI in determining its federal taxable income. The NECI of a foreign corporation is taxed at gross by withhold at source. No deductions are allowed against the NECI for federal purposes.

For federal purposes, a foreign corporation claiming deductions from gross income must furnish information sufficient to establish that the corporation is entitled to the claimed deductions. All information must be furnished in a manner suitable to permit verification of the claimed deductions. The IRS may require that an English translation be provided for any information that is presented in a foreign language.

If a foreign corporation fails to furnish sufficient information, the deductions may be disallowed in full or in part.

For federal purposes, a foreign corporation can only receive the benefit of allowable deductions if it files a true and accurate return. Furthermore, for taxable years ending after July 31, 1990, the foreign corporation can receive the benefit of deductions only if it timely files a return. In general, to be considered timely, the return must be filed within 18 months of the statutory return due date set forth in IRC §6072. If a foreign corporation believes that its activities are not sufficient to give rise to ECI, it may file a "protective" timely federal Form 1120F to preserve the right to receive the benefit of any allowable deductions in the event it is later determined that its activities are sufficient to give rise to ECI. Such a "protective" return must also be timely filed.

There is no provision in California law comparable to IRC §882(c) or Treas. Reg. §1.882-4(a)(2), which would similarly permit the permanent disallowance of deductions claimed by a foreign corporation solely for failing to timely file a tax return. Accordingly, any deduction that would otherwise be allowable in computing California taxable income of a deemed subsidiary is deductible for California purposes, regardless of whether a federal return is filed or the deductions were disallowed as a result of the application of IRC §882(c). Regardless, the burden of proof for substantiating allowable deductions still remains with the taxpayer.

The rules for determining the allowable California deductions attributable to ECI, includible in the water's-edge combined report, are found in Treas. Reg. §§1.861-8, 1.861-8T and 1.882-5. The rules contained in Treas. Reg. §§1.861-8 and 1.861-8T are applicable for purposes of determining the deductions other than interest expense, which are to be taken into account in determining net ECI includible in the water's-edge combined report. Treas. Reg. §1.882-5 contains the rules for determining the interest expense deduction allowed against gross ECI.

b. Allocation and Apportionment of Deductions Other Than Interest under Treas. Reg. §§1.861-8 and 1.861-8T

1. General Concept and Definitions

The general concept of Treas. Reg. §1.861-8 is that deductions should be related or attributed to the activity that produced the income.

While that concept may seem relatively straightforward, the regulation contains terminology that must be understood in order to apply the principles set forth in the regulation. For example, the determination of effectively connected deductions is accomplished by means of an “allocation and apportionment” system. However, the federal allocation and apportionment concept bears absolutely no resemblance to the Uniform Division of Income for Tax Purposes Act (UDITPA) concept for the same terms.

The basic rule for determining what deductions are related or attributed to the activity which produced the income requires deductions to be “allocated” to a “class of income.” Once so “allocated” to a “class of income,” the deduction is then “apportioned” between the “statutory” and “residual” groupings within the “class of income.” The definitions of these federal terms are as follows.

A. Class of Gross Income

A “class of gross income” is the gross income to which a specific deduction is definitely related and may consist of one or more items of gross income enumerated in IRC §61 (e.g., gross business income, interest, rents, royalties, etc.). For example, if the foreign corporation pays real property taxes, those taxes are definitely related to the income derived from the real property.

B. Statutory Groupings

A “statutory grouping of gross income” is gross income from a specific source or activity, which must first be determined to arrive at taxable income from such specific source or activity. For example, in determining a foreign corporation's net taxable ECI, the statutory grouping would be all of its gross income meeting the ECI standard. California would have this same statutory grouping since only ECI would be included in the water’s-edge combined report.

C. Residual Groupings

A “residual grouping of gross income” is gross income from all other sources or activities not included in the statutory groupings. For a foreign bank or corporation, a residual grouping is gross income not effectively connected with a US trade or business, e.g., foreign and US-source NECI. California would have the same residual groupings as for federal purposes.

D. Allocation

"Allocation" is the first step in what is generally a two-step process of determining allowable deductions. Deductions are first allocated to a specific class or classes of gross income. That is, deductions are allocated to the class with which they are definitely related.

E. Apportionment

"Apportionment" is the second step in the process of determining allowable deductions. After the expenses definitely related to a class of income have been allocated to that class of income, any remaining items must then be apportioned between the statutory grouping and the residual grouping within that class. Deductions not definitely related to any gross income are apportioned to all gross income.

Apportionment is accomplished by multiplying the deduction to be apportioned by some fractional component (e.g., units sold, gross receipts, gross sales, etc.,) of which the:

A. Numerator is comprised of the statutory or residual grouping component amount within the class of gross income to which the deduction is allocated.

