

LB&I Concept Unit Knowledge Base – International

Library Level	Number	Title
Shelf		Individual Inbound
Book	14	U.S. Business Activities
Chapter	2	U.S. Trade or Business Allocations
Section	1	Determination of Proper Income Allocation

Unit Name	Source of Income for Nonresident Alien Individuals	
Primary UIL Code	9441.02-01	Determination of Proper Income Allocation

Document Control Number (DCN)	USB/C/014_02_01-05
Date of Last Update	Revised: 07/19/19

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General Overview

Source of Income for Nonresident Alien Individuals

NOTE: This Practice Unit was updated to incorporate changes due to the Tax Cuts and Jobs Act for tax years beginning after 12/31/2017 and supersedes the 05/12/16 Unit with the same title.

Source of income is a fundamental concept in international taxation. Identifying the country in which taxpayers earn income is an important step in determining the taxability of a transaction. In general, the U.S. source rules are based on the location of the underlying income-producing property or activity that generated the income. However, the source of certain income is based on residency.

Although sourcing rules apply to U.S. and foreign persons, this Practice Unit focuses on how the sourcing rules apply to nonresident aliens (NRA). The source rules are used in determining the U.S. income tax liability of foreign persons. With few exceptions, the United States can only tax income from U.S. sources that is effectively connected to a U.S. trade or business. In most cases, effectively connected income (ECI) is limited to U.S. source income. In the case of nonbusiness income, such as fixed or determinable annual or periodical (FDAP) income, a 30 percent withholding tax is applicable only to U.S. source income.

Most of the source rules are found in IRC 861 through 865 as follows:

- IRC 861: Identifies U.S. source income.
- IRC 862: Identifies foreign source income.
- IRC 863: Deals with categories of income that are partially U.S. and partially foreign sourced.
- IRC 864: Provides definitions for a number of relevant terms and prescribes rules for allocation of certain expenses to U.S. and foreign source income.
- IRC 865: Provides rules for determining the source of income derived from the sale of various types of personal property.

Diagram of Concept

Source of Income for Nonresident Alien Individuals

Diagram of Concept

Type of income	U.S. source income if:	Foreign source income if:
Interest income	Debtor is a U.S. resident or a domestic corporation	Debtor is a foreign resident or a foreign corporation
Dividends	Payor is a domestic corporation	Payor is a foreign corporation
Personal services income	Services are performed in the U.S.	Services are performed abroad
Rentals and royalties	Property is used in the U.S.	Property is used abroad
Gain on the sale of real property	Property is located in the U.S.	Property is located abroad
Gain on the sale of personal property	Seller is a U.S. resident	Seller is a foreign resident
Gain on the sale of inventory purchased for resale	Title passes in the U.S.	Title passes abroad

Diagram of Concept (cont'd)

Source of Income for Nonresident Alien Individuals

Diagram of Concept (cont'd)

Type of income	U.S. source income if:	Foreign source income if:
Gain on the sale of inventory manufactured by taxpayer	<p>For years beginning before January 1, 2018 – Allocated between U.S. and foreign source income using the 50-50 method, the independent factor price method, or the books and records method.</p> <p>For tax years beginning after December 31, 2017 - Allocated and apportioned between sources within and without the United States solely on the basis of the production activities with respect to the property.</p>	
Gain on sale of depreciable property	Title passes in the U.S. ^a	Title passes abroad ^a
Gain on the sale of patents and other intangibles	Seller is a U.S. resident ^b	Seller is a foreign resident ^b

^a Different rules apply to the portion of the gain attributable to prior-year depreciation deductions.

^b Different rules apply if the intangible is sold for a contingent price, or if a portion of the gain is attributable to prior-year amortization deductions.

Detailed Explanation of the Concept

Source of Income for Nonresident Alien Individuals

The sourcing rules vary for different types of income.

