

(b) In 1967, A receives only the \$20,000 paid by M Corporation on the execution of the contract of sale. No gain is realized by A upon receipt of this amount, and his unrecovered adjusted basis in the patent is reduced to \$8,800 (\$28,800 less \$20,000).

(c) In 1968, M Corporation has gross sales of \$600,000 from products manufactured under the patent. Consequently, for 1968, M Corporation pays \$22,000 to A, \$10,000 being the annual installment on the fixed payment and \$12,000 being payments under the terms of the royalty provision. A's recognized gain for 1968 is \$13,200 (\$22,000 reduced by the unrecovered adjusted basis of \$8,800). Of the total gain of \$13,200, gain in the amount of \$6,000 ($\$10,000 - [\$8,800 \times \$10,000 / \$22,000]$) is considered to be from the fixed installment payment and of \$7,200 ($\$12,000 - [\$8,800 \times \$12,000 / \$22,000]$) is considered to be from the royalty payment. Since 54.5 percent ($\$7,200 / \$13,200$) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, all of the \$13,200 gain recognized in 1968 is treated, for purposes of section 871(a)(1)(D) and section 1441(b), as being from payments which are contingent on the productivity, use, or disposition of the patent.

Example 2. (a) F, a foreign corporation using the calendar year as the taxable year and not engaged in trade or business in the United States, holds a U.S. patent on certain property which it developed through its own efforts. Corporation F uses the cash receipts and disbursements method of accounting. On December 1, 1966, F Corporation enters into an agreement of sale with D Corporation, a domestic corporation, whereby D Corporation purchases the exclusive right and license, and the right to sublicense to others, to manufacture, use, and/or sell certain devices under the patent in the United States during the term of the patent. The agreement grants D Corporation the right to dispose, anywhere in the world, of machinery manufactured in the United States and equipped with such devices. Corporation D is granted the right, at its own expense, to prosecute infringers in its own name or in the name of F Corporation, or both, and to retain any damages recovered.

(b) Corporation D agrees to pay to F Corporation annually \$5 for each device manufactured under the patent during the year but in no case less than \$5,000 per year. In 1967, D Corporation manufactures 2,500 devices under the patent; and, in 1968, 1,500 devices. Under the terms of the contract D Corporation pays to F Corporation in 1967 \$12,500 with respect to production in that year and \$7,500 in 1968 with respect to production in that year. F Corporation's basis in the patent at the time of the sale is \$17,000.

(c) With respect to the payments received by F Corporation in 1967, no gain is realized

by that corporation and its unrecovered adjusted basis in the patent is reduced to \$4,500 (\$17,000 less \$12,500).

(d) With respect to the payments received by F Corporation in 1968, such corporation has recognized gain of \$3,000 (\$7,500 reduced by unrecovered adjusted basis of \$4,500). Of the total gain of \$3,000, gain in the amount of \$2,000 ($\$5,000 - [\$4,500 \times \$5,000 / \$7,500]$) is considered to be from the fixed installment payment and of \$1,000 ($\$2,500 - [\$4,500 \times \$2,500 / \$7,500]$) is considered to be from payments which are contingent on the productivity, use, or disposition of the patent. Since 33.3 percent ($\$1,000 / \$3,000$) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, only \$1,000 of the \$3,000 gain for that year constitutes gains which, for purposes of section 881(a)(4) and section 1442(a), are from payments which are contingent on the productivity, use, or disposition of the patent. The balance of \$2,000 is gain from the sale of property and is not subject to tax under section 881(a).

(g) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966, but only in respect of gains from sales or exchanges occurring after October 4, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44224, Dec. 23, 1974]

§ 1.871-12 Determination of tax on treaty income.

(a) *In general.* This section applies for purposes of determining under § 1.871-7 or § 1.871-8 the tax of a nonresident alien individual, or under § 1.881-2 or § 1.882-1 the tax of a foreign corporation, which for the taxable year has income described in section 872(a) or 882(b) upon which the tax is limited by an income tax convention to which the United States is a party. Income for such purposes does not include income of any kind which is exempt from tax under the provisions of an income tax convention to which the United States is a party. See §§ 1.872-2(c) and 1.883-1(b). This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year.

(b) *Definition of treaty and nontreaty income—(1) In general.* (i) For purposes of this section the term "treaty income" shall be construed to mean the

gross income of a nonresident alien individual or foreign corporation, as the case may be, the tax on which is limited by a tax convention. The term “non-treaty income” shall be construed, for such purposes, to mean the gross income of the nonresident alien individual or foreign corporation other than the treaty income. Neither term includes income of any kind which is exempt from the tax imposed by chapter 1 of the Code.

(ii) In determining either the treaty or nontreaty income the gross income shall be determined in accordance with §§ 1.872-1 and 1.872-2, or with §§ 1.882-3 and 1.883-1, except that in determining the treaty income the exclusion granted by section 116(a) for dividends shall not be taken into account. Thus, for example, treaty income includes the total amount of dividends paid by a domestic corporation not disqualified by section 116(b) and received from sources within the United States if, in accordance with a tax convention, the dividends are subject to the income tax at a rate not to exceed 15 percent but does not include interest which, in accordance with a tax convention, is exempt from the income tax. In further illustration, neither the treaty nor the nontreaty income includes interest on certain governmental obligations which by reason of section 103 is excluded from gross income, or interest which by reason of a tax convention is exempt from the tax imposed by chapter 1 of the Code.

