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Impact of the Proposed 863(d) and (e) Regulations on the Satellite Industry

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I. INTRODUCTION

On January 17, 2001, the Internal Revenue Service (IRS) issued proposed regulations under Sections 863(d) and (e)[1] addressing the source and characterization of income from space and ocean activities, and international communications activities, respectively.[2] The proposed regulations would make dramatic changes to the U.S. tax consequences for foreign and U.S. persons who have been applying, with minimal guidance, the general statutory rules enacted by the Tax Reform Act of 1986.[3]

This Article discusses the impact of the proposed regulations on both foreign and U.S. persons using examples from the satellite industry to illustrate that impact. The proposed regulations uniquely affect the satellite industry because it involves both communications and space activities.[4]

For U.S. persons, the proposed regulations would significantly change foreign tax credit (FTC) and Subpart F consequences when activities are conducted directly, through partnerships, or foreign corporations.[5] For foreign persons, the proposed regulations would

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1. Unless otherwise indicated, all "Code" section references are to the Internal Revenue Code of 1986 (as amended in 1995).

2. *See* Prop. Treas. Reg. §§ 1.863-8, 1.863-9, 66 Fed. Reg. 3903–16 (Jan. 17, 2001). The IRS scheduled a public hearing for March 28, 2001. *Id.* at 3903. Written comments and requests to speak at the hearing were due by March 7, 2001. *Id.* These regulations are proposed to apply for taxable years beginning on or after the date that is 30 days after the date of publication of the final regulations in the Federal Register. *Id.* at 3916.

3. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

4. Michael S. Lebovitz & Philip D. Mogen, *Taxation of Satellite Transactions: The View From 22,300 Miles*, 10 J. INT'L TAX'N 44, 48 (1999).

5. *Id.* at 49.

substantially alter current tax consequences, perhaps resulting in withholding in many cases.[6] Some foreign corporations or foreign partners of partnerships would incur U.S. tax liability for the first time.[7]

II. BACKGROUND

A. Source Rules, Generally

A general summary of the source rules will help in understanding the implications of the proposed regulations. These proposed rules substantially affect the extent to which the United States subjects income to taxation.

The United States subjects its own people to U.S. tax on income from sources within the United States (U.S. source income) and income from sources outside of the United States (foreign source income).[8] The United States claims the primary right to tax only U.S. source income, and therefore it does not allow foreign tax credits to offset this tax.[9] By contrast, the United States allows foreign tax credits to offset U.S. tax on foreign source income.[10] The amount of the foreign tax credit, however, is limited. Foreign taxes paid on one category of foreign source income, such as general business income, cannot offset the U.S. tax on another category of foreign source income, for instance, shipping income.[11] Under these rules, if two separate business activities generate the same category of income, foreign taxes imposed on the income from one activity can be cross-credited against the U.S. tax on income from the other activity.[12] Cross-crediting is not allowed between categories.[13]

In the case of foreign persons, the United States generally taxes U.S. source income on either a net or gross basis depending on whether the taxpayer has a trade or business, or permanent establishment in the United States.[14] The United States generally does not tax foreign

6. *See* discussion *infra* Part V.B.5.
7. *See id.*
8. *See generally* Tax Reform Act of 1986 §§ 1211–1249.
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*

source income unless it is connected with a trade or business that is conducted in the United States.[15]

B. Communications, Space, and Ocean Income

1. Congressional Concerns

Congress has expressed concern over granting a foreign tax credit absent double taxation—specifically, allowing cross-crediting against U.S. tax on income that a foreign country is unlikely to tax.[16] Due to Congress' belief that a foreign country was unlikely to tax income from space or ocean activity, Congress decided to prevent cross-crediting against the U.S. tax on this income by changing the statutory rules and enacting Section 863(d). These new statutory rules generally treat this income as 100% U.S. source income when derived by a U.S. person.[17] Congress reasoned, however, that income from communications activity was more likely to be subjected to foreign tax, and therefore modified U.S. law to a lesser extent by enacting Section 863(e) to generally treat income from international communications activity as 50% U.S. source and 50% foreign source when derived by a U.S. person.[18]

In addition, Congress was concerned that: (1) U.S. corporations might conduct activities through foreign corporations to alter the foreign tax credit consequences of the source rules for U.S. persons, and to defer U.S. tax,[19] and (2) foreign corporations might avoid U.S. tax on income from business activities conducted in the United States.[20] To deal with these concerns, Congress granted the U.S. Treasury the authority to issue regulations that create exceptions to the general statutory rules described above.[21]

2. Income from Space and Ocean Activity

Since 1986, the language of Sections 863(d) and (e) has provided the only guidance for sourcing income from space and ocean activity and international communications activity, respectively.[22] Under

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15. *Id.*

16. JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACTION OF 1986, 933 (JCS-10-87) (1997).

17. I.R.C. § 863(d) (1994).

18. JOINT COMM. ON TAXATION, *surpa* note 16, at 933.

19. *Id.* at 934.

20. *Id.*

21. *See generally id.*

22. I.R.C. § 863(d).

Section 863(d), income derived by a U.S. person from space and ocean activities is generally 100% U.S source income and such income derived by a foreign person is generally 100% foreign source.[23] Although it appears that Congress was primarily concerned with the taxation of U.S. persons, the statute permits regulations to change the source rules for both foreign and U.S. persons.[24]

For Subpart F purposes, the Tax Reform Act of 1986 treated a controlled foreign corporation's (CFC) income from space and ocean activities as "foreign base company shipping income" under Section 954(f). This rule subjects a U.S. shareholder of a CFC to potential current U.S. taxation of this income and prevents cross-crediting by causing this income to be placed in a separate foreign tax credit limitation.[25] This result reflects the congressional expectation that such income generally would not be subject to any foreign tax.[26]

3. Income from International Communications Activity

Under Section 863(e), 50% of the income derived by a U.S. person from space and ocean activities is U.S source and 50% is foreign source, while such income derived by a foreign person is 100% foreign source.[27] Again, although it appears that Congress was primarily concerned with the taxation of U.S. persons, the statute allows regulations to change the source rules for both foreign and U.S. persons.[28]

III. IMPACT OF THE PROPOSED REGULATIONS

A. *Character of Income: Space and Ocean or Communications?*

The consequences of the proposed regulations depend on the character of the income in question. The following section discusses the determination of whether income is from space, ocean, or international communications activity.

