

The White House did not have electric lighting until 1910. An attempt was made in 1890's, but President Harrison and his First Lady were afraid of being electrocuted so they used gas lamps.

This leads us to the world by the writers of our current tax law. The Great Depression created the need of American international taxation. We needed foreign money.

Who is this guy?



He is the American international tax guru. born in 1864! His tax laws work only his world of steam engines and horses and buggies.

Congressman Robert Doughton was the most powerful (1933–1947 and 1949–1953) Chairman of the powerful U.S. House Committee on Ways and Means. He oversaw the passage of the Social Security Act in 1935. He designed the Internal Revenue Code of 1939 and its clean up version in 1954.

Doughton's father was a captain in the Confederate Army during the American Civil War; Congressman was born at the end of the Civil War and his father named him Confederate General Robert E. Lee. The Congressman earned the equivalent of a high-school diploma from the Tra-phill Academy. He never attended college!

He was born in 1864 and died in 1954 at age ninety. He was in his eighty's when he designed our tax laws. How did this man see the world? It is this vision of the world that is embedded in our current tax code.

Today!

We all have heard people say that things are not what they used to be. In American business,

The Tungsten Light Bulb was put into use in 1916. Less than half of the homes had electricity in the 1930's.

Edison Day Oct. 21st 1879-1916

The Lamp that made the dream come true

MR. EDISON, we propose to you a toast. Across the brightly lighted table of the world tonight we wish to thank you—you who thirty-seven years ago gave to the world its first electric incandescent lamp.

In the years that have passed we have seen many changes, many improvements. Here, for instance, is this robust son-in-law of your first lamp, the modern EDISON MAZDA. It contains all the knowledge and experience of the General Electric Company with the known EDISON Lamp qualities, traditions and inheritances; and goes forth into the world to give better, brighter, cheaper electric incandescent illumination than ever before. So, here's to you! Mr. Edison: On this birthday of your lamp we extend to you in the cheery, bright, white, economical light of EDISON MAZDA our hearty good wishes for your health, long life and further achievement.

Edison MAZDA Lamps give three times the light of the old-style carbon lamps for the same current cost. Or you can avail yourself of the economy of EDISON MAZDA LAMPS and have your present light for one-third your present current bill with carbon lamps. To get the greatest current saving and greatest amount of light put them in every socket in every room.

EDISON LAMP WORKS of General Electric Co. HARRISON, N. J., U. S. A. Agencies Everywhere

EDISON MAZDA LAMPS
Made in U.S.A. and backed by MAZDA Service

this is particularly true. It was after 1910 that the White House had the tungsten bulb. Before then, cars were laughed at with jokes like “Get a horse! Movies were silent. Air travel did not exist. Yet, these men born before 1900 are the designers of our international tax laws, enacted in the IRC of 1939.

The authors of these laws were born before 1900. Phones were rare, and there was no air travel. Most of the congressional representatives who wrote the 1939 tax code were born before 1900. Their view of the world was what you see in many silent movies ... and so was their tax law.

Last year, the newspaper headlines were blaming a computer for the Dow’s “flash crash” of a thousand points in one hour: “Computers, Not Human Error, Likely Caused Market Meltdown.” Sounds like the movie *2001: A Space Odyssey* and Hal the computer!

The tax-planning chapter of this book revolves around a major flaw in American tax law caused by the speed of change.

Tax case law for the third wave economy has not occurred. However, there are two second wave-era court cases that have third wave traits. These cases provide the design for third wave tax law.

First, a 1930s tax dispute determined that a Mexican radio station operating out of Texas had tax-free foreign source income. From this case, we learn that the source of income from a computer hosted in a foreign country providing business services to American customers is foreign source income.

Lastly, Xerox rocked the IRS when a court ruled that income earned by its copiers was machine service income, which was to be sourced where the service computer was located.¹ From this case, we learn that a machine can provide “personal service income.” Today many devices provide personal services to us, such as a GPS navigation system and the Rosetta Stone language learning software.

¹ Allowing Xerox a big investment tax credit.

Piedras Negras Broadcasting Co., and/or Cia Radio Difusora De Piedras Negras, S.A. v. Commissioner of Internal Revenue (43 BTA)² involves the beginning of the third wave commerce. Until the advent of radio and music on records, entertainment and news were in the form of hard copy or live performances.



