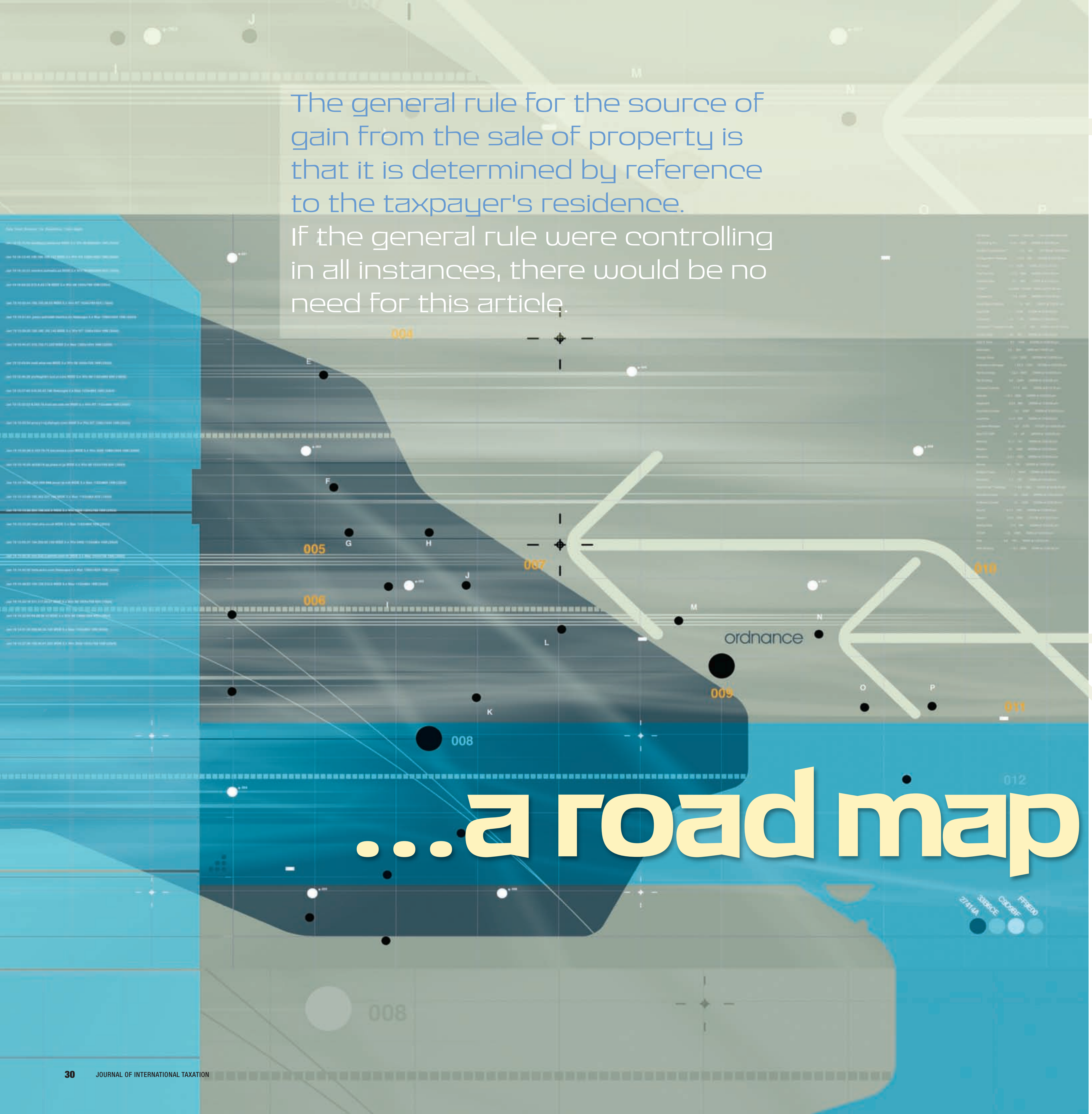


The general rule for the source of gain from the sale of property is that it is determined by reference to the taxpayer's residence. If the general rule were controlling in all instances, there would be no need for this article.

# Gain From Property Sales as Effectively Connected Income ...a road map

ROBERT P. ROTHMAN

The rules governing when the United States will treat gain from the sale of property recognized by a foreign corporation or nonresident alien as effectively connected with a U.S. trade or business are in myriad provisions, most of which are in Part I of Subchapter N of the Internal Revenue Code. Although these rules are not particularly difficult to understand in concept, they tend to be quite confusing in application. This is primarily because they are not organized logically, so it is necessary to navigate through a veritable maze of cross-references and exceptions. The purpose of this article, and the accompanying flowcharts, is to provide a **roadmap** to assist in that navigation.

## Basic Framework

The basic framework for the taxation of foreign persons is in Sections 871 (nonresident alien individuals) and 881 and 882 (foreign corporations). In general, under these rules, income is classified in one of three basic categories. First, income that is effectively connected with the conduct of a U.S. trade or business (effectively connected income (ECI)) is subject to U.S. tax in essentially the same manner as it would be if it were recognized by a U.S. person (Sections 871(b), 882). Second, some types of income that are not ECI are subject to a 30% tax on gross income, but only if they are from U.S. sources (Sections 871(a), 881). This generally applies to certain categories of passive income described in Section 871(a)(1) (fixed or determinable annual or periodical income (FDAPI)).[1] Finally all other income—that is, any income that is not ECI or FDAPI—is not subject to U.S. tax when recognized by a foreign person. This article is limited to a discussion of the application of the ECI net-basis taxation regime to income from the sale of property.[2]

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## ECI Rules

The starting point for determining whether gain from the sale of property is ECI is determining whether the taxpayer is engaged in a U.S. trade or business ("ETB") in the first place. What constitutes a U.S. trade or business is the subject of a large body of law, and is beyond the scope of this article.[3] What is important to understand—and may not always be quite as obvious as it would seem—is that, in general, income cannot be effectively connected with a U.S. trade or business unless the taxpayer is engaged in such a trade or business (Section 864(c)(1)(B)).

**Non-ETB taxpayers.** As always, however, there are exceptions. One exception (derived from the Foreign Investment in Real Property Tax Act (FIRPTA)) applies when the property sold constitutes a "U.S. real property interest." In that event, the taxpayer is treated as though it were ETB and the gain were ECI, even if the taxpayer is not otherwise ETB (Section 897(a)).

In addition to FIRPTA, there are a few other circumstances where a taxpayer can have ECI without being ETB. The most important of these deals with two situations where a taxpayer is not ETB in the year in which gain was recognized, but was previously so engaged. Section 864(c)(6) applies where property is sold in a year in which the taxpayer was ETB, but some or all of the gain is recognized in a year in which the taxpayer is not ETB (for example, where the gain from the sale was reported on the installment method and the taxpayer is no longer ETB in the year that payments are received). In this situation, the tests for determining whether the gain is ECI (discussed in detail below) are applied as though the gain were recognized in the year of sale (Section 864(c)(6)).

