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An Historical and Policy Analysis of the Title Passage Rule in International Sales of Personal Property

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AN HISTORICAL AND POLICY ANALYSIS OF THE TITLE PASSAGE RULE IN INTERNATIONAL SALES OF PERSONAL PROPERTY

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I. INTRODUCTION

Prior to the Tax Reform Act of 1986,[1] the source of profits from international sales of personal property was determined solely on the basis of the location of the sale.[2] Although the situs of sale rule itself[3]

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1. Pub. L. No. 99-514, 100 Stat. 2085. The 1986 Act made substantial changes to the Internal Revenue Code of 1954 and named the resulting statute the Internal Revenue Code of 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 2, 100 Stat. 2085, 2095. The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106, and the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, made some technical and other changes to the Internal Revenue Code of 1986 as originally enacted. Unless otherwise indicated, references herein to sections of the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended.

2. Unless otherwise indicated, source rules discussed herein pertain to gains, profits, and income derived from sales of personal property that previously was purchased by the selling taxpayer. *See* I.R.C. §§ 861(a)(6), 862(a)(6) (West Supp. 1990); I.R.C. of 1954 §§ 861(a)(6), 862(a)(6). Gains, profits, and income from the sale or exchange of personal property manufactured by the selling taxpayer are sourced pursuant to I.R.C. § 863 (West Supp. 1990) and are beyond the scope of this Article, except to the extent that the source of such income is determined by reference to the rules in I.R.C. § 865 (1988). *See* H.R. REP. NO. 426, 99th Cong., 2d Sess. 361 (1985) (portion of income that is associated with sale is sourced under the general residence-of-the-seller rule).

3. A sale or exchange within the United States resulted in income from U.S. sources even where the property had been purchased by the taxpayer outside the United States. I.R.C. of 1954 § 861(a)(6). The location of the sale determined the source of the entire proceeds. *In re* Yokohama Ki-Ito Kwaisha, Ltd., 5 B.T.A. 1248 (1927) (profits from sales within the United States of silk purchased in Japan were sourced entirely in the United States); *cf.* Tootal Broadhurst Lee Co. v. Commissioner, 9 B.T.A. 321 (1927), *aff'd*, 30 F.2d 239 (2d Cir. 1929), *cert. denied*, 279 U.S.

is not particularly complex, years of litigation and administrative examination were required to establish a legal standard for determining the location of a sale. The courts ultimately concluded that a sale is deemed to occur at the place at which title to the goods passes from the seller to the buyer.[4]

In 1984, the Treasury Department proposed that the "title passage rule"[5] be replaced and that gains be sourced in the country of the seller's residence.[6] The Treasury Department believed that the source of gains ought to be the location of the economic activity generating the gains, and that the title passage rule failed to accord any significance to this location. In the Treasury Department's view, the rule enabled thoughtful tax planners to manipulate arbitrarily the source of income derived from personal property sales.[7] Although the House of Representatives initially adopted the Treasury Department's proposal to repeal the title passage rule,[8] both houses of Congress ultimately agreed that a repeal could adversely affect the competitiveness of U.S.

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861 (1929); Birkin v. Commissioner, 5 B.T.A. 402 (1926) (entire gain on sales of property within the United States of property manufactured by the taxpayer outside the United States was from U.S. sources).

Similarly, a sale or exchange outside the United States resulted in non-U.S., or foreign, source income where the property had been purchased by the taxpayer within the United States. I.R.C. of 1954 § 862(a)(6). As in the case of income sourced under I.R.C. of 1954 § 861(a)(6), the location of sale determined the source of the entire proceeds. R.J. Dorn & Co. v. Commissioner, 12 B.T.A. 1102 (1928) (profits from sales without the United States of goods purchased within the United States were treated in their entirety as income from foreign sources).

The situs of sale rule also controlled where the sale or exchange occurred in the same country in which the taxpayer had purchased the property. Carding Gill Ltd. v. Commissioner, 38 B.T.A. 669, 672 (1938); De Stuers v. Commissioner, 26 B.T.A. 201 (1932); *cf.* Helvering v. Suffolk Co., 104 F.2d 505 (4th Cir. 1939); *see also* P. POSTLEWAITE & M. COLLINS, INTERNATIONAL INDIVIDUAL TAXATION § 2.15 (1982); P. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION § 2.14 (1980).

4. *See, e.g.*, East Coast Oil Co. v. Commissioner, 31 B.T.A. 558 (1934), *aff'd*, 85 F.2d 322 (5th Cir. 1935), *cert. denied*, 299 U.S. 608 (1936).

5. Although the rule had been followed administratively and judicially for some time, *see infra* notes 94-137 and accompanying text, the rule was first referred to by name in United States v. Balanovski, 131 F. Supp. 898, 902 (S.D.N.Y. 1955) ("the place where title passes test"), *aff'd in part and rev'd in part*, 236 F.2d 198, 305-06 (2d Cir. 1956) ("title passage test," "passage of title test or rule"), *cert. denied*, 352 U.S. 968 (1957).

6. 2 TREASURY DEPARTMENT REPORT TO THE PRESIDENT, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 366-67 (Nov. 1984) [hereinafter TREASURY I]; *see also* THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY 402-03 (May 1985) [hereinafter TREASURY II].

7. TREASURY I, *supra* note 6, at 365; TREASURY II, *supra* note 6, at 399-400.

8. H.R. 3838, 99th Cong., 2d Sess. § 611 (as reported by the House Ways and Means Committee (Dec. 7, 1985)).

businesses abroad.[9] Therefore, Congress replaced the title passage rule only with respect to sales of personal property other than inventory property;[10] inventory sales continue to be sourced pursuant to title passage principles, at least until the Treasury Department demonstrates to Congress that a total repeal of title passage would not have a detrimental effect on U.S. trade.[11] A Treasury Department study on the issue, mandated by statute,[12] is several years overdue.[13]

The House of Representatives originally estimated that a total repeal of the title passage rule would have increased revenue by amounts ranging from $170 million in 1986 to $432 million in 1990.[14] The statute ultimately adopted, which retained the title passage rule for sales of inventory property, was expected to increase annual revenues by less than $5 million.[15] These revenue estimates suggest that the title pas-

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9. H.R. REP. NO. 841, 99th Cong., 2d Sess. 596 (1986); *see also* S. REP. NO. 313, 99th Cong., 2d Sess. 329 (1986).

10. The term "inventory property" refers to personal property described in I.R.C. § 1221(1) (1988) ("stock in trade of the taxpayer or other property of a kind which would be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"); I.R.C. § 865(i)(1) (1988).

If a nonresident of the United States maintains an office or other fixed place of business in the United States, then gains from sales of personal property, including inventory, that are attributable to the U.S. office are sourced in the United States, unless the property is sold for use, disposition, or consumption outside of the United States and the taxpayer's foreign office materially participates in the sale. I.R.C. § 865(e)(2) (1988). Other sales of inventory property by nonresidents are subject to the title passage rule.

11. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1211, 100 Stat. 2085, 2533. The title passage rule does not generally apply to sales by nonresidents of the United States. Gains from sales of personal property, including inventory property, by nonresidents of the United States are sourced in the United States if the sale is attributable to an office or other fixed place of business maintained in the United States. I.R.C. § 865(e)(2)(A) (1988). However, the title passage rule applies to sales of inventory property by nonresidents that are attributable to U.S. offices if the property is sold for use, disposition, or consumption outside the United States and an office or other fixed place of business in a foreign country materially participates in the sale. I.R.C. § 865(b), (e)(2)(B) (1988). Gains from sales of non-inventory personal property that are not attributable to a U.S. office are sourced outside the United States. I.R.C. § 865(a)(2) (1988).

12. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1211(d), 100 Stat. 2085, 2536; *see also* H.R. REP. NO. 841, *supra* note 9, at 596.

13. Congress expected the report on or before September 30, 1987. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1211(d), 100 Stat. 2085, 2536. Recognizing that numerous Treasury Department studies are several years overdue, Congress recently extended the due dates of some studies and cancelled other studies altogether. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11831(b), 104 Stat. 1388; *see also* H.R. REP. NO. 894, 101st Cong., 2d Sess. 38 (1990). The due date for the study on the title passage rule was extended to January 1, 1992. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11831(b), 104 Stat. 1388.

14. H.R. REP. NO. 426, *supra* note 2, at 365.

15. S. REP. NO. 313, *supra* note 9, at 333.

sage rule still determines the source of gains from many cross-border sales of personal property.

In light of Congress's reluctance either to repeal the title passage rule or to endorse the inventory exception wholeheartedly, it is likely that Congress will reconsider the issue, particularly because a total repeal would contribute materially to the U.S. fisc. Viewed in proper historical context, however, opportunities to manipulate the source of gains ought not be viewed with suspicion.

The title passage rule had its genesis in the law of commercial sales. Judicial opinions that initially adapted the title passage rule from commercial law regarded risk of loss as the major ingredient of the title concept.[16] The title passage rule thus evolved as a risk of loss passage rule. If the term "title" is understood as connoting risk of loss rather than mere legal title, then the title passage rule does reflect economic substance, and any tax advantages resulting from application of the rule may be justified by the economic risks assumed by the taxpayer. Consequently, the rule is compatible with the policy objectives articulated by the Treasury Department.[17]

Since the title passage rule evolved out of the law of commercial sales, it is appropriate to question contemporary judicial and administrative reliance on the concept of title, which, in the modern law of sales, exists largely as an historical footnote. It would be logical at this time to incorporate into source analysis changes in the law of commercial sales and to recognize explicitly that the passage of risk of loss from the seller to the buyer ought to determine the source of gains in international sales of personal property.

The purpose of this Article is (1) to examine the role of the title passage rule in U.S. taxation of multinational enterprises in light of international law and jurisdictional legal principles; (2) to urge that any Congressional reexamination of the rule take into full account both the historical context in which the rule was created and the policy forces that contributed to its maturation; and (3) to reconcile judicial opinions and administrative pronouncements in the tax area with the abandonment of the title concept in commercial law. It is time for the courts to explicitly recognize both the centrality of risk of loss passage and the irrelevance of passage of title and to apply a risk of loss passage rule when determining the source of gains in international sales of

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16. *See, e.g.*, East Coast Oil Co. v. Commissioner, 31 B.T.A. 558, 561 (1934).

17. *See also* H.R. REP. NO. 426, *supra* note 2, at 360-61.

personal property. If Congress reexamines the statutory rules for sourcing gains from sales of inventory property, it must recognize that the title passage rule encompasses a risk of loss passage rule under which determinations of source of income reflect the economic substance of the underlying sales transactions, and, therefore, a total repeal of the title passage rule is not warranted.

II. ANALYSIS OF THE PURPOSE OF SOURCE RULES

To place the title passage rule in context, one must first consider the true purpose of source rules in the taxation of multinational enterprises and in the application of jurisdictional principles. International law places few restrictions on sovereign states with respect to national tax jurisdiction.[18] States have generally accepted restrictions based on territoriality, where some nexus exists between the state or territory, on the one hand, and the person, property, or activity generating the income to be taxed, on the other.[19] Further, a nation's ability to enforce its tax laws effectively must take into account inherent limits on the exercise of extraterritorial tax jurisdiction in a world of sovereign equality among states.[20]

With respect to residents, most states exercise taxing jurisdiction over income from sources both within and without the state.[21] Nonresidents, however, have limited connections with the taxing state and commonly are taxed only on income linked to economic activities carried on within the territory of the taxing state; the tax base may include income from sources outside the territory, but only if it arises from the activities conducted within the territory.[22] Some countries

18. Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 HARV. INT'L L.J. 1, 3-4 (1989); K. VAN RAAD, NONDISCRIMINATION IN INTERNATIONAL TAX LAW 21 (1986); Norr, *Jurisdiction to Tax and International Income*, 17 TAX L. REV. 431, 431 (1962).

19. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 402 and comments a & c (1987) [hereinafter RESTATEMENT]; RESTATEMENT, *supra*, § 411 comment b; Norr, *supra* note 18, at 432.

20. Palmer, *supra* note 18, at 4; Rädler, *Basic Origins of International Double Taxation and Measures for its Avoidance*, *reprinted in* 1 E. OWENS, INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION 59, 62-64 (1980).

21. Garbarino, *A Study of the International Tax Policy Process: Defining the Rules for Sourcing Income from Isolated Sales of Goods*, 29 HARV. INT'L L.J. 393, 394 (1988); 65 CAHIERS DE DROIT FISCAL INTERNATIONAL 15-18 (1980) [hereinafter I.F.A. GENERAL REPORT]; *see also* RESTATEMENT, *supra* note 19, § 412(1)(a).

22. I.F.A. GENERAL REPORT, *supra* note 21, at 15-18; K. VAN RAAD, *supra* note 18, at 22-24; *see also* RESTATEMENT, *supra* note 19, § 412(1)(b), (c).

Nonresidents may also be taxed on the basis of source. *See, e.g.*, I.R.C. §§ 871(a), 881(a)(1) (1988) (nonresident aliens and foreign corporations are taxed on certain categories of "fixed or choose to limit their jurisdiction by taxing only income arising from sources within the state.[23]

Overlapping exercises of jurisdiction by states often result in double or even multiple taxation of the same item of income.[24] One method of alleviating the burden of double or multiple taxation is to accord taxpayers a credit against their domestic income tax where income derived outside the country of residence (the "home country") is taxed by the country in which it was earned (the "host country"). Jurisdiction to tax on the basis of residence is generally considered subordinate to source-based jurisdiction;[25] hence, the host country is granted primary jurisdiction over income accruing within its borders, while the home country retains only secondary jurisdiction.[26]

A. The Role of Source Rules in the United States

Since the source concept described above is central both to the jurisdictional scope of a state's taxing authority and to procedures for relieving double taxation, one might expect to find a coherent set of general principles governing the determination of source. Surprisingly, there is none. Determinations of source are strictly matters of the domestic law of each individual state. The United States is typical in failing to provide a "unified concept that ties together the separate [sourcing] rules of the overall regime."[27] Source of income is ascertained for U.S. income tax purposes first by assigning the income in question to a

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determinable annual or periodical" income (so-called "FDAP" income, *see* Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX L. REV. 49, 53 n.20 (1980)), that are not effectively connected with a U.S. trade or business, but are derived from sources within the United States).

23. I.F.A. GENERAL REPORT, *supra* note 21, at 15-18.

24. Double taxation may also occur where two countries apply different tests in determining residence or domicile, or source of income.