The setting is the late 1930s. An American radio station moved to Mexico to serve its American audience. *Compania Radio Difusora de Piedras Negras, SA*, (the English translation of which is “Piedras Negras Broadcasting Company”) was organized under the state of Coahuila, Republic of Mexico. Piedras Negras, Mexico, and Eagle Pass, Texas, are separated only by the Rio Grande River.

The radio station at Piedras Negras was a powerful one, broadcasting on fifty kilowatts in 1936 and 1937, and the advertisers got listener responses over a wide area, from nearly all of the states in the United States. The station also received mail from Canada, Cuba and New Zealand. The Piedras Negras station had no directional antennae; the waves radiated by the antennae went in all directions with equal force. About 95 percent of the station’s income was from Amer-

ican advertisers, and about 90 percent of the listener responses to the advertisers came from the United States.

In 1936 and 1937, the radio station deposited \$72,204.14 and \$66,985.11 of its advertising income in its bank located in Texas.³ The IRS assessed the radio station taxes, claiming it was American source business income.

W. E. Branch, president of the radio station in 1936 and 1937, registered *The Radio Service Co.* in the assumed name records of Maverick County, Texas. Some contracts were entered in its name, which was used in connection with the business of the *Piedras Negras Broadcasting Co.* because of the difficulties Americans had in saying the name *Piedras Negras*.

Each day, employees of the radio station met at Eagle Pass, Texas, with the advertisers at the *Hotel Eagle*. The hotel furnished the radio station with a private meeting room. The radio used the hotel as its address. Besides opening the mail, the meeting room was at the disposal of sales clerks for their wares and samples. Tables and chairs were equipped for that purpose and furnished by the hotel.

Upon delivery of the mail, the employees of the advertiser, along with two employees of the radio station, opened the mail. During the meeting, the radio station and the advertisers divided payments received in the mail. The radio station deposited its share of the money (checks) to the radio station’s credit in one of two banks: in Eagle Pass or in a bank in Piedras Negras.

² 43 B.T.A. 297 ,1941, and affirmed by the Justice Holmes (before his time in Supreme Court) in the fifth circuit (127 F.2d 260, 1942)

³ As you will learn in this book, the place of bank deposit is *not* a factor in determine taxation.

The entertainers and announcers who put the programs on the air went to the studio in Piedras Negras, Mexico. The radio station generally employed the entertainers or musicians and furnished the programs that were broadcast. However, sometimes the advertisers would do so. In the latter instances, radio station furnished only the time on the air.

The judge noted that the IRS considered the activities at the meeting room as to constitute doing business in Texas, and thus the source of income was within the United States. The IRS argued that radio station's income came from the division in Eagle Pass, Texas.

The court noted, that "the income in question was collected from advertisers within the United States is not determinative of the source. In *East Coast Oil Co., S.A.*, 31 B.T.A. 558; affd. 85 Fed. (2d) 322; certiorari denied, 299 U.S. 608, we held that though a Mexican corporation received payment for oil at its office within the United States, and though the contract was made in the United States, the source of income from the sale of the oil was not within the United States, since the title to the oil, produced or purchased abroad, passed in Mexico. The statutes there involved were the Revenue Acts of 1918 and 1921, section 233(b) which were, in effect, the same as that here applied. In *Briskey Co.*, 29 B.T.A. 987, sales of skins by a domestic corporation were consummated in India, largely to Pennsylvania corporations. We held that the income was from sources without the United States." (43 B.T.A. 297, 1941 and affirmed by the Justice Holmes in the fifth circuit (127 F.2d 260, 1942)).⁴

Although the IRS wanted the meeting room to be "an office or fixed place of business," the court held otherwise. The judge stated,

"Nor should greater effect be given to the use by radio station of a room in the hotel in Eagle Pass, Texas, for the purpose of sorting the mail received by advertisers and dividing the proceeds of remittances received. No rent was paid for the room and no furniture or desk was owned or maintained therein by the radio station. It was a basement sample room donated by the hotel, obviously because of the patronage realized from those in connection with the broadcasting operations. It was not an office in any usual sense. As a place of business it was only incidental - for the sorting of mail and collection of income. Regulations 94, article 231-1(b), says in part:

"Whether a foreign corporation has an office or place of business within the United States depends upon the facts in a particular case. The term office or place of business, however, implies a *place for the regular transaction of business and does not include a place where casual or incidental transactions might be, or are, effected.*"⁵

The use of the meeting room for samples was not "casual" but daily. Yet the court ruled that it was "only incidental," allowing the radio station not to have a United States business

⁴ Before his appointment to the Supreme Court.