Analysis	Resources
<p><u>Interest Income</u></p> <p><u>General Rule</u></p> <p>The residence of the payor (also referred to as debtor) determines the source of interest income. Interest payments from U.S. residents and U.S. corporations are generally characterized as U.S. source income. Interest paid by foreign corporations and nonresidents, including U.S. citizens residing abroad, will generally be characterized as foreign source income. The residence of the payor is determined at the time the payment is made. For the purpose of these rules, a U.S. resident is:</p> <ul style="list-style-type: none">▪ An individual, who at the time the interest is paid, is a resident of the United States,▪ A domestic corporation,▪ A domestic partnership engaged in a U.S. trade or business and▪ A foreign corporation or foreign partnership engaged in a U.S. trade or business. <p>In determining the source of an interest payment, the place of payment, the place the debt is located, the recipient's location, and the currency used to make the payment all are irrelevant factors.</p>	<ul style="list-style-type: none">▪ IRC 861(a)(1)▪ IRC 862(a)(1)▪ Treas. Reg. 1.861-2(a)(2)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Interest Income (cont'd)</u></p> <p><u>Exceptions</u></p> <ul style="list-style-type: none">▪ Interest on deposits paid by a foreign branch of a commercial banking business and savings institutions is treated as foreign source income even though the payor is a U.S. corporation.▪ Interest paid by a U.S. branch of a foreign corporation is treated as if it were paid by a domestic corporation and will generally be treated as U.S. source income. This exception is part of the branch profits tax regime, which is a withholding-type tax imposed on a U.S. branch's dividend equivalent amount.	<ul style="list-style-type: none">▪ IRC 861(a)(1)(A)(i)▪ IRC 884(f)(1)(A)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Dividend Income</u></p> <p><u>General Rule</u></p> <p>Dividends are sourced where the payor corporation is incorporated. Generally, dividends received from a domestic corporation are U.S. source income and dividends received from a foreign corporation are foreign source income.</p> <p><u>Exception</u></p> <p>Dividends from a foreign corporation will be treated in part as U.S. source income if, during the preceding three taxable years, 25 percent or more of the corporation's gross income from all sources was effectively connected with the conduct of a U.S. trade or business. If applicable, the amount of the dividend deemed to be from U.S. sources will be a percentage determined by the ratio between the gross income effectively connected with the U.S. trade or business and the total gross income of the corporation.</p>	<ul style="list-style-type: none">▪ IRC 861(a)(2)▪ IRC 862(a)(2) ▪ IRC 861(a)(2)(B)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Personal Services Income</u></p> <p><u>General Rule</u></p> <p>The source of income from the performance of personal services is the place where the services are performed. Personal services income includes salaries, wages, fees, commissions, fringe benefits and self-employment income.</p> <p> CAUTION: It is not always clear if income received is compensation for personal services or some other type of income. For example, in <i>Boulez</i>, the taxpayer treated income as royalties and the court held it was personal services income.</p> <p>If personal services are performed both inside and outside the United States, an apportionment must be made. An apportionment is based on a time basis, such as number of days, if the individual is an employee. If not an employee, the apportionment is based on facts and circumstances and number of days may be the best method. Certain fringe benefits are sourced at a geographic location. The Secretary may accept alternative methods.</p>	<ul style="list-style-type: none"> ▪ IRC 861(a)(3) ▪ IRC 862(a)(3) ▪ <i>Boulez v. Commissioner</i> - 83 T.C. 584 (1984) ▪ Treas. Reg. 1.861-4(b) ▪ <i>Stemkowski v. Commissioner</i> - 690 F.2d 40 (2nd Cir. 1982)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Personal Services Income (cont'd)</u></p> <p><u>Exceptions</u></p> <p>The de minimis exception to the place-of-performance rule provides that personal services performed by a NRA temporarily present in the United States is foreign source income if:</p> <ul style="list-style-type: none"> ▪ The individual is not present the United States for more than 90 days during the taxable year, ▪ The compensation does not exceed \$3,000 and ▪ The payments are from a foreign employer not engaged in a U.S. trade or business in the United States or the foreign office of a U.S. employer. <p>Personal services income of a NRA while serving temporarily in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or U.S. possession will be treated as foreign source income.</p>	<ul style="list-style-type: none"> ▪ IRC 864(b)(1) ▪ IRC 861(a)(3)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Personal Services Income (cont'd)</u></p>	
<p><u>Pensions</u></p> <p>An allocation between U.S. and foreign sources must be made with respect to payments from a pension plan. Pension distribution income consists of 1) employer and employee contributions, and 2) earnings on those contributions.</p> <ul style="list-style-type: none"> ▪ The portion of the pension distribution consisting of contributions is sourced using the general rules for sourcing personal services income. As a result, the portion consisting of the contributions is sourced based on where the services were performed that generated the contribution amount. ▪ The portion of the pension distribution consisting of the earnings on the contributions accumulated in the trust are sourced based on where the pension trust is located. 	
<p><u>Stock Options</u></p> <p>The exercise of nonqualified stock options also gives rise to personal services income. If the taxpayer performed services both within and without the United States during the period beginning on the grant date and ending on the vesting date, the resulting compensation must be apportioned between U.S. and foreign source income based on the relative number of months worked in the United States and abroad from the grant date to the vesting date.</p>	
<p><u>Social Security Benefits</u></p> <p>U.S. social security benefits are U.S. source income.</p>	
	<ul style="list-style-type: none"> ▪ Rev. Rul. 79-388 ▪ Rev. Rul. 79-389 ▪ Rev. Proc. 2004-37 ▪ IRC 861(a)(3) ▪ Treas. Reg. 1.861-4(b)(2)(ii)(F) ▪ IRC 861(a)(8)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Rents and Royalties</u></p> <p><u>General Rule</u></p> <p>The source of rental and royalty income is determined by the place where the property is located or used.</p> <ul style="list-style-type: none">▪ The source of rental income for tangible property will depend on the place where the property is physically located when used.▪ The source of royalty income for intangible property, such as patents, copyrights, trade secrets, trademarks, and goodwill depends on where the rights to the property are used. This is generally the country in which the intangible property derives its legal protection.	<ul style="list-style-type: none">▪ IRC 861(a)(4)▪ IRC 862(a)(4)▪ Rev. Rul. 68-443