B. Denominator is comprised of the total component amount (both statutory and residual) of the class of gross income to which the deduction is allocated.

Treas. Reg. §1.861-8(f)(1)(iv) provides that the rules of Treas. Reg. §1.861-8 are applicable for purposes of identifying the deductions from gross ECI, which are allowable in determining net taxable ECI.

2. General Rules for Allocation of Deductions

The general rules for allocating expenses, losses and other deductions (referred to collectively as deductions) separate such deductions into three basic categories, deductions:

A. Definitely related to a class of gross income
B. Related to all gross income
C. Not definitely related to any gross income

As noted above, the allocation process is the first step in the two-step process of applying the rules of Treas. Reg. §1.861-8. The apportionment process is the second step. The allocation process does not produce a mathematical division of the expense against various types of income. It merely establishes whether the expense is definitely related to a class of gross income.

A. Deductions Definitely Related To a Class of Gross Income

If a specific deduction is definitely related to a specific type of gross income (such as rents, interest, etc.,) the income is referred to as a class of gross income. Classes of gross income are not predetermined (i.e., by reference to the income reported for the year,) but rather are determined on the basis of the deductions to be allocated. Thus, the allocation process is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to that class. The allocation is made without regard to the taxable year in which gross income is received or accrued, or is expected to be received or accrued.

The determination of classes of gross income by reference to the deductions is essential because there may be deductions, which are related to a class of gross income, which the corporation did not recognize during the year. For example, the property taxes were paid on a real property investment, for which no income was realized during the taxable year. The property taxes would still be considered definitely related to the real property income, which is currently or is expected to be generated.

Exempt income is to be taken into account in the allocation process. Expenses that are definitely related to exempt income are allocated to such income. The term exempt income means any income that is, in whole or in part, exempt, excluded, or eliminated from the income computation pursuant to the IRC and the R&TC. For example, exempt income would include dividends that are eliminated under R&TC §25106 or deducted under R&TC §24411. (Example 24 of Treas. Reg. §1.861-8T(g) demonstrates the application of the allocation process to exempt income.)

Finally, in allocating deductions, it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income, if both items of gross income are exclusively within the same statutory grouping or exclusively within the same residual grouping.

B. Deductions Related To All Gross Income

If a deduction does not bear a definite relationship to any specific class of gross income, then the deduction will generally be treated as related and allocable to all gross income. However, there are separate rules for allocating interest and research and development expenses. Although the regulation uses the term "allocable," such deductions are ratably apportioned between all gross income. (Realize the regulations have a tendency to inconsistently use the terms allocate and apportion.)

C. Deductions Not Related To Any Gross Income

The regulations list various deductions that are considered "not definitely related to any gross income," and are, therefore, ratably apportioned to all gross income. The only listed deduction relevant to corporations is the charitable contribution deduction. Such deduction is ratably apportioned between the statutory and residual groupings based on the ratio of gross income in the grouping to total gross income.

D. Rules for Allocating Deductions Definitely Related To a Class of Income

A deduction is considered definitely related to a class of gross income if it is incurred as a result of, incident to, or in connection with an activity or property from which the class of gross income is derived. In some cases, the definitely related test can be most readily applied by determining the categories of gross income to which a deduction is not related and concluding that it is definitely related to a class consisting of all other gross income.

To establish the relationship between the deduction and a particular class of gross income, an analysis must be made of the functions underlying the deduction. Moreover, it is not sufficient to base this analysis on broad categories of deductions such as general and administrative expenses or on deductions such as officers' salaries or taxes because the general category of a deduction, such as salaries, may include items which are definitely related to a class of gross income, related to all gross income, or not definitely related to any gross income. Therefore, the specific items comprising such deductions must be reviewed and a determination made as to where such items should be allocated.

For example, consider the case of a foreign bank. The salary of the president (included in officers' salaries), the salary of his staff (included in other salaries), and the portion of the overhead expenses of the headquarters office (where the president is located) that are attributable to the president's office, are typically related to all classes of gross income. The salary of the vice president in charge of US operations and the salaries of his staff and the overhead expenses attributable to his office are directly related to the income from banking activities earned by the US branch. The salary of the staff in charge of reviewing requests for charitable contributions and the overhead expenses attributable to this function are not definitely related to any gross income, and are therefore ratably apportioned to all items of gross income. As this example demonstrates, it is important to review organization charts, functional charts, manuals, or other documentation, which detail the functions of the various organizational units, employees, and assets of the taxpayer to determine the proper allocation of expenses.

E. Allocating Deductions Related To Supportive Functions

Deductions, which are supportive in nature (e.g., overhead, general and administrative costs, supervisory expenses, etc.,) may relate to other deductions, which can more readily be allocated to a class of gross income. If this is the case, such supportive deductions may be allocated along with the deductions to which they relate. On the other hand, it is equally acceptable to allocate supportive deductions on some reasonable basis directly to all gross income or to another broad class of gross income. For this purpose, reasonable departmental overhead allocation rates may be utilized.