⁵ 43 B.T.A. 297, 1941, and affirmed by the Justice Holmes (before his time in Supreme Court) in the fifth circuit (127 F.2d 260, 1942).

Many tax planners believe that “negotiating” a contract in the United States causes all future profits to be a domestic source. This is not the case. The judge stated,

“However, the only indication of the use of that company or name for solicitation in the United States is the fact of registration in the assumed name records of Maverick County, Texas. Internal activities of a corporation, such as holding a stockholders’ meeting, do not constitute transacting business. Nor is collection of debts, nor litigation to so collect, doing business [as argued in] *Equitable Credit Co. v. Rogers*, 299 S.W. 747; *Continental Assurance Co. v. Ihler*, 26 Pac. (2d) 792. “

The contract’s venue of Maverick County, Texas, for litigation was immaterial to the judge.⁶ Further, the place of signing a contract was not determinative in determining the source of this type of income.⁷

The judge was specific regarding sourcing:

“Income has been defined as the gain derived from capital, from labor, or from both combined, or from the sale or conversion of capital assets [as argued in] *Eisner v. Macomber*, 252 U.S. 189. In Paul and Mertens’ *Law of Federal Income Taxation*, vol. 4, p. 350, it is said, in part:

“[The source] is not a place, it is an activity or property. As such, it has a situs or location; and if that situs or location is within the United States, then the resulting income is taxable to nonresident aliens and foreign corporations.... Thus, if an income be taxed, the recipient thereof must have a domicile within the jurisdiction, or the property or activities out of which the income issues or is derived must be situated within the jurisdiction so that the source of the income may be said to have a situs in this country. The basic rule is that the consideration for taxation is protection of life and property and that the income rightly to be levied upon to defray the burdens of the United States government is that income which is created by activities and property protected by this government.”

The court gives us the first clue as to the sourcing income provided over an intangible pathway such as radio waves or the Internet.

“It thus appears that broadcasting through the *ether*⁸ does not in any ordinary sense cause contact or interaction between properties of different owners, such as transaction of

⁶ Citing “*Wells Fargo & Co. of Mexico, S.A. v. McArthur Brothers Mercantile Co.*, 26 Pac.(2d) 1021, it was held that the using of mail and telegraph facilities in Arizona by a Mexican corporation did not constitute doing business therein and did not give Arizona court’s jurisdiction over the Mexican corporation. The decision was not affected by the fact that the Mexican corporation employed a Mexican broker to effect transfer of express from Arizona to Mexico and that the broker in revising and classifying express used a room maintained by the Mexican corporation adjoining the American company’s office in Arizona.”

⁷ The court stated: “In *Helvering v. Stein*, 115 Fed.(2d) 468, affirming the Board, it was held that, where bankers in Germany by guaranteeing drafts drawn by their German customers on New York banks obtain funds for such customers, there was, in the profit made by the bankers, no income from sources within the United States, under section 119(e) and (f) of the Revenue Act of 1928 (the same as in the Act of 1936, so far as here material), although the negotiation of the drafts comprised sale of personal property in the United States.” (43 B.T.A. 297, 1941, and affirmed by the Justice Holmes (before his time in Supreme Court) in the fifth circuit (127 F.2d 260, 1942).)

⁸ An old fashion slang term similar to our current slang of “in the clouds,” meaning an intangible item with tangible characteristics.

business usually entails, and that the foreign broadcasting corporation here cannot be said to be using property in the United States. Shipping goods into a state is not doing business therein [as argued in] *Novelty Manufacturing Co. v. Connell*, 34 N.Y.S. 717; nor is sale by solicitor, transportation of merchandise into a state, and collecting therefore [as argued in] *Bruner v. Kansas Moline Plow Co.*, 168 Fed. 218; nor distributing a magazine by a foreign corporation [as argued in] *System Co. v. Advertisers' Cyclopedia Co.*, 121 N.Y.S. 611. If these physical activities do not constitute transaction of business within a state, we think that mere broadcasting through the ether over a state is not such.”

