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# Some Modest Simplification Proposals for Inbound Transactions

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## I. INTRODUCTION

IN April 2001, the staff of the U.S. Congressional Joint Committee on Taxation ("Joint Committee") released a comprehensive three volume study entitled *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986.*[1] Congress mandated the study as part of the IRS Restructuring and Reform Act of 1998 with the purpose of the study being a review of the overall state of the Federal tax system with recommendations to simplify taxpayer and administrative burdens.[2] The study received tremendous praise upon its release and serves as a blueprint for many members of Congress who have introduced tax simplifications bills since April 2001.[3]

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* Professor of Law and University Distinguished Teaching Professor, Southern Methodist University. I assisted the Joint Committee on Taxation in its simplification study released in April 2001; however, the views expressed in this article are strictly my own and in no way reflect the views of the Joint Committee on Taxation. I would like to thank Tom Barthold, Ray Beeman, and Larry Lokken for their comments on this article. I would also like to thank Dean John B. Attanasio for approving my summer research grant from the Smart Legal Education Endowment Fund.

1. Staff of J. Comm. on Tax'n, 107th Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, JCS-3-01 (Comm. Print 2001) [hereinafter JCT Simplification Study].

2. Internal Revenue Service Restructuring & Reform Act, Pub. L. No. 105-206, 112 Stat. 685, § 4002(a) (1998) (codified as amended at 26 U.S.C. § 8022 (2002)).

> [It shall be the duty of the Joint Committee] [s]ubject to amounts specifically appropriated to carry out this subparagraph, to report, at least once each Congress, to the Committee on Finance and the Committee on Ways and Means on the overall state of the Federal tax system, together with recommendations with respect to possible simplification proposals and other matters relating to the administration of the Federal tax system as it may deem advisable.

26 U.S.C. § 8022(3)(B) (2002).

3. *See, e.g.*, From the Editor, *Hey, How About a Little Appreciation Here?*, 91 Tax Notes 853 (2001) (JCT study is "one of the most significant contributions to tax literature and tax policy in the last 20 years. Period!"); Martin A. Sullivan, *Will Congress Follow JCT Simplification Roadmap?*, 91 Tax Notes 859, 860 (2001) ("[T]he shortcomings of the JCT report are minor compared to its enormous utility for furthering the cause of tax simplification."); N.Y. State Bar Ass'n, *Simplification of the Internal Revenue Code*, 95 Tax Notes 575, 576 (2002) (JCT "devoted more than 1,000 thoughtful pages to the subject [of simplification] in a study published in April 2001."); Letter from Pamela J. Pecarich, Chair, Tax

As part of the study, the Joint Committee discussed structural issues relating to international tax, including a discussion of promoting economic efficiency and fostering the competitiveness of U.S. businesses, providing relief from double taxation and preserving the U.S. income tax base, and taxing foreign persons.[4] The Joint Committee made ten recommendations with three of the recommendations specifically applicable to inbound transactions. The first of the three inbound recommendations proposed limiting the application of the uniform capitalization rules to foreign persons only for purposes of determining income that is effectively connected with a U.S. trade or business.[5] The second recommendation proposed eliminating the secondary dividend withholding tax with respect to dividends paid by foreign corporations.[6] The third recommendation proposed eliminating § 871(a)(2), which provides for a 30% tax on certain U.S. source capital gains of nonresident alien individuals.[7]

In this article, I propose four additional simplification recommendations specifically relating to inbound transactions. Similar to the recommendations made by the Joint Committee, the recommendations I am proposing will simplify the tax laws yet will not be significant policy changes. In other words, for the most part, the recommendations are quite modest.