A similar rule applies where the property had previously been used (or held for use) in connection with a U.S. trade or business but ceased to be so used before it was sold. In this situation, if the sale takes place within ten years of the time that the property ceased to be used in a U.S. trade or business, the tests for determining whether the gain is ECI (discussed in detail below) are applied as though the sale occurred



The **rules can be quite confusing** in application because they are not organized logically, so it is necessary to **navigate through a veritable maze** of cross-references and exceptions

immediately before the property ceased to be so used (Section 864(c)(7)).[4]

**Force-of-attraction principle.** Once it is determined that a taxpayer is ETB (or is subject to one of the exceptions discussed above), the general rule is that whether income is ECI depends on its source. Thus, subject to a few exceptions, U.S.-source income is ECI (Section 864(c)(3)); non-U.S.-source income is not (Section 864(c)(4)(A)). The first part of this proposition is frequently called the "unlimited force-of-attraction principle," reflecting the idea that once a U.S. trade or business is found to exist, it attracts to it all U.S.-source income, whether or not the income was actually generated by the operations of the business.[5]

**U.S.-source income not subject to unlimited force of attraction.** A few categories of U.S.-source income are not subject to the unlimited force-of-attraction principle. One consists of gain from the sale of capital assets. A second category consists of FDAPI (Section 864(c)(2)). In general, however, gain from the sale of property is definitionally excluded from FDAPI (Reg. 1.1441-2(b)(2)(i)); the only exceptions are (1) for a sale of a debt instrument, an amount equal to the original issue discount that accrued while held by the seller (Section 871(a)(1)(C)(i)); (2) gains on the disposition of certain natural resource property with a retained economic interest (Section 871(a)(1)(B)); and (3) gains from the sale of certain intangibles where the consideration is contingent on productivity, use, or disposition of the property (Section 871(a)(1)(D)).

If the property sold falls within one of these categories and the gain on the sale is U.S. source, the gain is not automatically ECI. Instead, the Code provides that "the factors taken into account [in determining whether the gain is ECI] shall include whether" (1) the gain is derived from assets used or held for use in the conduct of the trade or business ("asset-use" test), or (2) the activities of the trade or business were a material factor in the realization of the gain ("business-activities" test) (Sections 864(c)(2)(A) and (B)).[6] This formulation suggests that neither test is, in itself, determinative, and that there may be other factors that are also taken into account. However, some commentators have taken the position that U.S.-source income in these categories is, per se, ECI if it satisfies either the asset-use or business-activities test.[7]

In general, the asset-use test looks to whether the asset was, prior to being sold, used (or held for use) in the U.S. trade or business. If so, the test is satisfied even if the sale itself did not have anything to do with the trade or business (see Reg. 1.864-4(c)(2)). Conversely, the business-activities test looks at the extent to which the sale itself was connected with the U.S. trade or business—whether the property was used in the trade or business before being sold is irrelevant (see Reg. 1.864-4(c)(3)).

These rules do not mean that gain on the sale of any capital asset will automatically be treated as ECI if the asset-use test or the business-activities test is satisfied. Analytically, these tests are reached only once it has been determined that gain from the sale of a capital asset (or another type of asset not subject to the unlimited force-of-attraction principle) is U.S. source. As discussed below, the source of gain from the sale of property is a complex topic. Frequently, this gain will turn out to be foreign source, in which event the asset-use and material-factor tests are irrelevant.

**Foreign-source income.** As noted above, generally foreign-source income is not ECI (Section 864(c)(4)(A)). Section 864(c)(4) provides four exceptions to this rule. Two of those exceptions, covering certain rents, royalties, dividends,