Here the judge focused on the flaw in the American tax code by stating,

“The commonly accepted definition of the term ‘source’ is ‘that from which anything comes forth, regarded as its cause or origin, the first cause’ [according to] Webster's New International Dictionary.... Neither broadcasting nor the other facts above examined come within the items which section 119 of the Revenue Act of 1936 enumerates as to be treated as income from sources within the United States, viz., interest, dividends, personal services, rentals, royalties or sale of property, real or personal.”



Broadcasting over the ether is substantially similar to web base advertising. A giant Google computer farm sends content throughout the world. Much like satellite base radio. While there is a tax law for communication satellites, then fails to address artificial knowledge generated by computers. We address the first and only case on this topic below.

Xerox v. the United States (More Than Just a Machine)

The concept of photocopying was beyond my understanding at age nineteen. How could a picture be made so quickly?⁹ Finding the correct pricing was a challenge for Xerox because this product had never existed. Xerox wanted, as does any good business, to make its fortune while it had the monopoly. Xerox decided on pricing based upon the value of the copies. Unlike a rental, where the lessor looks at the capital expended for the asset (such as an auto lease or an apartment), Xerox looked at the value of an instant copy of the document.



Xerox treated the equipment as theirs and paid all of the cost of paper, ink and maintenance.

When the U.S. was in the great recession of the late 1970's and 1980's, ten percent of the cost of equipment was a tax credit. Thus, if you paid \$1,000, the tax credit was \$100.¹⁰ No tax credit was allowed when the equipment was leased to a tax-exempt organization or a government. The Xerox tax court case involved the U.S. government using the Xerox copier machines.

chines.

The IRS claimed that the U.S. government was leasing the equipment. Xerox claimed that the machines provided a service; the machines were not “used by” governmental units and tax-exempt organizations. In other words, the question was whether Xerox’s copying machines were providing a service to the government (and therefore used by Xerox to provide the service), and thus, the copiers were not “used by” the government’s employees—an interesting point.

For example, when I lease a car, I use the car. When you hire a taxi, you do not use the car; instead, you get the service of being driven somewhere. You also get “knowledge” of the driver. He knows how to find your address.



The court provided a thorough historical review of machines providing a service. The next few quotations are from the court. When the court references the plaintiff, it refers to Xerox. The text in *italics> is my emphasis on important items. The issue in the case was a law created to spur the economy during a recession. A tax credit up to 10 percent of the cost of equipment was allowed. If a business paid \$1,000 for equipment, a \$100 reduction in its taxes was allowed.*

The tax credit did not apply to equipment leased to a government or a nonprofit organization. Xerox leased equipment to the United States and claimed the tax credit.

Upon audit, Xerox told the IRS that the copies earned service income and not rental income. The court agreed with Xerox.

I found the court’s discussion of ancient equipment, such as switchboards and vending machines, helpful in seeing how a machine can provide a service. [You can read it at this link.](#)

⁹ My statement reflects on the speed of change. Today, we scan a digital copy for almost no cost. When Xerox started, the cost of three copies was equal to the cost of a gallon of gasoline.

¹⁰ In addition to the depreciation on the equipment.

The judge in this case provided advice to determine when equipment creates service income versus rental income. I am including portions of the judge's advice below. [The complete explanation is at this link.](#)

“Possession is the main feature that distinguishes a lessee's interest. I possessed the car I am leasing. A service contract allows the owner access to the property with the right to substitute property. A food vending machine is an example. You can access it for food. You have the right to get food from any other source. Lastly, the IRS has drawn a distinction between property used by the taxpayer to provide services to its customer (such as a taxi cab) and property placed with the customer to allow it to provide services to itself (the vending machine).

“Hence, what the parties call the transaction is important, but not conclusive. (A. J. Casner, 1 American Law of Property Section 3.3 (1952)).”