25. RESTATEMENT, *supra* note 19, § 413 reporter's note 1.

26. Bilateral tax treaties are another method of minimizing double taxation. These treaties allocate the conflicting tax claims of two contracting parties in a manner that might otherwise contradict the domestic sourcing principles of one or both contracting parties. *See, e.g.*, Convention for the Avoidance of Double Taxation, Dec. 31, 1975, United States-United Kingdom, art. 11, 31 U.S.T. 5668, T.I.A.S. No. 9862 (treaty exempts from taxation U.S. source interest received by residents of United Kingdom without regard to ownership interest in payor; conflicts with I.R.C. §§ 871(h)(3), 881(c)(3)(B) (1988), under which U.S. source interest received by a 10-percent shareholder is not exempt).

In addition, in the United States, most foreign taxes are deductible from gross income in computing taxable income. I.R.C. § 164 (1988). No deduction is allowed, however, for foreign taxes with respect to which a foreign tax credit is elected. I.R.C. § 275(a)(4) (1988). *See also* Treas. Reg. § 1.901-1(c) (as amended in 1987).

27. Palmer, *supra* note 18, at 51.

statutory category and then by applying source of income rules prescribed for that category.[28]

In the context of U.S. income taxation, source of income is relevant primarily in two settings. In the first setting, persons who are residents of the United States[29] are taxed on income from worldwide sources,[30] but, as one would expect, they are entitled to a corresponding credit against U.S. tax with respect to foreign taxes on income sourced abroad.[31] Foreigners who engage in trade or business in the United States are taxed on income from worldwide sources that is effectively connected with the U.S. business,[32] and also are eligible for the corresponding credit.[33] The importance of the source rules to residents and foreigners who conduct business in this country, then, lies in the foreign

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28. *E.g.*, I.R.C. §§ 861(a), 862(a) (West Supp. 1990).

29. With respect to individuals, residency is determined pursuant to objective rules set forth in I.R.C. § 7701(b) (1988). Corporations organized under the laws of a foreign country are not considered residents of the United States. I.R.C. § 7701(a)(4), (a)(30)(C) (1988).

30. *See* I.R.C. § 61(a) (1988). U.S. citizens are taxed on worldwide income even when they are neither domiciled nor resident in the United States. Cook v. Tait, 265 U.S. 47 (1924). "The government, by its very nature, benefits the citizen and his property wherever found and, therefore, has the power to make the benefit complete." *Id.* at 56. Asserting jurisdiction to tax citizens, regardless of residency, is relatively rare. Norr, *supra* note 18, at 436-37; K. VAN RAAD, *supra* note 18, at 19-20 n.4.

31. I.R.C. § 904, as amended by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (to be codified at 26 U.S.C. § 904). The allowable foreign tax credit may be less than the actual amount of foreign taxes incurred. *See* I.R.C. § 904 (1988). *See also infra* notes 40-41 and accompanying text.

Pursuant to I.R.C. § 901(b) (1988), the following persons are entitled to claim the foreign tax credit:

a. U.S. citizens and domestic corporations,
b. foreign individuals who are residents of the United States,
c. foreign individuals who are residents of Puerto Rico during the entire taxable year,
d. foreign individuals who are not residents of the United States and who are engaged in trade or business within the United States,
e. foreign corporations that are engaged in trade or business within the United States, and
f. individuals described in the preceding categories who are members of partnerships or beneficiaries of estates or trusts which pay or accrue eligible foreign taxes.

32. Nonresident aliens and foreign corporations that are engaged in trade or business within the United States, as a practical matter, are treated as residents for purposes of taxing their business profits. Thus, income from worldwide sources that is effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at the same rates that apply to citizens, residents, and domestic corporations. I.R.C. §§ 871(b), 882(a) (1988).

33. I.R.C. §§ 901(b)(4), 906 (1988). I.R.C. § 904 as amended by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (to be codified at 26 U.S.C. § 904) may limit the otherwise allowable foreign tax credit. *See infra* notes 40-43 and accompanying text.

tax credit, since the amount of the foreign tax credit is directly related to the amount of foreign source income derived by the taxpayer.[34]

In the second setting, the method of taxing nonresident aliens and foreign corporations depends on the source of income received by the taxpayer.[35] As stated above, foreigners who are engaged in trade or business within the United States are taxed on income from worldwide sources that is effectively connected with the U.S. trade or business.[36] In determining whether an item of income is effectively connected, different rules apply with respect to U.S. source income and foreign source income.[37] Nonresidents also are taxed on certain categories of income from U.S. sources, even if such income is not effectively connected with the conduct of a U.S. trade or business.[38]

B. *The Role of Source Rules in the United States: The Foreign Tax Credit Limitation*

Citizens, residents, domestic corporations, and foreign persons who engage in trade or business in the United States (roughly speaking, those persons who are taxed by the United States on worldwide source income), are entitled to a credit against U.S. tax if income taxes are paid or incurred abroad.[39] Thus, the United States effectively cedes its primary jurisdiction to tax U.S. residents on income derived from foreign sources.

In order that any credit does not intrude upon the U.S. tax attributable to U.S. source income, the foreign tax credit is limited to the proportion of U.S. tax that foreign source taxable income bears to total, or worldwide, income.[40] Stated mathematically:

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34. *See infra* notes 39-46 and accompanying text.

35. *See infra* notes 47-65 and accompanying text.

36. I.R.C. §§ 871(b)(1), 882(a)(1) (1988).

37. I.R.C. § 864(c) (1988). *See infra* notes 52-57 and accompanying text.

38. I.R.C. §§ 871(a)(1), (2), 881(a) (1988). *See infra* notes 63-65 and accompanying text.

39. I.R.C. § 901(a) (1988). The foreign tax credit is available only for income, war profits, and excess profits taxes paid to a foreign country or U.S. possession and for foreign taxes imposed in lieu of income, war profits, and excess profits taxes paid to a foreign country or U.S. possession. I.R.C. §§ 901(b), 903 (1988). *See generally* Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 TAX L. REV. 227 (1984).

A domestic corporation that owns at least 10% of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign taxes paid by the foreign subsidiary in the year in which its earnings and profits become subject to U.S. tax as dividend income to the U.S. corporate shareholder. I.R.C. § 902(a) (1988). Thus, a "deemed paid credit" is available to the U.S. corporation. *See also* I.R.C. § 960(a) (1988) (income included in income by a U.S. shareholder pursuant to subpart F of the Internal Revenue Code is eligible for the deemed paid credit).

40. I.R.C. § 904(a) (1988). Congress described the purpose of the foreign tax credit limita-

$$\text{foreign tax credit limitation} = \frac{\text{foreign source taxable income}}{\text{worldwide taxable income}} \times \text{U.S. tax on worldwide income}$$

The foreign tax credit limitation, as determined by the mathematical formula, is calculated separately with respect to several categories, or baskets, of income.[41]

If the foreign taxes paid or incurred exceed the allowable credit, the excess, referred to as an excess foreign tax credit, may be treated as taxes actually paid or incurred, and therefore eligible for credit, in another taxable year.[42] While the credit cannot exceed the aggregate amount of all foreign taxes paid,[43] the method for calculating the foreign tax credit limitation requires the taxpayer to aggregate his income from all foreign sources without regard to the actual foreign tax paid; it is irrelevant whether the U.S. tax exceeds or is less than the tax imposed by any particular foreign country.

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tion as follows:

> The income tax law allows a credit, dollar for dollar, against our tax for any income or profits taxes paid to any foreign country or to any possession of the United States, with certain modifications in the case of alien residents of the United States. Where foreign income or profits taxes are imposed at rates higher than those carried by the similar taxes in this country, this credit may wipe out part of our tax properly attributable to income derived from sources within the United States. To prevent this abuse, section 228 [of the Revenue Act of 1921] provides that in no case shall the amount of this credit exceed the same proportion of our tax which the taxpayer's net income from sources within the United States bears to his entire net income.

H.R. REP. No. 350, 67th Cong., 1st Sess. 13 (1921).

41. I.R.C. § 904(d)(1) (West Supp. 1990). *See generally* Tarris, *Foreign Tax Credit Limitation After Tax Reform: The Separate Limitation Categories and the Application of the Look-Through Rule*, 42 TAX LAW. 275 (1989). Prior to the 1986 Act, the foreign tax credit limitation was calculated separately for two major baskets of income: (1) interest income, and (2) everything else. I.R.C. of 1954 § 904(d)(1)(A), (E) (there also were separate baskets for DISC and FSC income, I.R.C. of 1954 § 904(d)(1)(B)-(D)). Congress increased the number of baskets out of concern that foreign source income subject to a high foreign tax rate was being "averaged" with foreign source income subject to a low foreign tax rate. S. REP. No. 313, *supra* note 9, at 302. The source of certain types of low-taxed income (such as passive interest) could be shifted among tax jurisdictions with relative ease. *Id.* at 303.

42. I.R.C. § 904(c) (1988). Excess foreign tax credits may be carried back two years and forward five years. *Id.* Unused credits expire at the end of the carryover period. The purpose of the carryover is to minimize differences between methods of reporting income in the United States and foreign countries. These differences may result in the same income being reported in one year in the United States and in another year in the foreign country, creating a disequilibrium between the timing of income recognition for U.S. tax purposes and the payment of foreign taxes. H.R. REP. No. 775, 85th Cong., 1st Sess. 27 (1957).

43. I.R.C. § 901(b) (1988).

In order to maximize benefits offered by the foreign tax credit, and thereby minimize U.S. tax liability, simple mathematics offers U.S. taxpayers two potent planning alternatives.[44] First, a taxpayer could increase the numerator in the limitation fraction by shifting income out of the United States to a jurisdiction with a lower income tax rate than the United States. Of course, the larger the numerator, the greater the portion of U.S. tax that would be credited. Second, a taxpayer also could shift income from one foreign jurisdiction to another that imposes tax at a lower rate. This shift of income would not affect the dollar amount of the U.S. foreign tax credit limitation. It would, however, enable the taxpayer to utilize excess foreign tax credits from other taxable years should the current year's limitation exceed the actual amount of foreign taxes paid.

Given the ability of U.S. taxpayers to reduce their income tax liabilities simply by shifting the source of income to low-tax or no-tax jurisdictions, the reduction in U.S. tax rates by the 1986 Act[45] to a level below that of many other industrialized countries increased the availability of foreign tax credits to U.S. taxpayers. At the same time, however, the Act increased the likelihood that excess foreign tax credits of multinational businesses would grow, magnifying the need for foreign tax credit planning through shifts in income source.[46]

C. *The Role of Source Rules in the United States: Foreign Persons*

Unlike U.S. residents, nonresident aliens[47] and foreign corporations[48] are not taxed by the United States on income from worldwide

44. Both planning alternatives are subject to the foreign tax credit separate basket limitation. *See supra* note 41.

45. The 1986 Act lowered the maximum rate on corporations to 34% and on individuals to 28% (both with a 5% surtax at specified levels of taxable income). Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 101(a), 601(a), 100 Stat. 2085, 2096, 2249. The maximum rate on individuals recently was raised to 31%, and the 5% surtax on individuals was repealed. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11101(a), (b), 104 Stat. 1388.

46. 1 TREASURY DEPARTMENT REPORT TO THE PRESIDENT, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 143 (Nov. 1984); TREASURY II, *supra* note 6, at 387; S. REP. NO. 313, *supra* note 9, at 333-34. Congress was acutely aware of the potential for source manipulation, however, when it enacted, in the 1986 Act, the interest allocation provisions of I.R.C. § 864(e) (1988) and the foreign tax credit separate basket limitation provisions of I.R.C. § 904(d) (West Supp. 1990), both of which often have the effect of reducing the foreign source taxable income numerator.

47. The tax imposed by I.R.C. § 1, as amended by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (to be codified at 26 U.S.C. § 1) applies to nonresident alien individuals only as provided by I.R.C. §§ 871 & 877 (1988). I.R.C. § 2(d) (1988).

48. The regular tax imposed by I.R.C. § 11 (1988) and the alternative minimum tax im-

sources. Instead, these persons are taxed only on selected items of income, the source rules playing a determinative role in the selection of items to be taxed.

As discussed previously, nonresident aliens and foreign corporations who conduct trade or business in the United States[49] are treated as residents of the United States, but only with respect to business-related income. These persons are taxed according to the same rules as are U.S. citizens, residents, and domestic corporations, but only on income that is considered effectively connected with their U.S. businesses.[50] Income that is effectively connected with a U.S. trade or business, thus, is subject to U.S. income tax regardless of the source of such income.[51]

To determine whether an income item is effectively connected, the item first must be placed into one of three categories prescribed by the

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posed by I.R.C. § 55, as amended by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (to be codified at 26 U.S.C. § 55) apply to foreign corporations only as provided by I.R.C. § 882 (1988). I.R.C. § 11(d) (1988).

49. Limited statutory guidance is provided for determining whether activities and contacts in the United States are, in any instance, regarded as a U.S. trade or business. *See* I.R.C. § 864(b) (1988) (referring only to performance of personal services for a foreign employer and trading in securities or commodities). Judicial opinions abound, but provide few if any legal standards, leaving the determination fact sensitive and imprecise. *See generally* Isenbergh, *The "Trade or Business" of Foreign Taxpayers in the United States*, 61 TAXES 972 (1983); Garelik, *What Constitutes Doing Business Within the United States by a Non-resident Alien Individual or a Foreign Corporation*, 18 TAX L. REV. 423 (1963).

50. I.R.C. § 871(b)(1) (1988) (nonresident alien individuals); I.R.C. § 882(a)(1) (1988) (foreign corporations). Prior to the Foreign Investors Tax Act, Pub. L. No. 89-809, 80 Stat. 1539 (1966), the taxation of foreigners was premised on the "force of attraction" principle, under which the conduct of trade or business in the United States "attracted" all business and investment (nonbusiness) income. Thus, foreign corporations and nonresident aliens who engaged in trade or business in the United States were taxed at regular rates on all taxable income from U.S. sources, even where the income was not connected with the U.S. trade or business. The Foreign Investors Tax Act abandoned the "force of attraction" principle as it applied to investment (nonbusiness-related) income. Foreign Investors Tax Act, Pub. L. No. 89-809, §§ 103(a), 104(a), 80 Stat. 1539, 1547-48, 1555 (1966). Business income continues to be taxed pursuant to "force of attraction" principles. Foreign Investors Tax Act, Pub. L. No. 89-809, §§ 102(d), 103(a), 104(b), 80 Stat. 1539, 1542, 1547-48, 1555 (1966). *See generally* S. ROBERTS & W. WARREN, FOREIGN INVESTORS TAX ACT ¶ S/7B(1) (1967); Jones, *Foreign Investors Tax Act—The "Effectively Connected" Concept and Taxation of Domestic Source Income*, 26 N.Y.U. INST. FED. TAX'N 389 (1968).