**EXHIBIT 1**
**General ECI Rules**

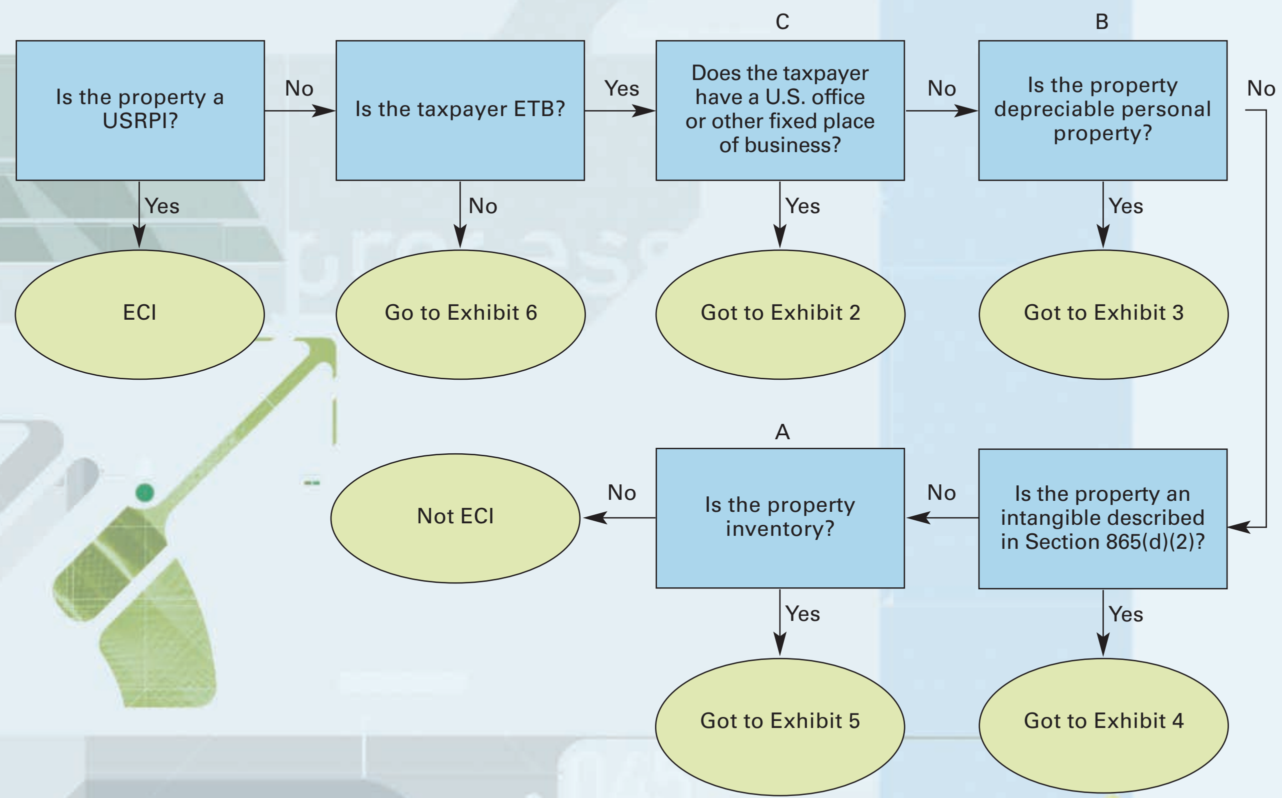



**EXHIBIT 2**
**Source Rules—Office or Fixed Place of Business**

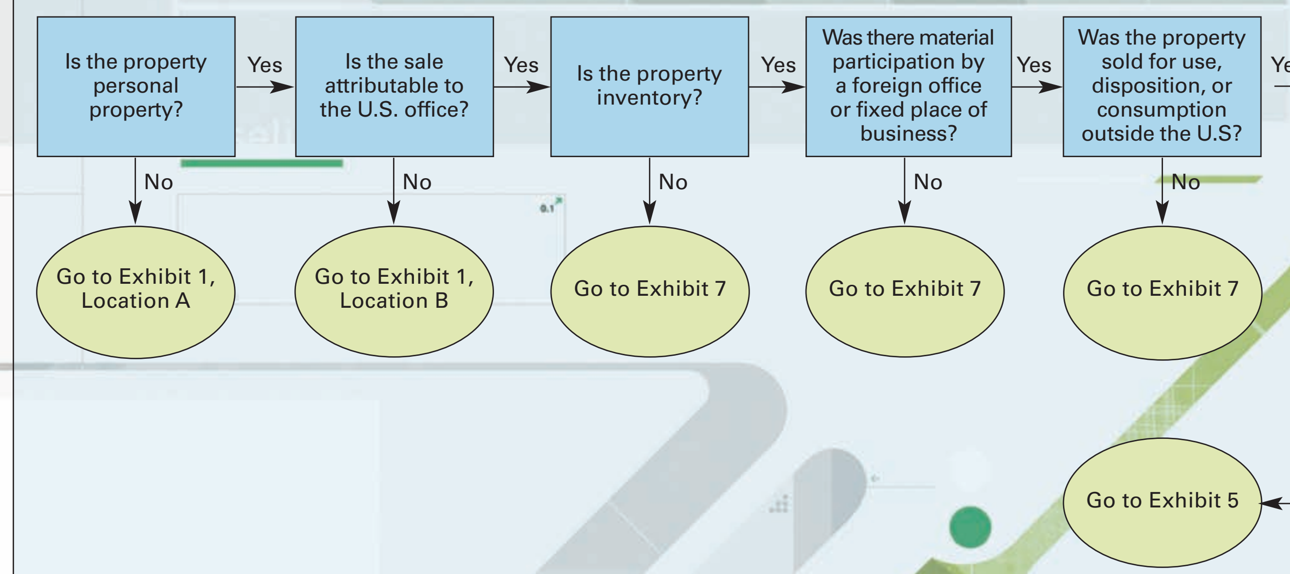



**EXHIBIT 3**
**Source Rules—Depreciable Personal Property**

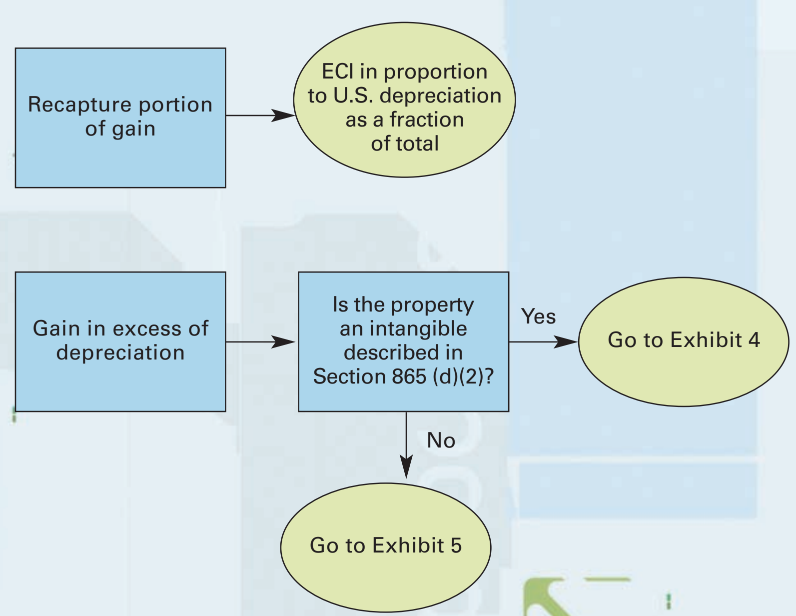



**EXHIBIT 4**
**Source Rules—Intangibles**

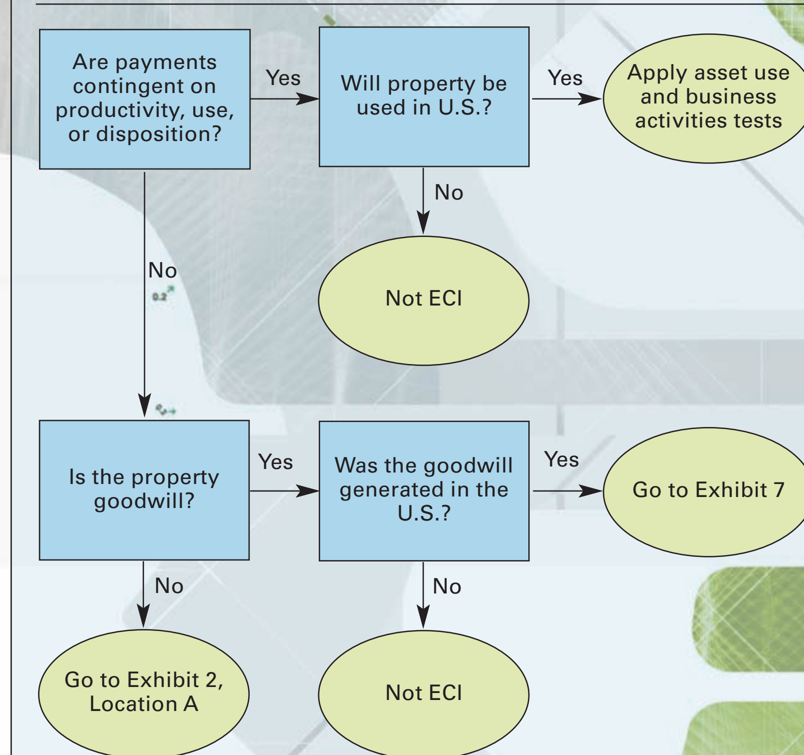
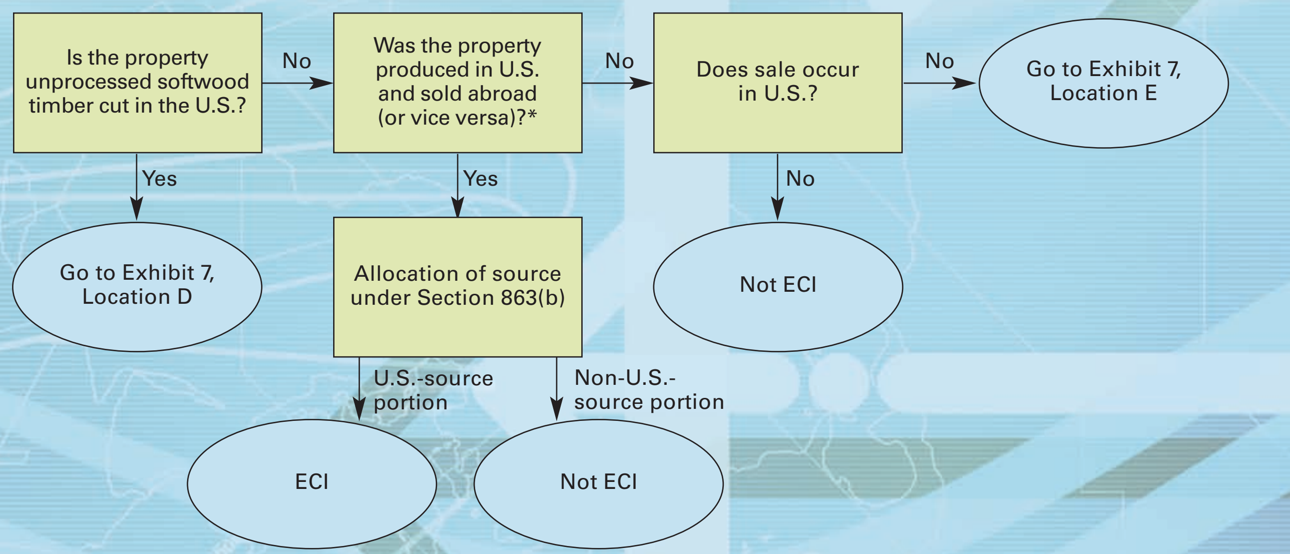
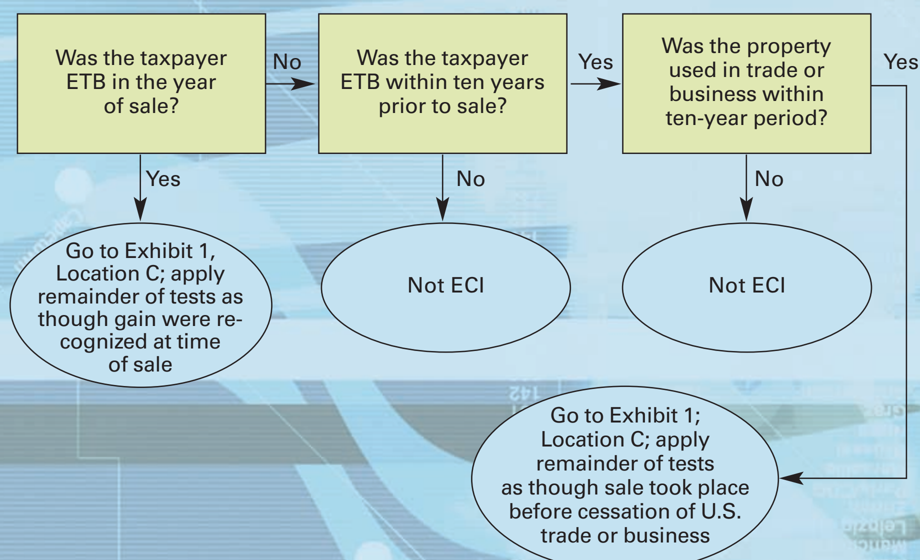


**EXHIBIT 5**
**Source Rules—Inventory**




* Allocation under Section 863(b) also applies where inventory is purchased in a possession and sold in U.S. (but not vice versa).

**EXHIBIT 6**
**ECI Rules—Non-ETB Taxpayers**




and interest (Sections 864(c)(4)(B)(i) and (ii)) are, by their terms, inapplicable to gain on the sale of property. A third exception is limited to certain insurance companies, and is beyond the scope of this article (see Section 864(c)(4)(C)).

The fourth exception, which appears on its face potentially to apply to gains on the sale of property, is something of a red herring. Section 864(c)(4)(B)(iii) provides that foreign-source income from the sale of inventory outside the United States that is attributable to an office or fixed place of business in the United