The second area of focus used by the IRS in determining whether an agreement is a service involved the degree to which the property was part of an integrated operation. Here the judge wrote:

“In this area, [the] IRS has drawn a distinction between property used by the taxpayer to provide services to its customer, *and property placed with the customer to allow it to provide services to itself*, see Rev. Rul. 71-397, supra; Rev. Rul. 72-407, supra. [The p]laintiff's position is that it provided a copy service, an integrated package of equipment and services designed to produce copies as its end result. [The d]efendant contends that customers only contracted for a machine which they could operate themselves. The totality of the record supports plaintiff's position *that its customer wanted more than just a machine*.

“The mode of payment in the rental agreements also suggests that [the] plaintiff provided a service. Although minimum fees were imposed in some cases, the amount paid by the customer primarily was determined by the number of copies made. In essence, therefore, the customer paid for an end result, i.e., the number of copies made, and not for use of a machine for some duration.”¹¹

We are often told that this is the “*information age*”.
Is that already obsolete. Is the new wealth of E-commerce different.

Maps- not only shows us change but the rate of change.



The population of Britain in 1675 was 5 million and there were no cars or lorries on the roads, just the odd horse, or horse and carriage or horse and cart.

This road atlas shows roads in England and Wales (in 1675, England and Wales were unified as one nation, but Scotland and Ireland hadn't yet joined the Union).
The Britannia Volume The First Or An Illustration Of

¹¹ This is similar to today's pricing, where users pay for megabytes of data.

The atlas depicts 7,500 miles of roads throughout Britain, but they were in such poor condition that travelling from London in the south of England to Newcastle in the north of England, a distance of almost 249 miles while the crow flies, could take two weeks.



Google and Yahoo maps were great, in the 1990's. Wow, no more Thomas Guide. While a map is rudimentary information, the Google and Yahoo maps were "smart information". Even some "intelligent" by linking the roads together. Google and Yahoo not only looked at the map, they wrote the travel instructions.

Starting this century, machine intelligence combined with satellite mapping replaces the Google and Yahoo map. Oh, yes I still take a look online before I travel. But once I am in my car, I use the GPS. Now, with traffic data via satellite, its information and intelligence exceeds mine (and don't laugh because I am today's teacher).

Sourcing of Income Rules

You learned in Chapter One that the IRC obsolescence is creating tax-planning opportunity. The sourcing rules are still in 1939. These rules worked well when the business activity existed in the 1930s.

Here is a table of the general rules.

Item	Rule
Salaries, wages,	Where services performed
Business income—personal services	Where services performed
Sale of inventory—purchased	Where sold
Sale of inventory—produced	Allocation of a variety of factors
Sale of personal property	Where title passes, with exceptions
Interest	Residence of obligor-payor
Dividends	Domestic if domestic corporation & foreign if foreign corporation
Rents	Location of property
Royalty—patents, copyrights, etc.	Where patent or copyright is used; laws are vague
Sale of real estate	Location of property
Personal service, consulting, training,	Where serviced performed
Pension	Where services were performed that earned the pension

International law uses the geographic area in which the activity—giving rise to the income of the activity—occurs as the source of income. Thus, for example, services income has its source at the location of the service provider. The United States ignores the place of deposit in determining the source. Financial guarantees have a surprising result, as we will see below.

Salary, Wages, and Services Income

Here is where the *absence* of tax law gets exciting.

While there is ample tax law on personal service activities of human beings, there is no IRS explanation of other service income. In the second wave economic environment, equipment provided services in the form of a tangible product (e.g., the vending machine or the Xerox copier, as discussed in Chapter One).

Wages and other compensation for labor (such as consulting services) performed in the United States are considered to be from U.S. sources.¹² The simple rule is: where your butt is located becomes the source of the income.

If the personal services are performed in a foreign country, then it is foreign source income.¹³

Independent contractors are different and easier. Generally, if a consultant comes to a country, he or she has a specific assignment and compensation.¹⁴ In many cases, this will be based on time. If so, then the same rule as for employees applies.

¹² Code Section 861(a)(3).

¹³ Code Section 862(a)(3).

¹⁴ Regulations Section 1.861-4(b)(1)(i), (b)(2)(i).

The regulation provides a simple equation for the allocation to the United States.¹⁵

Number of day services performed in the United States.

Total number of days of services.

