VIEWPOINT

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How Will Revised Sourcing Rules Affect Sales Of U.S.-Made Goods Abroad?

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In this article, the author considers how revisions to the sourcing rules in section 863 of the U.S. tax code may affect the taxation and availability of foreign tax credits for sales of goods that U.S. sellers produce in the United States and sell abroad, including in treaty jurisdictions such as Canada.

The issue at the heart of this article is the (conceptually) irrational revision of the IRC section 863 sourcing rule for inventory sales made by the Tax Cuts and Jobs Act. This revision is summarized as follows in proposed regulations dated December 23, 2019:

> Consistent with the [TCJA's] changes to section 863(b)(2), these proposed regulations amend section 1.863-3 in order to properly allocate or apportion gross income from Section 863 (b)(2) Sales based solely on production activity, and remove the methods for allocating or apportioning gross income between production and sales activity.[1]

The first question discussed herein is how this rule — when applied to a U.S. person producing in the United States and selling outside the United States — would change the U.S. tax effects in a non-treaty-country context. The article then looks at the effect of the change when the counterpart country has a tax treaty with the United States — as Canada does.

I. Background

In general, before the TCJA, all profit that a U.S. person derived from producing or manufacturing things in the United States and selling them to buyers located in another country was subject to U.S. tax under the IRC *after taking into account a credit for income taxes paid to the other country*. The rule was no different than it would be if the buyers were located in the United States except there would be no foreign tax credit in that case.

Further, that was so whether the customer was a third-party end consumer or a related-party on-seller (distributor).

The TCJA changed that in two fundamental ways.

First, the new foreign-derived intangible income rules (section 250) may reduce the amount of the profit from foreign sales subject to U.S. tax. That issue has been discussed at length and is not the focus of this article.

Second, as stated above, the sourcing rules in section 863 have been changed in a fashion that *eliminates the preexisting related FTCs*.

Under prior section 863 and related regulations, for purposes of determining FTCs, the gross revenue of a U.S. person from production in the United States and sale outside the United States would be allocated between the United States and the other country using one of

[1] *See* REG-100956-19 (released Dec. 23, 2019) (specifically, the section entitled "Explanation of Provisions"). The prelude to this revision was the 1986 Tax Reform Act, 31 years earlier, which adopted an equally irrational sourcing rule for gain from the sale of personal property under section 865. That 1986 change sources such gain in the country of the seller.

three rules. First, there was a 50-50 split. Second, there was an independent factory price method, which was akin to treating the two branches as separate persons and applying the arm's-length principle. Third, there was the books and records method. "Those methods provided rules for determining the amount of gross income attributable to production and sales activities, with different rules then applying to source the portion of income derived from production activity versus sales activity."[2] The calculations would provide the information on foreign-source income required to claim FTCs under IRC sections 901 and 904. That would, in principle, accord and coordinate with the tax laws of the other country, which would be expected in some circumstances to levy tax on the U.S. person's sales activity therein.

II. The TCJA's Revision of Section 863

Revised section 863 allocates all gross revenue from production and sales to the place of production. That rule is unequivocal when the producer is a U.S. person and all production takes place in the United States. The proposed regulations, specifically prop. reg. section 1.863-3(b), restate this:

> Sourcing based solely on production activities. Subject to the rules of section 1.865-3, all gain, profit, and the income derived from section 863(b)(2) Sales is allocated and apportioned solely on the basis of the production activities with respect to the inventory.

This change is the focus of this article. Not dealt with herein are the rules in the proposed regulations and in sections 863, 864, and 865 that address production both within and outside the United States by a U.S. or foreign person. Production outside the United States by non-U.S. persons selling in the United States is dealt with briefly in Section V.[3]

Prop. reg. section 1.863-3(d) provides for:

> Determination of source of taxable income. Once the source of gross income has been determined under paragraph (c) of this section, the taxpayer must properly allocate and apportion under subsection 1.8618 through 1.86114T and 1.86117T its expenses, losses and other deductions to its respective amounts of gross income from sources within and without United States from its section 863(b)(2) Sales.