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Disposition of Real Property</u></p> <p><u>General Rule</u></p> <p>Gain or loss from the disposition of U.S. real property or stock of a U.S. real property holding corporation (as defined in IRC 897(c)) is U.S. source income. Gain from the sale of real property located outside the United States is foreign source income.</p> <p> CAUTION: The gain from the sale of an interest in U.S. real property is subject to the special rules of the Foreign Investment in Real Property Act (FIRPTA).</p>	<ul style="list-style-type: none">▪ IRC 861(a)(5)▪ IRC 862(a)(5)▪ IRC 897▪ Practice Unit - <i>Overview of Withholding under FIRPTA for Sales by Individuals</i>, DCN: WIT/T/15_02-01 (formerly DCN: WIT/9442.02_01(2015))

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Sale or Exchange of Personal Property</u></p>	
<p><u>General Rule</u></p> <p>For the purpose of determining source, the term “personal property” essentially includes all property (both tangible and intangible) that is not real property.</p> <p>IRC 865 provides the general rule that the source of the gain or loss from the sale of personal property is based on the residence of the seller.</p> <p>Gain or loss from the sale or exchange of personal property generally has its source in the United States if the taxpayer has a tax home in the United States. If the taxpayer does not have a tax home in the United States, the gain or loss is generally considered to be from sources outside the United States.</p>	
<p><u>Special Rule</u></p> <p>If a U.S. citizen or resident alien pays foreign income tax equal to or greater than 10 percent on the gain from the sale of personal property, that individual will be treated as a nonresident of the United States and the gain on the sale will be foreign source.</p>	
	<ul style="list-style-type: none"> ▪ IRC 865(a) ▪ IRC 865(g)(1) ▪ IRC 865(g)(2)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Sale or Exchange of Personal Property (cont'd)</u></p> <p><u>Exceptions to the General Rule</u></p> <p><u>Depreciable or Amortizable Tangible Personal Property</u></p> <p>If there is a gain on sale of depreciable or amortizable tangible personal property, any depreciation or amortization deductions that were allocated against U.S. source income must be recaptured and treated as U.S. source income. The remaining portion of such gain (not in excess of the depreciation deductions) is treated as foreign source. Any gain in excess of the depreciation deductions is sourced as if the property were “inventory property” under IRC 861 through 863. This rule stops a taxpayer from taking deductions against U.S. source income (which reduces his or her basis in the property) and then avoiding tax on the sale of the property.</p> <p><u>Gain from the Sale of Intangible Property</u></p> <p>The source of gain realized by the sale of intangible property is generally determined by the residence of the taxpayer if there is a fixed price. If payments are contingent on the productivity, use or disposition of the intangible property, the source of income will be determined using the source rules for royalties under IRC 861(a)(4) and 862(a)(4).</p> <ul style="list-style-type: none"> ▪ To the extent that amortization deductions have been taken against U.S. or foreign source income from intangible property (not including goodwill), the gain not exceeding the deductions taken is treated as U.S. or foreign source income under IRC 865(c). ▪ Gain realized from the sale of goodwill is generally deemed to be from sources in the country where the goodwill was generated. 	
	<ul style="list-style-type: none"> ▪ IRC 865(c) ▪ IRC 861-863 ▪ IRC 861(a)(4) ▪ IRC 862(a)(4) ▪ IRC 865(c) ▪ IRC 865(d)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Sale or Exchange of Personal Property (cont'd)</u></p> <p><u>Exceptions to the General Rules (cont'd)</u></p> <p><u>Sales Through Offices or Fixed Places of Business in the United States</u></p> <p>Income from certain sales of personal property by nonresidents which are attributable to an office or other fixed place of business in the United States will be treated as U.S. source income.</p> <ul style="list-style-type: none">▪ There is an exception for inventory property sold for use outside the United States through a foreign fixed place of business that materially participated in the sale.	<ul style="list-style-type: none">▪ IRC 865(e)▪ IRC 865(e)(2)(B)▪ IRC 865(e)(1)(B)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Sale or Exchange of Inventory Property</u></p> <p><u>Purchased Inventory</u></p> <p>Inventory property is property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.</p> <p>The source of income realized from the purchase and sale of inventory property will generally be determined by the location of the property at the time title passes. Title passes at the location and time when the seller's rights, title and interest in the property are transferred to the buyer.</p> <p>The title passage rule derives from the law of sales and generally allows the parties to arrange title passage wherever they choose. However, Treas. Reg. 1.861-7(c) provides that, when a sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, "all factors of the transaction, such as the negotiations, the execution of the agreement, the location of the property, and the place of payment will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred."</p>	<ul style="list-style-type: none"> ▪ IRC 865(i)(1) ▪ IRC 1221(a) ▪ IRC 861(a)(6) ▪ IRC 865(b) ▪ IRC 862(a)(6) ▪ IRC 863 ▪ Treas. Reg. 1.861-7(c)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Sale or Exchange of Inventory Property (cont'd)</u></p> <p><u>Production and Sale of Inventory Property (For Tax Years Beginning Before January 1, 2018)</u></p> <p>The gain from the production and sale of inventory property shall be allocated between U.S. and foreign sources where the production and the sale do not both occur either inside or outside the United States. Under IRC 863, two steps must be undertaken in order to determine the source of income from the manufacture and sale of inventory.</p> <p>The first step is to divide the income between the manufacturing activity and the sale activity. The regulations provide three methods to allocate the gain.</p> <ol style="list-style-type: none"> 1. The income generally is apportioned 50 percent to manufacturing activities and 50 percent to sales activities (the “50/50 method”). This is the most common method. 2. The taxpayer may elect to apportion using an independent factory price (IFP) if such price is fairly established (the “IFP method”). 3. If permission is obtained from the IRS, the taxpayer may allocate based on the “books and records” method. <p>The second step is to source the income from the manufacturing and sales activities.</p> <ul style="list-style-type: none"> ▪ The portion of the income attributable to manufacturing is treated as U.S. or foreign source income, or some combination of the two, based on the location of the taxpayer’s production assets. ▪ The portion of the income attributable to sales is treated as U.S. or foreign source based on the specific source rules. 	<ul style="list-style-type: none"> ▪ IRC 863(b)(2) ▪ Treas. Reg. 1.863-3

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p data-bbox="87 382 762 415"><u>Sale or Exchange of Inventory Property (cont'd)</u></p> <p data-bbox="87 444 1408 476"><u>Production and Sale of Inventory Property (For Tax Years Beginning After December 31 2017)</u></p> <p data-bbox="87 505 1398 843">As amended by the 2017 Tax Cuts and Jobs Act, IRC 863(b) now provides that gains, profits, and income from the sale or exchange of inventory property that is produced in whole or in part within and sold or exchanged without the United States (or vice versa) is allocated and apportioned solely on the basis of the production activities with respect to the property. Title passage and location of sale are no longer factors in determining the source of income from the sale or exchange of inventory property. If the inventory is produced entirely in the United States, the income is U.S. source income. If the inventory is produced entirely in a foreign country, the income is foreign source income. Income from the sale or exchange of inventory produced in both the United States and a foreign country is mixed-source income.</p> <p data-bbox="87 876 1398 1368">The new law obsoletes the current regulations allocating such income between production and sales activities, and the source rules applicable to the portion of income attributable to sales activities. However, current treasury regulations are still effective to the extent they describe the source of income attributable to production activities. 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. 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. For inventory produced both inside and outside of the U.S., the source of income is determined by the ratio of the average adjusted bases of where production assets are located.</p>	<ul style="list-style-type: none"> <li data-bbox="1425 554 1757 586">▪ IRC 863(b)(2) and (3) <li data-bbox="1425 611 1947 682">▪ <i>Tax Cuts and Jobs Act</i>, Pub. L. No. 115-97, sec.14303(b) <li data-bbox="1425 876 1881 909">▪ Treas. Reg. 1.863-3(c)(1)(i)(A) <li data-bbox="1425 933 1881 966">▪ Treas. Reg. 1.863-3(c)(1)(i)(B) <li data-bbox="1425 991 1846 1023">▪ Treas. Reg. 1.863-3(c)(1)(ii)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Other Types of Income</u></p> <p><u>Scholarships, Fellowships, Grants, Prizes and Awards</u></p> <p>The source of scholarships, fellowships, grants, prizes and awards is the residence of the payor, regardless of who actually distributes the funds.</p> <p><u>International Communications Income</u></p> <p>International communications income includes income derived from the transmission of communications or data from the United States to a foreign country or from a foreign country to the United States. The source rule for international communications income varies depending on whether the taxpayer is a U.S. person or a foreign person. A foreign person generally treats all international communications income as foreign source income, unless that person maintains an office or fixed place of business in the United States, in which case any income attributable to that fixed place of business is treated as U.S. source income.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.863-1(d) ▪ Rev. Rul. 89-67 ▪ IRC 863(e) ▪ IRC 863(e)(1)(B) ▪ Treas. Reg. 1.863-9(b)