The events basis rule is an economic substance rule. The facts and circumstances of the event determine the source. The source of compensation for labor or personal services determined on an event basis is the location of the specific event.¹⁶

Source of Income from the Sales Inventory and Personal Property

Generally, if a U.S. resident sells personal property, the gain or loss from the sale is U.S. source. If a nonresident sells personal property, then the gain or loss is foreign source.

U.S. resident. For this purpose, the term means a U.S. citizen or resident alien who does not have a tax home in a foreign country. The term also includes a nonresident alien who has a tax home in the United States. The definition of U.S. resident for the sourcing of income is different from the determination of when an alien is taxed on his or her worldwide income.

Some individuals do not have a tax home. If you travel too much, you may not have a tax home.

Nonresident. A nonresident is any person who is not a U.S. resident.

U.S. citizens and resident aliens with a foreign tax home are nonresidents for a sale of personal property only if an income tax of at least 10 percent of the gain on the sale is paid to a foreign country.

This rule also applies to losses if the foreign country would have imposed a 10 percent or higher tax had the sale resulted in a gain.¹⁷

Inventory. Income from the sale of inventory that you purchased is sourced where the property is sold. Generally, this is where the title to the property passes to the buyer.

These rules are used by the cross-border tax advisor. Merely being using a foreign entity, income can be foreign source. The Subpart F law also governs related party cross-border inventory sales for a controlled foreign corporation.

We start by determining where the seller has a place of business that negotiated the sale.¹⁸ The IRC uses the term “fixed place of business.” Tax treaties use the term “permanent establishment.”

Inventory sourcing of a taxpayer purchased inventory for resale; the gain or loss on the sale is sourced in the country where the property was sold, generally where title to the property passes

¹⁵Regulations Section 1.861-4(b)(2)(ii)(E).

¹⁶Regulations Section 1.861-4(b)(2)(ii).

¹⁷ Regulations Section 1.865-1(f)(2). For stock losses, see Regulations Section 1.865-2(e).

¹⁸ “Negotiated sale” in tax jargon means where the agreement was completed. The case *Amp Inc. V. U.S. Amp, Inc. versus United States of America*, [at this link, exemplifies the courts approach of determining where sales are negotiated.](#)

to the buyer.¹⁹ If the title to the inventory passes within the United States, the income is domestic source.²⁰

The tax planners' first thought is to prearrange the place where title passes. However, if the title passage is structured solely for tax avoidance purposes, the title passage rule will not apply. Other factors will be used for establishing the source of income.

If a taxpayer produces inventory in the United States and sells it in another country, or produces inventory in another country and sells it in the United States, a portion of the income is U.S. source income.²¹

A great tax law is known as the "50/50 rule." The sourcing of income is computed under a 50/50 allocation method.²² The seller of the inventory is allowed to allocate 50 percent of the income to its sales activities and 50 percent of the income to its production activities. The production activity location looks at *only* tangible and intangible assets that are directly owned and used in the production of the inventory qualifies.²³ You can learn more details at regulation 1.863-3 which is [at this link](#).

Alternatively, the independent factory price (IFP) method or the books and records method can be used with IRS approval. Obtaining an IRS private letter ruling on how to apply these rules is the key in a successful tax plan.

The IFP amount is allocated to the production activity. The portion of the gross sales price over the IFP is allocated to the sales activity. Once elected, the IFP method must use it for that sale and similar sales.²⁴ The income sourced is based on the allocation of income and expenses from production and sales activities. The taxpayer must maintain accurate books and records to obtain IRS permission to use books and records method.²⁵

Inventory produced in the United States and sold in a U.S. possession, or vice-versa, have the same sourcing rules.²⁶

Income from the sale of inventory that you produced in the United States and sold outside the United States (or vice versa) is sourced based on an allocation.²⁷

Intangibles. Intangibles include patents, copyrights, trademarks and goodwill. The gain from the sale of amortizable intangible property (other than patents, copyrights and trademarks), up to the previously allowable amortization or depreciation deductions, is sourced in the same way as the original deductions were sourced. This is a "recapture" of the tax benefit rule. Thus, if you received a U.S. tax deduction, then the gain is U.S. source, up to the amount of accumulated amortization.

