Internal Revenue Service
memorandum

date: JUL 23 1996

to:
John T. Lyons
Assistant Commissioner (International) CP:IN:I:IF

from:
Margaret O'Connor
Chief Branch 6 CC:INTL:Br6

subject:
Case Assistance for the Mexican Growers/Cattle Projects

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Background

The transactions for which your Office seeks guidance are sales in the United States (meaning title passing in the United States) of foreign natural resources by foreign persons. This memorandum does not address the sale of foreign natural resources where title passes outside the United States. In your memorandum dated May 16, 1996, you requested guidance on how to source income from sales of natural resources after Phillips Petroleum and Affiliated Subsidiaries v. Commissioner, 70 F. 3d 1282 (10th Cir. 1995), aff'g without published opinion, 97 T.C. 30 (1991) and 101 T.C. 78 (1993). In Phillips, the Tax Court ruled Treas.

Reg. § 1.863-1(b)(1)'s natural resource rule, generally sourcing sales income in its entirety to the location of the natural resources, invalid as inconsistent with the Court's interpretation of the statute, which in its view requires mixed source income in all cross-border sales. [redacted] DP

For years prior to the effective date of new regulations, and, therefore, for years currently under audit, we believe nonresidents selling foreign natural resources in the United States should be required to source some sales income to the United States. Thus, consistent with Phillips, it is inappropriate to source all of the sales income to the foreign jurisdiction under the natural resource rule. As discussed below, the approach taken will be different depending on the year at issue and the form of sale.

Taxable years after 1986

Section 865, effective for taxable years after 1986, determines the source of income from sales of personal property. Two subsections apply to nonresidents selling natural resources in the United States, one, section 865(e)(2), governing the source of income for nonresidents selling through a U.S. office, the other, section 865(b), governing the source of income for nonresidents without a U.S. office. Section 865(e)(3) explicitly provides that section 864 principles apply in determining whether a nonresident has a U.S. office. Under those principles, a dependent agent with authority to conclude contracts constitutes a U.S. office. See Treas. Reg. § 1.864-7(d). Therefore, section 865(e)(2) applies to determine the source of income for nonresidents selling through an actual U.S. office or through a dependent agent with authority to contract.

1. Section 865(e)(2)

Section 865(e)(2)(A) reads in relevant part as follows:

> Sales by nonresidents....Notwithstanding any other provisions of this part, if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced in the United States....

As the rules currently operate, the amount of U.S. or foreign source income a nonresident derives in cross-border sales

potentially could vary, depending upon whether section 865(e)(2) or section 865(b) applies. In cases falling under section 865(e)(2), individuals in this Office working on the issue have reached a general consensus that, notwithstanding section 865(e)(2)'s broad language, we do not intend to source 100% of the sales income to U.S. sources. We may, however, define language in section 865(e)(2), referring to the "income attributable to the U.S. office," perhaps by reference to section 863, to limit the amount of U.S. source income, based in some way on income attributable to the sales functions performed in the United States. The legislative history to this provision supports an approach for determining the amount of U.S. and foreign source income from the sale based upon section 863.[1]

We believe it is fully appropriate for examiners, currently auditing returns sourcing income from sales of natural resources subject to section 865(e)(2), to apply Treas. Reg. § 1.863-1(b)(2), a provision permitting the Commissioner to exercise her discretion to reasonably allocate or apportion income between U.S. and foreign sources. That regulation provides in relevant part:

> (2) If the Commissioner determines that the application of the provisions of subparagraph (1) of this paragraph does not result in a proper allocation or apportionment of income, the Commissioner may make such other allocation or apportionment as will, in his opinion, more clearly reflect the proper source of the income to which such subparagraph applies.

Subparagraph (1) applies to income from sales of natural resources, and is the regulation the Tax Court invalidated in Phillips. The Tax Court did not address subparagraph (2), quoted above. As long as the Commissioner does not allocate 100% of the sales income entirely to one jurisdiction, we believe the Commissioner is free to apply subparagraph (2) to reasonably allocate or apportion income from sales of natural resources subject to section 865(e)(2), sourcing income attributable to functions performed in the United States as U.S. source income. The government would cite Phillips for the proposition that nonresidents cannot apply Treas. Reg. § 1.863-1(b)(1) to make the income foreign source in its entirety.[2]

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[1] We have previously provided a full discussion of this legislative history to the Mexican Growers/Cattle Project.