23. Lebovitz & Mogen, *supra* note 4, at 48.
24. *See generally* I.R.C. § 954(f).
25. I.R.C. § 904(d)(1)(D).
26. *See generally id.*
27. I.R.C. § 863(e).
28. *See generally id.*

1. Space and Ocean Activity

Space activity is any activity conducted in space, including: the provision of services in space; leasing equipment located in space (including spacecraft, satellites, and transponders); licensing technology or other intangibles for use in space; and the production, processing, or creation of property in space.[29]

Ocean activity is any activity conducted on or under international water.[30] Ocean activity includes: performance and provision of services in international water; leasing of equipment (including underwater cables) located in international water; licensing of technology or other intangibles for use in international water; the production, processing, or creation of property in international water; sales of property (other than inventory) on international water; communications activity (other than international communications activity); underwriting income from insurance of risks on activities that produce ocean income; any activity performed in Antarctica; leasing of a vessel that does not transport cargo or persons for hire between ports (e.g., includes leasing of a vessel to engage in research activity); and leasing of drilling rigs for extraction of minerals, and the performance and provision of services related thereto in international water.[31]

The Regulations broadly define space and ocean activities. A service performed in space or international water is a space or ocean activity, even if the activity is de minimis relative to other activities in the transaction.[32] As a result, income from activity both within and outside of space or international water can be sourced under the proposed regulations regarding income from space and ocean activity if they are considered to arise from the same transaction.[33] Similarly, certain communications activity apparently could be categorized as a space or ocean activity if even a de minimis portion were performed in

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29. *See* Prop. Treas. Reg. § 1.863-8(d)(1)(i), 66 Fed. Reg. 3911 (Jan. 17, 2001). "Space activity also includes underwriting income from insurance of risks on activities that produce space income." *Id.*

30. International water is defined as water that is not within the jurisdiction (as recognized by the United States) of a foreign country, U.S. possession, or the United States. *Id.* § 1.863-8(d)(1). Though the issue is beyond the scope of this Article, taxpayers should note that it is not exactly clear when territorial water becomes international water. For background on this topic, see Darren G. Pratt, *Three Knots or Twelve? At What Distance from Shore Do U.S. Waters Become the International High Seas for Federal Income Tax Purposes?*, 26 TAX MGM'T INT'L J. 332 (1997).

31. Prop. Treas. Reg. § 1.863-8(d)(1)(ii), 66 Fed. Reg. at 3911.

32. *Id.* § 1.863-8(d)(2)(ii)(A).

33. *Id.*

space or international water.[34] The proposed regulations would give great discretion to the Commissioner to broadly apply the source rules for space and ocean income by treating different activities as arising from a single transaction. The proposed regulations' broad definition of space and ocean activities overlaps with many communications activities and can cause some surprising and harsh results, which are discussed in detail below.

Space and ocean activity, however, does not include the taxpayer's communications made in the course of providing services that otherwise would not be, in whole or part, a space or ocean activity.[35] Only a taxpayer who performs such activities himself has income from space or ocean activity.[36] If a taxpayer obligated to perform such activity subcontracts that obligation to another person, only that other person has income from space or ocean activity.[37] This is consistent with the approach that the IRS and Treasury adopted in Treasury Regulation section 1.863-3 dealing with sourcing income from inventory sales.[38] The proposed regulations explicitly exclude from space and ocean activities any transportation, natural resource related, and international, but not other, communications activities,[39] which are addressed under other source rules in the Code. If an activity is not performed in space or international water, the IRS cannot treat income from that activity as income from space or ocean activity. The source of such income is determined by attempting to apply the other source rules set forth in Sections 861 through 865, including the rules regarding communications income (discussed below).[40]

2. Communications Activity

Proposed Treasury Regulation section 1.863-9(d)[41] defines communications activity as consisting solely of the delivery by transmission of communications or data.[42] This activity includes a

34. *See generally id.*

35. *Id.* § 1.863-8(d)(2)(ii)(B).

36. *Id.* § 1.863-8(a), 66 Fed. Reg. at 3910. It is not clear from the proposed regulations whether conducting activity through a partnership is considered a direct activity of the partner.

37. *See id.*

38. *See* Pmbl. to Prop. Treas. Reg. §§ 1.863-8, 1.863-9, 66 Fed. Reg. 3903–16 (Jan. 17, 2001).

39. Prop. Treas. Reg. § 1.863-8(d)(3), 66 Fed. Reg. at 3912.

40. I.R.C. §§ 861–865 (1994).

41. As previously mentioned, income from international communications activity is excluded from space/ocean activity. Prop. Treas. Reg. § 1.863-8(d)(3)(iii), 66 Fed. Reg. at 3912.

42. *Id.* § 1.863-9(d)(1), 66 Fed. Reg. at 3914.

provision for the capacity to transmit communications, but excludes delivery other than by transmission, such as delivery of physical packages and letters, and also excludes the provision of content or additional services along with or in connection with communications activity.[43] A taxpayer may derive income from communications activity even if it does not perform a transmission function.[44] This is in direct contrast to income from space or ocean activity discussed above. The critical requirement is that the taxpayer "is paid to transmit, and bears the risk of transmitting, the communications."[45] If the taxpayer is not paid to transmit, the income is not income from communications activity and, therefore, must be analyzed under other source rules.[46]

3. Communications Activity—U.S., Space/Ocean, Foreign, and International

Communications activity is delineated between U.S. communications activity, space or ocean communications activity, foreign communications activity, and international communications activity.[47] The determination of each type of communication is predicated on identifying the two points between which the taxpayer is paid to transmit the communications.[48] The taxpayer must establish, to the satisfaction of the Commissioner, the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting the communication.[49] If the taxpayer, whether a foreign or U.S. person, is unable to establish the transmission start and end points, then the IRS will presume the income to be 100% U.S. source.[50]

a. U.S. Communications Activity

Income derived by a taxpayer from U.S. communications activity, otherwise known as "U.S. communications income," is income derived from communications activity when the taxpayer is paid to transmit

43. *Id.* § 1.863-9(d)(1)(i).
44. *See id.*
45. *See id.* § 1.863-9(d)(2).
46. For example, the basic "place of performance" rule regarding the sourcing of services income may be applicable. *See* I.R.C. §§ 861(a)(3), 862(a)(3) (1994).
47. *See generally* Prop. Treas. Reg. § 1.863-9, 66 Fed. Reg. at 3913.
48. *Id.* § 1.863-9(d)(3)(i), 66 Fed. Reg. at 3914.
49. *Id.*
50. *Id.* § 1.863-9(b)(6).