States is ECI. There is an exception where (1) the property is sold for use, disposition, or consumption outside the United States, and (2) a foreign office or fixed place of business materially participated in the sale.

However, as discussed below, under Section 865(e)(2), a sale of any property (whether or not it is inventory and regardless of where the sale takes place) by a nonresident that is attributable to a U.S. office or fixed place of business is treated as U.S.-source income (subject to an exception identical to the exception under Section 864(c)(4)(B)(iii)). Thus, any gain that otherwise would be subject to Section 864(c)(4)(B)(iii) is, in almost all instances, preempted by Section 865(e)(2). Section 865(e)(2) characterizes that gain as U.S. source, whereupon it becomes ECI under the unlimited force-of-attraction principle. The analysis never gets as far as Section 864(c)(4)(B)(iii), which (if it did apply) would treat foreign-source income as ECI.[8]

## Source Rules

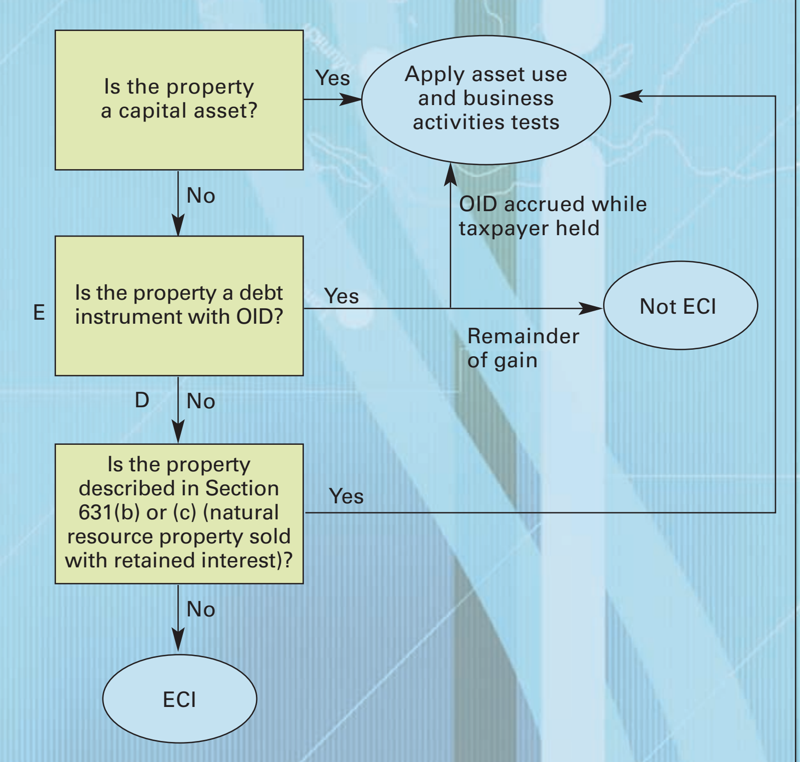
The foregoing discussion shows that a crucial step in the analysis of whether gain from the sale of property is ECI is the determination of whether that gain is U.S. or foreign source. That is the next issue discussed below.