The elimination of the FTC (as noted above) and the resulting potential for double taxation (as illustrated below in a Canada-U.S. context) may not have been intentional. Jeffery Kadet notes:

> From the limited material in the committee reports accompanying the TCJA, it is unclear whether Congress intended this result (double taxation) or whether such a possibility was even considered, particularly taking into account that Congress has traditionally attempted to avoid double taxation through the FTC mechanism.[4]

Moreover, in another article, David Koontz and Kadet express surprise that the significant effects of section 863 on FTCs are totally ignored in the committee reports explaining the change of law.[5] In particular, they point to the unfocused (this writer's word) language in the House Ways and Means Committee's report.[6]

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[2] Kristen A. Parillo, "Proposed Regulations Implement TCJA Changes to Inventory Source Rule," *Tax Notes Int'l*, Jan. 6, 2019, p. 107.

[3] Regarding the latter, see in particular Jeffery M. Kadet, "Sourcing Rule Change: Manufacturing and Competitiveness," *Tax Notes*, Nov. 5, 2018, p. 717. Kadet's article raised concerns that the TCJA's changes might favor foreign manufacturers, concerns that may have been addressed in the December 19 proposed regulations. His article also touches on the subject of this article. *See also* Kadet and David L. Koontz, "Effects of the New Sourcing Rule: ECI and Profit Shifting," *Tax Notes*, May 21, 2018, p. 1119; Monica Gianni, "Inventory Sourcing Rules After the U.S. Tax Cuts and Jobs Act: Do the Changes Work?" *Tax Notes Int'l*, June 25, 2018, p. 1513; and Jasper L. Cummings, Jr., "Selective Tax Act Analysis: Subpart F and Foreign Tax Credits," *Tax Notes*, Jan. 29, 2018, p. 653.

[4] Kadet, *supra* note 3.

[5] Koontz and Kadet, *supra* note 3.

[6] H.R. Rep. No. 115-409, at 384 (Nov. 14, 2017).

III. Double Taxation: Non-Treaty Context

Given the magnitude of the ongoing business and trade between the United States and Canada, it is important to consider the consequences of the new rules for a U.S. person who manufactures or produces solely in the United States and sells the resulting product in Canada. This section analyzes this issue on the (counterfactual) assumption that there is no tax treaty between the two countries. The next section takes into account the treaty that does in fact exist.

In general terms, there are three commercial formats that a U.S. manufacturer might use to sell to a Canadian buyer. For Canadian tax purposes, in each of the three cases, there are two ways in which the sale would be concluded. Each option is analyzed below.

First, the U.S. entity may sell to a Canada-based distributor (whether related or not) that resells to Canadian retailers or end users.

If no part of the negotiation or conclusion of a sale to the distributor takes place in Canada, the U.S. seller will not be considered to be carrying on business in Canada under sections 2(3) and 115 of the Income Tax Act (Canada). The seller will not be subject to Canadian income tax, so there are no possible lost FTCs in the United States as a result of the revised section 863 sourcing rule.

However, if the sale to the distributor is concluded in Canada or if it is concluded outside Canada but further to an offer to sell that was made in Canada, then the U.S. seller does carry on business in Canada[7] and will be liable for Canadian federal income tax on the portion of the overall profit from producing and selling that is considered to have arisen in Canada. That would trigger double taxation resulting from the new denial of U.S. FTCs in accordance with the new section 863 sourcing rule.

There could be uncertainty regarding the magnitude of the problem because there are no specific Canadian statutory rules with which to calculate the portion of profits taxable in Canada. Section 4(1)(b) of the ITA provides that when a business is carried on in two or more different places, the net profit from the part of the business carried on in one of those places should be computed "on the assumption that the taxpayer had during the taxation year no income or loss except from the part of the business that was carried on in that particular place." The Canada Revenue Agency has interpreted that totally uninformative provision in the context of a nonresident offering goods for sale in Canada that the nonresident produced outside Canada as, when computing the profits taxable in Canada, permitting a deduction of the fair market value of the goods when they enter Canada.[8] But query at what level of trade that FMV is to be established.