between two points in the United States or between the United States and a point in space or in international water.[51]

b. Space/Ocean Communications Activity

"Space/ocean communications income" is income derived from a communications activity when the taxpayer is paid to transmit between a point in space or in international water and another point in space or in international water.[52]

c. Foreign Communications Activity

"Foreign communications income" is income derived from communications activity when the taxpayer is paid to transmit between two points in a foreign country or countries (or possession or possessions of the United States), or between a foreign country (or a possession of the United States) and a point in space or international water.[53]

d. International Communications Activity

International communications income (ICI) is income derived from communications activity when the taxpayer is paid to transmit between a point in the United States and a point in a foreign country or possession of the United States, or vice versa.[54]

Under Proposed Treasury Regulation section 1.863-9(d)(3)(i), the taxpayer must establish, to the satisfaction of the Commissioner, the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication.[55]

Consider the potential record-keeping and technology that must be created to enable a transmitter of communications to meet this requirement. Some transmitters might not have the capabilities to determine the exact locations of the beginning and end points of a transmission. For example, a digital wireless Internet service provider (ISP) might contract with a satellite operator to provide transmission capacity. That satellite operator is conducting communications and space activities under the proposed regulations, but may not know or care where a user is located when it accesses the ISP global wireless

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51. *Id.* § 1.863-9(d)(3)(iii), 66 Fed. Reg. at 3915.
52. *Id.* § 1.863-9(d)(v).
53. *Id.* § 1.863-9(d)(3)(iv).
54. *Id.* § 1.863-9(d)(3)(ii), 66 Fed. Reg. at 3914–15.
55. *Id.* § 1.863-9(d)(3)(i), 66 Fed. Reg. at 3914.

network using its satellite, especially if the user pays a lump sum under an unlimited usage plan. Another situation in which a company might not be able to keep track of starting and end points is a U.S. company that transmits data from the United States, using its satellite transponder, to foreign buyers, and also leases space on its satellite to other users. The U.S. company might not have a mechanism to keep track of where the lessees are receiving or sending their communications. In fact, the proposed regulations appear to contemplate that, "[w]hether the taxpayer contracts out part or all of the transmission function is not relevant [to the requirement to establish start and end points of transmissions]."[56]

4. Allocation Between Communications and Non-Communications Income

The IRS treats communications and non-communications activities separately, assuming neither is de minimis.[57] If both of these activities are part of a single contract, the taxpayer must allocate the gross income between them to the satisfaction of the Commissioner, "based on all relevant facts, and circumstances, which may include functions performed, resource employed, risks assumed, and any other contributions to value."[58] This standard provides little guidance on how to allocate income between communications income and space and ocean income when the taxpayer receives income from both types of activities in a single payment. An illustration of this issue in the context of allocating income between activities involving transmission, content, and use of infrastructure is set forth below.

Example 10 under Proposed Regulation section 1.863-9(f) describes a situation in which a U.S. company transmits television programs from the United States, using its satellite transponder, to a cable systems operator in Country Y.[59] The foreign cable systems operator receives the transmission and distributes the television programs to its customers in Country Y. The analysis accompanying the example merely states that the U.S. company has received income

56. *Id.*

57. Explanation of Provisions § A(2)(c), 66 Fed. Reg. 3904, 3905 (Jan. 17, 2001) (explaining the special rule for determining the source of income from services).

58. Prop. Treas. Reg. § 1.863-9(d)(1)(ii), 66 Fed. Reg. 3914 (Jan. 17, 2001). The allocation must be made on a timely filed original return. *Id.* § 1.863-9(g), 66 Fed. Reg. at 3916. The Commissioner may separate or combine transactions. *Id.* § 1.863-9(d)(1)(ii), 66 Fed. Reg. at 3914.

59. *Id.* § 1.863-9(f)(Ex. 10), 66 Fed. Reg. at 3916.

from both a communications activity (i.e., the transmission of the television programs) and from non-communications activities, presumably for the cost of the television programs themselves, the use of the of the satellite itself, and other infrastructure located within the United States.[60]

Taxpayers might have very different views on what comprises the payment for the transmission of the television programs. One might view the payment for the transmitted television programs in Example 10 as almost entirely for the television program content. For example, the foreign buyer might not really care how the content is delivered; it just cares that it receives the content. Under this economic rationale, the bulk of the payment to the U.S. company would be for non-communications income, presumably space and ocean income, and the bulk of the U.S. company-seller's income would be classified as 100% U.S. source income.[61]

Another taxpayer might view the bulk of income as a receipt for recouping the huge sunk costs of built infrastructure (i.e., the satellite). For example, the U.S. company might view income as mainly for the delivery of data by transmission because it could not transmit the television programs without the satellite. Under this economic rationale, the bulk of the payment to the U.S. company would be for communications income and the bulk of the U.S. company's income would be classified as 50% U.S and 50% foreign source income.[62]

The IRS and Treasury mention in the preamble to the proposed regulations that they believe their narrow view of the definition of communications income (i.e., the delivery by transmission or communication of data) is consistent with legislative history.[63] While this narrow definition may be true, how one computes the exact amount of income to allocate for communications income is still very subjective.

The interaction between the characterization and sourcing rules relating to space and ocean activity and communications activity are confusing at best. The distinction between character and source of income is difficult to separate, but the implications could greatly impact taxpayers, most likely for the worse.

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60. *Id.*
61. *See id.* § 1.863-8(b), 66 Fed. Reg. at 3910.
62. *Id.* § 1.863-9(b)(2)(i), 66 Fed. Reg. at 3913.
63. Explanation of Provisions, 66 Fed. Reg. 3904 (Jan. 17, 2001).

5. Characterization of Income

As described above, space and ocean activities includes activities occurring in space or in international water that are characterized as communications activity (other than international communications activity) under Section 1.863-8(d).[64] Therefore, the IRS may never consider international communications activity to be a space or ocean activity. As a result, any income earned as a result of such activity, in other words ICI, may never be characterized as space and ocean income. Because no express carve-outs exist for the other types of communications activities (i.e., U.S. communications activity, foreign communications activity, or space/ocean communications activity), the IRS will characterize these activities as space and ocean activity to the extent they involve transmission activity in space (e.g., via satellite) or international water (e.g., via undersea cables).[65] These various types of communications activity were defined earlier.[66]

6. Sourcing of Income

Gross income derived from space or ocean communications activity is generally is categorized according to the communications income sourcing rules rather than the space and ocean activity sourcing rules.[67] The communications activity sourcing rules provide that U.S. communications income will be deemed U.S. source income and foreign communications income will be deemed foreign source income.[68] Income derived by a foreign or U.S. person from space/ocean communications activity, however, is determined under the space and ocean sourcing rules.[69] This result occurs because the communications sourcing rules that direct taxpayers with space/ocean communications income back to the space and ocean sourcing rules do so with a specific reference to ignore the very rule that sent the taxpayer to the communications sourcing rules in the first place.[70] Thus, all communications income, except for space and ocean communications income, will be sourced according to the communications sourcing rules.