51. I.R.C. §§ 871(b)(2), 873 (1988) (nonresident alien individuals); I.R.C. § 882(a)(2), (c) (1988) (foreign corporations). Appropriate deductions may offset the gross amount received, but generally only to the extent connected with income effectively connected with the conduct of a U.S. trade or business. I.R.C. §§ 873(a), 882(c)(1)(A) (1988).

Internal Revenue Code. A separate set of operative rules applies to each category.[52] The categories are:

(1) passive or investment (FDAP)[53] income and capital gain and loss from sources within the United States,[54]
(2) all other income from U.S. sources,[55] and
(3) certain specified categories of income from sources without the United States.[56]

A cursory review of the three categories indicates that whether an income item is effectively connected and, therefore, taxable to a foreign recipient, depends in the first instance upon the source of the income item.[57]

Nonresidents, then, must plan their affairs with respect to both source and effective connection. These two concepts have tremendous impact on taxation of gains from sales of personal property, which, since the 1986 Act,[58] are sourced in the United States if attributable to an office or other fixed place of business in the United States, unless (1) the goods are sold for use, disposition, or consumption outside the United States, and (2) an office or other fixed place of business of the taxpayer in a foreign country materially participates in the sale.[59] Thus, source is determined not only by the degree of involvement of the U.S. office, but also by the ultimate destination of the goods sold. U.S. source gains from personal property sales fall within the second category described above, and in all events are considered effectively connected.[60]

The title passage rule applies to nonresidents with respect to sales of inventory property that are not attributable to a U.S. office.[61] Non-

52. I.R.C. § 864(c) (1988).

53. *See supra* note 22.

54. I.R.C. § 864(c)(2) (1988). The specific items of income included in this category are listed in I.R.C. §§ 871(a)(1), 871(h), 881(a), 881(c) (1988).

55. I.R.C. § 864(c)(3) (1988).

56. I.R.C. § 864(c)(4) (1988).

57. While an in-depth analysis of the substantive rules applicable to each category is beyond the scope of this article, an in-depth analysis is provided in Dale, *Effectively Connected Income*, 42 TAX. L. REV. 689 (1987). *See also* Stevenson, *Is the Connection Effective? Through the Maze of Section 864*, 5 NW. U. J. INT'L L. & BUS. 213 (1983).

58. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1211(a), 100 Stat. 2085, 2533.

59. I.R.C. § 865(e)(2) (1988).

60. I.R.C. § 864(c)(3) (1988).

61. Sales of personal property by nonresidents who do not maintain offices or fixed places of business in the United States are sourced pursuant to the general rule of I.R.C. § 865(a)(2) (1988). Thus, gains from non-inventory sales are sourced outside the United States, I.R.C.

residents who sell property to purchasers in the United States, however, face the risk that minimal presence (including mere use of an agent) in the United States might constitute an office or fixed place of business to which sales could be attributable.[62] In that event, gains would be sourced in the United States and would be taxed as effectively connected income.

In addition to effectively connected income, nonresident aliens and foreign corporations are also taxed by the United States on statutorily prescribed categories of passive or investment (FDAP)[63] income from sources within the United States.[64] Gains from sales of personal property that are sourced in the United States are not among the statutory categories;[65] thus, such gains may be taxed only if they are effectively connected with a U.S. trade or business.

III. Historical Development of the Title Passage Rule

Prior to the 1986 Act, the source of gains from sales of personal property was determined, as a statutory matter, solely on the basis of the location of the sale.[66] This rule continues to apply with respect to sales of inventory property by U.S. persons.[67] The question of where a

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§ 865(a)(2) (1988), and gains from inventory sales are sourced under the title passage rule. I.R.C. § 865(b) (1988).

62. The principles of I.R.C. § 864(c)(5) (1988) apply in determining whether a taxpayer has an office or other fixed place of business in the United States and whether a sale is attributable thereto. I.R.C. § 865(e)(3) (1988). *See also* Treas. Reg. § 1.864-7 (1972). These rules determine whether an agent of the taxpayer constitutes an independent or dependent agent. In the latter case, the U.S. place of business of the dependent agent is attributed to the foreign taxpayer. *Cf.* Williams, *Permanent Establishments in the United States*, 29 TAX LAW. 277 (1976) (analyzing tax treaty provisions under which the activities of agents determine permanent establishment status).

63. *See supra* note 22.

64. I.R.C. § 871(a)(1), (2) (1988) (nonresident alien individuals); I.R.C. § 881(a) (1988) (foreign corporations).

65. There is no statutory provision for taxing non-effectively connected gains from sales of personal property. With respect to nonresident alien individuals, however, I.R.C. § 871(b) (1988) purports to tax U.S. source gains if the seller is present in the United States for 183 days or more during the taxable year of sale. Although it has not been repealed, I.R.C. § 871(b) (1988) became largely obsolete upon enactment of I.R.C. § 7701(b) (1988), which treats as a U.S. resident an alien individual who is present in the United States for 183 days or more in one taxable year. *See* I.R.C. § 7701(b)(3)(A) (1988). Since resident aliens are taxed on income from worldwide sources under Treas. Reg. § 1.1-1(b) (as amended in 1974), gains from sales of personal property would be subject to U.S. tax regardless of source.

66. I.R.C. of 1954 §§ 861(a)(6), 862(a)(6).

67. I.R.C. § 865(b) (1988). Notwithstanding this general rule, gains derived by nonresidents of the United States from sales of inventory property are sourced in the United States if the nonresident maintains an office or other fixed place of business in the United States to which the

sale is located, however, is problematic, and has been the focus of both judicial and administrative attention, ultimately resulting in the title passage rule.[68]

The history of the title passage rule may be viewed in five distinct stages, each of which is characterized by a dramatic shift, if not a complete reversal, in the government's position with respect to the appropriate test for locating a sale.

A. *Stage One: 1920-1928*

The issue of source arose for the first time following Congressional enactment of the Revenue Act of 1916,[69] which imposed an income tax on the net income of nonresident aliens[70] and foreign corporations[71] from sources within the United States.[72] Neither the statute nor Congressional committee reports offered any guidance or method for determining the source of a nonresident alien or foreign corporation's income. Treasury Regulations defined source modestly as "the place of the origin of the income."[73]

In interpretive rulings, the Treasury Department initially focused on the location of the seller's activities in connection with a sale, a concentration of activity in the United States being a prerequisite for sourcing income in this country. Thus, where a foreigner manufactured goods abroad for sale to U.S. purchasers, gain could not be sourced in the United States unless the seller's representatives in the United States contributed to consummation of the sales.[74] "The carrying on of

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gains are attributable, unless the inventory property is sold for use, disposition, or consumption outside the United States and an office or other fixed place of business outside the United States materially participates in the sale. I.R.C. § 865(e)(2) (1988). *See supra* notes 59-62 and accompanying text.

68. *See, e.g.*, East Coast Oil Co. v. Commissioner, 31 B.T.A. 558, 560 (1934).

69. Ch. 463, 39 Stat. 756. The Revenue Act of 1916 was amended by the Revenue Act of 1917, ch. 63, 40 Stat. 300, which left intact the 1916 provisions pertaining to the taxation of nonresident aliens and foreign corporations, except that the applicable rates increased. Revenue Act of 1917, ch. 63, §§ 2-3 (nonresident aliens), § 4 (foreign corporations), 40 Stat. 300, 301, 302.

70. Revenue Act of 1916, ch. 463, § 1(b), 39 Stat. 756, 756.

71. Revenue Act of 1916, ch. 463, § 10, 39 Stat. 756, 765.

72. The Revenue Act of 1913, ch. 16, 38 Stat. 114, had imposed a tax on nonresident aliens with respect to net income "from all property owned and of every business, trade, or profession carried on in the United States by persons residing elsewhere," and on foreign corporations with respect to net income "accruing from business transacted and capital invested within the United States." Revenue Act of 1913, ch. 16, §§ II(A)(1), II(G)(a), 38 Stat. 114, 166, 172.

73. Treas. Reg. 33, art. 66 (1918).

74. Law Opinion 502 (unpublished), *quoted in* A.R.R. 723, 1-1 C.B. 113, 115 (1922), *de-*

business by a foreign corporation through an office or agent in the United States [was] an essential of income from 'sources within the United States.' "[75]

The Board of Tax Appeals, in *R.J. Dorn & Co. v. Commissioner*,[76] was the first court to explicitly consider the government's position that the transaction of business in the United States results in U.S. source income, and the court rejected it. In *Dorn*, a foreign partnership consisting of foreign partners maintained an office in New York for the sole purpose of purchasing goods for resale to non-U.S. purchasers. Practically all orders were taken from points outside the United States. Accounts were kept in New York and purchase payments were made in New York. Where drafts were drawn on customers, they were discounted by a bank located in New York.[77]

The Board of Internal Revenue argued that partnership profits were U.S. source because the partnership was transacting business in the United States.[78] Rather than focus on the seller, however, the Board of Tax Appeals in *Dorn* focused on the nationality or location of the buyer.[79] The court's conclusion that partnership profits were foreign source was based on the facts that the purchasers were nonresidents and that the money from which the partnership's income was derived

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clared obsolete, Rev. Rul. 78-345, 1978-2 C.B. 346.

75. A.R.R. 723, 1-1 C.B. 113, 115 (1922). *Cf.* O.D. 651, 3 C.B. 265 (1920) (income sourced in country where it grows out of a business activity).

76. 12 B.T.A. 1102 (1928), *acq.*, 8-1 C.B. 13 (1929). As the years in issue ended in 1917, 1918, 1920, and 1921, the *Dorn* case was decided under Revenue Acts of 1916, 1917, 1918, ch. 18, 40 Stat. 1057 (1919), and 1921, ch. 136, 42 Stat. 227.

77. Sales were made on a cost, insurance, and freight (C.I.F.) basis. *See infra* notes 98-99 and accompanying text. As a general rule, in a C.I.F. contract, title passes to the purchaser upon delivery on board the carrier. 1 S. WILLISTON, THE LAW GOVERNING SALES OF GOODS AT COMMON LAW AND UNDER THE UNIFORM SALES ACT § 280c, at 607 (1924) [hereinafter WILLISTON]. This principle is not affected by a bill of lading to the seller's order; ownership in this case is retained only for purposes of securing performance by the buyer. *Id. See also* UNIF. SALES ACT § 20, 1 U.L.A. 363-64 (1950). If the *Dorn* facts had been analyzed under title passage principles, then the income in question likely would have been sourced in the United States since title would have passed when the goods were delivered to carriers in the United States. *Cf.* INTERNATIONAL CHAMBER OF COMMERCE, INCOTERMS 1990, at 52-53 (1990) [hereinafter INCOTERMS 1990] (in a C.I.F. contract, seller must "bear all risks of loss of or damage to the goods until such time as they have passed the ship's rail at the port of shipment" and buyer must "[b]ear all risks of loss of or damage to the goods from the time they have passed the ship's rail at the port of shipment").

78. *Dorn*, 12 B.T.A. at 1106.

79. *Id.* at 1102. *See also In re* Yokohama Ki-Ito Kwaisha, Ltd., 5 B.T.A. 1248 (1927) (profits from sales to U.S. residents of silk purchased in Japan were sourced in the United States).

was received from a foreign consignee; the status of the seller was largely irrelevant.[80]

Although the Revenue Act of 1918[81] made some minor changes pertaining to source determinations, these changes had no effect on the government's or Board's positions with respect to gains from personal property sales. Thus, while the government continued to focus on the location of the taxpayer's selling activities,[82] the Board of Tax Appeals continued to focus on the nationality or location of the buyer.[83]

Where goods were manufactured in one country for sale to purchasers in another, the Board held on several occasions that the entire gain was sourced in the country of sale, notwithstanding that the manufacturing process contributed to the value of the goods sold.[84] Largely in response to these draconian decisions by the Board,[85] Congress included in the Revenue Act of 1921 a provision for allocating income between the country of manufacture and the country of sale.[86] Without explanation, the 1921 Act also provided for non-allocation where goods were purchased (as opposed to manufactured) in one country for sale in another; the gain was "treated as derived entirely from the country in which sold."[87] Again, Congress offered no guidance for determining the country in which property was considered sold.

Treasury Regulations promulgated under the 1921 statute de-

80. *Dorn*, 12 B.T.A. at 1108. The court also noted that title to the goods remained with the seller until delivered to the foreign consignee outside the United States. *Id.* This statement is inconsistent with principles of commercial law, which treat title in C.I.F. contracts as passing when the seller delivers the goods to the carrier (here, in the United States). *See supra* note 77.

81. Revenue Act of 1918, ch. 18, §§ 213(c) (nonresident aliens), 233(b) (foreign corporations) 40 Stat. 1057, 1066, 1077 (1919).

82. *See* T.D. 3111, 2 C.B. 280 (1920). In O.D. 1100, 5 C.B. 118 (1921), the Treasury Department ruled that profits from sales to U.S. purchasers by a foreign manufacturer resulted in foreign source income, based largely on the seller's non-U.S. activities. The decision notes, without ascribing weight thereto, that title to the goods passed in a foreign country.

83. *Dorn*, 12 B.T.A. 1102 (1928). *Cf.* Billwiller v. Commissioner, 11 B.T.A. 841 (1928) (gains from sales to U.S. purchasers by foreign manufacturer sourced in United States), *aff'd*, 31 F.2d 286 (2d Cir. 1928), *cert. denied*, 279 U.S. 866 (1929); *accord* Tootal Broadhurst Lee Co. v. Commissioner, 9 B.T.A. 321 (1927), *aff'd*, 30 F.2d 239 (2d Cir. 1928), *cert. denied*, 279 U.S. 861 (1929); Birkin v. Commissioner, 5 B.T.A. 402 (1926).

84. *Billwiller*, 11 B.T.A. at 841; *Tootal Broadhurst Lee*, 9 B.T.A. at 321; *Birkin*, 5 B.T.A. at 402.

