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KPMG report: Final regulations on source of income for certain sales of personal property, including inventory

The U.S. Treasury Department and IRS (collectively, “Treasury”) on September 29, 2020, released a version of final regulations (T.D. 9921) concerning the source of income for certain sales of personal property.

The [final regulations](#) [PDF 335 KB] (63 pages) have not yet been released for publication in the Federal Register. The purpose of this report is to provide initial impressions of the final regulations released on September 29, 2020.

Background

The 2017 U.S. tax law (Pub. L. No. 115-97)—the law that is often referred to as the “Tax Cuts and Jobs Act” (TCJA)—amended section 863 regarding special rules for determining the source of income, including income partly from within and partly from without the United States.

Specifically, section 863(b) provides for allocation or apportionment of income from the sale or exchange of inventory property produced (in whole or in part) by a taxpayer within and sold or exchanged outside the United States, or produced (in whole or in part) by the taxpayer outside and sold or exchanged within the United States solely on the basis of production activities with respect to that inventory.

Before the 2017 tax law changes, section 863(b) provided that income from section 863(b)(2) sales would be treated as derived partly from sources within and partly from sources outside the United States but without providing the basis for such allocation or apportionment.

In addition, section 865(e)(2) provides rules for sourcing income from sales of personal property (including inventory) by a nonresident attributable to an office or fixed place of business in the United States. While the TCJA did not amend section 865(e)(2), because both provisions provide rules for determining the source of income from sales of inventory, these rules overlap in certain circumstances, necessitating guidance to address the interaction of these provisions.

Final regulations

The final regulations in large part finalize the rules in the proposed regulations with only minor changes. However, the final regulations make a noteworthy change to one of the rules under section 865(e)(2):

- The proposed regulations provided that sales of inventory property produced outside the United States and sold through an office maintained by a nonresident in the United States must be sourced in the United States in part. The proposed regulations provided rules for determining the portion of gross income from sales (sourced in the United States) and production activities (sourced according to the rules of section 863(b)).
- Under the proposed rules, the default method would allocate 50% of gross income to each category (“50/50 method”), but nonresidents could elect to use their books and records to make the allocation (“books and records method”) if they met certain requirements.
- The final rules modify this approach by providing that once a nonresident elects the books and records method, the method continues until revoked and may not be revoked, without the consent of the IRS Commissioner, for any tax year beginning within 48 months of the end of the tax year in which the election is made.

Notably, the final regulations do not directly address the interaction of Reg. section 1.865-3 and U.S. income tax treaties.

KPMG observation

In response to a comment, the preamble explains that the regulations “do not affect the ability of a taxpayer to rely on treaty provisions to mitigate or relieve double taxation,” including provisions permitting taxpayers to request competent authority assistance. Thus, for example, where a treaty partner country attributes to a permanent establishment gross income that otherwise would be considered U.S.-source income under the final rules, some treaties may permit resourcing of that income for purposes of applying the U.S. foreign tax credit rules.

While the final regulations do not make significant changes to the rules under section 863(b), they do make an important “clarification” to the anti-abuse rule that may limit the ability of taxpayers that produce inventory in the United States to mitigate the impact of the change to section 863(b) by restructuring their production activities. Specifically, the final regulations add a new sentence to the anti-abuse rule that would treat a taxpayer as engaging in production activities in the United State if it transfers domestic production assets to a related partnership (or a subsidiary of a related partnership) with a principal purpose of reducing its U.S. tax liability.

In addition, the preamble to the final regulations suggests that Treasury is contemplating a comprehensive review of the sourcing rules for production activity. In particular, the preamble notes that a comment on the proposed regulations suggested expanding the scope of covered production activities and ownership of production assets to include activities conducted and assets owned by related parties and unrelated agents of the taxpayer. The final regulations do not adopt the comment, but the preamble indicates that Treasury may consider this comment in a future notice of proposed rulemaking. The preamble also notes that Treasury continues to request comments regarding potential approaches to determine the location or existence of production activities or other modifications to the regulations under section 863(b).

KPMG observation

The approach in the current regulations considers only production assets owned directly by the taxpayer. An approach that included production assets owned by related or unrelated contract manufacturers, or an approach that accounted for oversight and management activities, could result in dramatic changes in how income from production activities is sourced. However, it remains to

be seen whether and, if so, how Treasury will update its approach to accounting for production activity in future guidance.

For more information, contact a tax professional with KPMG's Washington National Tax:

Marissa Rensen | +1 202 533 4497 | mrensen@kpmg.com

Jesse Eggert | +1 202 533 5512 | jeggert@kpmg.com

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