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64. Prop. Treas. Reg. § 1.863-8(d)(1)(i)–(ii), 66 Fed. Reg. at 3911.
65. *Id.*
66. *See supra* Part III.A.3.
67. Prop. Treas. Reg. § 1.863-8(b)(6), 66 Fed. Reg. at 3911.
68. *Id.* § 1.863-9(b)(3)–(4), 66 Fed. Reg. at 3914.
69. *Id.* § 1.863-9(b)(5), 66 Fed. Reg. at 3914.
70. *Id.* (citing Prop. Treas. Reg. § 1.863-8(b)(6), 66 Fed. Reg. at 3911).

Because certain communications income is characterized as space and ocean income under these proposed regulations, the U.S. shareholder(s) of a CFC that provides satellite communications services and earns foreign source communications income may be taxed currently on the CFC's income.[71] For example, if the communication between two foreign countries such as Singapore and China, involves a space-based satellite, the CFC's income will be characterized as space/ocean income and therefore will likely be currently taxable to its U.S. shareholders under Subpart F[72]. Moreover, those U.S. shareholders are unlikely to be able to claim a foreign tax credit for any foreign taxes imposed on this income against foreign source income from any other communications activity that did not, in part, take place in space or international water because communications income that is treated as derived from space and ocean activity is placed in the "shipping basket" under Section 904(d).[73]

While these results seem contrary to legislative intent,[74] the IRS and Treasury may believe that they did not have the authority to exclude foreign or U.S. communications income from space/ocean income because the statute only excluded "international communications income."[75] Notwithstanding any hesitancy to contradict statutory language, the effect of this rule is an expansion of Subpart F by re-characterizing income that might otherwise have been excluded as shipping income.

In contrast to the rules regarding communications income, services performed in space or international water are considered space or ocean activity even if de minimis relative to other activities in the transaction.[76] Arguably, all services income from an activity involving even de minimis amount of space activity is therefore treated entirely as foreign base company shipping income under Section 954(f).[77] There

71. *Id.* § 1.863-9(b)(4), 66 Fed. Reg. at 3914. This section, discussed later in this Article, states that income from foreign communications activity (i.e., transmission starting and ending in a foreign country) is foreign source income.

72. I.R.C. § 954(f) (1994).

73. *Id.* § 904(d)(1)(D).

74. Congress believed that communications income was subject to at least some foreign tax when it enacted the basic 50% foreign–50% U.S. source rule, causing certain communications income to be taxable under Subpart F and limiting the ability to take a foreign tax credit. *See generally id.* § 954(f). The consequences under these proposed regulations appear contrary to the belief that communications income is subject to foreign tax. Prop. Treas. Reg. § 1.863-8(b)(4)(ii), 66 Fed. Reg. 3910 (Jan. 17, 2001).

75. *See* I.R.C. § 904(d).

76. *See* Prop. Treas. Reg. § 1.863-8(d)(2)(ii)(A), 66 Fed. Reg. at 3911.

77. I.R.C. § 954(f).

is no relief under Section 954(f); the flush language at the end of Section 954(f) states that foreign base shipping income includes "any income derived from a space or ocean activity (as defined in Section 863(d)(2))."[78] There is also no relief under the allocation rule in Proposed Treasury Regulation section 1.863-8(b)(5) because that rule permits allocation of space and ocean and non-space and ocean income for sourcing purposes only, and not for recharacterizing the activity that gives rise to the income.[79] This expansive definition of space/ocean activity for services may effectively supersede the existing definition of foreign base company services income to include current foreign base company services income that has a de minimis component of space or ocean activity. Therefore, the proposed regulations create a harsher foreign tax credit than current law provides because it results in additional shipping basket income. There would also be a harsher result under Subpart F because there would be a loss of the ability to qualify for Subpart F exceptions for non-shipping income.[80] This approach is different from the rule for communications income, which excludes non-communications services from communications activity unless the non-communications activity is de minimis.[81]

In contrast to its broad definition of a space or ocean activity, the proposed regulations potentially provide a taxpayer who engages in a space or ocean activity with the ability to avoid deriving income from a space or ocean activity that is subject to sourcing under Section 863(d).[82] The proposed regulations state that a taxpayer can derive income from a space or ocean activity only by conducting that space or ocean activity directly.[83] Thus, if a taxpayer contracts with an unrelated person to do the actual conduct of a space or ocean activity, that taxpayer would apparently be able to avoid deriving income from that expansively defined space or ocean activity for purposes of applying the source rule in Section 863(d). That taxpayer, however, takes a risk that the independent contractor may fail to perform that activity.[84]

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78. *Id.*

79. Prop. Treas. Reg. § 1.863-8(b)(5), 66 Fed. Reg. at 3911.

80. Under Section 954(e), foreign base company services income only includes services that are performed for related parties outside the foreign corporation's country of incorporation. I.R.C. § 954(e). There are no such exceptions for foreign base company shipping income under Section 954(f). *See* I.R.C. § 954(f).

81. Prop. Treas. Reg. § 1.863-9(d)(i), 66 Fed. Reg. 3914 (Jan. 17, 2001).

82. I.R.C. § 863(d)(1) (1994).

83. Prop. Treas. Reg. § 1.863-8(a), 66 Fed. Reg. at 3910.

84. A possible explanation for this apparently schizophrenic aspect of the proposed space

IV. SOURCE AND OTHER TAX CONSEQUENCES OF SPACE AND OCEAN INCOME

A. Sourcing of Space and Ocean Income

1. U.S. Person

If a U.S. person derives income from space or ocean activity then that income will generally be treated as 100% U.S. source income.[85] For these purposes, a U.S. person includes: a citizen or resident of the United States; a domestic partnership; a domestic corporation; and a domestic estate or trust.[86] The determination of the source of income from space or ocean activity for a U.S. partnership will be made at the partnership level, so space and ocean income derived by a U.S. partnership always will be treated as 100% U.S. source, even if all of the partners are foreign.[87]

2. Non-U.S. Person

If a non-U.S. person derives income from space or ocean activity then that income will generally be foreign source income.[88] A non-U.S. person would be any person or entity that does not fall under the definition of a U.S. person. For a foreign partnership, the determination of the source of income from space or ocean activity will be made at the partner level.[89] The disparity in treatment of foreign and U.S. partnerships presumably is a result of concerns by the Treasury and IRS that U.S. persons might otherwise use a foreign partnership to obtain foreign source income by conducting activity through a foreign partnership rather than directly, thereby circumventing the purposes of Section 863(d).[90]

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and ocean source regulations could be that the Treasury felt obligated to conform this proposed rule to its position with respect to the effect of contract manufacturing on the application of the subpart F foreign base company sales rule. *See* Rev. Rul. 97-48, 1997-2 C.B. 89 (revoking Rev. Rul. 75-7, 1975-1 C.B. 244).