## II. PERSONAL SERVICES OF NONRESIDENT ALIEN INDIVIDUALS

### A. Present Law

In general, compensation for labor or personal services performed in the United States is treated as income from sources within the United States. Under a special exception, compensation for labor or services performed in the United States by a nonresident alien individual is not treated as income from sources within the United States if three requirements are met.[8] First, the nonresident alien must be temporarily present in the United States for a period or periods not exceeding a total of 90 days. Second, the compensation does not exceed $3,000 in the aggregate. Third, the nonresident alien individual performs such services either as an employee of or under a contract with a nonresident alien individual, foreign partnership, or foreign corporation not engaged in trade or business within the United States or as an employee of or under a contract with a

Executive Committee of the American Institute of Certified Public Accountants, to The Honorable William Thomas, Chair of the Ways and Means Committee (Feb. 7, 2002), 2002 Tax Notes Today 27-15 (2002) ("[T]he [JCT] study [is] of the highest quality that provides an excellent understanding of both the sources of tax law complexity and its effect on the present system.").

4. JCT Simplification Study, *supra* note 1, at 384-97.

5. *Id.* at 432-35.

6. *Id.* at 436-39.

7. *Id.* at 440-44.

8. I.R.C. § 861(a)(3) (2002).

foreign office of a U.S. individual, domestic partnership or domestic corporation.

A parallel rule applies with respect to being engaged in a U.S. trade or business. The term "trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year. Under a special exception, a nonresident alien individual performing personal services within the United States is not treated as engaged in a U.S. trade or business if three requirements are met.[9] First, the nonresident alien must be temporarily present in the United States for a period or periods not exceeding a total of 90 days. Second, the compensation may not exceed $3,000 in the aggregate. Third, the nonresident alien individual performs such services either as an employee of or under a contract with a nonresident alien individual, foreign partnership, or foreign corporation not engaged in trade or business within the United States or as an employee of or under a contract with a foreign office of a U.S. individual, domestic partnership or domestic corporation.

The United States has entered into a number of treaties which provide that remuneration for labor or services performed in the United States, by a nonresident alien individual temporarily present in the United States, for a period or periods not exceeding a total of 183 days, regardless of the amount of remuneration, is not taxed by the United States if such remuneration is paid by a nonresident and not borne by a U.S. permanent establishment or U.S. fixed base of the nonresident.[10]

### B. Sources of Complexity

A nonresident alien individual is generally not required to file an income tax return with the United States unless the nonresident alien individual is engaged in a trade or business in the United States.[11] As a result, if the nonresident alien individual receives interest or dividend income from U.S. sources, which is not effectively connected to a U.S. trade or business, the income will either not be subject to U.S. tax, such as interest on a bank deposit or portfolio interest, or subject to the gross basis withholding tax, such as the 30% withholding tax on U.S. sourced dividends. In either case, no income tax return is required.

The dollar threshold of $3,000 under the special exception for both sourcing and engaging in a U.S. trade or business by a nonresident alien individual has not changed since its enactment by Congress in 1936. When Congress enacted this provision, it wrote

> [t]he purpose . . . is to permit residents of other countries to make brief visits to the United States for business purposes, such as the buying and selling of goods, without being subject, before leaving the country, to a demand for payment of tax on their compensation dur-

9. I.R.C. § 864(b)(1) (2002).
10. *See generally* U.S. Model Income Tax Convention art. 15(2) (Sept. 20, 1996).
11. Treas. Reg. § 1.6012-1(b)(2)(i) (as amended in 1986).

> ing the period of their stay here. Numerous cases of this character arising under the present law have created irritation and ill will quite disproportionate to the slight revenue involved.[12]

In year 2002, if a nonresident alien individual working for a foreign employer comes to the United States on business for even a short period of time (such as two or three weeks), the nonresident alien individual's income will, in many cases, exceed the $3,000 threshold even though the 90-day and foreign employer requirements will easily be met. If the $3,000 threshold is surpassed, the nonresident alien individual must now file a U.S. income tax return,[13] and in most cases, pay taxes to the United States.[14] Because the nonresident alien individual, in almost all cases, is being paid in foreign currency by the foreign employer usually with foreign taxes withheld on the foreign wages, the nonresident must: (1) calculate the portion of the foreign wages allocable to the services performed in the United States, (2) determine the U.S. dollar equivalent, (3) file the U.S. income tax return, and (4) attempt to avoid being double taxed on the foreign wages.