85. S. REP. NO. 275, 67th Cong., 1st. Sess. 16 (1921); H.R. REP. NO. 350, 67th Cong., 1st Sess. 12 (1921).

86. Revenue Act of 1921, ch. 136, § 217(e), 42 Stat. 227, 244. The current version of this provision is codified as I.R.C. § 863 (West Supp. 1990).

87. Revenue Act of 1921, ch. 136, § 217(e), 42 Stat. 227, 244.

scribed the place of sale as "the place where marketed,"[88] a definition of minimal help when one considers the ambiguity of the term "marketed." In light of the government's pre-1921 position, that location of the taxpayer's selling activities determined source, one might suppose that the verb "market" was used in its ordinary sense, i.e., "to expose for sale in a market."[89] The Treasury Department's first post-1921 Act pronouncement, however, referred both to the taxpayer's selling activities and also to the country in which title passed from the seller to the buyer,[90] suggesting another interpretation of the verb "market," i.e., to "sell,"[91] and hinting also that the government's previously firm position was softening.

By 1928,[92] the Treasury Department in fact had explicitly interpreted the regulation in the latter fashion, unequivocally adopting the notion of title passage as the definitive test for determining the country of sale. In General Counsel Memorandum 2,467,[93] faced with facts that were virtually identical to those in *Dorn*,[94] the Treasury Department ruled that gains were sourced in the United States since title passed there,[95] a ruling that squarely contradicted the result reached in *Dorn*.

Where the *Dorn* court had ignored commercial law concepts such as title,[96] and focused instead on the foreign situs of the buyer, the

88. Treas. Reg. 62, art. 323 (1922).

89. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE UNABRIDGED 1383 (1986) [hereinafter WEBSTER'S DICTIONARY].

90. I.T. 1569, 2-1 C.B. 126 (1923).

91. *See* WEBSTER'S DICTIONARY, *supra* note 89, at 1383. This interpretation is circular, however, causing the regulation effectively to read, à la Gertrude Stein: "The place where property is sold is the place where property is sold." Alexander, *Where is a Sale Made?*, 27 TAXES 133 (1949).

92. Although the Revenue Act of 1924, ch. 234, § 217(e), 43 Stat. 253, 274, was now the governing statute, the applicable language was identical. In fact, the language remained the same in subsequent statutes. The Internal Revenue Code of 1954 changed the terminology slightly, but retained the substance of the rule. I.R.C. of 1954 §§ 861(a)(6), 862(a)(6).

93. 7-2 C.B. 188 (1928); *see also* I.T. 2068, 3-2 C.B. 164 (1924).

94. 12 B.T.A. 1102 (1928).

95. Gen. Couns. Mem. 2,467, 7-2 C.B. 188, 195 (1928).

96. The Uniform Sales Act uses the term "property" in relation to goods to express ownership as between seller and buyer, *see* UNIF. SALES ACT § 17, 1 U.L.A. 309-10 (1950), and the term "title" in relation to goods to express ownership as against third parties, *see* UNIF. SALES ACT § 23, 1 U.L.A. 379 (1950). As a practical matter, the terms are largely interchangeable. Whiteside, *Uniform Commercial Code—Major Changes in Sales Law*, 49 KY. L.J. 165, 167 n.14 (1960); R. BRAUCHER & A. SUTHERLAND, COMMERCIAL TRANSACTIONS: TEXT, FORMS, STATUTES 23 (1958). *Cf.* Williston, *The Law of Sales in the Proposed Uniform Commercial Code*, 63 HARV. L. REV. 561, 566 n.7 (1950); Latty, *Sales and Title and the Proposed Code*, 16 LAW &

Treasury Department wholeheartedly embraced the law of commercial transactions. Both in *Dorn* and General Counsel Memorandum 2,467, sales were made on a cost, insurance, and freight (C.I.F.) basis.[97] In a C.I.F. contract, the price paid by the buyer reflects not only the cost of the goods but also the cost of insurance and freight procured by the seller. Since the buyer pays the cost of freight, it is reasonable to suppose that he does so because the goods belong to him.[98] Thus, in C.I.F. contracts, title passes to the buyer when the seller delivers the goods to the carrier and forwards the appropriate documents.[99] In General Counsel Memorandum 2,467, title to goods sold to foreign customers passed at ports in the United States. Therefore, sales were considered made in the United States and the resulting profits were domestically sourced.[100]

Stage One in the history of the title passage rule, then, was marked by confusion in interpreting ambiguous statutory rules that taxed foreigners on gains from sales of goods in the United States, but provided no legal standards for defining the location of a sale. The government ultimately interpreted the statutory language as referring only to the country in which title to goods passed from seller to purchaser, regardless of the level of activity conducted by the seller within or without the United States.[101]

CONTEMP. PROBS. 3, 5 n.11 (1951).

97. Some of the sales described in Gen. Couns. Mem. 2,467, 7-2 C.B. 188, 195 (1928) were made on a cost and freight (C. & F.) basis. Incidence of title passage is the same in contracts made in accordance with either of these terms. The Hans Maersk, 266 F. 806 (2d Cir. 1920). *Cf.* INCOTERMS 1990, *supra* note 77, at 46-47 (in a C. & F. contract, risk of loss passes from the seller to the buyer when the goods pass the ship's rail at the port of shipment).

98. WILLISTON, *supra* note 77, § 280c, at 605; *accord* Smith Co. v. Marano, 267 Pa. 107, 110 A. 94 (1920).

99. Smith v. Moscahlades, 193 A.D. 126, 183 N.Y.S. 500 (1920); Smith Co. v. Marano, 267 Pa. 107, 110 A. 94 (1920). *See generally* WILLISTON, *supra* note 77, § 280c, at 605.

100. Gen. Couns. Mem. 2,467, 7-2 C.B. 188 (1928).

101. In a case decided by the Board of Tax Appeals after the issuance of Gen. Couns. Mem. 2,467, 7-2 C.B. 188 (1928), title passage concepts were not addressed by the parties or the court. One might hypothesize that the case was already in the proverbial pipeline when the government changed its official view, and attempts were not made to reverse the positions taken on brief.

In Porto Rico Consol. Fruit Co. v. Commissioner, 16 B.T.A. 778 (1929), the taxpayers were U.S. corporations that raised fruit and sugar cane in Puerto Rico for sale to customers in the United States. Pursuant to § 262 of the Revenue Act of 1921, ch. 136, § 262, 42 Stat. 227, 271 (the predecessor I.R.C. § 936, as amended by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (to be codified at 26 U.S.C. § 936)), U.S. corporations were not taxed on income from foreign sources if they derived at least 80% of gross income from sources within a U.S. possession and if at least 50% of gross income was derived from the active

B. *Stage Two: The Supreme Court Changes the Commissioner's Mind (1929-1934)*

Notwithstanding his unequivocal 1928 statement that income is

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conduct of a trade or business within a U.S. possession.

The taxpayers argued that their entire income was derived from foreign sources since all of their income was derived from the sale of farm products grown in Puerto Rico. The government likewise focused on the location of the taxpayers' activities, as was its pre-Gen. Couns. Mem. 2,467, 7-2 C.B. 188 (1928) practice, but argued that these activities were predominantly in the United States, an interesting position in light of the lack of importance placed upon the farming operations themselves. Consistent with its own prior decisions, the Board focused on the nationality or location of the buyers, not on the location of the sellers; since the customers were U.S. persons, the gains were entirely U.S. source. 16 B.T.A. at 780. *See* Brookfield Linen Co. v. Commissioner, 15 B.T.A. 168 (1929); Billwiller v. Commissioner, 11 B.T.A. 841 (1928); *In re* Yokohama Ki-Ito Kwaisha, Ltd., 5 B.T.A. 1248 (1927); Birkin v. Commissioner, 5 B.T.A. 402 (1926).

The Board's decision, although seemingly consistent with prior cases, is noteworthy for its ignorance of the then prevailing statutes and regulations, which effectively overturned the decisions relied upon by the court and supported a decision in the taxpayers' favor. The Revenue Act of 1921, ch. 136, 42 Stat. 227, contained no rules for determining source in connection with § 262. Sourcing rules applicable to the taxation of nonresident aliens and foreign corporations, however, were provided in § 217. In the case of goods manufactured by the taxpayer within and sold without the United States, or manufactured without and sold within the United States, gains were treated as derived partly from sources within and partly from sources without the United States. Revenue Act of 1921, ch. 136, § 217(c), 42 Stat. 227, 244. The purpose of this rule was to overturn prior law, exemplified in *Birkin*, 5 B.T.A. at 402, *Billwiller*, 11 B.T.A. at 841, and *Brookfield Linen*, 15 B.T.A. at 168, under which gains were sourced entirely in the country of sale, regardless of where the goods were manufactured. S. REP. NO. 275, *supra* note 85, at 16.

Authority was delegated to the Treasury Secretary to prescribe regulations allocating and apportioning items not specifically sourced by statute. These regulations provided a separate rule for sourcing income derived from natural resources:

> The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States.

Treas. Reg. 62, art. 326 (1922). This rule treats farming income differently from manufacturing income by placing primary (or sole) importance on the location of production, i.e., the farm. In *Porto Rico*, one might have argued that the converse of the farm rule ought to apply, namely that income derived from the ownership or operation of a farm located outside the United States ought to be treated entirely as income from foreign sources. This argument apparently was not made or considered.

Contemporary I.R.S. pronouncements indicate that today, the I.R.S. would, in fact, apply the converse rule and view the income as foreign source. Treas. Reg. § 1.863-1(b)(1) (as amended in 1958) (restating verbatim Treas. Reg. 62, art. 326 (1922); Treas. Reg. § 1.863-6 (as amended in 1975) (converse of principle stated in Treas. Reg. § 1.863-1 applies in determining income from foreign sources). *See also* Gen. Couns. Mem. 35,538 (Nov. 1, 1973) (advances and patronage dividends paid by a domestic farmers' cooperative to nonresident alien members for crops grown outside the United States are sourced outside the United States regardless of the location of title passage); Rev. Rul. 71-198, 1971-1 C.B. 210 (income of a Puerto Rican corporation from the sale of raw tuna fish caught in international waters to canners in the United States is from foreign sources); Rev. Rul. 67-194, 1967-1 C.B. 183 (income of a foreign corporation from mining and sourced in accordance with passage of title,[102] the Commissioner of Internal Revenue soon experienced a change of heart. What precipitated this change was the Supreme Court decision in *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*,[103] in which neither the Commissioner nor the Treasury Department played a role. The Commissioner misconstrued *Compania* to justify abandoning his prior acquiescence in the title passage rule.

In *Compania*, the United States Supreme Court reviewed a decision of the Supreme Court of the Philippine Islands construing a section of the Philippine income tax statute. The statute, which was similar to corresponding provisions of United States revenue laws, taxed "the total net income received in the preceding year from all sources within the Philippine Islands by every corporation . . . organized . . . under the laws of any foreign country."[104]

The taxpayer, Compania, was a Spanish corporation engaged in the Philippine Islands in buying, selling, and exporting sugar, oils, and tobacco. From time to time, Compania exported its products to the United States. The parties stipulated that the merchandise "was sold in the United States" by Compania's U.S. agency, but also stipulated that each sale was "subject to confirmation and absolute control as to price and other terms and conditions thereof, by the plaintiff's Philippine branch."[105]

The Court found the stipulation susceptible to two distinct interpretations, resulting in opposite tax consequences. First, the stipulation could have meant that, as to each sale, confirmation was given by the Philippine home office directly to the buyer, or was otherwise the final act consummating the sale. Under this interpretation, since the final act would have occurred in the Philippines, the sale would have concluded there. Gains from such sales would have been derived from Philippine sources and, therefore, would have been subject to Philippine income tax.[106]

On the other hand, the stipulation could have meant that the Philippine office was merely approving or ratifying negotiations already completed by the U.S. agent, that is, sales consummated by the agent

processing sylvinite in a foreign country and sale in the United States is from foreign sources).

102. Gen. Couns. Mem. 2,467, 7-2 C.B. 188, 195 (1928).

103. 279 U.S. 306 (1929).

104. *Id.* at 307 (quoting Philippine Income Tax Law of March 7, 1919, Act 2833, 14 Pub. Laws, P.I. 221, as amended by Act 2926, March 20, 15 Pub. Laws, P.I. 260).

105. 279 U.S. at 308.

106. *Id.* at 309.

in the United States. Since the sales would have been concluded in the United States, gains would have been derived from U.S. sources and, therefore, would not have been subject to Philippine income tax.[107]

In light of the ambiguous stipulation, the Court found that Compania had failed to prove that the lower court's findings in favor of the tax collector were clearly erroneous.[108] The lower court's decision was affirmed and the taxpayer's gains from export sales were sourced in the Philippine Islands.

In 1930, within months after the *Compania* decision was handed down, the Commissioner released General Counsel Memorandum 8,594,[109] revoking his prior adoption of the title passage rule. Henceforth, the location where an agreement to sell is made would determine the source of profits on the underlying sale.[110]

The Commissioner explained that while the term "sale," in the context of commercial law, refers to the transfer of property (that is, title)[111] from one person to another, this characterization does not present the essential character of the transaction for purposes of determining source.[112] For the latter purpose, the Commissioner mistakenly interpreted *Compania* as characterizing the essential nature of the transaction as the agreement to sell, i.e., the contract itself.[113] Therefore, the source of income ought to follow the location where the agreement is made, without regard to the location of title passage.[114] The Commissioner incorrectly understood the Supreme Court to have rejected the title passage rule when the Court concluded that the time and place of delivery were irrelevant to its holding.[115]

The Commissioner in General Counsel Memorandum 8,594 misread and, therefore, misapplied the *Compania* decision, which is entirely consistent with title passage principles. In commercial sales, a contract to sell unascertained goods cannot transfer title to the buyer

107. *Id.* at 309.

108. *Id.* at 310.

109. Gen. Couns. Mem. 8,594, 9-2 C.B. 354 (1930).

110. *Id.* at 359. All prior inconsistent pronouncements, including Gen. Couns. Mem. 2,467, 7-2 C.B. 188 (1928) were revoked. Gen. Couns. Mem. 8,594, 9-2 C.B. 354 (1930).

111. *See supra* note 96.

112. Gen. Couns. Mem. 8,594, 9-2 C.B. 354 (1930).

113. *Id.* at 358.

114. *Id.* at 358-59.