**General source rule.** The general rule for the source of gain from the sale of property is that it is determined by reference to the taxpayer's residence. That is, gain recognized by a U.S. resident is U.S. source, and gain recognized by a nonresident is foreign source (Section 865(a)). For this purpose, a corporation is deemed to be a resident in the jurisdiction where it is organized (Sections 865(g)(1)(A)(ii), 865(g)(1)(B), 7701(a)(30)(C)).

If the general rule were controlling in all instances, there would be no need for this article. Gain recognized by a foreign person on the sale of property would automatically be foreign source and, therefore, would (except for gain recognized by certain insurance companies) be non-ECI. Alas, all is not so simple. Several exceptions to the general source rule all but swallow up the general rule.

**Office or other fixed place of business.** Under the first exception, which applies "[n]othwithstanding any other provisions of this part," if gain from a sale of personal property (including, but not limited to, inventory) is "attributable to" an office or other fixed place of business in the United States, the gain is sourced in the United States (Section 865(e)(2)(A)). However, this special rule does not apply if (1) the property sold is inventory, (2) it is sold for use, disposition, or consumption outside the United States, and (3) in addition to the U.S. office, an office or fixed place of business maintained by the taxpayer in a foreign country also materially participated in the sale (Section 865(e)(2)(B)). If this exception applies, the effect is not to

**EXHIBIT 7**
**ECI Rules—U.S-Source Property**



What may not always be as obvious as it would seem is that, in general, income cannot be effectively connected with a U.S. trade or business unless the taxpayer is engaged in such a trade or business

treat the gain automatically as foreign source. Rather, it simply negates the effect of the "office or fixed place of business" rule (which otherwise would have caused the gain to be U.S. source automatically). It is still necessary to apply the other relevant sourcing rules. In particular, since the exception is available only for inventory, the effect of qualifying for the exception from the office or fixed place of business rule is that the source will be tested under the rules applicable to sales of inventory.

In determining whether (1) a taxpayer has an office or other fixed place of business, and (2) gain on a sale of property is "attributable to" such an office or other fixed place of business, the Code says that the principles of Section 864(c)(5) apply (Section 865(e)(3)). Section 864(c)(5), and the Regulations thereunder, provide rules for applying Section 864(c)(4)(B)(iii), under which foreign-source gains from sales of property can be treated as ECI if they are attributable to a U.S. office or other fixed place of business. As discussed above, however, Section 864(c)(4)(B)(iii) itself has been almost entirely preempted by Section 865(e)(2) and, in the context of property sales, has extremely limited application.[9] Thus, in that context, Section 864(c)(5) and the Regulations thereunder have little significance other than for purposes of applying Section 865(e)(2).

In general, an office or other fixed place of business is a "fixed facility" through which a foreign taxpayer engages in a trade or business. There is no requirement that the facility be used continuously (Reg. 1.864-7(b)(1)). However, where a foreign taxpayer uses another person's office or fixed place of business (including those of a related person) to conduct its business, such use does not cause the taxpayer to have an office or other fixed place of business if the taxpayer's use of the facilities is sporadic or infrequent (Reg. 1.864-7(b)(2)). A fixed facility is not treated as an office or other fixed place of business if the only activity conducted from the facility is general supervision or control, including top management decisions (Reg. 1.864-7(c)).

Special rules apply to determine whether an office or other fixed place of business of an agent is attributed to a principal that is a foreign taxpayer. Where the agent is an independent agent—that is, a general commission agent, broker, or other agent of independent status acting in the ordinary course of its business (Reg. 1.864-7(d)(3))—the facility is not attributed to the principal (Reg. 1.864-7(d)(2)). For a dependent agent, the facility is attributed to the principal only if the agent (1) has, and regularly exercises, the authority to bind the principal contractually, or (2) maintains a stock of merchandise belonging to the principal from which it regularly fills orders (Reg. 1.864-7(d)(1)). In determining whether an agent is dependent or independent, that the agent may be related to or controlled by the principal is disregarded (Reg. 1.864-7(d)(3)(ii)); where there is an exclusive agency relationship between the parties, all of the facts and circumstances are considered (Reg. 1.864-7(d)(3)(iii)).

Once it has been determined that a foreign taxpayer has a U.S. office or other fixed place of business, the next question is whether particular income is attributable to that office or other fixed place of business. Gain is treated as attributable to an office or other fixed place of business only if (1) the office or other fixed place of business is a material factor in the realization of the gain, and (2) the gain "is realized in the ordinary course of the trade or business carried on through the office or other fixed place of business" (Reg. 1.864-6(b)).

A special twist on the "attributable to" standard may apply where the property sold is an interest in a partnership that itself has a U.S. office or other fixed places of business. These facts were the subject of Rev. Rul. 91-32, 1991-1 CB 107, in which the Service concluded that (1) the partnership's office or other fixed place of business is attributed to the selling partner,[10] and (2) gain on the sale of the partnership interest is presumed to be attributable to that office or other fixed place of business. In reaching the latter conclusion, the Service first reasoned that the "aggregate" theory of partnership taxation should apply for this purpose. It then applied the asset-use test of Reg. 1.864-4(c)(2) to conclude that a hypothetical sale by the partnership of assets used in its trade or business would have given rise to ECI and that, under the aggregate theory, gain from a sale of the partnership interest should be similarly characterized.