### C. Recommendation for Simplification

*The $3,000 de minimis level of compensation should be increased to $25,000.*[15]

### D. Analysis

The first two requirements under the special exceptions for personal services, the 90-day limitation and the $3,000 *de minimis* limitation, focus on the limited amount of contact the nonresident alien individual has with the United States. Congress has not changed these two requirements since their enactment in 1936. As originally enacted, the $3,000 *de minimis* amount for sourcing and trade or business purposes exempted what were perceived to be more than token levels of compensation of certain nonresident alien individuals. These individuals, whose residence is outside the United States and who spend more than three-fourths of the year outside the United States, could thereby be freed from filing

12. S. Rep. No. 74-2156, at 22 (1936).

13. Treas. Reg. § 1.6012-1(b)(1) (as amended in 1986).

14. As a general rule, nonresident alien individuals are permitted only one personal exemption and no standard deduction. I.R.C. §§ 873(b)(3) (2002), 63(c)(6)(B) (Supp. 2002).

15. If $3,000 is indexed for inflation from 1936 to 2002, then the inflation adjusted amount is approximately $39,000. *See* U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Price Indexes: Inflation Calculator*, *at* http://www.bls.gov/cpi/home.htm. As a result, the proposed increase to $25,000 is quite modest.

In 1987, the American Law Institute ("ALI") recommended increasing the $3,000 *de minimis* threshold to the lesser of: (i) $50,000, or (ii) $1,000 multiplied by the number of days in the United States in which the services were performed. *See* ALI, Fed. Income Tax Project: Int'l Aspects of U.S. Income Taxation: Proposals on U.S. Taxation of Foreign Persons, at 99 (1987) [hereinafter Income Tax Project]. The ALI noted that these increased thresholds are "fairly generous." *Id.*

burdens. Increasing the *de minimis* threshold to $25,000 would return the exemption to a level closer to original Congressional intent and reduce the filing and compliance burden on certain nonresident alien individuals and the Service. In addition, the third requirement that the nonresident alien individual work for a foreign employer or the foreign office of a U.S. employer appears to prevent the situation in which the nonresident alien individual is exempted from U.S. tax while the employer gets a deduction for U.S. income tax purposes.[16] To illustrate the recommendation, assume a nonresident alien individual earns $100,000 a year working for a foreign corporation. The nonresident alien individual comes to the United States for two weeks each year for the annual worldwide executive meeting and to meet with U.S. executives. The nonresident alien individual must now file a U.S. income tax return because more than $3,000 of the $100,000 salary is attributable to services performed in the United States. By increasing the threshold to $25,000, the nonresident alien individual, in this example, is freed of the responsibility to file a U.S. income tax return.

Under the United States Model Income Tax Convention of September 20, 1996, two of the three requirements of the special rule for personal services are significantly modified. First, the 90-day limitation is changed to a 183-day limitation and, second, the $3,000 threshold is dropped completely so that no dollar limitation is imposed.[17] The treaty position implies that limited contact by nonresident alien individuals performing services in the United States for a foreign employer is better defined by physical presence than by compensation.

One possible concern in raising the amount relates to a nonresident alien individual who exploits the U.S. market in earning the income.[18] For example, a foreign entertainer who gives a concert in the U.S. is exploiting the U.S. market and is arguably distinguishable from the foreign executive who comes to the U.S. for a short period of time to attend a series of meetings.[19] It would be difficult to enact a rule distinguishing the foreign entertainer from the foreign executive based on market exploitation and, in any event, raising the amount to $25,000 should not lead to abuse of the rule.[20]

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16. Income Tax Project, *supra* note 15, at 98.
17. U.S. MODEL INCOME TAX CONVENTION, *supra* note 10, art. 15(2)(a).
18. Income Tax Project, *supra* note 15, at 99.
19. *Id.*
20. In some cases, the foreign entertainer will not be performing the services in the U.S. as either an employee of or under a contract with a nonresident alien individual, foreign partnership, or foreign corporation not engaged in trade or business within the United States or as an employee of or under a contract with a foreign office of a U.S. individual, domestic partnership or domestic corporation. *See* U.S. MODEL INCOME TAX CONVENTION, *supra* note 10, art. 17(1) ($20,000 threshold for foreign entertainers).