115. *Id.* at 358. *See Compania*, 279 U.S. at 309 ("If, in fact, the sales were thus made in the Philippine Islands, we think it unimportant whether the merchandise sold was exported before or after its sale.").

until the goods are ascertained.[116] A contract at this point is, at most, an executory contract to sell.[117] If, however, the contract is for sale of specific or ascertained goods, title is transferred to the buyer when the parties to the contract intend it to be transferred.[118] Absent specific contractual recitals to the contrary, title is presumed to pass to the buyer when the contract is made; the time of delivery is irrelevant.[119]

The facts stipulated in *Compania* did not specify whether the goods were ascertained when the contracts were entered into, nor did they specify whether the contracts contained recitals that would negate the presumptions of title passage. In addition, as noted by the Court, the stipulated facts were ambiguous as to the location of consummation of the contracts.[120] Thus, once the Court had concluded that the contracts of sale were finalized in the Philippines, basic principles of commercial law mandated a finding that title to the goods passed in the Philippines if the goods were ascertained at the time that the contract was finalized. Since for tax purposes the location of sale followed the passing of title, gains from the sale were correctly sourced in the Philippines.

This analysis is consistent with the opinion of the Board of Tax Appeals in *Briskey Co. v. Commissioner*,[121] in which a U.S. corporation received and accepted orders from purchasers in the United States and cabled them to its India branch. The India branch then purchased the goods to fill the orders and shipped the goods to the U.S. office for forwarding to the purchasers. Since the goods were not in the possession of the taxpayer when it negotiated with purchasers in the United States, i.e., the goods were not ascertained, the earliest time a sale could have been consummated was when the goods were ascertained through a purchase in India.[122] Until the goods were purchased, an ac-

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116. UNIF. SALES ACT § 17, 1 U.L.A. 309-10 (1950); *accord* Hettrick Mfg. Co. v. Srere, 235 Mich. 306, 209 N.W. 97 (1926); Cassinelli v. Humphrey Supply Co., 43 Nev. 208, 183 P. 523 (1919); *see generally* WILLISTON, *supra* note 77, § 258, at 520.

117. UNIF. SALES ACT § 1(1), 1 U.L.A. 2 (1950); *see generally* WILLISTON, *supra* note 77, § 2.

118. UNIF. SALES ACT § 18(1), 1 U.L.A. 311 (1950); *accord* Rehr v. Trumbull Lumber Co., 110 Ohio St. 208, 143 N.E. 558 (1924); Cassinelli v. Humphrey Supply Co., 43 Nev. 208, 183 P. 523 (1919); *see generally* WILLISTON, *supra* note 77, § 261.

119. UNIF. SALES ACT § 19(1), 1 U.L.A. 323-24 (1950); *accord* Levinson v. Connors, 269 Mass. 209, 168 N.E. 736 (1929); Delaney v. Globe Shipbuilding Co., 175 Wis. 167, 184 N.W. 696 (1921); *see generally* WILLISTON, *supra* note 77, § 264.

120. *Compania*, 279 U.S. at 309.

121. 29 B.T.A. 987 (1934), *acq.* 1947-2 C.B. 1, *aff'd*, 78 F.2d 816 (3d Cir. 1935).

122. *Briskey*, 29 B.T.A. at 991.

ceptance of an order by the home office created, at most, an executory contract to sell. "The earliest moment that there could be a sale under such circumstances was when the goods were acquired in India and appropriated to the contract."[123] Since the final acts consummating the sales, appropriation of the goods to the contract, occurred in India, the location of sale and the source of gains were foreign.[124]

C. *Stage Three: The Commissioner Decides That Maybe He Was Right in the First Place (1934-1947)*

Following the issuance of General Counsel Memorandum 8,594, the Commissioner's litigating position was firmly grounded on his curious interpretation of *Compania*.[125] The Board of Tax Appeals, how-

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123. *Id.*

124. *Id.* Curiously, the Commissioner failed to apply its own *Compania*-inspired analysis in 1934, only four years after adopting it. In Gen. Couns. Mem. 13,475, 13-2 C.B. 224 (1934), a Canadian corporation, which owned timber lands and produced pulpwood, contracted with a U.S. corporation, which operated paper mills, for the sale of pulpwood to be delivered in the United States. The contract was negotiated and drawn up in the United States and signed in this country by the American buyer, but was signed by the Canadian seller in Canada.

Pursuant to § 119(e) of the Revenue Act of 1928, ch. 852, 45 Stat. 791, 828, the income attributable to production was sourced in Canada. At issue was the source of the income attributable to sale. Citing Gen. Couns. Mem. 8,594, 9-2 C.B. 354 (1930), the taxpayer argued that since the contract became final upon being signed in Canada, the income attributable to sales was sourced outside the United States.

The Commissioner made the following heretical statement:

> The physical operations, not the contract, are the substantial thing. That Congress in enacting the law was likewise looking to substance in the case of purchase and sale is a fair assumption. The use in the taxing statute of the word "sold" with the word "produced," and "sale" with "purchase," shows contemplation of the ordinary commercial processes whereby the manufacturer of goods sells them to the consumer or middleman, and the middleman purchases and resells to the consumer or another middleman. The substance as well as the purpose of such purchases and sales is passage of the property in the goods. In the overwhelming majority of cases the goods pass into the physical possession of the purchaser, and the transaction is not regarded as complete until the purchaser controls the goods.

Gen. Couns. Mem. 13,475, 13-2 C.B. 224 (1934). *Compania* was distinguished on the basis that the Philippine home office in *Compania* had authority and control over the terms of the contract while, in the transaction at issue, all negotiations as to price, terms, and conditions were settled in the United States, where the contract was drafted; the signature was a "mere formality." The portions of the taxpayer's profits attributable to sales, thus, were sourced in the United States.

While the Commissioner did not go so far as to say that title passage principles applied, Gen. Couns. Mem. 13,475, 13-2 C.B. 224, 225 (1934) clearly did not apply a strict final acts analysis.

125. *See, e.g.*, East Coast Oil Co. v. Commissioner, 31 B.T.A. 558 (1934), *aff'd*, 85 F.2d 322 (5th Cir.), *cert. denied*, 299 U.S. 608 (1936); Exolon Co. v. Commissioner, 45 B.T.A. 844 (1941), *acq.* and *nonacq.*, 1942-1 C.B. 6 & 22, *nonacq. withdrawn and acq.*, 1947-2 C.B. 2; *see also* Ronrico Corp. v. Commissioner, 44 B.T.A. 1130 (1941), *nonacq.* 1941-2 C.B. 22, *nonacq. withdrawn* and *acq.*, 1944-1 C.B. 24 (discarding significance of location of negotiations leading to,

ever, consistently applied title passage principles and, in the ensuing years of Stage Three, the Commissioner failed to win a single case on *Compania* grounds. Ultimately, he capitulated.

In 1934, the same year the Commissioner issued General Counsel Memorandum 8,594, both the Board and the Court of Appeals for the Fifth Circuit decisively rejected the government's analysis of *Compania*,[126] finding that case completely consistent with the "established rule that the place where title passes is the place of sale."[127] Notably, the case, *East Coast Oil Co. v. Commissioner*,[128] was the first to refer to the fact that title encompasses risks, which pass to the buyer when title passes.[129] During the ensuing thirteen years, the Board consistently held against the Commissioner where title passed outside the United States, deeming irrelevant the location of the final act consummating the contract.[130]

Finally conceding defeat, the Commissioner agreed that in a sales transaction, the place where title passes determines the source of income.[131] However, capitulation was not total. Where a seller retains bare legal title, e.g., for purposes of securing payment, the Commissioner deemed the sale to have occurred at the time and place of passage to the buyer of the beneficial ownership and risk of loss. This exception is consistent with basic principles of commercial law.[132]

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and execution of, contract of sale).

126. *East Coast Oil*, 31 B.T.A. at 560-61, 85 F.2d at 323.

127. *East Coast Oil*, 31 B.T.A. at 561. *See supra* notes 103-20 and accompanying text. Both the Board and the court of appeals also ascribed weight to the lengthy period during which the government had adhered to the title passage rule prior to Gen. Couns. Mem. 8,594, 9-2 C.B. 354 (1930). *East Coast Oil*, 31 B.T.A. at 560, *aff'd*, 85 F.2d 322, 323 (5th Cir. 1936).

128. 31 B.T.A. 558 (1934), *aff'd*, 85 F.2d 322 (5th Cir.), *cert. denied*, 299 U.S. 608 (1936).

129. *East Coast Oil*, 31 B.T.A. at 561.

130. Hazleton Corp. v. Commissioner, 36 B.T.A. 908 (1937), *nonacq.*, 1938-1 C.B. 50; Anglo-Mexican Petroleum Co., Ltd., 1937 B.T.A.M. (P-H) ¶ 37,353; Ronrico Corp. v. Commissioner, 44 B.T.A. 1130 (1941); Exolon Co. v. Commissioner, 45 B.T.A. 844 (1941). Even where the Board's decision favored the Commissioner, title passage principles were applied. Ardbern Co. v. Commissioner, 41 B.T.A. 910 (1940), *modified*, 120 F.2d 424 (4th Cir. 1941) (title to stock passed when share certificates were delivered in New York); Askania Werke v. Commissioner, 33 B.T.A. 875 (1936), *rev'd*, 96 F.2d 717 (D.C. Cir. 1938) (title to goods passed in United States; on appeal, decision reversed for evidentiary and procedural errors).

131. Gen. Couns. Mem. 25,131, 1947-2 C.B. 85 (1947). "No doubt there were in the seventeen year interval, 1930 [Gen. Couns. Mem. 8,594] to 1947 [Gen. Couns. Mem. 25,131], many taxpayers who paid United States income tax on income not properly ascribable to United States sources. It seems that the only ones to escape that fate were those hardy taxpayers who litigated the question." Baker & Meek, *Tax Problems of Doing Business Abroad: Some Practical Considerations*, 1957 WIS. L. REV. 75, 92 n.52.

132. Baker & Meek, *supra* note 131, at 92 n.52. *See* WILLISTON, *supra* note 77, § 280c;

The Commissioner added the following warning:

> [I]n any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as 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.[133]

The position stated in General Counsel Memorandum 25,131 was eventually incorporated into regulations, and remains applicable today.[134] Although the government ultimately acquiesced to title passage concepts, it was not willing to tolerate abuse by sophisticated tax planners. If transactions were designed primarily for avoiding tax, the government would not respect the location of title passage. Nevertheless, the parameters of the Commissioner's admonition were vague.

D. Stage Four: The Commissioner Tries Again (1955-1974)[135]

With the title passage rule firmly in place, the courts finally began to contemplate the meaning of the rule in Stage Four. The backdrop

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accord Ronrico, 44 B.T.A. at 1135-36; Briskey Co. v. Commissioner, 29 B.T.A. 987, 991 (1934).

133. The government's tax avoidance concerns were based on Kaspare Cohn Co. v. Commissioner, 35 B.T.A. 646 (1936), *appeal dismissed*, 109 F.2d 1014 (9th Cir. 1940), in which the stockholders of a closely held U.S. corporation attempted to avoid tax on gains from the sale by the U.S. corporation of certain public utility stocks. A foreign corporation was formed, to which the public utility stocks were transferred in a nontaxable exchange. The foreign corporation then sold the utility stocks to a U.S. purchaser, with delivery (and passage of title) outside the United States. Since the foreign corporation was taxable only on its U.S. source income, Revenue Act of 1926, ch. 27, §§ 217, 233(b), 44 Stat. 9, 30, 41, the gains, which were foreign source, would not be taxable. If the foreign corporation had distributed any of its gain, the U.S. corporate stockholder might have been taxed on the distribution. Revenue Act of 1926, ch. 27, §§ 213(a), 233(a), 44 Stat. 9, 23, 41.

The Board never discussed the source of the gains; it found that the foreign corporation was an agent of the U.S. corporation, a mere conduit for passing title to the utility stocks, and disregarded the separateness of the two corporations. *Kaspare Cohn*, 35 B.T.A. at 668.

The facts in *Hazleton*, 36 B.T.A. at 908, were substantially similar to those in *Kaspare Cohn*. The Commissioner, however, did not make the tax avoidance arguments that he had pursued in *Kaspare Cohn*, and the case was heard only on the issue of where the sale took place. Since the documents clearly established the parties' intent to pass title abroad, the (newly incorporated) foreign corporation's gains were foreign source and, therefore, not subject to U.S. income tax. *Hazleton*, 36 B.T.A. at 924.

134. Treas. Reg. § 1.861-7(c) (1957).

135. Nothing of significance, with respect to the title passage rule, occurred between 1947, the end of Stage Three, and 1955, the beginning of Stage Four. *But cf.* Estate of Cadwallader v. Commissioner, 13 T.C. 214 (1949); G.A. Stafford & Co. v. Pedrick, 78 F. Supp. 89 (S.D.N.Y. 1948), *aff'd*, 171 F.2d 42 (2d Cir. 1948) (title passage rule applied).

for a new set of government challenges was provided by the Court of Appeals for the Second Circuit in *United States v. Balanovski*.[136] In *Balanovski*, an Argentine partnership with minimal contacts in the United States purchased trucks and equipment from U.S. suppliers for resale to an agency of the Argentine Government, on an F.O.B. (free on board) New York City basis.[137] The government argued that the title passage rule dictated a finding that gains were sourced in the United States.[138]

Despite the overwhelming precedent that had evolved in Stages One, Two, and Three, the District Court refused to apply the title passage rule. In the court's view, sourcing the gains in the United States would have been unreasonable, particularly where passage of title in New York City had been arranged at the insistence of the purchaser.[139] The court justified its brushing aside of precedent on the grounds that the negotiations were carried out in Argentina, the buyer was an agency of the Argentine government, and the ultimate destination of the goods was Argentina. Not surprisingly, the decision was reversed on appeal in light of the "universally adopted"[140] title passage rule.[141]

The Second Circuit Court of Appeals, however, made the following gratuitous statement, which drew the attention of the Commissioner: "Of course, this test may present problems, as where passage of title is formally delayed to avoid taxes. Hence it is not necessary, nor is it desirable, to require rigid adherence to this test under all circumstances."[142] Coupled with the Commissioner's previous warning that the title passage rule would not apply where a transaction was ar-

136. 236 F.2d 298 (2d Cir. 1956), *cert. denied*, 352 U.S. 968 (1957).