85. Prop. Treas. Reg. § 1.863-8(b)(1), 66 Fed. Reg. at 3910.

86. I.R.C. § 7701(a)(30).

87. Prop. Treas. Reg. § 1.863-8(e), 66 Fed. Reg. at 3912.

88. *Id.* § 1.863-8(b)(1), 66 Fed. Reg. at 3910.

89. *Id.* § 1.863-8(e), 66 Fed. Reg. at 3912.

90. Explanation of Provisions § B, 66 Fed. Reg. 3904, 3907 (Jan. 17, 2001) (discussing communications activity under Sections 863(a), (d), and (e)).

3. U.S.-Owned Foreign Corporations (Non-CFC)

If a U.S. person owns 50% or more of the vote or value of the stock of a foreign corporation (directly, indirectly, or constructively) that is not a CFC within the meaning of Section 957,[91] then all income derived by that foreign corporation from space or ocean activity is considered U.S. source income.[92] This provision would likely affect foreign corporations that are publicly traded on a U.S. stock exchange. As a practical matter, it would be quite onerous for such foreign corporations (and for its customers) to monitor ownership composition in order to determine the source of income from space and ocean activities. Furthermore, if a foreign corporation that is publicly traded on a U.S. stock exchange were able to monitor its ownership composition, it is not clear when the ownership composition should be determined (e.g., monthly, quarterly, or annually).

4. Foreign Person Engaged in a U.S. Trade or Business

If a foreign person, other than a CFC or a U.S.-owned foreign corporation, is engaged in a U.S. trade or business, all income derived by that person from space or ocean activity is presumed to be U.S. source income.[93] If the foreign person, however, can allocate income between sources within the United States, space, or international water, and sources outside the United States, space, or international water,[94] then space or ocean income allocated to sources outside the United States, space, or international water shall be treated as foreign source.[95] When a taxpayer allocates gross income to the satisfaction of the Commissioner, he does so by making the allocation on a timely filed original return (including extensions).[96] An amended return does not qualify, and Section 9100 relief will not be available.[97]

B. Source of Income from the Sale of Property

A taxpayer must apply the rules of Section 863(d) and the proposed regulations to determine the source of income from sales of

91. I.R.C. § 957(a).

92. Prop. Treas. Reg. § 1.863-8(b)(2), 66 Fed. Reg. at 3910.

93. *Id.* § 1.863-8(b)(3).

94. The determination will be based upon facts and circumstances, but the allocation may be based upon functions performed, resources employed, risks assumed, or other contributions to value.

95. Prop. Treas. Reg. § 1.863-8(b)(3), 66 Fed. Reg. at 3910.

96. *Id.* § 1.863-8(g), 66 Fed. Reg. at 3912.

97. *Id.*

property purchased or produced by the taxpayer, either when the sale occurs in space or in international water, or when the taxpayer produces the property in whole or in part in space or in international water.[98] In essence, these rules adapt the residency and title passage rules of Section 865 and Treasury Regulation section 1.861-7(c), and the 50/50 rules of Treasury Regulation section 1.863-3 for the space, ocean, and communications contexts.[99]

1. Sales of Purchased Property

When a taxpayer sells property (i.e., transfers right, title, and interest) in space or in international water, the source of gross income will be determined under the general sourcing provisions for space and ocean activity contained in the proposed regulations, discussed above.[100] Generally, income from property sold by a U.S. person is U.S. source income. Income from property sold by a foreign person is foreign source income unless the foreign person is at least 50% U.S.-owned, is engaged in a trade or business in the United States, or has a fixed place of business in the United States.[101]

These general rules do not apply, however, to a taxpayer's sale of inventory on international water. The definition of ocean activity excludes the sale of inventory on international water.[102] Consequently, the source of income on sales of inventory on international water is determined under Treasury Regulation section 1.863-3(c)(2).[103]

2. Sales of Property Produced by Taxpayer

The general sourcing provisions for space and ocean activity contained in the proposed regulations may also be applied to determine the source of income from sales of property produced by a taxpayer.[104] A taxpayer who produces the property he sells, however, must first divide gross income from such sales between production activity and sales activity under a 50/50 method.[105] The source of the income attributable to the production and sales activities, respectively, are

98. *Id.* § 1.863-8(d).
99. I.R.C. § 865 (1994); Treas. Reg. §§ 1.861-7(c), 1.863-3 (revised as of Apr. 1, 2000).
100. Prop. Treas. Reg. § 1.863-8(b)(4)(i), 66 Fed. Reg. at 3910.
101. *Id.*
102. *Id.* § 1.863-8(d)(1)(ii), 66 Fed. Reg. at 3911.
103. Treas. Reg. § 1.863-3(c)(2).
104. Prop. Treas. Reg. § 1.863-8(b)(4)(i), 66 Fed. Reg. at 3910.
105. *See id.* § 1.863-8(b)(4)(ii)(A).

determined separately.[106] For these purposes, property is "produced" if the taxpayer engages in an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages property within the meaning of Section 864(a) and Treasury Regulation section 1.864-1.[107]

Under this 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity.[108] The remaining one-half of such gross income will be considered attributable to sales activity and the source of this income will be determined under the provisions mentioned above relating to the place of sale of purchased property. These provisions generally determine source for non-inventory property based upon whether the seller is a foreign or U.S. person.[109] If the taxpayer, however, sells such property outside of space or outside of international water, the source of gross income attributable to sales activity will be determined under the traditional rules under Section 863(b) for determining the source of income from sales of inventory.[110]

3. Income Attributable to Production Activity

As discussed above, when production activity occurs only in space or in international water, the source of that income will be determined under the general sourcing provisions for space and ocean activity contained in the proposed regulations.[111] Generally, under those rules, income from property sold by a U.S. person is U.S. source income, and income from property sold by a foreign person generally is foreign source income unless the foreign person is at least 50% U.S.-owned, is engaged in a trade or business in the United States, or has a fixed place of business in the United States.[112]