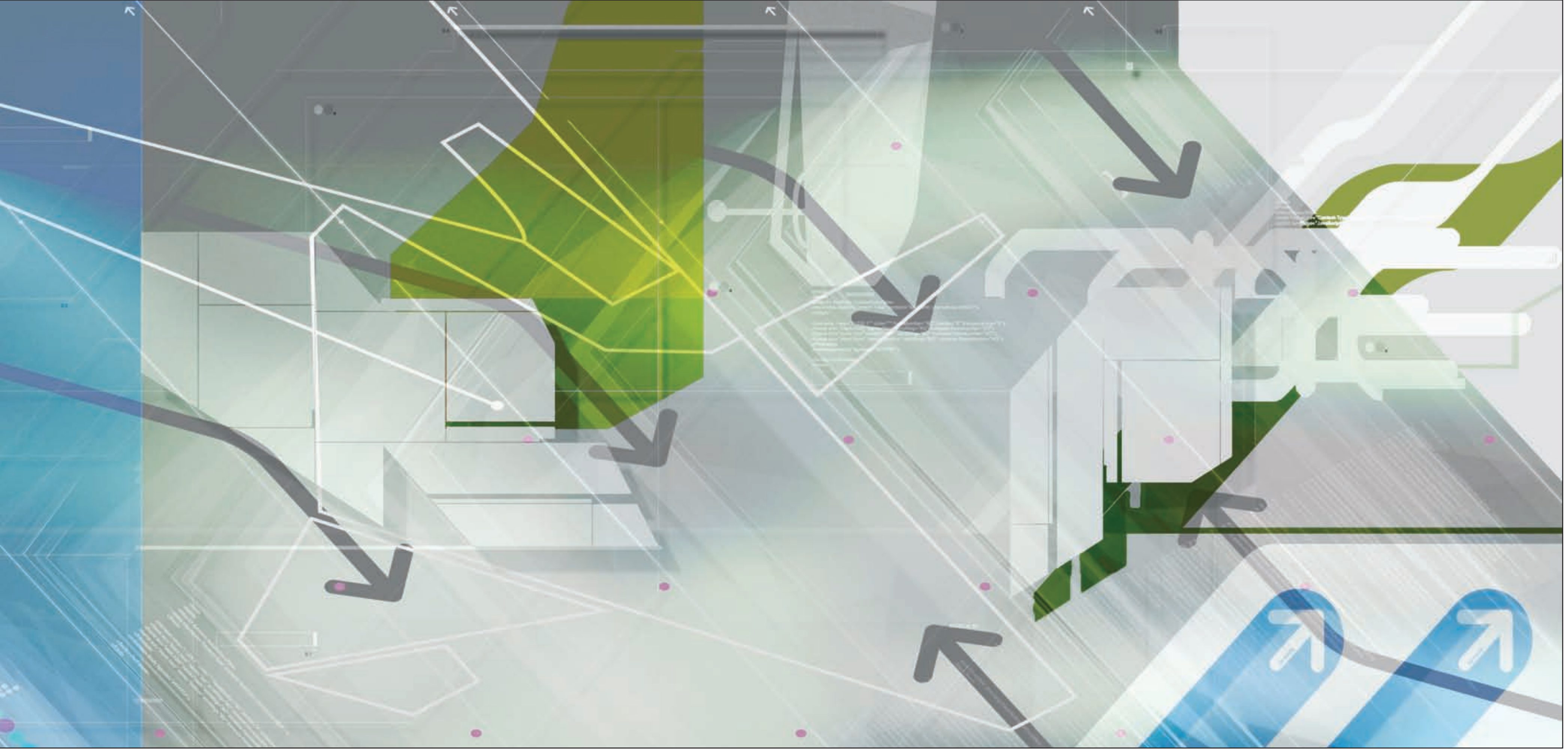
As discussed above, the asset-use test, where applicable, applies only to certain limited categories of assets and, more importantly, only once it has been determined that the income is U.S. source. Rev. Rul. 91-32 seems to assume that gain from the sale of any asset by the partnership would be U.S. source and subject to the asset-use test.

The Ruling does allow some leeway to rebut the all-ECI presumption. If the selling partner can establish that a portion of the gain that the partnership would have recognized on a hypothetical sale of all of its assets would not be ECI, a corresponding portion of the gain from the sale of the partnership interest is not ECI. However, as discussed throughout this article, whether gain from the sale of property is ECI may depend on several different factors. Therefore, absent an actual sale, it is not clear how to apply these factors.

For example, as discussed below, income from the sale of inventory is generally sourced where the sale takes place.[11] Thus, an actual sale could give rise to either ECI or non-ECI, depending on where the sale takes place (although, as noted below, the place of sale could be determined based on all of the facts and circumstances if the sale is arranged in a particular manner for the primary purpose of tax avoidance). In applying the hypothetical sale approach of Rev. Rul. 91-32 to a partnership that owns inventory, what is the assumed location of the sale? Since the Ruling places the burden on the taxpayer to rebut the all-ECI presumption, the Service conceivably could take the position that all gain from the sale of the partnership interest is ECI except to the extent that the taxpayer can establish, with respect to a particular asset, that gain from a hypothetical sale of that asset would be non-ECI regardless of the circumstances of the sale. This would lead to gain on the sale of the partnership interest being ECI even if an actual sale of partnership assets could have been structured to produce non-ECI.

The reasoning and conclusion of Rev. Rul. 91-32 have been criticized[12] and seem difficult to reconcile with the language of the Code. Nonetheless, it evidently continues to represent the Service's position.

**Depreciable personal property.** The second exception to the general source rule for sales of property applies when the property is depreciable personal property. Gains from the sale of this property are bifurcated into two components. The first is an amount of gain up to the prior depreciation deductions that are reflected in the basis of the property. This component is allocated between U.S. source and foreign source by treating it as U.S. source in the same proportion that the U.S. depreciation adjustments with respect to the property bear to total depreciation adjustments (Section 865(c)(1)).



In general, U.S. depreciation adjustments are those that were allowable in computing U.S.-source taxable income (Section 865(c)(3)(A)).[13]

The component of gain that exceeds prior depreciation adjustments is generally sourced under the rules for sales of inventory (Section 865(c)(2)). As discussed below, these rules generally consider where the sale takes place, with two exceptions. First, if the property sold consists of intangibles described in Section 865(d)(2) and the price at which it is sold is contingent on the use, disposition, or productivity of the intangibles, special sourcing rules apply, discussed below (Section 865(d)(1)). Second, if the property consists of goodwill (and the price is not contingent on use, disposition, or productivity), the gain from the sale is sourced according to where the goodwill was generated (Section 865(d)(3)).

**Contingent-price sales of intangibles.** The third exception to the general source rule applies to sales of certain intangibles where the price is contingent on the use, disposition, or productivity of the property. The intangibles covered by this rule are patents, copyrights, secret processes or formulæ, goodwill, trademarks, trade brands, franchises, and "other like property" (Section 865(d)(2)). If this exception applies, the gain is sourced as though it were a royalty (Section 865(d)(1)(B)). In general, royalties for the use of property (including intangible property) are sourced according to where the property is used (see Sections 861(a)(4), 862(a)(4)).

1 In theory, the gross-basis taxation regime also applies to U.S.-source non-ECI capital gains recognized by a nonresident alien individual who is present in the U.S. for 183 days or more during the tax year. Section 871(a)(2). However, in almost all instances, an alien who is present for that period will be treated as a resident under Section 7701(b), so it is extremely rare that Section 871(a)(2) will actually apply. There are theoretically circumstances under which this is possible, which result from different rules governing which days are taken into account under Sections 871(a)(2) and 7701(b). For example, an individual who is unable to leave the United States due to a medical condition may be treated as present for purposes of Section 871(a)(2) but not Section 7701(b). See Section 7701(b)(3)(D).