137. In an F.O.B. contract, the seller is bound to put the goods on board a vessel or carrier free of expense to the buyer. *See* WILLISTON, *supra* note 77, § 280a, at 597. Expressions F.O.B. the point of destination are less common, and require the seller to deliver the goods, free of expense to the buyer, to the point named. *Id.* at 601. Title in the goods passes to the buyer at the designated point of delivery. *Id.* § 280b, at 602. *Cf.* INCOTERMS 1990, *supra* note 77, at 38-39 (in an F.O.B. contract, seller must "bear all risks of loss of or damage to the goods until such time as they have passed the ship's rail at the named port of shipment" and buyer must "[b]ear all risks of loss of or damage to the goods from the time they have passed the ship's rail at the named port of shipment").

138. United States v. Balanovski, 131 F. Supp. 898, 901 (S.D.N.Y. 1955).

139. *Id.* at 902-03.

140. *Balanovski*, 236 F.2d at 305 n.4.

141. *Id.* at 304-05. The court of appeals also noted that the risk of loss passed before the ocean voyage and that it was the buyer, not the seller, who purchased marine insurance. *Id.* at 306. *See infra* text accompanying notes 154-59.

142. *Balanovski*, 236 F.2d at 306.

ranged primarily to avoid tax,[143] the court's dicta inspired the Commissioner to explore the limits of title passage and the breadth of its tax avoidance exception.

The vehicle for the Commissioner's expedition was the Western Hemisphere Trade Corporation (WHTC), a legislatively created entity entitled to preferential tax treatment.[144] To qualify for favorable status, a domestic corporation was required to: (1) conduct all of its business in the Western Hemisphere, (2) derive ninety-five percent of its gross income from sources outside the United States, and (3) derive ninety percent or more of its gross income from the active conduct of a trade or business.[145] In a typical scenario,[146] a U.S. exporter would organize a domestic subsidiary whose sole purpose was to purchase goods manufactured by the parent and then resell the goods to purchasers in the Western Hemisphere.[147] To ensure that all of the subsidiary's income was from foreign sources, sales documents would explicitly state that title to the goods passed from the seller to the buyer outside the United States.

The Commissioner apparently believed that WHTC benefits required more than a series of paper transactions,[148] and launched a full scale attack on corporations claiming WHTC benefits. The government

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143. Gen. Couns. Mem. 25,131, 1947-2 C.B. 85, 86; Treas. Reg. § 1.861-7(c) (1957). *See supra* text accompanying note 134.

144. Created by the Revenue Act of 1942, ch. 619, § 141, 56 Stat. 798, 838, the WHTC was exempt from the corporate surtax until the exemption was eliminated by the Revenue Act of 1950, ch. 989, § 122(c), 64 Stat. 906, 920, which substituted a credit against the normal tax. *See* I.R.C. of 1939 § 109. Most recently, WHTCs were entitled to a deduction. *See* I.R.C. of 1954 § 921. The WHTC provisions were repealed for taxable years beginning after December 31, 1979. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1052(b), 90 Stat. 1520, 1647-48.

145. Revenue Act of 1942, ch. 619, § 141, 56 Stat. 798, 838.

146. *E.g.*, Barber-Greene Americas, Inc. v. Commissioner, 35 T.C. 365 (1960), *acq.*, 1961-2 C.B. 4, *acq.*, 1964-2 C.B. 4.

147. The parent never could meet the 95% foreign income requirement, since a portion (generally, 50%) of its income would be allocable to manufacturing, and would be sourced in the United States. *See* I.R.C. § 863 (West Supp. 1990) and its predecessors.

148. In Pan Am. Eutectic Welding Alloys Co. v. Commissioner, 36 T.C. 284 (1961), the Commissioner argued that "within the intendment of the statute the petitioner would have to be present and conducting some business within the foreign countries of the Western Hemisphere to establish that the source of its sales income was without the United States." *Id.* at 290-91. *Cf.* Gen. Couns. Mem. 34,464 (Mar. 25, 1971) (where a foreign subsidiary acts as the export arm of a domestic parent corporation, "[t]his office has taken the position that where there is no significant economic penetration into the foreign market areas by the export subsidiary, the significant acts in making and completing the sales have occurred in the United States, and no business purpose can be shown in passing title outside the United States, the substance of the sale test [rather than the title passage rule] can be applied").

typically argued that, since passage of title was delayed solely or primarily for the purpose of avoiding tax, the location at which the seller's obligations with respect to the sale were performed, and not the situs of title passage, ought to determine source.[149] The government also argued that retention of title until the goods arrived at a foreign point had no substance, since recitals delaying title passage did not prevent beneficial ownership from passing in the United States even though title technically remained with the seller.[150]

The government lost every case.[151] For example, in *Barber-Greene Americas v. Commissioner*,[152] the court reasonably viewed the tax-inspired arrangements as within the contemplation of Congress, since the WHTC was created specifically to provide tax benefits to U.S. corporations engaged in foreign trade.[153] As to the government's second argument, the court correctly concluded that both beneficial ownership and legal title passed at the foreign port, reasoning that, in retaining ownership, the seller undertook real responsibilities, risks, and obligations that would not have been assumed had title passed in the United States.[154]

> The petitioners assumed the risk of delays in transit or loss or damage en route, the responsibility of engaging freight forwarders and of arranging many other details. They could and did protect themselves to some extent by insurance against losses in transit, but if the insurer would not or could not pay, the loss would be that of the petitioners. It is their right to elect whether to avoid these

149. *See, e.g.*, Barber-Greene Americas, Inc. v. Commissioner, 35 T.C. 365, 384-85 (1960).

150. *See, e.g.*, *id.* at 385.

151. Commissioner v. Pfaudler Inter-American Corp., 330 F.2d 471 (2d Cir. 1964), *aff'g*, 22 T.C.M. (CCH) 506 (1963); Commissioner v. Hammond Organ W. Export Corp., 327 F.2d 964 (7th Cir. 1964), *aff'g*, 22 T.C.M. (CCH) 426 (1963); Frank v. International Canadian Corp., 308 F.2d 520 (9th Cir. 1962), *aff'g*, 61-1 U.S. Tax Cas. (CCH) ¶ 9405 (W.D. Wash. 1961); Baldwin-Lima-Hamilton Corp. v. United States, 69-1 U.S. Tax Cas. (CCH) ¶ 9269 (N.D. Ill. 1967); A.P. Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960); Babson Bros. Export Co. v. Commissioner, 22 T.C.M. (CCH) 677 (1963); *Pan Am. Eutectic*, 36 T.C. at 284; *Barber-Greene*, 35 T.C. at 365. *But see* American Food Prods. Corp. v. Commissioner, 28 T.C. 14 (1957) (terms of sales by a WHTC caused title to pass in the United States and the Commissioner successfully argued that title passage principles applied). *Cf.* Philipp Bros. Intercontinent Corp. v. United States, 66-1 U.S. Tax Cas. (CCH) ¶ 9421 (S.D.N.Y. 1966) (in connection with excess profits tax, court applied substance of sale test, not title passage rule, and found that gains were sourced in United States; in most sales, title passed in United States).

152. 35 T.C. 365 (1960).

153. *Barber-Greene*, 35 T.C. at 386.

154. This conclusion is consistent with commercial law, which provided that title passed when the parties intended, UNIF. SALES ACT § 18(1), 1 U.L.A. § 11 (1950), and in ascertaining those intentions, regard was given to the terms of the contract and usages of trade, UNIF. SALES ACT § 18(2), 1 U.L.A. 311 (1950). *See generally* WILLISTON, *supra* note 77, § 261.

risks or to undertake these risks and qualify for the tax benefits offered by Congress.[155]

Other motives for delaying title passage might include control over goods while in transit,[156] rights and remedies in the event the purchaser fails to pay or becomes insolvent,[157] and protection against losses caused by a trade embargo, seizure or nationalization by a foreign government, or strike.[158] In addition, retaining title permits the shipper to insure goods with a United States insurance carrier, enabling it to recover directly in U.S. currency.[159]

In light of his mounting losses,[160] the Commissioner agreed to apply the title passage rule to WHTCs, even where foreign presence was minimal or nonexistent.[161]

E. Stage Five: The Modern Era (1981-1990)[162]

The axiom, "better late than never," is exemplified in the most recent title passage cases, in which the Tax Court finally incorporated the Uniform Commercial Code ("U.C.C.") into its analyses of title

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155. *Barber-Greene*, 35 T.C. at 387-88. *Accord Pfaudler*, 330 F.2d at 475; *Hammond Organ*, 327 F.2d at 966; *Babson Bros.*, 22 T.C.M. (CCH) at 686; *Pan Am. Eutectic*, 36 T.C. at 291.

The Court of Claims has indicated that retention of title until delivery must serve a business purpose apart from the expected tax consequences, *A.P. Green*, 284 F.2d at 390, but other courts have not discussed business purpose. *But see Pfaudler*, 22 T.C.M. (CCH) at 511 (without discussion, court rejected I.R.S. argument that retention of title served no business purpose). Notably, *A.P. Green* is the first opinion in the area citing the Uniform Commercial Code, albeit without discussion. 284 F.2d at 388.

156. *Hammond Organ*, 327 F.2d at 966.

157. *Id.*

158. *A.P. Green*, 284 F.2d at 390.

159. *Id. See also* Baker & Meek, *supra* note 131, at 80-83; Baker & Hightower, *The Western Hemisphere Trade Corporation: A Problem in the Law of Sales*, 22 TUL. L. REV. 229, 251-53 (1947). *Cf. infra* text accompanying notes 221-25 (discussion of risks retained by seller where passage of title or risk of loss is delayed).

160. The government had lost in three circuit courts of appeal, the Court of Claims, and the Tax Court. Perhaps the Commissioner hoped to obtain contradictory decisions at the circuit court level, enabling him to bring the issue to the Supreme Court for resolution. *Cf. Hammond Organ*, 327 F.2d at 966 ("In effect, the Commissioner is seeking from this Court, a holding which would be in conflict with the decision of every court which has considered the issues here presented.").

161. Rev. Rul. 64-198, 1964-2 C.B. 189; *accord* Rev. Rul. 74-249, 1974-1 C.B. 189. I.R.S. internal memoranda indicate that the agency would have continued to argue against applying the title passage rule to a foreign subsidiary acting as the export arm of its U.S. parent unless the subsidiary maintained a substantial U.S. presence. Gen Couns. Mem. 34,464 (Mar. 25, 1971); Gen. Couns. Mem. 33,666 (Oct. 26, 1967).

162. Nothing of significance, with respect to the title passage rule, occurred between 1974, the end of Stage Four, and 1981, the beginning of Stage Five.

passage and source. Drafting of the U.C.C. formally began in 1942,[163] and Pennsylvania, the first state to adopt the U.C.C., did so in 1953.[164] Yet, the difficulties that inspired changes in commercial law and culminated in widespread adoption of the U.C.C., including article 2 (sale of goods), were never referred to in relevant tax decisions until 1981.[165] The Tax Court has yet to reach a full understanding of the principles underlying article 2, in particular its repudiation of the title concept, and, therefore, has been unable effectively to incorporate the U.C.C. into its analyses of source.

Prior to the U.C.C., the location of title to goods as between seller and buyer determined a variety of legal consequences, such as risk of loss, a seller's right to the purchase price, a buyer's right to the goods, and rights of third parties (e.g., creditors or trustees in bankruptcy).[166] The location of title also had consequences outside the commercial realm, such as the sourcing of income in international sales of personal property. Thus, the "great game in sales" was to find the location of title; "[w]hen title passed, title passed, and we could all go home, whatever the specific issue."[167]

Although title passage depended upon the intentions of the parties,[168] lay persons generally did not think in terms of title and, therefore, frequently failed to state expressly their intentions regarding title passage.[169] Legal presumptions intended to fill these gaps generated litigation with confusing and often inconsistent results.[170]

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163. *General Comment of National Conference of Commissioners on Uniform State Laws and the American Law Institute*, 1 U.L.A. xv, xvi (1989).

164. 1953 Pa. Laws 3, No. 1 (repealed 1979).

165. *See* Miami Purchasing Service Corp. v. Commissioner, 76 T.C. 818 (1981). *But cf. A.P. Green*, 284 F.2d at 388 (U.C.C. cited without discussion).

166. *See generally* Whiteside, *supra* note 96, at 173; Note, *A Comparison of the Rights and Remedies of Buyers and Sellers Under the Uniform Commercial Code and the Uniform Sales Act*, 49 KY. L.J. 270 (1960).

167. Whiteside, *supra* note 96, at 173; *accord* Llewellyn, *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L.Q. 159, 169 (1938).

168. UNIF. SALES ACT § 18, 1 U.L.A. 311 (1950).

169. Whiteside, *supra* note 96, at 174; *cf.* 1 STATE OF NEW YORK, REPORT OF THE LAW REVISION COMMISSION FOR 1954 AND RECORD OF HEARINGS ON THE UNIFORM COMMERCIAL CODE 28-29 (1954) (statement of Professor Karl N. Llewellyn, chief reporter of the Uniform Commercial Code). *Id.* at 152 (statement of James M. Snee); *cf. Miami Purchasing*, 76 T.C. at 827 ("The individual who served as president of both petitioning corporations testified that he knew that the term [F.O.B.] meant 'free on board,' that he understood the term to indicate only the price of the goods at the indicated location, and that he had never heard of the Uniform Commercial Code in all of the time that he had been in the exporting business.").

170. Whiteside, *supra* note 96, at 174. "The purpose [of Article 2] is to avoid making practical issues between practical men turn upon the location of an intangible something, the

The U.C.C. replaced the title approach by considering the various factual situations in which rights and responsibilities arose, and prescribing specific legal consequences with respect to each.[171] For example, the U.C.C. includes provisions regarding risk of loss,[172] a seller's right of action for the price,[173] and a buyer's right to obtain the goods.[174] Title is largely irrelevant.[175] The U.C.C.'s catch-all title rule, which restates pre-U.C.C. principles, applies only to factual situations that were not envisioned by the drafters.[176]

The Tax Court first attempted to incorporate U.C.C. principles in *Miami Purchasing Service Corp. v. Commissioner*,[177] in which the Internal Revenue Service challenged the qualification of two domestic corporations for WHTC benefits.[178] Although the taxpayers claimed that they had intended to pass title to goods outside the United States, the Court found that the terms of sales documents (such as invoices and insurance policies) provided for title passage within the United States.[179]

The court's analysis was traditional: the terms of the agreement

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passing of which no man can prove by evidence and to substitute for such abstractions proof of words and actions of a tangible character." U.C.C. § 2-101 official comment (1987). *See also* Llewellyn, *supra* note 167, at 167-68. *But see* Williston, *supra* note 96, at 566-69.