## III. ELECTION TO TREAT REAL PROPERTY INCOME AS EFFECTIVELY CONNECTED INCOME

### A. PRESENT LAW

A nonresident alien or foreign corporation owning real property in the United States is subject to net basis taxation on the income from the real property, if the ownership and maintenance of the property constitutes a trade or business in the United States. In other words, the income from the real property is effectively connected to a U.S. trade or business. If, however, the ownership and maintenance of the U.S. real property does not constitute a U.S. trade or business, then the nonresident alien or foreign corporation is subject to the 30% gross basis tax on the income from the property. In the latter situation, an election is available to the nonresident alien or foreign corporation to treat the income from the property as income effectively connected to a U.S. trade or business and, therefore, net basis taxation will apply.[21] Once the election is made, it remains in force for all subsequent years unless revoked with the consent of the government. The election applies to all income from U.S. real property that does not constitute a U.S. trade or business. In the case of a nonresident alien, it applies only to property held for the production of income and not to real property held for personal use.

In general, the United States has entered into a number of (generally older) treaties in which the nonresident can elect on an annual basis to treat real property income as income attributable to a permanent establishment and therefore taxed on a net basis.[22] Under the United States Model Income Tax Convention of September 20, 1996, however, article 6(5) provides that any election by a nonresident to treat income from real property as if it were attributable to a permanent establishment and, therefore, subject to net basis taxation, is binding for the taxable year of the election and all subsequent years unless terminated by request of the nonresident with the consent of the competent authorities.

### B. SOURCES OF COMPLEXITY

It is not always easy to determine whether a nonresident alien or foreign corporation's ownership and maintenance of U.S. real property constitute a U.S. trade or business. The courts and the Service have generally held that considerable, continuous and regular activity with respect to U.S. real property, which is beyond the mere receipt of rental income and payment of expenses, is a U.S. trade or business.[23]

If the election is made, the nonresident alien individual or foreign corporation must attach a statement to the return detailing a complete list of

21. I.R.C. §§ 871(d), 882(d) (2002).
22. *See generally* Rev. Rul. 77-174, 1977-1 C.B. 414.
23. *See, e.g.*, Lewenhaupt v. Comm'r, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955); Herbert v. Comm'r, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; De Amodio v. Comm'r, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); Rev. Rul. 73-522, 1973-2 C.B. 226.

all real property (or any interest in real property) located in the United States, the extent of ownership of the property, the location of the property, a description of any major improvements to the property, and details of any previous choices and revocations of the election.[24] Some of this information will be duplicated on the income tax return (for example, as to the nonresident alien individual, on form 1040 schedule E that will be attached to form 1040NR) that must now be filed by the nonresident alien individual or foreign corporation. In addition, the nonresident alien individual or foreign corporation must provide the withholding agent or payer a completed form W-8ECI to claim the exemption from the 30% gross basis withholding tax.[25] Generally, the form is valid until the last day of the third succeeding calendar year.[26]

In 1966, when Congress, as part of the Foreign Investors Tax Act, permitted nonresident aliens and foreign corporations to elect to treat income from non-business U.S. real property as income effectively connected to a U.S. trade or business, the highest individual tax rate was 70% and the highest corporate tax rate was 48%. In addition, Congress had not yet enacted the Foreign Investment in Real Property Tax Act ("FIRPTA"), which since 1980 treats gains (and losses) from the sale of U.S. real property as income effectively connected to a U.S. trade or business. As a result, a nonresident alien or foreign corporation would often not make the election and would therefore be subject to 30% gross basis taxation on the income from the real property and no tax on the gain from the disposition of the real property.