[2] Even had Phillips not invalidated Treas. Reg. § 1.863-1(b)(1), the Commissioner could have relied on § 1.863-1(b)(2) if there were peculiar conditions of production and sale. Generally, additional production activities in the country of sale would have qualified as a peculiar condition. See GCM

2. Section 865(b)

For cases where a nonresident does not maintain a U.S. office, or does not act through a dependent agent, section 865(b), rather than section 865(e)(2), applies to determine the source of income from sales of natural resources in the United States. Significantly, section 865(b) could apply, for example, where the nonresident is engaged in a U.S. trade or business through an independent agent, since only a dependent agent qualifies under section 865(e)(2) as a U.S. office. Section 865(b) reads in relevant part as follows:

> Exception for inventory property.
> In the case of income derived from the sale of inventory property --
> (1) this section shall not apply, and
> (2) such income shall be sourced under the rules of sections 861(a)(6), 862(a)(6), and 863(b)....

Unfortunately, a statutory glitch in section 865(b) has created a legal stumbling block in sourcing certain income subject to this section. The problem arises because section 865(b) by its terms refers only to section 863(b). Thus, a technical reading of the statute makes section 863(a), as well as any regulation promulgated under that section, inapplicable in determining the source of income from inventory sales. Treasury Reg. § 1.863-1(b)(1)'s natural resource regulation provides a method of allocation to determine the source of income (rather than a method of apportionment), and is promulgated under section 863(a). Consequently, even had we challenged Phillips to establish the validity of the natural resource regulation, we would confront section 865(b)'s plain language, making section 863(a) and its regulations inapplicable.

Treasury Reg. § 1.863-3(b)(2), Example (2), which illustrates a method of apportionment, however, is promulgated under section 863(b). That regulation splits income 50/50 between production and sales activity. If title to the natural resources passes in the United States, Example (2) apportions at least 50% of the nonresident's sales income to U.S. sources.[3] Although taxpayers very much like the 50/50 rule in outbound sales, the rule can produce harsh results on inbound sales. Examiners could encounter this problem in some of the Mexican

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[3] The half apportioned based on where the sale takes place would be U.S. source income, since under Treas. Reg. § 1.861-7(c), a sale generally takes place where title passes.

cases under audit. If they conclude that the result under Example (2)'s 50/50 method unfairly apportions too much of the taxpayer's income to U.S. sources, we believe examiners may apply Treas. Reg. § 1.863-1(b)(2), the regulation discussed above granting the Commissioner discretion to reasonably apportion as well as allocate income. We believe examiners could devise an apportionment approach similar to Example (2)'s 50/50 method that would pass muster under section 863(b). Such an approach could base the amount of U.S. source income on the sales or other production functions performed by the nonresident -- or its agent -- in the United States.

Taxable years prior to 1986

For any year prior to 1986, only the rules of section 863 apply. In all of these cases -- regardless of whether the taxpayer sells through a U.S. office -- if title passes in the United States, the Commissioner can apply Treas. Reg. § 1.863-1(b)(2) to reasonably divide the income between U.S. and foreign sources, as long as the Commissioner, consistent with Phillips, does not allocate 100% of the income to one tax jurisdiction. In contrast, if the nonresident passes title to U.S. customers outside the United States, the nonresident's income would be foreign source income, not governed by section 863. Any foreign source income effectively connected with a U.S. trade or business under section 864 would be subject to U.S. tax. The amount of foreign source income that can be effectively connected is limited under section 864(c)(5)(C), to an amount that would be U.S. source income, determined as if title passed in the United States. See Treas. Reg. § 1.864-6(c)(2). We believe that based on the section 864 regulations, the Commissioner could apply Treas. Reg. § 1.863-1(b)(2) to determine the amount of income that would be U.S. source, and, therefore, subject to U.S. tax. Again, consistent with Phillips, a nonresident cannot rely on Treas. Reg. § 1.863-1(b)(1)'s natural resources rule to claim that all its income is derived from foreign sources, and is, therefore, not subject to U.S. tax.

Conclusion

We hope we have answered your questions as to how to source income from U.S. sales of foreign natural resources in the Mexican grower and cattle cases currently under audit, in view of the decision in Phillips. If you have any questions, please call Anne Shelburne at 622-3880.