2 There may be an issue as to whether a particular item of income is from the sale of property. For example, Section 1234A treats gain attributable to the cancellation, lapse, expiration, or termination of certain types of financial instruments as gain or loss from the sale of a capital asset. Where an item of income is from a sale, there may be issues as to which particular type of income it should be classified as. For example, a trader in securities may elect, under Section 475(f), to account for its trading activities by marking to market. A trader that so elects recognizes gain on its securities as though it had sold them for fair market value at the end of each year. Section 475(f)(1(A). Moreover, Section 475(f) incorporates by reference Section 475(d)(3), which treats any such gain as ordinary. However, there may be an issue as to whether the gain should be tested for ECI status under the unlimited force-of-attraction rule of Section 864(c)(3) or under the more limited rule of Section 864(c)(2). See letter from Leon M. Metzger to Donald C. Lubick, Asst. Secretary for Tax Policy, February 11, 1999, 1999 TNT 37-23. These issues are beyond the scope of this article.

3 For more on this issue, see Katz and Plambeck, 908 T.M. (BNA), *U.S. Income Taxation of Foreign Corporations*; Kuntz and Peroni, *U.S. International Taxation* (Thomson Reuters/WG&L), ¶ C1.04(4).

4 The Code provides a few other limited situations in which a taxpayer can have ECI even without being ETB, but these are not relevant to gain on sales of property. Section 882(e), which applies to banks organized in U.S. possessions, applies only to certain interest income. Sections 871(d) and 882(d), which allow taxpayers engaged in real estate activities to elect to be treated as ETB even if they are not actually so engaged, is effectively irrelevant with respect to gain on sale since the gain is treated as ECI under FIRPTA regardless of whether the election is made.

5 One might designate the converse rule for non-U.S.-source income the "unlimited force-of-repulsion principle."

6 Regulations also provide a separate rule for gain on stocks or securities by a taxpayer engaged in the active conduct of a banking, financing, or similar business. Reg. 1.864-4(c)(5). A detailed discussion of this rule is beyond the scope of this article.

7 See, e.g., Katz and Plambeck, *supra* note 3, page A-24; Kuntz and Peroni, *supra* note 3, ¶ C1.04[5][c][i].

8 Under very limited circumstances, Section 864(c)(4)(B)(iii) can apply. Section 865(g) defines "resident" and "nonresident" for purposes of Section 865 slightly differently from the Section 7701(b) definition (which applies for other purposes, including Section 864). For example, if an individual who sells inventory property is a nonresident alien under the general rule of Section 7701(b) but has a tax home in the United States, he is a resident (for Section 865 purposes) under Section 865(g). Thus, the "office or other fixed place of business" rule of Section 865(e)(2) does not apply. However, because the property is inventory, the general rule of Section 865(a), which equates source to residence, does not apply (see Section 865(b)); instead, the income is sourced by the place of sale. Thus, if the sale takes place abroad, the income would be foreign source. In that event, if the sale is attributable to a U.S. office or other fixed place of business, Section 864(c)(4)(B)(iii) would nonetheless characterize the income as ECI.



A crucial step in the analysis of whether gain from the sale of property is effectively connected income is the determination of whether that gain is U.S. or foreign source

**Inventory.** The general rule for sourcing gain from the sale of inventory[14] is that the source is where the sale occurs (Sections 861(a)(6), 862(a)(6); see Section 865(b)).[15] This is generally where "the rights, title, and interest of the seller in the property are transferred to the buyer." However, if a sales transaction is arranged in a particular manner for "the primary purpose" of tax avoidance, all factors, including negotiations, execution of the agreement, location of the property, and place of payment are considered in determining where the substance of the sale occurred.[16]

As always, there are exceptions, the most important of which applies when the taxpayer produced the property within the United States and sold it outside the United States, or vice versa. In that situa-

9 As discussed in note 8, *supra*, Section 864(c)(4)(B)(iii) can still apply in the rare instance where inventory is sold by a nonresident individual who has a tax home in the United States (and who is, therefore, not a resident for Section 865 purposes). Section 864(c) is also relevant in determining whether certain other categories of foreign-source income, such as rents, royalties, dividends, and interest are ECI. See Sections 864(c)(4)(B)(i) and (ii). Discussion of these other categories of income is beyond the scope of this article.

10 This conclusion is generally consistent with Section 875, which treats a partner as engaged in a trade or business if the partnership is so engaged.

11 As discussed in the text below, gain on depreciable personal property (to the extent that it exceeds prior depreciation adjustments) is also generally sourced as if it were inventory.

12 See, e.g., Blanchard, "Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners," 97 TNT 173-69.

13 For certain specifically enumerated types of property that were used predominantly within or outside the U.S. during a given year, all depreciation adjustments for the year are treated as either U.S. or non-U.S., depending on the location of the predominant use. See Section 865(c)(3)(B).

14 As noted in the text above, this rule also generally applies to gain on the sale of depreciable personal property, to the extent that the gain exceeds previously claimed depreciation deductions.

15 Technically, Sections 861(a)(6) and 862(a)(6) apply the place-of-sale rule when the property was not purchased in the place (within or outside the United States) where the sale takes place. It would seem that, *a fortiori*, this rule should also apply when the purchase occurred in the same place; Reg. 1.861-7(a) so provides, and the cases are consistent with that interpretation. See, e.g., Carding Gill Ltd., 38 BTA 669 (1938).

16 Reg. 1.861-7(c). On authorities applying the "title passage" rule, see Blessing and Lubkin, 905-2nd T.M. (BNA), *Source of Income Rules*, ¶ VII(B)(1)(a).

17 For similar rules where the production takes place in a U.S. possession and the sale in the United States (or vice versa), see Reg. 1.863-3(f)(2).

18 Section 863(b)(3). Unlike the rule for production, the purchased inventory rule applies only to possessions (not foreign countries) and does not apply in reverse (that is, where the purchase occurs in the United States and the sale is in a possession).

19 Please do not panic; the analysis of whether property is a USRPI can itself give rise to significant legal fees.

20 If Section 865(e)(2) does not apply because the property is not personal property, when returning to Exhibit 1, skip testing whether it is depreciable personal property or intangible property since the answer to those questions will necessarily be "no."

21 This does not depend on whether the character recapture rules of Section 1245 or 1250 apply.

22 Since the only possible exception from the unlimited force-of-attraction principle that could apply to the property is that applicable to property described in Section 631(b), skip directly to that exception.

23 By definition, inventory is not a capital asset; hence, Exhibit 7 skips over the test that looks to capital asset status.

24 The exception is U.S.-source gain from contingent-payment sales of intangibles, where the determination of whether it is ECI is covered in Exhibit 4.

tion, the gain on sale is bifurcated into the portions allocable to the production and sales activities (Section 863(b)(2)).