In year 2002, the highest individual tax rate is 38.6% and the highest corporate tax rate is 35%. By making the election, the nonresident alien or foreign corporation is permitted deductions for depreciation, interest, repairs, maintenance, real property taxes, and other expenses associated with ownership of the real property. These deductions will, in almost all cases, reduce the effective tax rate on the income from the real property below 30%. As a result, a nonresident alien or foreign corporation generally gives up no benefit in making the election yet avoids the 30% gross basis tax.

### C. Recommendation for Simplification

*A nonresident alien or foreign corporation should not be required to make an election to treat income from nonbusiness U.S. real property as income effectively connected to a U.S. trade or business. Rather, the provision should be mandatory unless the nonresident alien or foreign corporation elects for it not to apply.*[27]

24. Treas. Reg. §§ 1.871-10(d)(1)(ii) (1974), 1.882-2(a) (as amended in 1973).

25. Treas. Reg. §§ 1.1441-1(b)(4)(viii) (as amended in 2001), 1.1441-4(a)(2) (as amended in 2000).

26. Treas. Reg. § 1.1441-1(e)(4)(ii)(C) (as amended in 2001).

27. Even if the nonresident alien individual or foreign corporation does not derive income from the U.S. real property, the mandatory rule will apply unless the taxpayer elects for it not to apply. This will change the statute, regulations and the holding in Rev.

### D. Analysis

It is almost always advantageous for a nonresident alien or foreign corporation to elect to treat nonbusiness income from U.S. real property as income effectively connected to a U.S. trade or business. Prior to 1980, the primary disadvantage to making the election was that the gain on disposition of the U.S. real property would be subject to net basis taxation. With the enactment of FIRPTA in 1980, the gain on disposition of the U.S. real property will be subject to net basis taxation whether or not the election is made. There is no downside to making the election. As a result, failure to make the election appears to be a trap for the unwary.

The recommendation will make the favored result the general rule rather than forcing the nonresident alien individual or foreign corporation to make the election to get the favored result. In addition, the recommendation will result in taxing the income from the U.S. real property on a net basis, which is consistent with taxing the gain or loss on disposition of the U.S. real property.

Even if the nonresident alien or foreign corporation enters into a "net lease" in which the lessee pays the rent, as well as real estate taxes, repairs, operating expenses, interest and principal on existing mortgages, and insurance in connection with the real property, this will not avoid the harshness of the 30% gross basis tax. The 30% gross basis tax applies to rents received from U.S. sources. In calculating the amount of the "rent," the government includes amounts paid by the lessee that constitute expenses of the lessor, such as taxes and repairs.[28]

The recommendation will minimally reduce the paperwork by eliminating the need to make the election unless, in the rare case, the nonresident alien individual or foreign corporation's ownership of the U.S. real property does not rise to the level of a trade or business in the U.S. and the nonresident alien individual or foreign corporation wants the 30% gross basis tax to apply. The recommendation will not change the requirement that the nonresident alien individual or foreign corporation provide the withholding agent or payer a completed form W-8ECI to claim the exemption from the 30% gross basis withholding tax.

## IV. SOURCE RULES FOR PERSONAL PROPERTY SALES OF NONRESIDENT ALIENS[29]

### A. Present Law

In general, the sourcing of income from the sale of personal property is

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Rul. 91-7, 1991-1 C.B. 110 (nonresident alien or foreign corporation cannot make an election under § 871(d) or § 882(d) for a taxable year in which the taxpayer does not derive income from the U.S. real property).