Note that there is an important difference between "supportive" functions and so-called "stewardship" functions. Supportive functions are those that provide a direct benefit to the subsidiary or branch, while stewardship functions are overseeing functions undertaken for the corporation's own benefit as an investor in a related subsidiary. Deductions related to supportive functions are typically allocated to all classes of gross income. Deductions related to stewardship functions are always considered definitely related to dividend income. Stewardship expenses are discussed in more detail below.

F. Allocating Deductions Related To All Classes of Gross Income

Deductions related to gross income that do not bear a definite relationship to a specific class of gross income are generally allocated to all gross income using a reasonable method, except as specifically provided otherwise in the regulations.

G. Allocating Deductions Not Definitely Related To a Class of Income

Deductions that are not definitely related to income are ratably apportioned to all gross income.

3. General Rules for Deduction Apportionment

After all deductions have been appropriately allocated to the various classes of income, the next step is to apportion the deductions between the statutory grouping and residual grouping within each class of gross income. For purposes of determining the taxable ECI of foreign corporations, the statutory grouping is all gross income meeting the ECI standard and the residual grouping is all other income. For California purposes, the statutory grouping would be all ECI, and the residual grouping would be all income of the foreign bank or corporation excluded from the water's-edge combined report for California purposes. For the apportionment process to apply, a class of gross income, such as dividends, must contain both a statutory and residual grouping of income.

Example

> During 2006, Coupe Corporation, a foreign corporation, received dividend income from an equity investment in a US corporation. The dividend income is considered effectively connected with Coupe's US trade or business. Coupe incurred stewardship and other expenses related to the management of its equity investment in the US corporation. Coupe did not receive any other dividend income. The stewardship and other expenses are allocable to the dividend income as deductions definitely related to a class of income (dividends.) Since all of the dividend income is included in the water's-edge combined report, there is no need to apportion the deductions within the class of income because all of the income is in the statutory grouping.

The general rules for apportionment of deductions provide that the apportionment is to be based on the factual relationship between the deductions and the statutory and residual groupings of gross income. In determining the method of apportionment for a specific deduction, factors to be considered include, but are not limited to, the following comparisons:

- Units sold in the US to units sold without the US
- Amount of gross receipts in the US to gross receipts from without the US
- Cost of goods sold in the US to the cost of goods sold outside the US
- Profit contribution made by each grouping
- Expenses incurred, assets used, salaries paid, space utilized and time spent, which are attributable to the activities or properties generating the income
- Amount of gross income in the statutory and residual groupings

The method of apportionment must be one that "reflects to a reasonably close extent the factual relationship between the deduction and the groupings of gross income." For example, the gross income method would be inappropriate in cases where the deductions for the year are definitely related to a class of income, and there is no gross income in that class.

Deductions not definitely related to any gross income (e.g., charitable contributions) must be apportioned ratably between the statutory grouping and the residual grouping on the basis of gross income within each grouping to total gross income. Deductions related to all gross income, (e.g., supportive general and administrative expenses, etc.,) would similarly be apportioned ratably between the statutory and residual groupings using a method, which reasonably reflects the relationship between the deduction and the groupings. Virtually all foreign corporations engaged in a US business will claim a deduction from ECI for "home office" supportive expenses.

A home office deduction represents a US tax deduction for expenses incurred by the home office, which are attributable to the US business operations. The administration of a multinational operation requires some degree of centralized management, which benefits the organization as a whole, and a reasonable portion of the total cost of such management services may be considered to be in support of the US business activities. Typical expenses, which might be considered supportive expenses, include legal fees, training programs, and international department expenses.

Common methods of allocating home office expenses include the use of ratios of either:

- US to worldwide assets
- US to worldwide income
- Ratios of time spent by pertinent employees on the US operations to time spent by such employees on total operations.

Tax planning of any foreign corporation would maximize the apportionable deduction pool to obtain an increased home office expense deduction.

Note that the regulations do not rule out the apportionment of expenses based on gross receipts or gross income as being a reasonable method. The gross receipts or income method may be used to apportion supportive expenses between the statutory grouping and residual grouping in cases where the facts would not justify a method on more specific factors.

Finally, in contrast to the deduction allocation process, exempt income is not taken into account in apportioning deductions between the statutory and residual groupings. Example 24 of Treas. Reg. §1.861-8T(g) demonstrates the application of this rule.