By contrast, when production activity occurs only outside space or international water, the traditional sourcing principles of Section 863(b) determine the source of income attributable to production activity.[113] Under those principles, the source is determined under Treasury Regulation section 1.863-3(c)(1)[114] or the similar rules

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106. *See id.*
107. *Id.* § 1.863-8(d)(2)(i), 66 Fed. Reg. at 3911.
108. *Id.* § 1.863-8(b)(4)(ii)(A), 66 Fed. Reg. at 3910.
109. *Id.*
110. *Id.*
111. *Id.* § 1.863-8.
112. *Id.* § 1.863-8(b)(4)(ii)(B).
113. *See id.* (citing Treas. Reg. § 1.863-3(c)(1)).
114. *Id.*

provided in the proposed regulations depending upon the situs of the production activity.[115]

When property is produced both in space or in international water and outside space or international water, gross income must be allocated to production occurring in space or in international water and production occurring outside space or international water.[116] The source of gross income allocated to space or international water is determined under the general sourcing provisions for income from space or ocean activity discussed above, which generally determine source for non-inventory property based upon whether the seller is a foreign or U.S. person.[117] The source of gross income allocated outside space and international water is determined under Treasury Regulation section 1.863-3(c)(1), and the traditional sourcing principles of Section 863(b).[118]

4. Income Attributable to Sales Activity

Under the 50/50 method, one-half of the gross income will be considered attributable to sales activity and the source of that income will be determined under the provisions in the proposed regulations that are applicable to the sales of purchased property.[119] The source of income from a sale occurring in space or international water is generally determined based upon whether the seller is a foreign or U.S. person.[120] A sale is deemed to take place in space or in international water if the property is located in space or in international water when rights, title, and interest pass to the buyer (or when bare legal title is retained, at the time and place of passage of beneficial ownership of risk of loss), or if property is sold for use in space or in international water.[121] Thus, the sales portion of the 50/50 method should always be U.S. source if sold by a U.S. person.

A traditional business model of global income exists in the satellite industry, involving companies that both produce and sell their own satellites. The production activities are probably conducted in the

115. *Id.* § 1.863-8(b)(4)(ii)(A).

116. *Id.* § 1.863-8(b)(4)(ii)(C), 66 Fed. Reg. at 3910–11. The determination must be "based on all the facts and circumstances, which may include functions performed, resources employed, risks assumed, and any other contributions to value." *Id.*

117. *Id.*

118. *Id.*

119. *Id.* § 1.863-8(b)(4)(ii)(A), 66 Fed. Reg. at 3910.

120. *Id.* § 1.863.8(b)(1).

121. *Id.* § 1.863-8(d)(2)(iii), 66 Fed. Reg. at 3912.

United States and as a result, that portion of the income under the 50/50 method has been U.S. source. The U.S. companies, however, may structure their sales so that the titles to the satellites pass outside the United States, arguably giving rise to foreign source income for the remaining half of the income generated from the sale. The sourcing rules under the proposed regulations would now likely treat both the production activity (to the extent performed in the United States) and the sales activity as U.S. source.[122] This, of course, could affect a U.S. corporations foreign tax credit limitation and possibly result in double taxation.

C. Source of Income from Space/Ocean Services

Unlike the rules regarding communications income, the source of all income from space/ocean services activities generally is determined under Proposed Treasury Regulation section 1.863-8(b)(1), (2), or (3), which generally bases the source determination on whether the seller is a foreign or U.S. person, even if a de minimis portion of the services is being performed in space or in international water.[123] Services are performed in space or in international water if functions are performed, resources employed, risks assumed, or other contributions to value occur in space or in international water, regardless of whether performed by personnel, equipment, or otherwise.[124] An activity generally will not be considered a space or ocean activity, however, if performed by another taxpayer.[125] Consequently, a taxpayer's income from an activity will not be space or ocean income that is sourced under these proposed regulations to the extent attributable to activities that the taxpayer contracts out to other persons.

In determining the source of income, a taxpayer may allocate gross income between services in space/ocean and outside space/ocean based upon all facts and circumstances "including functions performed, resources employed, risks assumed, or other contributions to value," if to the satisfaction of the Commissioner.[126] This rule places the burden

122. *See id.* § 1.863(b)(1), 66 Fed. Reg. at 3910.

123. *See id.* § 1.863-8(d)(2)(ii)(A), 66 Fed. Reg. at 3911. "If a transaction is characterized as the performance of a service, then such service will be treated as a space or ocean activity when a part, even if de minimis, is performed in space or in international water." *Id.*

124. *Id.*

125. *See id.* § 1.863-8(a), 66 Fed. Reg. at 3910. This regulation is subject to the treatment of consolidated groups in Treas. Reg. § 1.1502-13. *Id.*

126. *Id.* § 1.863-8(b)(5), 66 Fed. Reg. at 3911. Making such an allocation might require the support of an economic study prepared in accordance with I.R.C. § 482. *See* I.R.C. § 482 (1994).

on the taxpayer to establish relative value of the space/ocean portion of any income producing activity.[127] The IRS has the power to reject taxpayer allocations, and that rejection cannot be overturned unless the taxpayer can meet an "abuse of discretion" standard.[128] Because this standard is extremely difficult to meet, the IRS effectively will have veto power over taxpayer allocations.[129]

V. SOURCE AND OTHER TAX CONSEQUENCES OF COMMUNICATIONS INCOME

The type of communications income in question will have as much bearing on the sourcing and the consequences as does the residence of the taxpayer earning the communications income.

A. Sourcing of Non-ICI

If a foreign or U.S. taxpayer is unable to establish the communications transmission start and end points, then the income will be presumed to be 100% U.S. source.[130] U.S. communications income derived by either a foreign or U.S. person will always be U.S. source income.[131] Foreign communications income derived by either a foreign or U.S. person will always be foreign source income.[132]

B. Sourcing of ICI

1. U.S. Person

A U.S. person who derives ICI will source that income 50% U.S. source and 50% foreign source.[133] The proposed regulations do not alter the statutory provision as it relates to U.S. persons.[134] For these purposes, a U.S. person includes a citizen or resident of the United States, a domestic partnership, a domestic corporation, and a domestic estate or trust.[135] In the case of a U.S. partnership, the determination of