28. Rev. Rul. 73-522, 1973-2 C.B. 226.

29. This recommendation should be read in conjunction with the Joint Committee's recommendation to repeal § 871(a)(2), which provides for a 30% tax on certain U.S. source capital gains of nonresident alien individuals.

based on the residence of the taxpayer.[30] If the taxpayer is a U.S. resident, then the source of income from the sale of personal property is U.S. source. If the taxpayer is a nonresident, then the source of income from the sale of personal property is foreign source. In determining whether a taxpayer is a U.S. resident or nonresident, the general rules for determining residency are not applicable. Rather, a special residency rule applies solely for purposes of determining the source of income from the sale of personal property.[31]

Under the residency rule for determining the source of income from the sale of personal property, the primary focus in the case of an individual is the individual's tax home. The term "tax home" means the individual's home for purposes of § 162(a)(2) (relating to traveling expenses away from home). Generally, it is the individual's regular or principal (if more than one regular) place of business. As a result, if a nonresident alien has a tax home in the United States, then the individual is treated as a U.S. resident under the sourcing rule for personal property sales.

A domestic corporation is treated as a U.S. resident and a foreign corporation is treated as a nonresident for purposes of the sourcing of income from the sale of personal property. No provision comparable to the tax home concept for individuals applies to foreign corporations.

### B. Sources of Complexity

The general definitions of resident and nonresident alien individuals are provided in § 7701(b).[32] The general residency test under § 7701(b) must be applied as an initial step to alien individuals in determining their classification as a resident or nonresident for U.S. taxing purposes. It is unnecessary to have a separate definition of residency solely for purposes of the sourcing of income from personal property sales. Not only does this separate definition of residency add additional complexity to the tax laws, it also creates some surprising results. For example, assume a nonresident alien has a tax home in the United States. The nonresident alien sells stock on a foreign stock exchange and also sells a painting in the nonresident alien's home country. The income from both of these transactions will be U.S. sourced and possibly subject to the 30% gross basis tax.

The definition of residency for purposes of the sourcing of income from personal property sales is based on the concept of a tax home.[33] The tax home concept, in many cases, is difficult to apply in practice. It is generally defined as the taxpayer's regular or principal (if more than one regular) place of business.[34] If the taxpayer does not have a regular or

30. I.R.C. § 865(a) (2002).
31. I.R.C. § 865(g)(1) (2002).
32. I.R.C. § 7701 (2002).
33. I.R.C. § 865(g)(1)(A)(i)(II) (2002); I.R.C. § 911(d)(3) (2002); I.R.C. § 162(a)(2) (2002).
34. Treas. Reg. § 1.911-2(b) (2002).

principal place of business, it is the taxpayer's regular place of abode. The general residency test for individuals, under § 7701(b), in almost all cases, is a more straightforward and simpler test than the tax home concept.[35]

### C. Recommendation for Simplification

*The presence of a tax home in the United States should be deleted in determining the residency of a nonresident alien individual for purposes of the sourcing of income from personal property sales under § 865. As a result, a nonresident alien individual will be treated as a nonresident for purposes of the sourcing of income from the sale of personal property.*[36]

### D. Analysis

As part of the Tax Reform Act of 1986, Congress changed the general rule for determining the source of income from personal property sales from the place of sale to the residence of the seller. In making this change, Congress noted that the source rules for personal property sales

> should generally reflect the location of the economic activity generating the income, taking into account the jurisdiction in which those activities are performed. With regard to foreign persons, . . . prior law [place of sale] allowed foreign persons in certain circumstances to avoid U.S. taxation despite the presence of a fixed U.S. business by manipulating the transfer of ownership to their property.[37]

As a result, Congress provided that a nonresident alien individual is a resident of the United States in determining the source of income from the sale of personal property if the individual has a tax home in the United States. But interestingly, Congress did not require some nexus between the income from the sale of the personal property and the tax home in determining the source of the income.

When a nonresident alien or foreign corporation sells an investment asset or personal asset, the United States appears to have little interest in taxing the income unless the income is effectively connected to a U.S. trade or business. For example, a nonresident alien is taxed on U.S. source capital gains that are not effectively connected to a U.S. trade or business only if the nonresident alien is present in the United States for 183 days or more during the taxable year. However, it is almost impossible for this taxing rule to apply because a nonresident alien present for 183 days or more will be treated as a resident alien and therefore taxed on worldwide income. In addition, no similar taxing rule applies to a for-

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35. Section 7701(b) does incorporate the tax home concept as an exception to the general rule of the substantial presence test. I.R.C. § 7701(b)(3)(B) (2002).