The first step in applying these rules is to determine the amount of income allocable to sales and to production. The Regulations allow the taxpayer to choose between two methods (or, with the Service's consent, a third method) for making this allocation (Reg. 1.863-3(b)). One method, always available, is to allocate gross income 50% each to sales and production ("50/50 method") (Reg. 1.863-3(b)(1)).[17] A second method ("independent factory price (IFP) method") generally allows a taxpayer that regularly sells part of its output to independent third parties to allocate gross sales price to the production activity based on the price at which the third-party sales occur; the remaining portion of the gross sales price is allocated to sales activity. To determine the gross income attributable to each activity, the gross proceeds must then be reduced by the cost of goods sold attributable to each activity (Reg. 1.863-3(b)(2)).

A third method ("books-and-record method") allocates gross income between production and sales activity based on identification of specific receipts and expenditures, as reflected in the taxpayer's books and records. This method is available only if the taxpayer obtains advance permission from the Service (Reg. 1.863-3(b)(3)).

Once income has been allocated between production and sales, different source rules apply to each component. The production component is sourced according to where the production assets are located (Reg. 1.863-3(c)(1)). Where production assets are located both within and outside the United States, the income attributable to production is allocated in proportion to the adjusted basis of the production assets located in the two places (Reg. 1.863-3(c)(1)(ii)). For this purpose, intangible production assets are treated as located in the same place as the taxpayer's tangible production assets to which they relate (Reg. 1.863-3(c)(1)(C)).

In general, the component of income attributable to sales activity is sourced according to the general rule for sales of inventory (i.e., place of sale). However, where the property is (1) wholly produced in the United States (disregarding, for this purpose only, packaging, repackaging, labeling, or other minor assembly operations outside the United States), and (2) sold for use, consumption, or disposition in the United States, the place of sale is "presumed" to be the United States (Reg. 1.863-3(c)(2)).

There are two other exceptions to the general source rule for inventory sales, both of quite limited scope. One applies to sales of unprocessed softwood timber that was cut in the United States. Gain from these sales is, per se, U.S. source (Section 865(b)).

The other exception applies where the inventory property is purchased in a U.S. possession and sold within the United States ("possession purchase sales").[18] In that event, income from the sale is generally sourced to the possession in proportion to the amount of "business activity" with respect to possession purchase sales that is in the possession (as compared to worldwide business activity with respect to possession purchase sales), and the remainder of the income is sourced to the United States (Reg. 1.863-3(f)(3)(ii)(A)). For this purpose, "business activity" is the sum of (1) the amount paid for wages, salaries, other compensation, and other non-capitalized expenses attributable to possession purchase sales; (2) the cost of goods sold attributable to possession purchase sales; and (3) the amount of possession purchase sales (Reg. 1.863-3(f)(3)(ii)(B)). Alternatively, the taxpayer, with the Service's prior consent, may use the books-and-records method to allocate the source of income (Reg. 1.863-3(f)(3)(i)(B)).

## Putting it all Together

The flowcharts in the exhibits summarize the foregoing graphically, to provide a literal map through the maze. In Exhibit 1, the first inquiry is whether the property sold is a USRPI. If so, go directly to ECI—do not pass Go, do not collect large legal fees for analyzing source rules.[19]

If the property is not a USRPI, the next inquiry is whether the taxpayer is ETB. If so, Exhibit 1 goes on to test whether the sale is potentially subject to any of the exceptions to the general sale-of-property source rule. If no exceptions apply, under the general source rule, the source of income is foreign (since a non-U.S. taxpayer is assumed); hence, the income is not ECI.

Alternatively, if the taxpayer is not ETB, Exhibit 1 tells us to go to Exhibit 6, which determines whether either of the "formerly ETB" rules applies. If not, the conclusion is that the income is not ECI; otherwise, return to Exhibit 1.

The first possible exception to the general source rule is where the taxpayer has a U.S. office or fixed place of business. If so, Exhibit 2 analyzes the application of Section 865(e)(2). The threshold requirements for this section to apply are that (1) the property must be personal property, and (2) the sale must be attributable to a U.S. office or other fixed place of business. If either of these two requirements is not satisfied, the income will not be sourced under Section 865(e)(2), so return to Exhibit 1 to see whether any of the other exceptions to the general sourcing rule apply.[20] If the basic requirements for application of Section 865(e)(2) are satisfied, it still must be determined whether the exception of Section 865(e)(2)(B) is available. If any of the three requirements for that exception are not available, the income is U.S. source, so we go to Exhibit 7 (more about that below). If all of the requirements for the Section 865(e)(2)(B) exception are available, it is still necessary to test whether it could be U.S. source under another rule; since it has already been determined (as one of the requirements for the Section 865(e)(2)(B) exception) that the property is inventory, go to Exhibit 5, which addresses the rules for inventory.

Back to Exhibit 1, the next test is whether the property is depreciable personal property. If so, go to Exhibit 3, which applies the rules of Section 865(c). The "recapture" portion of the gain (that is, gain up to the depreciation deductions previously claimed)[21] is U.S. source in proportion to the U.S. depreciation as a fraction of total depreciation. Moreover, depreciable personal property cannot qualify for any of the exceptions to the unlimited force-of-attraction principle, so the U.S.-source portion is necessarily ECI. Gain in excess of the recapture portion is tested under the rules applicable to either inventory or intangibles, so the next step is Exhibit 4 or 5, as appropriate.

Returning to Exhibit 1, if the property is an intangible described in Section 865(d)(2), go to Exhibit 4, which applies the rules of Section 865(d). The first inquiry is whether the consideration for the sale is contingent on the use, productivity, or disposition of the property. If so, apply the royalty-sourcing rule, which looks to where the property will be used. If the use is outside the United States, the source is foreign and the gain is not ECI. If the use is within the United States, the source is U.S.; however, since gain from contingent-payment sales of intangibles is one of the exceptions to the unlimited force-of-attraction rule, it is still necessary to apply the asset use and business activity tests to determine whether the gain is ECI.

If the consideration for the sale is not contingent on use, productivity, or disposition, the next question is whether the property is goodwill. If so, the source is determined based on where the goodwill was generated. If the source, as so determined, is foreign, the gain is not ECI; if the source is U.S., go to Exhibit 7. If the property is not goodwill, return to Exhibit 1.

Exhibit 5 applies the rules for sales of inventory. The first question is whether the property is subject to the special rule for unprocessed softwood timber cut in the United States. If so, it is U.S. source, so go to Exhibit 7.[22] If not, ask whether the gain from the property is subject to allocation under Section 863(b), and, if appropriate, apply those rules. If the gain is not subject to allocation, we fall through to the general inventory-sourcing rule, which looks to the place of sale. If the sale takes place outside the United States, the gain is foreign source and is not ECI. If the sale occurs within the United States, the gain is U.S. source, which sends us to Exhibit 7.[23]

Finally, Exhibit 7. This chart applies once gain from the sale of property has been determined to be U.S. source, but where an exception to the unlimited force-of-attraction principle may apply.[24] If one of the exceptions applies, the asset-use and business-activities tests apply to determine whether the income is ECI; otherwise, the unlimited force-of-attraction principle applies, and the gain is ECI. ●