¶730 Source of Income Rules for Cross-Border Inventory Sales

NEW LAW EXPLAINED

Cross-border inventory sales sourced based on production activities.— Gains, profits, and income from the sale or exchange of inventory property that is produced in whole or in part within the United States and sold outside of the United States (or vice versa) is allocated and apportioned between U.S. and foreign sources solely on the basis of the production activities with respect to the property (Code Sec. 863(b), as amended by the Tax Cuts and Jobs Act). Under the rule, if income is produced entirely in the United States, it is U.S. source income and income produced entirely in a foreign country is foreign source income. Inventory produced in both the United States and a foreign country is mixed-source income.

> **COMMENT**
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> Cross-border inventory sales will now be sourced without regard to the title passage rule. The title passage rule is seen as a means by which taxpayers can manipulate the source of income rules.

The current regulations, which provide rules for sourcing income attributable to production activity, should continue to apply with respect to determining where production activities are located and allocating and apportioning mixed-source income. The regulations provide rules for sourcing income attributable to production activity. Under the regulations, production activity means activity that creates, fabricates, manufactures, extracts, processes, cures or ages inventory. With some exceptions, the only production activities that are taken into account are those carried on by the taxpayer. The income attributable to production activities is sourced according to the location of the production assets, where the production activity is solely in the United States (Reg. §1.863-3(c)(1)(i)(A)). Production assets include only tangible and intangible assets that are directly used by the taxpayer to produce inventory. Production assets do not include assets that are not directly used to produce inventory, such as accounts receivable, marketing intangibles and customer lists (Reg. §1.863-3(c)(1)(i)(B)).

If there is production both inside and outside of the United States, the regulations provide that the source of the income is determined by multiplying the income attributable to the production activities by the ratio of the average adjusted basis of the production assets located outside of the United States to the total adjusted basis of all production assets. The remaining income is U.S. source income (Reg. §1.863-3(c)(1)(ii)).

Effective date. The amendment made by this section applies to tax years beginning after December 31, 2017 (Act Sec. 14303(b) of the Tax Cuts and Jobs Act)