¹⁹Code Section 865(b). and the *Amp Inc.* case, in the prior footnote.

²⁰Code Sections 861(a)(6), 862(a)(6), 863(b).

²¹Code Sections 865(b), 863(b)(2).

²²Regulations Section 1.863-3(f)(2)(i).

²³Regulations Section 1.863-3(c)(1)(i)(B).

²⁴Regulations Section 1.863-3(b)(2)(ii).

²⁵Regulations Section 1.863-3(b)(1).

²⁶Regulations Section 1.863-3(f).

²⁷Regulations Section 1.863-3.

Gain in excess of the amortization or depreciation deduction is sourced in the country where the property is used if the income from the sale is contingent on the production, use or disposition of that property. If the income is not contingent on the production, use or disposition of the property, the source is the seller's tax home as discussed earlier.

The source for payments for goodwill is the country where the goodwill exists. When goodwill is multinational, no tax law exists. American ancient tax laws (based on the early 1900 world) are absent the concept of corporation such as Apple.

Patents, copyrights and trademarks exist solely because of a government license. Income earned by these items is sourced in the country that granted the license.

Sales through Foreign Office or Fixed Place of Business

Income earned by U.S. residents and domestic corporations from the sale of personal property through an office or other fixed place of business outside the United States is generally treated as foreign source if:

- The income from the sale is from the business operations located outside the United States
- At least 10 percent of the income is paid as tax to the foreign country

If the tax is less than 10 percent, then the income is U.S. source. The foreign tax credit uses this sourcing rule. This rule does not apply to foreign corporation with no U.S. office.

This rule does not apply to income sourced under the rules for inventory property, depreciable personal property, goodwill and intangible property when payments in consideration for the sale are contingent on the production, use or disposition of the property.

Rents and Royalties

U.S. source income includes rent and royalty income received during the tax year from property located in the United States. U.S. source income also includes rents or royalties for the use of, or the privilege of using, intangible property such as patents, copyrights, secret processes and formulas, goodwill, trademarks, franchises and similar property in the United States.

The office computer system in the Isle of Man presents an interesting question. The business in the U.S. pays an Isle of Man corporation to use the computer system including its data base. One tax answer is that rent is being paid (which is the IRS position in the *Xerox case*). Under this theory, the total income is foreign source paid for the computer system in the Isle of Man is foreign source even though the user is in the USA. Obviously the 1939 Tax Code never envisions the user of rental equipment being 8,000 miles away. This is one of the many examples of the obsolesces of the U.S. tax law.

Code Sections 861(a)(4) and 862(a)(4) provide that the source of rental and royalty payments is determined by where the property is used. Yep, we are back in the 1900's thinking. With real estate or tangible equipment, this simple approach is great. But with intangibles, not so simple. Few patents have only one government filing. Now, we have intangible equipment.²⁸ We will

²⁸ The cloud computer also known as the virtual computer.

explore this concept below in “Sales of Personal Property.”

The Place Where Services Are Performed

The other answer, is that the computer is providing a service. Much like when I process my payroll with Bank of America.

The place where services will be considered to have been performed depends on the facts and circumstances of each case. As a general rule, services will be considered performed where the persons performing services for the controlled foreign corporation that derives income in connection with the performance of technical, managerial, architectural, engineering, scientific, skilled, industrial, commercial, or like services are physically located when they perform their duties in the execution of the service activity resulting in such income.

In many cases, the total gross income of a controlled foreign corporation, derived in connection with each service contract or arrangement performed for or on behalf of a related person, must be apportioned between income that is not foreign base company services income and that which foreign base company services income is. The apportionment is determined on a basis of employee time spent within the foreign country under the laws of which the controlled foreign corporation is created or organized and employee time spent without the foreign country under the laws of which such corporation is created or organized. In allocating time spent within and without the foreign country relative weight must also be given to the value of the various functions performed by persons in fulfillment of the service contract or arrangement.

For example, clerical work will ordinarily be assigned little value, while services performed by technical, highly skilled, and managerial personnel will be assigned greater values in relation to the type of function performed by each individual.

As we read the IRS examples, you saw examples of manufacturing (which created wealth during the second wave) but no examples of human services or more importantly services provided by an intelligent computer system. Tax planning in this area is wide open.