127. Prop. Treas. Reg. § 1.863-8(b)(5), 66 Fed. Reg. at 3911.
128. *See generally id.*
129. *See id.* § 1.863-8(g), 66 Fed. Reg. at 3913 (describing the reporting and documenting requirements).
130. *Id.* § 1.863-9(b)(6), 66 Fed. Reg. at 3914.
131. *Id.* § 1.863-9(b)(3).
132. *Id.* § 1.863-9(b)(4).
133. I.R.C. § 863(e)(1)(A) (1994); Prop. Treas. Reg. § 1.863-9(b)(2)(i), 66 Fed. Reg. at 3913.
134. *See id.*
135. I.R.C. § 7701(a)(30).

the source of the ICI will generally be made at the partnership level.[136] If foreign persons own 50% or more of the partnership interests, however, then the determination of the source of income from international communications activity will be made at the partner level.[137] This serves as an additional anti-abuse rule that applies to ICI, but is not contained in the space and ocean income provisions.[138]

2. Non-U.S. Person

If a non-U.S. person derives income from international communications activity then that income will generally be foreign source income.[139] Consequently, a non-U.S. person would be any person or entity that is not mentioned above as being a U.S. person. In the case of a foreign partnership, the determination of the source of the ICI will be at the partner level.[140] The disparity in the treatment of foreign and U.S. partnerships is a result of concerns by the Treasury and IRS that U.S. persons may use a foreign partnership to circumvent the purposes of Section 863(e).[141]

3. U.S.-Owned Foreign Corporations (Non-CFC)

If a U.S. person owns 50% or more of the vote or value of the stock of a U.S.-owned foreign corporation (directly, indirectly, or constructively), then all income derived by that foreign corporation from space or ocean activity is U.S. source income.[142] This provision mirrors the one contained in the space and ocean activity regulations, and consequently will give rise to the same issues relating to the ownership composition and its impact on the foreign corporations sourcing of its income.[143]

4. Foreign Person with a Fixed Place of Business in the United States

If a foreign person (other than a U.S.-owned foreign corporation (non-CFC)) maintains an office or other fixed place of business in the United States, the foreign person's ICI attributable to the office or other

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136. Prop. Treas. Reg. § 1.863-9(e)(1), 66 Fed. Reg. at 3915.
137. *Id.* § 1.863-9(e)(2).
138. The preamble to the proposed regulations does not provide any guidance as to what abuses the Treasury and IRS were trying to prevent by having this added provision.
139. Prop. Treas. Reg. § 1.863-9(b)(2)(ii)(A), 66 Fed. Reg. at 3913.
140. *Id.* § 1.863-9(e)(1), 66 Fed. Reg. at 3915.
141. *Id.* §§ 1.863-8, 1.863-9, 66 Fed. Reg. at 3907.
142. *Id.* §1.863-9(b)(2)(ii)(B), 66 Fed. Reg. at 3913.
143. *See supra* Part IV.A.3.

fixed place of business is from sources within the United States.[144] The principles of Section 864(c)(5) apply in determining whether a foreign person has an office or fixed place of business in the United States.[145]

5. Foreign Person Engaged in a U.S. Trade or Business

If a foreign person (other than a U.S.-owned foreign corporation (non-CFC)) is engaged in a U.S. trade or business, all of the foreign person's ICI is presumed to be U.S. source.[146] If the foreign person can allocate income between sources within the United States, or space, or international water and sources outside the United States, space, or international water,[147] then the income allocated to sources outside the United States, space, or international water shall be treated as foreign source.[148] When a taxpayer allocates gross income, to the satisfaction of the Commissioner, he does so by making the allocation on a timely filed original return.[149] An amended return does not qualify, and Section 9100 relief will not be available.[150]

These exceptions to the general rule that foreign persons earn foreign source income effectively cause foreign corporations to treat income that had previously been foreign source income as U.S. source income. As a result, foreign and U.S. customers of these foreign corporations could be required to withhold and pay over U.S. tax from their payments to these foreign corporations. Generally, an obligation to withhold arises when a U.S. payor is making a U.S. source payment of income that constitutes fixed, determinable, annual, or periodic (FDAP)[151] income to a foreign payee.[152] To the extent that the

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144. Prop. Treas. Reg. § 1.863-9(b)(2)(ii)(C), 66 Fed. Reg. at 3914.

145. *Id.*

146. *Id.* § 1.863-9(b)(2)(ii)(D).

147. *Id.* (providing that this determination is "based on the facts and circumstances, which may include functions performed, resources employed, risks assumed, or other contributions to value.").

148. *Id.*

149. Prop. Treas. Reg. § 1.863-9(g), 66 Fed. Reg. at 3916.

150. *Id.*

151. Treas. Reg. § 1.1441-2(a) (2000). This provision provides that, generally speaking, "fixed or determinable annual or periodical" (FDAP) income is subject to withholding under Section 1441. Treasury Regulation Section 1.1441-2(b) defines FDAP income as "all income included in gross income under section 61" with some exceptions. Treas. Reg. § 1.1441-2(b). Treasury Regulation Section 1.1441-2(b)(2) provides exceptions from FDAP income that include gains derived from the sale of property and any other income the IRS may determine. Treas. Reg. § 1.1441-2(b)(2). Section 1.1441-2(c) further expands the exceptions: (1) gains on the disposal of timber, coal, or domestic iron ore with a retained economic interest; and (2) gains relating to

payment made by customers to a foreign corporation represents effectively connected income, however, no withholding obligation should exist.[153] Consequently, foreign and U.S. customers could be liable for the withholding tax, penalties, and interest if they fail to withhold and pay over the tax.[154] The impact on existing operations is particularly onerous. For example, customers of existing 50% U.S.-owned foreign partnerships or joint ventures will suddenly have newly-created withholding obligations, potentially midway through a taxable year, and under an existing contract. This withholding obligation is also burdensome because the customers making payments will not be able to easily determine whether the payments they make to foreign corporations are treated as U.S. source income under the proposed regulations.[155]

To the extent a foreign corporation earns U.S. source income subject to withholding, but its customers fail to withhold, that foreign corporation is subject to a 30% tax on gross income under Section 881. In either case, the foreign corporation would be entitled to only $70 of a $100 customer bill. Because the tax is imposed on gross receipts, this result could cause the foreign corporation to have a net loss on that transaction.

B. Treaty Considerations

Tax treaties entered into by the United States may alter the U.S. tax consequences that result under the proposed regulations. In general, tax treaties may reduce or limit U.S. withholding taxes, may limit U.S. tax on business income to that income attributable to a permanent establishment in the United States, may alter sourcing rules otherwise applicable under the Code in order to allow a foreign tax credit that can reduce double taxation of income that the treaty permits a foreign country, and may prevent discriminatory treatment of foreign

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contingent payments received from the sale or exchange of patents, copyrights, and similar intangible property. Treas. Reg. § 1.1441-2(c).