171. Whiteside, *supra* note 96, at 172-74. *See also* U.C.C. § 2-101 official comment (1987). A similar approach is followed in the United Nations Convention on Contracts for the International Sale of Goods, arts. 66-70, U.N. Doc. A/CONF.97/18/Annex 1 (1980), *reprinted in* 52 Fed. Reg. 6262, 6274 (1987), which went into effect on January 1, 1988. Honnold, *The New Uniform Law for International Sales and the UCC: A Comparison*, 18 INT'L LAW. 21, 27 (1984); Mendes, *The U.N. Sales Convention & U.S.-Canada Transactions: Enticing the World's Largest Trading Bloc to do Business Under a Global Sales Law*, 8 J.L. & COM. 109, 136 (1988). According to one commentator, "[w]hat American lawyers learned from the UCC made a profound contribution to international sales law." Honnold, *supra*, at 27. Unlike the U.C.C., however, the Convention on Contracts for the International Sale of Goods is concerned only with the rights and obligations of the seller and buyer arising from a sales contract, and not with claims of third parties. United Nations Convention on Contracts for the International Sale of Goods, art. 4, U.N. Doc. A/CONF.97/18/Annex 1 (1980), *reprinted in* 52 Fed. Reg. 6262, 6264 (1987).

172. U.C.C. §§ 2-509, 2-510 (1987).

173. U.C.C. § 2-709 (1987).

174. U.C.C. §§ 2-502, 2-716 (1987).

175. *See* U.C.C. § 2-509 official comment 1 (1987); U.C.C. § 2-709 official comment 1 (1987).

176. U.C.C. § 2-401 (1987). The section also is meant to apply where a public regulation depends upon the location of title as defined in private law. *Id.* official comment 1. *Cf.* Llewellyn, *supra* note 167, at 170-71.

177. 76 T.C. 818 (1981).

178. *See supra* notes 144-45 and accompanying text. The taxable years in issue predated repeal of the WHTC legislation.

179. *Miami Purchasing*, 76 T.C. at 827-29.

were analyzed to determine where the parties intended to pass title. The U.C.C. was cited, but only with respect to definitions of the terms "C.I.F." and "F.O.B."[180] The U.C.C.'s catch-all title rule was never mentioned. Although the court occasionally referred to risk of loss, the U.C.C.'s risk of loss rules were never mentioned. The court's conclusion, that title passed in the United States, was correct, but the opinion failed to incorporate either the statutory provisions of the U.C.C. or its underlying philosophy.

In *Kates Holding Co. v. Commissioner*,[181] the court fashioned a solution that effectively rewrote the Commissioner's regulation. The regulation (which restates the position set forth in General Counsel Memorandum 25,131)[182] provides in relevant part:

> [A] sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss.[183]

Both the regulation and the General Counsel Memorandum merely restated pre-U.C.C. commercial law—that title, including the sum of rights and responsibilities attendant to ownership, passed from the seller to the purchaser notwithstanding that the seller nominally retained title for the limited purpose of securing payment.[184]

The *Kates* court, however, construed the regulation as always requiring an examination of the passage of beneficial ownership and risk of loss, since the notion of title could never refer to more than "bare legal title" under modern commercial laws.[185] The court's interpretation is without precedential support, and can be explained only by the court's recognition of the diminishing importance of the title concept and confusion as to how to incorporate the newer concepts in the U.C.C. Reinterpreting the regulation makes its future applicability uncertain: if the location of title passage is irrelevant, then why pay it lip

180. *Id.* at 828 (citing U.C.C. §§ 2-319 and 2-320).

181. 79 T.C. 700 (1982).

182. Gen. Couns. Mem. 25,131, 1947-2 C.B. 85.

183. Treas. Reg. § 1.861-7(c) (1957).

184. *See supra* note 77. *Cf.* U.C.C. § 2-401(2) (1987) ("title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods, despite any reservation of a security interest and even though a document of title is to be delivered at a different time or place; and in particular and despite any reservation of a security interest by the bill of lading").

185. *Kates*, 79 T.C. at 707.

service at all? Should the regulation be rewritten to reflect modern commercial law and its focus on risk of loss?

The most interesting case decided in this era is also the most recent. In *Liggett Group, Inc. v. Commissioner*,[186] the government's arguments bore an eerie resemblance to its pre-title passage rule positions. The taxpayer, Paddington, a domestic corporation, was the exclusive distributor in the United States of J&B Rare Scotch Whiskey, which Paddington purchased from the manufacturer, J&B. In a typical transaction,[187] Paddington received an order to purchase a specified quantity of J&B Rare from a customer in the United States, whereupon Paddington issued its own purchase order to J&B, reflecting essentially the same information as set forth in the customer's order. J&B then delivered the goods on board a carrier in Scotland and forwarded the appropriate documentation (including a bill of lading to the order of Paddington) to Paddington, who endorsed the bill to its customer and transmitted the documents to either the customer or the customer's customs broker. Paddington took no responsibility for clearing the goods through United States Customs and did not store the goods at its own warehouse.

Paddington's written purchase orders to J&B contained no language concerning freight charges, insurance, risk of loss or passage of title in the ordered goods. The term "F.O.B." did not appear in any of the sales documents. The parties understood, however, that when the goods passed over the ship's rails, they became the property of Paddington.[188] Similarly, customers' written purchase orders to Paddington contained no language concerning freight charges, insurance, risk of loss, or passage of title in the ordered goods. The parties understood, however, that ownership and risk of loss passed from Paddington to the customer when J&B loaded the goods aboard the ship in Scotland; in fact, the customers insured the goods in transit.[189] Paddington, thus, simultaneously acquired and disposed of the risk of loss and, in the court's view, Paddington's transitory ownership was sufficient to create a sale, for purposes of the source rules.[190]

The court made no issue of risk of loss, but focused instead on

186. 58 T.C.M. (CCH) 1167 (1990).

187. Paddington also sold small quantities of J&B Rare F.O.B. its own U.S. warehouse. The taxpayer did not dispute that these sales were made in the United States. *Id.* at 1167-70.

188. *Id.*

189. *Id.*

190. *Id.* at 1173.

passage of title, ultimately holding that title passed from Paddington to its customers when the goods were delivered on board the carriers in Scotland.[191] The court's protracted analysis demonstrates the absurdity of relying upon the concept of title in a U.C.C. milieu. Since title customarily passes concurrently with risk of loss,[192] it ought to be an exceptional case that requires a discrete examination of both. If in fact both aspects of ownership do not pass at the same time, only risk of loss has real consequences to the parties. As in both of the preceding cases, citations to U.C.C. risk of loss rules are noticeably absent; only the catch-all title passage rule, which has no substantive relevance in commercial law, is cited.[193]

The government's interest in the case was apparently prompted by Paddington's lack of activity outside the United States. For example, the government argued that gains could not be sourced outside the United States when Paddington performed no acts in connection with the contract outside the United States.[194] The government also argued that title could not pass until there was a contract for sale, and that a contract had been concluded by Paddington's endorsement and transmittal of the documents in the United States.[195] The government further argued that there could have been no contract for sale until Paddington received the shipping documents from J&B in the United States.[196] These arguments ignore the consistent holdings in the WHTC cases, where the courts did not require taxpayers to engage in foreign activities as a prerequisite for sourcing gains outside the United States.[197] Has the government tortuously come "full circle" and returned to its "final acts" or "substance of the sale" analysis?[198]

191. *Id.* at 1174-75.

192. *See, e.g.*, Barber-Greene Americas, Inc. v. Commissioner, 35 T.C. 365, 387 (1960).

193. *See, e.g.*, *Liggett Group*, 58 T.C.M. (CCH) at 1172. A troubling aspect of the case, and a possible explanation for the government's pursuance of it, is the fact that, despite the court's conclusion that title vested in Paddington momentarily, risk of loss never was assumed by Paddington. But, Paddington took other risks, most notably the risk of payment by its customers; Paddington was obliged to pay J&B for goods regardless of whether Paddington ultimately was paid by its customers. *Id.* at 1171.

194. *Id.* at 1176-77.

195. *Id.* at 1176.

196. *Id.* at 1177.

197. *See* cases cited *supra* note 151.

198. *See supra* notes 109-15 and accompanying text.

IV. Passage of Risk of Loss Should Determine the Source of Gains from International Sales of Personal Property

When the title concept was originally adopted by the Board of Tax Appeals to analyze the source of gains from international sales of personal property, title was everything—a single concept that incorporated all of the rights, risks, and responsibilities associated with ownership.[199] Tax courts never were called upon to determine precisely which attributes of ownership were most important, so that the location at which these attributes passed could determine the location of the sale and thereby characterize the source of gains.

By way of contrast, legal scholars in the area of commercial sales realized long ago that unifying all aspects of ownership under one concept was unworkable.[200] Thus, the U.C.C. appropriately abandoned the single concept of title in favor of distinct rules that were intended to achieve fair results in various factual situations. The U.C.C. allocated risks, responsibilities, and benefits in varying ways depending upon the context in which the rules operated.[201] Curiously, tax courts have stubbornly adhered to the title concept and, thus, are thirty to forty years behind the times.

The tax courts' initial and continuing attraction to the commercial law concept of title may be explained by a lack of rigidly developed principles within the tax area governing determinations of source. Without any internal guidance, the tax courts have looked to the commercial law of sales and adopted its solution to an analogous set of problems.[202] In light of the title concept's lack of purpose in the modern commercial realm, however, it makes no sense for tax rulings to follow title unless an independent rationale can be offered. Attempts by the tax courts to explain the centrality of title have focused only on the attribute of risk of loss. Notably, risk of loss passes along with, or perhaps as part of, title.[203] Thus, it is both logical and fitting that in determining the source of profits from international sales of personal prop-

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199. *See supra* notes 166-67 and accompanying text.

200. *See, e.g.*, Llewellyn, *supra* note 167.

201. *See supra* notes 171-76 and accompanying text. *See also* United Nations Convention on Contracts for the International Sale of Goods, arts. 66-70, U.N. Doc. A/CONF.97/18/Annex 1 (1980), *reprinted in* 52 Fed. Reg. 6262, 6274 (1987) (allocation of risk of loss between buyer and seller).

202. *See* Alexander, *supra* note 91, at 133.

203. *See, e.g.*, Barber-Greene Americas, Inc. v. Commissioner, 35 T.C. 365, 387-88 (1960).

erty, the term "title" be understood as connoting risk of loss rather than mere legal title, a connotation with substantive significance.

In 1984, the Treasury Department advocated repealing the title passage rule.[204] However, it misunderstood the true nature of the title passage rule *qua* risk of loss passage rule, and, therefore, mistakenly concluded that the title passage rule ought to be repealed. To support its position, the Treasury Department articulated a set of tax policy principles that it believed ought to apply in formulating rules for determining the source of income.[205] These principles reflect an attempt to define a nexus between the United States and income to be taxed,[206] and are not themselves controversial. When the Treasury Department applied its tax policy principles to the title passage rule, however, it not surprisingly found the title passage rule deficient.[207] The Treasury Department's conclusions with respect to the title passage rule are questionable. The shortfall may be explained by the Treasury Department's failure to understand the pivotal role played by risk of loss in the context of title passage.

A. A Risk of Loss Rule Does Not Permit Artificial Manipulation of Source of Income

The first principle stated by the Treasury Department is that a source of income rule "should not allow erosion of the legitimate U.S. tax base through taxpayer manipulation of the source rules or of the foreign tax credit limitation."[208] With respect to the title passage rule, the Treasury Department argued that artificial manipulation of the location of title passage erodes both the U.S. tax base and the foreign tax credit limitation.[209] The Treasury Department believed that shifting the site of title passage is arbitrary and nonsubstantive, and that any resulting reduction in U.S. tax liability is unwarranted.[210]

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204. TREASURY I, *supra* note 6, at 364-68; TREASURY II, *supra* note 6, at 399-405.

205. TREASURY I, *supra* note 6, at 365; *accord* TREASURY II, *supra* note 6, at 399.

206. *See supra* text accompanying notes 18-20.

207. TREASURY I, *supra* note 6, at 365; *see also* TREASURY II, *supra* note 6, at 399-400.

208. TREASURY I, *supra* note 6, at 365; *accord* TREASURY II, *supra* note 6, at 399; *see also* Garbarino, *supra* note 21, at 397.

Where title to goods sold by a U.S. exporter passes outside the United States, gains are treated as foreign source income. *See* I.R.C. § 862(a)(6) (West Supp. 1990). These foreign source gains increase the numerator in the foreign tax credit limitation fraction, ultimately increasing the amount of the allowable foreign tax credit. *See supra* text accompanying notes 40-44.

209. TREASURY I, *supra* note 6, at 365; *accord* TREASURY II, *supra* note 6, at 399.

210. TREASURY I, *supra* note 6, at 365; *accord* TREASURY II, *supra* note 6, at 399.

Parties to a sale may contractually determine where title,[211] or risk of loss,[212] passes. While a rule allowing for manipulation of tax consequences without attendant economic or commercial significance clearly is questionable as a matter of tax policy, the title passage rule, when understood as a risk of loss passage rule, provides no such opportunities for manipulation. Any transfer of the risk of loss effects a real benefit to the party that is relieved of the risk and a real burden to the recipient.[213] The location at which risk of loss passes is negotiated by the parties, but, if an exporter departs from custom and passes title abroad,[214] it has undertaken additional responsibility with respect to those goods.

In a typical C.I.F. or F.O.B. contract, title and risk of loss pass to the buyer when the goods are delivered to a carrier.[215] The seller of the goods is freed from any hazards encountered after delivery. This is particularly beneficial to the seller where the carrier will be outside of the seller's home country throughout most of its journey. By passing risk of loss before shipment, the seller has relieved itself of risks occurring on foreign territory.[216] If, however, passage of title and risk of loss are delayed, the seller takes on the burden of additional risks. For example, the goods may be lost or damaged during shipment.[217] There may be delays in transit, which could cause damage to perishable goods or up-

211. *See* U.C.C. § 2-401 (1987) (except as otherwise provided in the U.C.C., "title to goods passes from the seller to the buyer in any manner and on any conditions explicitly agreed upon by the parties"); *accord* A.P. Green Export Co. v. United States, 284 F.2d 383, 387 (Ct. Cl. 1960). For examples of contractual recitals regarding passage of title, see R. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE—LEGAL FORMS §§ 1121-26 (1974 & Supp. 1989); F. HART & W. WILLIER, FORMS AND PROCEDURES UNDER THE UNIFORM COMMERCIAL CODE ¶ 22.07 (1990).