4. Rules for Allocating and Apportioning Specific Categories of Deductions

To provide additional guidance, Treas. Reg. §1.861-8(e) also sets forth rules governing the allocation and apportionment of specific categories of deductions. These categories are:

A. Interest expense of domestic corporations and CFCs. (Treas. Reg. §1.861-8(e)(2).)
B. Stewardship expenses. (Treas. Reg. §1.861-8(e)(4).)
C. Research and development expenses. (Treas. Reg. §1.861-8(e)(3).)
D. Legal and accounting fees and expenses. (Treas. Reg. §861-8(e)(5).)
E. Income taxes. (Treas. Reg. §1.861-8(e)(6).)
F. Losses on the sale, exchange or other disposition of property. (Treas. Reg. §1.861-8(e)(7).)

G. Net operating losses. (Treas. Reg. §861-8(e)(8).)

All the above categories, except interest expense and income taxes, are applicable for purposes of determining a foreign corporation's taxable ECI includible in a water's-edge combined report. Category A, interest expense, generally only applies to domestic corporations (although, at the taxpayer's option, the rules may also be used to determine the net income of a CFC). Category E, income taxes, is not deductible for California purposes.

5. Foreign Currency Rules

IRC §989 provides that a Qualified Business Unit (QBU) is any separate unit of a trade or business of a taxpayer, which maintains separate books and records. Pursuant to IRC §985, each QBU must determine its "functional currency" (generally the currency in which its business is primarily transacted), and use that currency to make all determinations required under the IRC. Non-functional currency amounts must be translated into the functional currency using the appropriate exchange rate. The appropriate exchange rate is generally the weighted average exchange rate for the year. The term "weighted average exchange rate" generally means the simple average of the daily exchange rates.

A foreign corporation that has income that is effectively connected with, or treated as effectively connected with, the conduct of a US trade or business is treated as a separate QBU with a dollar functional currency. The US branch income and expense amounts must, therefore, be stated in US dollars. In all probability, the home office income and expense amounts will be stated in the foreign currency of the home office. Given this, the question arises as to how to go about allocating and apportioning the home office expenses to the US trade or business.

In situations where the home office expenses are being apportioned using a method based on non-monetary factors, such as a comparison of units sold or employee time records, the appropriate apportionment ratio is applied to the home office expenses, and the resulting apportioned expense is converted to US dollars. In situations where the method of apportionment is based on monetary amounts, such as a comparison of gross receipts, the amounts must first be converted into a common currency to calculate the appropriate apportionment ratio.

6. Examples of the Application of Treas. Reg. §1.861-8 to Foreign Corporations

The following examples demonstrate the application of the Treas. Reg. §1.861-8 rules.

Example

Alpha Corporation, a foreign corporation doing business in the US, is a manufacturer of electronic equipment. Alpha Corporation sells its products in the US (through a US branch) as well as worldwide. Alpha Corporation also has four non-US subsidiaries, B Corporation, C Corporation, D Corporation, and E Corporation, which act as distributors for Alpha's products in countries other than the US.

Alpha's income for the taxable year consists of:

	Sales	Gross Profit
Non US Sales Income	100,000,000	$20,000,000
US Sales Income	60,000,000	12,000,000
Dividends From B, C, D & E		7,000,000
Fees From C for Services		1,000,000
Total Gross Profit		$ 40,000,000

Among other deductions, Alpha incurs the following expenses:

Expenses of International Department	$ 1,600,000
Personnel Department Expenses	50,000
Training Department Expenses	35,000
General and Administrative	55,000
President's Salary	40,000
Sales Manager's Salary	20,000
Total	$ 1,800,000

The International Department performs two principle types of activities, it:

- Provides services for the direct benefit of C, for which it receives a fee of $1 million.

- Engages in stewardship activities in the nature of management review that duplicates functions performed by the subsidiaries. For example, a team of internal auditors from Alpha's accounting department periodically audits the subsidiaries books and prepares internal reports for use by Alpha management. Similarly, Alpha's Treasurer periodically reviews the subsidiaries' financial policies for Alpha's Board of Directors. The cost of the duplicative services is $600,000.

The other listed expenses (e.g., personnel department, training department, etc.,) are supportive expenses with respect to Alpha's worldwide manufacturing and sales activities.

For purposes of applying the Treas. Reg. §1.861-8 allocation and apportionment rules, Alpha's statutory grouping is all gross income meeting the ECI standard. The residual grouping is gross income not meeting the ECI standard. For purposes of determining California's statutory and residual groups, the federal groupings would apply since all of Alpha's US source income is ECI (i.e., Alpha does not have any US-source NECI.) The allocation and apportionment process is used to determine the deductions attributable to these two groupings.

Step 1 - Allocation:

The international department's outlay of $1 million is the basis for the charge to C for services rendered. Therefore, the $1 million expense is allocated to the fee income from C. The remaining $600,000 of the department's deductions is definitely related and allocable to the types of gross income to which they give rise, namely dividends from subsidiaries B, C, D and E.