36. The recommendation does not affect the tax home rule for U.S. citizens and resident aliens contained in § 865(g)(1)(A)(i)(I).

37. Staff of J. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, at 917-18 (Comm. Print 1987).

eign corporation with U.S. source capital gains that are not effectively connected to a U.S. trade or business.

If the U.S. source capital gains are effectively connected to a U.S. trade or business, then the United States will tax it under net basis taxation. In order for this to take place, the capital gain must meet an asset use test or a business activities test. In other words, some nexus must exist between the capital gain and the U.S. trade or business. In 1986, Congress enacted a sourcing rule that is also an activities or nexus rule. Under this sourcing rule, if a nonresident maintains an office or other fixed place of business in the United States, income from the sale of personal property attributable to that office is U.S. source income. It also will be, in almost all cases, effectively connected income.

The major impact of this recommendation applies to a nonresident alien who has a tax home in the United States and sells personal property (other than inventory and depreciable personal property) during the year. For example, if a nonresident alien with a tax home in the United States sells stock of a domestic corporation, stock of a foreign corporation, and a painting, then the income from all three transactions will be U.S source income because the nonresident alien has a tax home in the United States. Even though it is U.S. source income, the United States will, in almost all cases, not tax it unless it is effectively connected to a U.S. trade or business. In order for it to be effectively connected income, the U.S. source income must meet either the asset use test or the business activities test. In other words, some nexus must exist between the U.S. source income and the U.S. trade or business so that the income will be effectively connected income and therefore subject to net basis taxation by the United States.

Under the recommendation, the income from all three transactions will be foreign source. If, however, the nonresident alien has an office or other fixed place of business in the United States and the income from the sale of the personal property is attributable to such office or other fixed place of business, then the source will be U.S. source.[38] The source rule is also an "activities" type of rule and the income will almost always be effectively connected income. If the income is not U.S. source, then it should not be effectively connected income. In other words, the sourcing rule for personal property sales, in essence, performs two functions: sourcing and nexus. It is true that under this sourcing rule, having a trade or business in the U.S. is not enough for the rule to apply. A higher standard is required in the form of an office or other fixed place of business, which is very similar to the permanent establishment concept in tax treaties.

The recommendation will also affect the sourcing of the gain from the sale of intangibles in certain cases. Generally, in the case of a sale of an intangible, the portion of the gain, not in excess of the depreciation ad-

38. I.R.C. § 865(e)(2)(A) (2002).

justments in the intangible, is sourced under the special rule for depreciable personal property.[39] Any gain in excess of the depreciation adjustments is sourced under the residency of the seller rule to the extent the gain is attributable to payments, in consideration of such sale, that are not contingent on the productivity, use, or disposition of the intangible. Under present law, this portion of the gain from non-contingent payments will be U.S. source if the nonresident alien individual has a tax home in the United States, or if the nonresident alien individual does not have a tax home in the United States, but the sale is attributable to a U.S. office or other fixed place of business of the nonresident alien individual. Under the recommendation, the gain will be foreign source and therefore not taxed by the United States unless the gain from the sale is attributable to a U.S. office or other fixed place of business of the nonresident alien individual.[40]

## V. FOREIGN SOURCE EFFECTIVELY CONNECTED INCOME FROM THE SALE OF INVENTORY

### A. Present Law

In general, a nonresident alien or foreign corporation is subject to net basis taxation on income effectively connected to a U.S. trade or business.[41] U.S. source income will be effectively connected to a U.S. trade or business if the income meets the asset use test, business activities test, or is subject to the force of attraction principle.[42]