152. Treas. Reg. §§ 1.1441-1(b), 1.1441-2(a).

153. *Id.* § 1.1441-4(a)(2).

154. *See* I.R.C. §§ 1441–1442 (1994).

155. For example, the source of income may vary depending upon: (1) whether the corporation receiving payment is foreign or U.S.-based; (2) the percentage of U.S. ownership of any foreign corporation receiving payments; (3) whether the foreign corporation is providing services from a point in the United States to a point in a foreign country, in space, or in international water; or (4) whether an activity constitutes transmission of communications or data, and the extent to which the foreign corporation bears risk of loss. Understandably, in many instances, customers will not have such information.

persons.[156] A detailed discussion of how U.S. tax treaties may alter the U.S. tax consequences of these proposed regulations is beyond the scope of this Article. A few general observations, however, are appropriate.

The proposed regulations do not purport to override U.S. tax treaties.[157] Accordingly, although the proposed regulations may alter the result under current U.S. income tax rules and subject certain foreign persons who derive income from communications activities and space/ocean activities to U.S. income tax (by declaring that income of such foreign persons is from U.S. sources), it appears that any U.S. tax liability on U.S. source income created by the proposed regulations might be reduced or eliminated under U.S. treaty obligations. To the extent that the resulting U.S. tax is presumed to be the 30% tax on gross income under Sections 871(a) and 881,[158] it would appear that foreign and U.S. customers paying U.S. source income to a foreign person would have to withhold U.S. tax from those payments unless the foreign person affirmatively claimed a tax treaty benefit by providing the customer with the appropriate documentation before the payment is made.[159]

Although the proposed regulations characterize income from communications activities or from space or ocean activities, they do so for purposes of determining the source of such income.[160] The proposed regulations do not appear to alter the characterization of such income for other U.S. tax purposes, including the application of U.S. income tax treaties. For example, a payment to a U.S.-owned foreign corporation for the right to use intangible property in space would be treated as income from a space activity[161] that is U.S. source income under the proposed regulations.[162] To the extent the payment satisfied the definition of a royalty for purposes of a U.S. income tax treaty, the U.S. tax on such U.S. source income could be reduced or eliminated under a U.S. income tax treaty. Similarly, although a payment to a U.S.-owned foreign corporation (i.e., income) for international communications services is U.S. source income under the proposed

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156. Explanation of Provisions § B(2)(a), 66 Fed. Reg. 3904, 3907 (Jan. 17, 2001).

157. *Id.* "When a foreign person is entitled to the benefits of a tax treaty with the United States, such person may elect to be taxed under the rules of that treaty." *Id.*

158. I.R.C. §§ 871(a), 881. This tax is collected by withholding under the regulations contained in Sections 1441 and 1442. I.R.C. §§ 1441–1442.

159. Explanation of Provisions § B(2)(a), 66 Fed. Reg. 3904, 3907 (Jan. 17, 2001).

160. Prop. Treas. Reg. § 1.863-8(b)(6), 66 Fed. Reg. 3911 (Jan. 17, 2001).

161. *Id.* § 1.863-8(d)(1)(i).

162. *Id.* § 1.863-8(b)(2), 66 Fed. Reg. at 3910.

regulations,[163] it also satisfies the definition of business profits for purposes of a U.S. income tax treaty.[164] The U.S. tax on such U.S. source income, however, could be eliminated under a U.S. income tax treaty if the foreign person did not have a permanent establishment in the United States to which that income was attributable.

The U.S. tax treaties do permit the United States, however, to tax foreign persons on their U.S. source income in many situations. In some of those situations, the proposed regulations could impose a more burdensome U.S. tax on some foreign corporations than on U.S. corporations.[165] An issue exists as to whether a U.S. tax treaty might prevent such a discriminatory result. The answer might depend on the precise wording of the relevant nondiscrimination article of a specific U.S. tax treaty.

For example, income derived by a foreign corporation that is 50% owned by U.S. persons and 50% owned by foreign persons who are qualified residents under a U.S. income tax treaty would be considered 100% U.S. source if derived from international communications activities.[166] If this income was attributable to a permanent establishment that the foreign corporation had in the United States, then the United States would be allowed to tax the full amount of that income under a typical business profits article of a U.S. tax treaty. That income is treated as 100% U.S. source income, so the foreign person could not satisfy its U.S. tax liability on such income with a credit for any foreign taxes it paid on the same income. By contrast, an identical amount of income derived by a U.S. corporation from the same activity would be considered to be 50% U.S. source income and 50% foreign source income. Although the full amount of such income also would be taxable to the U.S. corporation as it was to the foreign corporation, the U.S. corporation could satisfy its U.S. tax on the foreign source half of that income with a credit for any foreign taxes it paid on the same income. The difference in the source label given such income in the hands of the foreign corporation and the U.S. corporation results in a higher net U.S. tax liability on the foreign corporation.

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163. *Id.* § 1.863-9(b)(2)(ii)(B).

164. *See* Explanation of Provisions § B(2)(a), 66 Fed. Reg. 3904, 3907 (Jan. 17, 2001).

165. *Compare supra* Part II.A (mentioning that the United States generally does not tax foreign source income unless it is connected with a trade or business that is conducted in the United States) *with* Prop. Treas. Reg. § 1.863-9(b)(2)(ii)(D) (discussing income derived by foreign persons engaged in a U.S. trade or business).

166. Prop. Treas. Reg. §1.863-9(b)(2)(ii)(B), 66 Fed. Reg. at 3910.

VI. CONCLUSION

The proposed regulations regarding the source and characterization of income from space/ocean activities and communications activities, if finalized in their current form, would have a dramatic impact on the taxation of the satellite and other high-growth industries. As illustrated above, the requirement that taxpayers establish the two points between which the taxpayer is paid to transmit may force some companies to change the way they do business. The overlap between space or ocean activity and communications activity—especially in a world where a growing percentage of communications are transmitted via satellites and/or undersea fiber-optic cables—effectively expands the scope of Subpart F income and creates adverse FTC consequences. These proposed regulations essentially convert certain income from foreign source to U.S. source income. Therefore, some foreign corporations and foreign partners in joint ventures will likely incur tax for the first time and face a myriad of potential withholding obligations.

These are just some examples of the potential adverse consequences of the proposed regulations. It is important to recognize that these regulations have a broad impact as communication revolutionizes the world economy. Interested parties should carefully parse through these complex regulations and make sure their voices are heard.