(iii) For purposes of applying any income tax convention to which the United States is a party, original issue discount which is subject to tax under section 871(a)(1)(C) or 881(a)(3) is to be treated as interest, and gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4) are to be treated as royalty income. This subdivision shall not apply, however, where its application would be contrary to any treaty obligation of the United States.

(2) *Application of permanent establishment rule of treaties.* In applying this section with respect to income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or foreign corporation, see section 894(b), which

provides that with respect to such income the nonresident alien individual or foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year for purposes of applying any exemption from, or reduction in rate of, tax provided by any tax convention.

(c) *Determination of tax—(1) In general.* If the gross income of a nonresident alien individual or foreign corporation, as the case may be, consists of both treaty and nontreaty income, the tax liability for the taxable year shall be the sum of the amounts determined in accordance with subparagraphs (2) and (3) of this paragraph. In no case, however, may the tax liability so determined exceed the tax liability (tax reduced by allowable credits) with respect to the taxpayer’s entire income, determined in accordance with § 1.871-7 or § 1.871-8, or with § 1.881-2 or § 1.882-1, as though the tax convention had not come into effect and without reference to the provisions of this section. Determinations under this paragraph shall be made without taking into account any credits allowed by sections 31, 32, 39, and 6402, but such credits shall be allowed against the tax liability determined in accordance with this subparagraph.

(2) *Tax on nontreaty income.* For purposes of subparagraph (1) of this paragraph, compute a partial tax (determined without the allowance of any credit) upon only the nontreaty income in accordance with § 1.871-7 or § 1.871-8, or with § 1.881-2 or § 1.882-1, whichever applies, as though the tax convention had not come into effect. To the extent allowed by paragraph (d) of § 1.871-8, or paragraph (c) of § 1.882-1, the credits allowed by sections 33, 35, 38, and 40 shall then be allowed, without taking into account any item included in the treaty income, against the tax determined under this subparagraph.

(3) *Tax on treaty income.* For purposes of subparagraph (1) of this paragraph, compute a tax upon the gross amount, determined without the allowance of any deduction, of each separate item of treaty income at the reduced rate applicable to that item under the tax convention. No credits shall be allowed

§ 1.871-13

against the tax determined under this subparagraph.

(d) *Illustration.* The application of this section may be illustrated by the following example:

Example. (a) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1967 from sources within the United States total gross income of \$22,000, consisting of the following items:

Compensation for personal services the tax on which is not limited by the tax convention (effectively connected income under § 1.864-4(c)(6)(ii))	\$20,000
Oil royalties the tax on which is limited by the tax convention to 15 percent of the gross amount thereof (effectively connected income by reason of election under § 1.871-10)	2,000
Total gross income	22,000

(b) The taxpayer is engaged in business in the United States during the taxable year but does not have a permanent establishment therein. There are no allowable deductions, other than the deductions allowed by sections 613 and 873(b)(3).

(c) The tax liability for the taxable year is \$6,100, determined as follows:

Nontreaty gross income	\$20,000
Less: Deduction for personal exemption	600
Nontreaty taxable income	19,400
Tax under section 1 of the Code on nontreaty taxable income (\$5,170 plus 45 percent of \$1,400)	5,800
Plus: Tax on treaty income (Gross oil royalties) (\$2,000×15 percent)	300
Total tax (determined as provided in paragraph (c) (2) and (3) of this section)	6,100

(d) If the tax had been determined under paragraph (b)(2) of § 1.871-8 as though the tax liability would have been \$6,478, determined as follows and by taking into account the election under § 1.871-10:

Total gross income	\$22,000
Less: Deduction under section 613 for percentage depletion (\$2000×27½ percent)	\$550
Deduction for personal exemption ...	600
Taxable income	20,850
Tax under section 1 of the Code on taxable income (\$6,070 plus 48 percent of \$850)	6,478

(e) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR

1.871-7(e) (Revised as of January 1, 1971).

[T.D. 7332, 39 FR 44225, Dec. 23, 1974; as amended at T.D. 8657, 61 FR 9338, Mar. 8, 1996]

§ 1.871-13 Taxation of individuals for taxable year of change of U.S. citizenship or residence.

(a) *In general.* (1) An individual who is a citizen or resident of the United States at the beginning of the taxable year but a nonresident alien at the end of the taxable year, or a nonresident alien at the beginning of the taxable year but a citizen or resident of the United States at the end of the taxable year, is taxable for such year as though his taxable year were comprised of two separate periods, one consisting of the time during which he is a citizen or resident of the United States and the other consisting of the time during which he is not a citizen or resident of the United States. Thus, for example, the income tax liability of an alien individual under chapter 1 of the Code for the taxable year in which he changes his residence will be computed under two different sets of rules, one relating to resident aliens for the period of residence and the other relating to nonresident aliens for the period of nonresidence. However, in determining the taxable income for such year which is subject to the graduated rate of tax imposed by section 1 or 1201 of the Code, all income for the period of U.S. citizenship or residence must be aggregated with the income for the period of nonresidence which is effectively connected for such year with the conduct of a trade or business in the United States. This section does not apply to alien individuals treated as residents for the entire taxable year under section 6013 (g) or (h). These individuals are taxed under the rules in § 1.1-1(b).

(2) For purposes of this section, an individual is deemed to be a citizen or resident of the United States for the day on which he becomes a citizen or resident of the United States, a nonresident of the United States for the day on which he abandons his U.S. residence, and an alien for the day on which he gives up his U.S. citizenship.

(b) *Acquisition of U.S. citizenship or residence.* Income from sources without