The supportive expenses are definitely related and allocable to the sales income derived from both US and foreign markets.

Step 2 - Apportionment:

The $1.6 million of expenses of the international department is allocable to classes of income (dividends and service fees), which are solely within the residual grouping. There is therefore no need to apportion these expenses. They are simply 100 percent allocated to the residual grouping, and not deductible from ECI.

Since the $200,000 in supportive expenses is definitely related to a class of gross income, sales, which consists of both statutory (ECI) and residual (foreign source NECI) groupings, the expenses must be apportioned between the two groupings. In the absence of any other facts (such as time records for the employees,) an acceptable method of apportionment would be on the basis of gross receipts.

Statutory Grouping (ECI):

$$\frac{\$60 \text{ million}}{\$100 \text{ million} + \$60 \text{ million}} \quad X \quad \$200{,}000 \quad = \quad \$75{,}000$$

Thus, Alpha can reduce its income effectively connected with its US business by $75,000, even though the deduction reflects disbursements mainly in the foreign country.

Example

Alpha Corporation, a foreign corporation doing business in the US, is a manufacturer of electronic equipment. Alpha Corporation sells its products in the US (through a US branch) as well as worldwide. Alpha Corporation also has four non-US subsidiaries, B Corporation, C Corporation, D Corporation and E Corporation, which act as distributors for A's products in countries other than the US. Alpha also made a substantial investment in California municipal bonds. The bonds come due in 2006, and Alpha intends on using the proceeds for future expansion of its US business activities.

Alpha's income for the 2004 taxable year consists of:

	Sales	Gross Profit
Non-US Sales Income	$ 100,000,000	$ 20,000,000
US Sales Income	60,000,000	12,000,000
Dividends From B, C, D & E		8,000,000
Interest Income From US Bank		2,000,000
Interest Income From UK Bank		1,000,000
Interest From CA Municipal Bonds		4,000,000
Fees From C for Services		1,000,000

Total Gross Profit	$ <u>48,000,000</u>

The US sales income is effectively connected with Alpha's US trade or business. The interest income from US Bank is also effectively connected with Alpha's US trade or business, while the interest income from United Kingdom (UK) Bank is not. The interest from the California municipal bonds is not effectively connected with Alpha's US trade or business, but represents US-source business income.

Among other deductions, Alpha incurs the following expenses:

Expenses of International Department	$ 1,600,000
Treasury and Finance Department	100,000
Personnel Department Expenses	50,000
General and Administrative	90,000
President's Salary	<u>60,000</u>
Total	$ <u>1,900,000</u>

The International Department performs two principle types of activities, it:

- Provides services for the direct benefit of C, for which it receives a fee of $1 million.
- Engages in stewardship activities in the nature of a management review, which duplicates functions performed by subsidiaries B, C, D and E. For example, a team of internal auditors from Alpha's accounting department periodically audits the subsidiaries books and prepares internal reports for use by Alpha's management. Similarly, Alpha's treasurer periodically reviews the subsidiaries' financial policies for Alpha's Board of Directors. The cost of the duplicative services is $600,000.

The other listed expenses (Personnel Department, Treasury Department, etc.,) are supportive expenses with respect to Alpha's worldwide manufacturing and sales activities.

For purposes of applying the Treas. Reg. §1.861-8 allocation and apportionment rules to determine a "deemed subsidiary's" income includible in a water's-edge combined report, Alpha's statutory grouping is all gross income meeting the ECI standard. The residual grouping is all other gross income. The allocation and apportionment process is used to determine the deductions attributable to these two groupings.

Step 1 - Allocation:

The International Department's outlay of $1 million is the basis for the charge to C for services rendered, and therefore the $1 million expense is allocated to the fee income from C. The remaining $600,000 in the department's deductions is definitely related and allocable to the types of gross income to which it gives rise, namely dividends from subsidiaries B, C, D and E.

The supportive expenses are definitely related and allocable to the sales and interest income derived from both US and foreign markets.

Step 2 - Apportionment:

The $1.6 million of expenses of the international department is allocable to classes of income (dividends and service fees), which are solely within the residual grouping. There is therefore no need to apportion these expenses. They are simply 100 percent allocated to the residual grouping and not deductible from income includible in the water's-edge combined report.

Since the $300,000 in supportive expenses is definitely related to a class of gross income (sales and interest income), which consists of both statutory (ECI) and residual (foreign source NECI and US-source NECI) groupings, the expenses must be apportioned between the two groupings. In the absence of any other facts (such as time records for the employees), an acceptable method of apportionment would be on the basis of gross receipts.