Once the taxable income is determined, the actual tax thereon will be determined as follows. Assuming there is no domestically defined permanent establishment in a province to which the sale is referable, the federal rate will be 25 percent plus a branch profit tax of 25 percent (assuming no treaty reduction) on the residual 75 percent unless reinvested. In the unlikely event that sales to a distributor gave rise to a provincial PE, the federal rate would be reduced to 15 percent plus a provincial tax at a rate ranging from 8 to 16 percent (taking into account announced reductions by the province of Alberta) and the federal branch profit tax.

Turning to the second commercial format, the sales may be to Canadian retailers or end-users on a nondigital basis. In theory, the seller could avoid the "carrying on business in Canada" nexus. However, that is doubtful. Instead, it must be assumed that (ignoring the treaty) liability for Canadian tax would arise and the double tax issue caused by the amendment to section 863 would also arise. As noted, there has been some development of an administrative-made (deemed notional separate entity/arm's-length transaction) approach to allocating profit between a country of production and country of sale.[9] This approach — which is not unlike the pre-TCJA "independent factory price" method under the section 863 regulations or the authorized OECD approach

[7] Regarding the former, see case law. Regarding the latter, see section 253 of the ITA. For an example of preliminary marketing and selling activities (by a Washington state company seeking to sell Washington real estate to Vancouver residents) that did not amount to an offer to sell made in Canada but instead was a mere "invitation to treat" and thus did not trigger section 253, see *Sudden Valley Inc. v. The Queen*, 76 DTC 6448 (FCA).

[8] *See* CRA Doc. 2006-0196221C6. Note: CRA interpretations do not have the force of law.

[9] *See id.*

(AOA) used by the Canada-U.S. treaty (discussed below) — would allocate the overall profit to the country of production and the country of sale as if there were an arm's-length-priced sale of the inventory by the production team (or branch) to the selling team (or branch) with each treated as though it were a separate legal entity.

The third commercial format involves sales to Canadians made through e-commerce. This would raise the level of (Canadian) tax uncertainty because relevant rules have yet to be added to the ITA. The newly elected minority Liberal government's campaign platform expressed the intent to enact rules regarding the big internet companies that are comparable to those now in force in France. However, this was not seen in the new government's December 18 "throne speech" — that is, the speech that previews forthcoming government legislative and other plans — perhaps because the government is now awaiting the completion of the OECD's pillar 1 proposal on the digital economy. Separately, this area raises questions about how inventory is defined for section 863 purposes and how that response influences the scope of the problem. Section 865(i)(1) defines inventory property to include intangible products such as software. Thus, the potential net is wide.[10]

In summary, sales by U.S. producers to Canadian buyers would give rise to broad exposure to double tax under post-TCJA section 863 in the absence of a treaty between the two countries. However, there is a treaty, and the effects thereof are considered in the next section.

IV. The Effects of the Canada-U.S. Treaty

Will the Canada-U.S. tax treaty — notwithstanding the new section 863 sourcing rule — require the United States to grant a credit for taxes that the treaty permits Canada to impose on a U.S. resident entity that produces goods in the United States and sells them to Canadians?

To start, the treaty (specifically, Article VII) only permits Canada to impose tax when sales are made in conjunction with a PE (within the meaning of Article V) maintained in Canada by the U.S. seller.

Next, the portion of the U.S. seller's overall profit that Canada may tax is determined by the language in Article VII, as explained by Treasury's technical explanation (which Canada accepts as reflecting the intention of the parties) and an OECD-related competent authority agreement, both of which are detailed below.

Further, section 9 of Annex B to the 2007 protocol states that the two countries:

> understood that the business profits to be attributed to a permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment. The principles of the OECD Transfer Pricing Guidelines shall apply for purposes of determining the profits attributable to a permanent establishment taking into account the different economic and legal circumstances of a single entity.