212. *See* U.C.C. § 2-509 (1987) (U.C.C. provisions allocating risk of loss "are subject to contrary agreement of the parties"). For examples of contractual recitals regarding risk of loss, see R. ANDERSON, *supra* note 211, §§ 1251-53; F. HART & W. WILLIER, *supra* note 211, ¶ 22.07.

213. *See* Barber-Greene Americas, Inc. v. Commissioner, 35 T.C. 365, 387-88 (1960).

214. Traditionally, F.O.B., C.I.F., and C. & F. are the most favored trade terms. Ramberg, *Incoterms 1980* in N. HORN & C. SCHMITTHOFF, THE TRANSNATIONAL LAW OF INTERNATIONAL COMMERCIAL TRANSACTIONS 137, 139 (1982). In sales utilizing any of these three trade terms, title passes to the purchaser upon delivery of the goods to the carrier. *See supra* notes 77 (C.I.F. and C. & F.) and 137 (F.O.B.).

215. *See supra* notes 77 (C.I.F. contracts) and 137 (F.O.B. contracts).

216. C. SCHMITTHOFF, EXPORT TRADE 22 (1990); Ramberg, *supra* note 214, at 139; *accord* Commissioner v. Pfaudler Inter-American Corp., 330 F.2d 365, 475 (2d Cir. 1964); Commissioner v. Hammond Organ W. Export Corp., 327 F.2d 964, 966 (7th Cir. 1964); Barber-Greene Americas, Inc. v. Commissioner, 35 T.C. 365, 387-88 (1960).

217. D. SASSOON, C.I.F. AND F.O.B. CONTRACTS ¶ 4 (3d ed. 1975).

set arrangements for local delivery or resale.[218] In addition, there are political risks; the business of a foreign purchaser may be subject to expropriation or confiscation by a governmental authority.[219]

One might argue that in modern day sales, risk of loss is limited by readily available insurance, and that the buyer ultimately bears the cost of insurance, either by purchasing coverage directly or by paying a price that reflects the cost of insurance purchased by the seller.[220] These arguments fail to take into account potential defenses on the part of insurance carriers, which could reduce proceeds or nullify coverage altogether.[221] For example, the loss event may be excluded from the policy,[222] the amount of insurance coverage may be inadequate,[223] or the seller may inadvertently fail to satisfy the terms of the policy.[224] In addition, if the party who was expected to obtain coverage fails to do so, then the party who bears the risk of loss indeed bears a very real economic risk. Insurance, then, does not provide full and complete protection in all circumstances.

One might also argue that the title passage rule, even when understood as a risk of loss passage rule, permits taxpayers to determine tax consequences contractually by arbitrarily agreeing upon the location of passage of risk of loss. In this event, a transaction could be structured

218. C. SCHMITTHOFF, *supra* note 216, at 108.

219. S. EZER, INTERNATIONAL EXPORTING AGREEMENTS ¶ 9.02[2] (1989); *accord* A.P. Green Export Co. v. United States, 284 F.2d 393, 390 (Ct. Cl. 1960); Tech. Adv. Mem. 82-10-018 (Nov. 25, 1981). *See also* Ramberg, *supra* note 214, at 140 (seller may choose to retain the risk of loss throughout shipment because ability to control goods contributes to likelihood that goods will arrive in good condition); *accord Hammond Organ*, 327 F.2d at 966.

220. Where the seller is required by the terms of the contract to obtain the insurance, e.g., in a C.I.F. contract, *see supra* note 98 and accompanying text, the policy must cover against risks that are customary or usual in the particular trade, with respect to the cargo and voyage in question. C. SCHMITTHOFF, *supra* note 216, at 38; BENJAMIN'S SALE OF GOODS ¶ 6147 (A. Guest ed., 3d ed. 1987); D. SASSOON, *supra* note 217, ¶ 183.

221. *See Barber-Greene*, 35 T.C. at 387-88.

222. It is not unusual for policies to exclude from coverage loss or damage resulting from, e.g., war, strikes or labor disturbances, or terrorists acts. C. SCHMITTHOFF, *supra* note 216, at 519-20; D. SASSOON, *supra* note 217, ¶¶ 125-134. An exclusion for loss or damage due to ordinary leakage also is common. C. SCHMITTHOFF, *supra* note 216, at 517. *See also* BENJAMIN'S SALE OF GOODS, *supra* note 220, ¶ 1653 (loss or damage due to transhipment and deviation).

223. In the absence of a clear custom of trade to the contrary, the seller is required to insure only the reasonable value of the goods at the place of shipment. Although this value normally would include the cost of the goods as well as freight and insurance, it would not include any anticipated rise in the value of the goods or profits expected by the buyer upon resale. C. SCHMITTHOFF, *supra* note 216, at 38-39; BENJAMIN'S SALE OF GOODS, *supra* note 220, ¶ 1655; D. SASSOON, *supra* note 217, ¶ 194.

224. It is not unusual for coverage to exclude loss or damage caused by insufficient packing of the goods. C. SCHMITTHOFF, *supra* note 216, at 518.

to afford desired tax consequences, rather than having the tax consequences flow from the structure of the transaction. Surely, it is preferable from a tax policy perspective that the latter be the norm. It would be naive, however, to ignore the role played by tax considerations in planning business transactions, including transactions with admittedly economic substance.

The ability to locate risk of loss passage contractually should not overshadow the fact that a party who benefits, taxwise, from locating passage of title and risk of loss in a particular location also undertakes risks, which could outweigh both the certainty of tax benefits and the tax dollars saved.[225] In light of the additional risks and uncertainties that are assumed, it is simplistic in the extreme to regard tax considerations as either the sole or principal driving force in negotiating the terms of international sales. Recognizing the importance of risks of ownership, by acknowledging risk of loss passage as determinative of source, simply reflects a recognition of reality in international sales transactions.

B. *A Risk of Loss Passage Rule Reflects the Economic Activity Generating the Income*

The second principle stated by the Treasury Department is that a source of income rule "should allocate income to the place where the economic activity generating that income occurs."[226] The Treasury Department argued that the title passage rule bears no relationship to the place where the economic activity generating the income occurs.[227]

The general approach advocated by the Treasury Department in 1984, and ultimately adopted by Congress in 1986 only as to sales of personal property other than inventory, was to source gains at the location of the seller's residence.[228] An exception applies if the predominant portion of the selling activity is conducted by the seller through a fixed place of business outside the seller's country of residence.[229] The aim of

225. The foreign tax credit depends not only on the fraction of worldwide income derived from foreign sources, but also on the amount of income derived by the taxpayer and the U.S. tax that otherwise would be payable.

226. TREASURY I, *supra* note 6, at 365. *Accord* TREASURY II, *supra* note 6, at 399; *see also* Garbarino, *supra* note 21, at 397.

227. TREASURY I, *supra* note 6, at 365. *Accord* TREASURY II, *supra* note 6, at 399.

228. I.R.C. § 865(a) (1988).

229. I.R.C. § 865(e)(1) (1988). The exception applies to nonresidents of the United States with respect to all sales of personal property, including inventory property, unless the property is sold for use, disposition, or consumption outside of the United States, and the taxpayer's foreign

the rule is to correlate the source of the income with the underlying selling activity.[230]

Admittedly, the new rules are consistent with the articulated Treasury Department principles. The new rules, despite their semantical symmetry with Treasury Department objectives, however, may operate in a way that is fundamentally inconsistent with sound taxing policy. In reality, a sale of goods that have been purchased by the seller for resale purposes is likely to involve economic activity at numerous locations. For example, the seller's home office may be located in a different country from the place where the goods were purchased, where the marketing activities occur, where the buyer is located, where the goods will be consumed, or where the seller's relationship with goods is severed. The seller's residence, then, is only one site at which substantive economic activities pertaining to the sale take place. In fact, if source is to depend upon economic activities, focusing on passage of risk of loss may be nearer to reality and more appropriate than a seller's residence rule, because it focuses on the goods themselves and on the quintessence of the seller's relationship with them, that is, the point at which the seller no longer maintains any real risks or responsibilities with respect to the goods.

C. *A Risk of Loss Passage Rule Is Clear and Readily Applied*

A third objective in formulating a sound and useful source rule might be a rule that is clearly understandable and may be readily applied.[231] The title passage rule, even where it is understood as a risk of loss passage rule, has the advantage of clarity and certainty. By applying pre-U.C.C. concepts, the point of title passage was an easily identifiable event,[232] with commercial, as well as tax, significance. A plethora

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office materially participates in the sale. I.R.C. § 865(e)(2)(B) (1988). *See supra* notes 58-62 and accompanying text.

230. TREASURY I, *supra* note 6, at 366; *accord* TREASURY II, *supra* note 6, at 402; H.R. REP. NO. 426, *supra* note 2, at 360-61.

231. Although this third objective was discussed in the Treasury report, TREASURY I, *supra* note 6, at 365; *accord* TREASURY II, *supra* note 6, at 399, the report did not explicitly contend that the principle is violated by the title passage rule. *See also* Garbarino, *supra* note 21, at 397.

232. *See, e.g.*, Commissioner v. Pfaudler Inter-American Corp., 330 F.2d 471, 474 (2d Cir. 1964); A.P. Green Export Co. v. United States, 284 F.2d 383, 388 (Ct. Cl. 1960). *But see* Garbarino, *supra* note 21, at 404. Although the normative principle is simple, Garbarino concludes that the title passage rule is difficult to administer. According to Garbarino, adjudication is required on a case-by-case basis because the rule is not clear when applied in varying fact patterns. Garbarino's conclusion in this regard is unsupported. A review of judicial consideration of the title passage rule indicates that relatively few courts have encountered any difficulties in applying the title

of statutory rules and judicial interpretations in the commercial area were available for guidance. Of course, the concept of title in tax cases suffered from the shortcomings of commercial law.[233] Under modern commercial law, however, pre-U.C.C. uncertainties no longer exist, and the point of risk of loss passage is both clear and easily identified.[234]

D. *A Risk of Loss Passage Rule Is Consistent with Judicial Precedent and Administrative Practice*

Both the courts and the I.R.S. have identified risk of loss as the essential component of ownership. Since the beginning of Stage Four,[235] courts almost invariably have mentioned or discussed the passage of risk of loss in lock step with title passage. Recent opinions of the Tax Court reflect an overt willingness to shift the focus from title to risk of loss.[236] These opinions recognize the attributes of ownership that reflect economic substance, namely responsibility for the goods and risk of loss or damage. Why, then, have the courts been reluctant to completely and explicitly abandon the concept of title? If the courts overcame their reluctance and recognized openly what they recognize in substance, then the charade of title passage would be abolished and risk of loss could find its rightful place in tax law, as it has in commercial law.

The government has itself stressed the importance of risk of loss in Treasury Regulations.[237] The regulations provide that, notwithstanding that gains are sourced at the location of title passage, "[w]here bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the *risk of loss*."[238] A risk of loss passage rule, then, is consistent with I.R.S. practice.

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passage rule to the particular transactions in issue. Where issues have arisen regarding application of the title passage rule, opinions have tended to focus on whether the title passage rule is the appropriate test, not on how to apply the title passage rule to the presented facts.

233. *See supra* notes 168-70 and accompanying text.

234. *See* U.C.C. §§ 2-509, 2-510 (1987); *accord* INCOTERMS 1990, *supra* note 77, at 52-53 (C.I.F. contracts), 38-39 (F.O.B. contracts).

235. *See supra* notes 135-61 and accompanying text.

236. Liggett Group, Inc. v. Commissioner, 58 T.C.M. (CCH) 1167 (1990); Kates Holding Co. v. Commissioner, 79 T.C. 700 (1982); Miami Purchasing Service Corp. v. Commissioner, 76 T.C. 818 (1981).

237. Treas. Reg. § 1.861-7(c) (1960). The regulation is based on Gen. Couns. Mem. 25,131, 1947-2 C.B. 85.

238. Treas. Reg. § 1.861-7(c) (1960) (emphasis added). *Cf. Kates*, 79 T.C. at 707. If the *Kates* court's construction of the regulation is correct, then perhaps the regulation ought to be

It is curious that the 1984 Treasury Department report omitted a discussion of the weight accorded risk of loss by the courts and the I.R.S. Thus, it is not surprising that the title passage rule, understood as connoting mere legal title, failed to meet the tax policy objectives outlined by the Treasury Department. If the title passage rule is understood as connoting a risk of loss passage rule, however, then the Treasury Department's tax policy principles would be satisfied.

V. CONCLUSION

The courts already have recognized that risk of loss is the predominant component of title. The Tax Court has even attempted to incorporate U.C.C. risk of loss concepts into title passage analyses. It is now time for the courts to take the next step by acknowledging explicitly that passage of risk of loss alone ought to determine the source of gains in international sales of personal property. It is not necessary to handcuff title and risk of loss together in legal discussions of source of income. Rather, risk of loss may be dealt with discretely and in its own right, supported by legal precedent and logic. The government's recent interest in litigating the title passage rule may represent the start of another effort to overturn title passage rule precedents in favor of a "final acts" analysis.[239] If so, courts will soon have a clear opportunity once and for all to set matters right and to embrace and adopt a risk of loss passage rule.

It is likely that Congress again will consider a total repeal of the title passage rule, in light of revenue estimates[240] and the Treasury Department's impending study.[241] Congress should recognize that the Treasury Department's 1984 repeal proposal was premised upon a misunderstanding of the title passage rule. The title passage rule in fact encompasses a risk of loss passage rule, under which determinations of source of income reflect the economic substance of underlying international sales transactions. When viewed in proper historical context, the title passage rule is consistent with international tax policy objectives, and a total repeal is not warranted.

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rewritten to place primary, if not exclusive, importance on passage of risk of loss.

239. *See supra* notes 186-98 and accompanying text.

240. *See supra* text accompanying notes 14-15. Of course, a repeal could be justified solely on the basis of financial concerns.

241. *See supra* notes 12-13 and accompanying text.