Statutory Grouping:

$$\frac{\$60\text{ million (sales)} + \$6\text{ million (interest)}}{\$100\text{ million} + \$60\text{ million} + \$1\text{ million} + \$6\text{ million}} \times \$300{,}000 = \$120{,}000$$

Thus, Alpha can reduce its income includible in the water's-edge combined report by $120,000, even though the deduction reflects disbursements mainly in the foreign country.

c. Computation of Interest Expense under Treas. Reg. §1.882-5 for Taxable Years Beginning On or After June 6, 1996

1. In General

A significant number of foreign entities filing federal Form 1120F are either foreign banks or real estate investment corporations. Accordingly, for many of these companies, interest expense will be one of the largest deductions, and one of the most material expenses to be allocated and apportioned to ECI.

The IRS issued revised regulations under IRC §882, which are effective for taxable years beginning on or after June 6, 1996. (For taxable years beginning prior to June 6, 1996, see former Treas. Reg. §1.882-5 (1981-1996) T.D. 7749, 1981-1 C.B. 390.) The revised Treas. Reg. §1.882-5(a)(2) clearly states that it is the exclusive method that may be used to determine a foreign corporation's interest expense effectively connected to its US trade or business. The question of whether older tax treaties, such as the UK treaty, provide alternative methods to compute the allowable interest expense deduction is no longer an issue.

Direct allocations of interest expense to US asset and indebtedness that meet the requirements of Treas. Reg. §1.861-10T(b) and (c), as limited by Treas. Reg. §1.861-10T(d)(1), may be made in accordance with Treas. Reg. §1.861-10T. However, the interest expense, assets and liabilities that relate to the interest expense that was directly allocated will be disregarded in the interest expense computation under Treas. Reg. §1.882-5. A similar rule applies to a foreign corporation that is a partner in a partnership that has US asset and indebtedness that meets the requirements of Treas. Reg. §§1.861-10T(b) and (c).

Treas. Reg. §1.882-5(a)(3) provides that in no event may the interest expense computed under Treas. Reg. §1.882-5 exceed the amount of interest expense paid or accrued by the taxpayer within the taxable year. Furthermore, under Treas. Reg. §1.882-5(a)(5), any provision that disallows, defers or capitalizes interest expense applies after determining the amount of interest expense allocated to ECI under Treas. Reg. §1.882-5. For example, in determining the interest expense disallowed under IRC §163(j), deferred under IRC §§163(e)(3) or §267(a)(3), or capitalized under IRC §263A with respect to a US trade or business, a taxpayer takes into account only the amount of interest expense allocable to ECI under Treas. Reg.

§1.882-5. See Treas. Reg. §1.882-5(a)(8) for examples illustrating the above rules.

2. Making an Election under Treas. Reg. §1.882-5

A corporation must make each election required by Treas. Reg. §1.882-5 on the corporation's federal Form 1120F for the first taxable year beginning on or after the date of this revised regulation. An election cannot be made on an amended return. The election is made by using the method elected to calculate interest expense claimed on the original return for the year. An elected method must be used for a minimum period of five years before a taxpayer may elect a different method. A change in election prior to the end of the five-year period will rarely be granted. If a taxpayer fails to make an election in a timely fashion, then the Assistant Commissioner (International) may make any or all of the elections on behalf of the taxpayer, and the elections shall be binding as if made by the taxpayer.

3. Computing the Allowable Interest Deduction

The amount of interest expense deduction allowed against the ECI of a foreign corporation is the sum of:

1. Specially allocated interest expense.
2. Interest paid or accrued by the foreign corporation on its liabilities booked in the US adjusted under the three-step process set forth in Treas. Reg. §1.882-5(b), (c) and (d).

A. Specially Allocated Interest Expense

Under Treas. Reg. §1.882-5(a)(1)(ii), a foreign corporation with a US asset and indebtedness *may* directly allocate interest expense from such indebtedness to income from such asset as provided in Treas. Reg. §1.861-10T.

B. Interest Expense Allocable to US Booked Liabilities

This computation consists of three basic steps, determining the value of:

1. US assets for the taxable year
2. US effectively connected liabilities (ECL) for the taxable year
3. Interest deduction allowed

The terms and rules are common to all the steps for taxable years beginning on or after June 6, 1996.

- Classification of items - The classification of such items as assets or liabilities must be on a consistent basis from year-to-year, and must be in accordance with US tax principles. The determination of whether items reported on the foreign entity's balance sheet represent assets or liabilities is made by applying US tax principles. Thus, for example, items such as unfunded pension reserves, which are not considered liabilities for US tax purposes, are not considered liabilities for purposes of applying the provisions of Treas. Reg. §1.882-5.

- Average total values - The average total value of assets or the average total value of liabilities is determined by taking the average of the totals computed at the most frequent, regular intervals for which data are reasonably available. In no event, the value shall not be computed less frequently than monthly for large banks, and semi-annually for any other taxpayer.