As a general rule, foreign source income will not be income effectively connected to a U.S. trade or business.[43] If, however, the nonresident alien or foreign corporation has an office or other fixed place of business in the United States to which the foreign source income is attributable, then several categories of foreign source income will be treated as income effectively connected to a U.S. trade or business.[44] One of these categories includes income from the sale or exchange (outside the United States) of inventory property through such U.S. office or other fixed place of business. As a result, this income from the sale of inventory property is foreign source effectively connected income.[45] If the inventory property is sold for use, consumption or disposition outside the United States and an office or fixed place of business of the nonresident

39. I.R.C. § 865(d) (2002).

40. The ALI noted that "[i]n a case in which the sale or exchange [of an intangible] is made for consideration that is not measured by exploitation or use, however, despite the conceptual validity of the U.S.'s source claim, imposition of tax would represent an unjustifiable intrusion by the US. into normal business transaction not focused on the U.S. at all." Income Tax Project, *supra* note 15, at 113.

41. I.R.C. §§ 871(b), 882 (2002).

42. I.R.C. §§ 864(c)(2)-(c)(3) (2002).

43. I.R.C. § 864(c)(4)(A) (2002).

44. I.R.C. § 864(c)(4)(B) (2002).

45. I.R.C. § 864(c)(4)(B)(iii) (2002).

alien or foreign corporation materially participates in the sale, then the foreign source income will not be effectively connected income.

### B. Legislative Background

As part of the Tax Reform Act of 1986, Congress deleted § 864(c)(4)(B)(iii), which treats certain foreign source income from the sale of inventory as effectively connected income (§ 1211(b)(2)). Congress retroactively reinstated it in almost identical form as part of the Technical and Miscellaneous Revenue Act of 1988 (§ 1012(d)(7)).

### C. Sources of Complexity

Since 1986, it is almost impossible for a nonresident alien or foreign corporation to have foreign source income from the sale or exchange of inventory property that is effectively connected to a U.S. trade or business. As part of the Tax Reform Act of 1986, Congress enacted a sourcing rule that has almost identical language to the provision involving foreign source income from inventory sales which is effectively connected income.[46] Under the sourcing rule, if a nonresident maintains an office or other fixed place of business in the United States, then income from the sale of personal property (including inventory property) attributable to such office or fixed place of business is U.S. source income. This U.S. source income will be effectively connected income for inventory property under the force of attraction principle.

If the inventory property is sold for use, disposition, or consumption outside the United States and an office or other fixed place of business of the nonresident in a foreign country materially participates in the sale, then the source may be foreign source. Even if it is foreign source income, however, it will not fall within the provision treating foreign source income from inventory property as effectively connected income because an almost identical exception is provided under the foreign source effectively connected income rules.

### D. Recommendation for Simplification

*Section 864(c)(4)(B)(iii), which treats foreign source income from the sale or exchange of inventory property attributable to an office or fixed place of business in the United States as effectively connected income, should be repealed.*

### E. Analysis

There is one situation that § 864(c)(4)(B)(iii) can apply to under existing law. Assume a nonresident alien has an office or other fixed place of business in the United States that sells inventory property. The nonresident alien also has a tax home in the United States. Under the sourc-

46. I.R.C. § 865(e)(2) (2002).

ing rule for sales of personal property, the nonresident alien will be treated as a resident and the place of sale rule for the sale of inventory property will apply. If the U.S. office sells the inventory property and the sale takes place outside of the United States, then the source will be foreign source. Under existing law, part or all of the foreign source income will be effectively connected income.[47] Congress recognized this situation in 1988, when it retroactively reinstated § 864(c)(4)(B)(iii) after deleting it from the Code in 1986.

Under another recommendation contained in this article, the definition of nonresident under the sourcing rules for sales of personal property will be the same as the general definition of nonresident alien. In other words, the separate definition of nonresident under the sourcing rules for sales of personal property will be deleted. Therefore, a nonresident alien who has an office or other fixed place of business in the United States will have U.S. source income on the sale of inventory property if attributable to the U.S. office. This will be the result even if the nonresident alien has a tax home in the United States. As a result, the one possible application of § 864(c)(4)(B)(iii) will be eliminated.

47. I.R.C. § 864(c)(5)(C) (2002).