In light of the OECD's subsequent 2010 publication of the AOA and the principle therein — that is, that the profits attributable to a PE are those the PE would have made were it a separate legal entity (for example, a corporate subsidiary) — the two countries signed a competent authority agreement on June 26, 2012, that adopts the AOA.[11]

The bottom line is that a U.S. seller operating through a Canadian PE has firm guidelines to use when determining the amount of tax that the treaty will allow Canada to impose on profits derived from producing goods in the United States and selling them in Canada.

It is those taxes that the United States should allow FTCs for under section 901, notwithstanding the TCJA's amendment to section 863. That is because Article XXIV(1) — taking into account the sourcing rule in Article XXIV(3) — seems to be straightforward in providing for those credits.

However, the question remains: Does the TCJA amendment override this and deny the credit, either because of the later-in-time rule of section 7852(d)(1) (regarding conflicts between

[10] *See* Koontz and Kadet, *supra* note 3, at note 34 and related text.

[11] *See also* CRA, "Canada-U.S. Tax Convention — Agreement Between Competent Authorities on the Interpretation of Article VII (Business Profits)" (June 26, 2012).

the code and a treaty provision) or the language in Treasury's 1984 technical explanation? Article XXIV of the latter provides:

> The direct and deemed-paid credits allowed by paragraph 1 are subject to the limitations of the Code as they may be amended from time to time without changing the general principle of paragraph 1. Thus as is generally the case under U.S. income tax conventions, provision such as Code sections 901(c), 904, 905, 907, 908, and 911 apply for purposes of computing allowable credit under paragraph 1. In addition, the United States is not required to maintain the overall limitation currently provided by U.S. law.

As a foreign observer, this writer will leave it to *Tax Notes International*'s U.S. readers to answer that question. However, regarding the later-in-time rule and the oft-stated view that it requires clear congressional intent for a treaty to be overridden, consider the comments referenced above by Kadet and by Koontz and Kadet. Those indicate a clear absence of any congressional expression of that intent. Further, nothing in the December 2019 proposed regulations seems to address the FTC issues for a U.S. seller who sells U.S.-made goods or products abroad. Is it of concern that the only reference to treaties in the proposed regulations is to "foreign treaty residents"?[12]

V. Canadian Sales Into the United States

As noted above, both the TCJA's amendment to section 863 and the December proposed regs also affected, *inter alia*, foreign persons manufacturing abroad — such as Canadians manufacturing in Canada — and then selling into the United States. There was initially some uncertainty regarding whether the new sourcing rules would override section 865(e)(2) and interrupt the preexisting effects of sections 863 through 865, which imposed (subject to treaty limitations) U.S. tax on at least part of profits derived from such activities by foreign persons.[13]

The proposed regs confirm that a foreign person would, in appropriate circumstances, continue to be considered to derive income effectively connected to a U.S. trade or business from this type of activity, and in the case of a person in a treaty jurisdiction (for example, a Canadian), preexisting treaty limitations on applicable U.S. tax would continue to apply.[14]

VI. Concluding Comment

U.S. observers[15] have suggested that the TCJA's revision to section 863 responds, in the case of U.S. sellers of U.S.-made goods to foreign buyers, to inappropriately high levels of foreign-source income for section 904 purposes created by the 50-50 split that the regulations under the pre-TCJA section 863 allowed. But isn't the cure — that is, the TCJA's amendment to section 863 — worse than the illness when, seemingly, all that was really required was to rein in the regulations instead of creating a code rule that appears to be irrational?

And, to add to the concerns raised by the amendment for U.S. sellers into Canada through a Canadian PE, is it really clear that the treaty fixes the related FTC issue? ■

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[12] Proposed regulations, *supra* note 1, at Section II.C.

[13] See articles cited in note 3, *supra*.

[14] *See* proposed regulations, *supra* note 1. Section II.C states:

> The Treasury Department and the IRS are aware that under U.S. income tax treaties, the business profits of foreign treaty residents may be taxable in the United States only if the profits are attributable to a permanent establishment in the United States. With respect to taxpayers entitled to the benefits of an income tax treaty, the amount of profit attributable to a U.S. permanent establishment will not be affected by these regulations.

[15] *See supra* note 3.