- Inter-branch loans - Assets, liabilities and interest expense amounts resulting from loans or credit transactions of any type between the separate branches of the same corporation are disregarded.

- Currency translations - An asset or liability amount that is denominated in one currency is translated into another currency at the exchange rate consistent with the method the taxpayer uses for financial reporting purposes provided the method used is applied consistently from year-to-year. Interest paid or accrued shall be translated under the rules of Treas. Reg. §1.988-2. In the event the functional currency of the taxpayer's home office is a hyperinflationary currency, then the taxpayer may be required to make the necessary computations using US dollars if such a method is necessary to prevent distortion.

Step 1: Determination of Total Amount of US Assets

The first step, asset determination, involves the determination of the average total value of *US assets* for the taxable year. The value of a US asset is the adjusted basis of the asset for determining gain or loss from the sale or other disposition of that item. A taxpayer may elect to value all of its US assets on the basis of fair market value (FMV). Once elected, the FMV must be used for both step 1 and step 2, and must be used for all subsequent years unless the IRS consents to a change.

An asset is a US asset to the extent that it is a US asset under Treas. Reg. §1.884-1(d). Based on this broad definition, US assets include:

- US real property held in a wholly-owned domestic subsidiary of a foreign corporation that qualifies as a bank under IRC §585(a)(2)(B) (without regard to the second sentence thereof), provided that the real property would qualify as used in the foreign corporation's trade or business.

- Assets that produce income treated as ECI under IRC §§921(d) or 926(b), relating to certain income of a Foreign Sales Corporation (FSC) and certain dividends paid by a FSC to a foreign corporation. Note, for tax years after 2001, this section will no longer apply, as the FSC provisions were repealed.

- Assets that produce income treated as ECI under IRC §953(c)(3)(C), relating to certain income of a captive insurance company that a corporation elects to treat as ECI, that is not otherwise ECI.

- An asset that produces income treated as ECI under IRC §882(e), relating to certain interest income of possession banks.

US assets do not include assets that produce income or gain described in IRC §§883(a)(3) and (b). Furthermore, the total value of US assets is reduced by the amount of bad debt reserves under IRC §585.

Step 2: Determination of US ECL

The second step in the computation of the allowable interest expense deduction is the determination of total amount of US ECL for the taxable year. The foreign corporation determines its US ECL by multiplying the average total value of its US assets, as calculated in Step 1, by one of two ratios:

- Fixed ratio
- Actual ratio

On the first return to which Treas. Reg. §1.882-5 applies, the foreign corporation must either use the actual ratio, or it may elect to use the fixed ratio. The corporation must continue to use that ratio for a minimum of five years before it can elect another method.

The US ECL computation essentially determines the amount of average US assets, which are deemed funded by debt. As will be seen in Step 3, an interest rate is then applied to this deemed debt funding to arrive at the amount of deductible interest expense.

A taxpayer that is a bank as defined in IRC §585(a)(2)(B) (without regard to the second sentence thereof) may elect to use a fixed ratio of 93 percent in lieu of the actual ratio. A taxpayer that is neither a bank nor an insurance company may elect to use a fixed ratio of 50 percent in lieu of the actual ratio.

The actual ratio is the taxpayer's total amount of worldwide liabilities for the taxable year divided by the total value of the taxpayer's worldwide assets for the taxable year. For purposes of computing this ratio, all asset values and liability amounts must be consistently stated from year-to-year in either US dollars or in the currency of the country in which the head office of the corporation is located. The classification of an item as a liability or an asset must also be consistent from year to year and in accordance with US tax principles. The worldwide assets values must be determined using the same adjusted basis or the FMV basis that the taxpayer elected for valuing US assets in Step 1.

Example

> Big Bucks Bank, a Hong Kong corporation, has a US branch office engaged in the banking business. Big Bucks elects to use adjusted book values for its assets. It also elects to state its accounts for the Step 2 computation in US dollars. The average total value of corporate worldwide assets is $100 million; the average total value of US assets is $20 million; and the average total amount of corporate worldwide liabilities is $80 million.
>
> Based on these facts, Big Bucks' fixed ratio is 93 percent, and its actual ratio is 80 percent ($80/$100.) US ECL would be $18.6 million ($20 million x 93%), if the fixed ratio were used, and $16 million ($20 million x 80%) if the actual ratio were used.

The average worldwide assets and liabilities of a large bank (as defined in IRC §585(c)(2)) must be computed semi-annually. In the case of any other taxpayer, the computation must be done annually. Most corporations should have annual financial statements; interim worldwide statements may not be available (unlike interim statements which should be readily available for the US branch activities.)