Detailed Explanation of the Concept (cont'd)

Source of Income for Nonresident Alien Individuals	
Analysis	Resources
<p><u>Other Types of Income (cont'd)</u></p> <p><u>Distributive Shares of Income from a Pass -Through Entity</u></p> <p>In the case of a partnerships or trusts, the source of income usually is determined at the entity level and the characterization carries over to the partner or beneficiary's distributive share of income. An exception is the sale of personal property by the partnership, in which case the applicable source rule is applied at the partner level rather than the partnership level.</p>	<ul style="list-style-type: none">▪ IRC 702(b)▪ IRC 865(i)(5)

Index of Referenced Resources

Source of Income for Nonresident Alien Individuals
IRC 702(b)
IRC 861
IRC 862
IRC 863
IRC 864(b)(1)
IRC 865
IRC 884(f)(1)(A)
IRC 897
IRC 1221(a)
Treas. Reg. 1.861-2(a)(2)
Treas. Reg. 1.861-4
Treas. Reg. 1.861-7(c)
Treas. Reg. 1.863-1
Treas. Reg. 1.863-3
Treas. Reg. 1.863-9
Rev. Proc. 2004-37
Rev. Rul. 68-443

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Source of Income for Nonresident Alien Individuals

Rev. Rul. 79-388

Rev. Rul. 79-389

Rev. Rul. 89-67

Tax Cuts and Jobs Act, Pub. L. No. 115-97, sec.14303(b)

Boulez v. Commissioner - 83 T.C. 584 (1984)

Stemkowski v. Commissioner - 690 F.2d 40 (2nd Cir. 1982)

Training and Additional Resources

Source of Income for Nonresident Alien Individuals	
Type of Resource	Description(s)
Databases / Research Tools	<ul style="list-style-type: none">▪ <i>Bittker & Lokken Fed. Tax'n Inc, Est and Gift</i> Para 73.1-73.10▪ <i>Kuntz & Peroni - U.S. Int'l Tax</i> Para A2.01–A2.05▪ <i>BNA Tax Management Int'l Portfolio</i> 905-2nd

Glossary of Terms and Acronyms

Term/Acronym	Definition
ECI	Effectively Connected Income
FDAP	Fixed or Determinable Annual or Periodical
FIRPTA	Foreign Investment in Real Property Tax Act
IFP	Independent Factory Price
NRA	Nonresident Alien

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
9441.01	<i>Identification of a U.S. Trade or Business of a Nonresident Alien</i>	USB/C/14_01-02 (formerly DCN: USB/CU/P_14.1_01(2014))
9441.02-01	<i>Effectively Connected Income</i>	USB/C/14_02_01-01 (formerly DCN: USB/CU/P_14.2_01(2014))
9441.02-02	<i>Allocation and Apportionment of Deductions for Nonresident Alien Individuals</i>	USB/C/14_02_02-03 (formerly DCN: USB/CU/C_14.2.2_04(2016))
9442.02	<i>Overview of Withholding Under FIRPTA for Sales by Individuals</i>	WIT/T/15_02-01 (formerly DCN: WIT/9442.02_01(2015))