The District Director or the Assistant Commissioner (International) of the IRS may make appropriate adjustments to prevent a foreign corporation from intentionally and artificially increasing its actual ratio.

With respect to stating the worldwide assets and liabilities on a US tax accounting basis, there are some general principles, which may be applied to more closely approximate a balance sheet on a US accounting basis. This analysis is similar to that made on a worldwide basis to properly reflect worldwide income and factors on a California tax accounting basis. The following are some possible areas of adjustment.

i. Amounts Reflected On US Tax Basis

Many foreign countries allow hidden contingent liability reserves, unfunded pension reserves, unrealized write-offs, or re-valuations of assets, or other similar items to be recorded on the financial statements. Any such account or adjustment, which would not be recognized under US tax principles, should be backed out of the computation of worldwide assets and liabilities.

Similarly, some foreign country financial statements treat the reserve for bad debts as a liability account. For US purposes, the bad debt reserve is a contra-asset account. Therefore, the bad debt reserve should decrease asset values (assuming the taxpayer has not elected to state assets at FMV) and should be eliminated from the amount of liabilities.

ii. Exclusion of Accounts

Memorandum accounts, (i.e., those accounts that are recorded both on the asset and liability side of the balance sheet), should be excluded from the computation. These would include items such as forward contracts in foreign exchange, prepaid income with an offsetting liability account, and customer’s liabilities (where, for example, the taxpayer is merely acting as an agent for another party, such as a tax collecting agent for a government).

iii. Inclusion of Omitted Assets and Liabilities

The worldwide balance sheet of some foreign corporations may not include the assets and liabilities of their branches outside the country of incorporation. Branches outside the country of incorporation may be treated as if they were subsidiaries, and only the net investment is recorded on the books of the home office. Such treatment would, of course, understate the amount of worldwide assets and liabilities. In such cases, the balance sheets of all foreign branches of the entity should be obtained, converted into the home country currency, and added to the worldwide balance sheet.

Step 3: Interest Deduction Allowed

The third step is the computation of the interest deduction allowed against ECI. There are two methods for determining the allowable interest expense deduction:

- Adjusted US Booked Liabilities Method
- Separate Currency Pools Method

The corporation elects which method it wishes to use on its first return to which Treas. Reg. §1.882-5 applies for taxable years beginning on or after June 6, 1996. The bank or corporation must continue to use that method for a minimum of five taxable years, unless it obtains permission from the IRS to change methods.

- Adjusted US Booked Liabilities Method

Under the Adjusted US Booked Liabilities Method, the adjustment to the amount of interest expense paid or accrued on US booked liabilities is determined by comparing the amount of US ECL for the taxable year, as determined under Step 2, with adjusted US booked liabilities determined under this step. If the amount of US booked liabilities, as determined in Step 2, equals or exceeds the amount of US ECL, as determined in Step 2, then allowable interest expense is determined by multiplying total interest expense paid or accrued on the US books by the ratio of US ECL to average total US booked liabilities. If the amount of US booked liabilities, as determined in Step 2, is less than the amount of US ECL, as determined in Step 2, then the allowable interest expense equals the total amount of interest paid or accrued, plus the excess of the amount of US ECL over US booked liabilities multiplied by the applicable interest rate.

For purpose of this discussion, the average total amount of US booked liabilities under Step 3 is the liability that is properly reflected on the books of the US trade or business. For entities other than banks, a liability is considered properly reflected on the books of a US trade or business if the liability is secured predominantly by a US asset of the foreign corporation, if the foreign corporation enters the liability on a set of books relating to an activity that produces ECI at a time reasonably contemporaneous with the time at which the liability is incurred, or if the IRS determines that there is a direct connect between the liability and the activity that produces ECI. If the foreign entity is a bank, a liability is considered properly reflected on the books of the US trade or business if the bank enters the liability on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred and there is a direct connection or relationship between the liability and that activity.

Examples of how to compute the allowable interest deduction under the Adjusted US Booked Liabilities Method can be found under Treas. Reg. §1.882-5(d)(6).

- Separate Currency Pool Method

A foreign corporation may elect to determine its interest rate on US ECL by reference to its US assets, using the Separate Currency Pools Method, instead of the Adjusted US Booked Liabilities Method in Treas. Reg. §1.882-5(d). Taxpayers treat their US assets in each currency as funded by the worldwide liabilities of the taxpayer in that same currency. To prevent distortion, taxpayers that have more than 10 percent of their US assets denominated in hyperinflationary currency are precluded from using the Separate Currency Pools Method. Taxpayers may also convert into US dollars any currency pool in which the foreign corporation holds less than three percent of its US assets.

Examples of how to compute the allowable interest deduction under the Separate Currency Pools Method can be found under Treas. Reg. §1.882-5(e)(5).