6 T.C. 1141 (1946)

Income received by a nonresident alien from a U.S. corporation is considered income from sources within the United States, even if the corporation's income is derived from sales of products used in foreign countries.

Summary

Pedro Sanchez, a nonresident alien, invented a sugar refining process and assigned his patent rights to a U.S. corporation. This corporation then licensed the process and manufactured a key chemical (Sucro-Blanc) in the U.S., selling it to licensees both for domestic and foreign use. Sanchez received payments based on a percentage of the corporation's sales, including those for foreign use. The Tax Court held that all payments to Sanchez were income from U.S. sources, regardless of where the end-users of Sucro-Blanc were located. Additionally, the Court addressed the timing of income recognition for a cash-basis taxpayer.

Facts

Sanchez, a nonresident alien residing in Cuba, invented a process for refining sugar using a chemical called Sucro-Blanc.
In 1934, Sanchez granted Buffalo Electro-Chemical Co. (Becco), a New York corporation, the exclusive worldwide license to use and sell his inventions.
In 1936, Becco assigned its rights to Sucro-Blanc, Inc., another New York corporation controlled by Becco.
Sanchez received stock in Sucro-Blanc, Inc.
Sucro-Blanc, Inc. manufactured Sucro-Blanc in Michigan and sold it to licensees, some of whom used it in foreign countries.
Sanchez received payments from Sucro-Blanc, Inc. based on 10% of its sales, including sales for use outside the U.S.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Sanchez's 1940 income tax.
Sanchez contested the inclusion of royalty payments, arguing they were income from sources outside the U.S.
The Tax Court reviewed the Commissioner's determination.

Issue(s)

1. Whether payments received by a nonresident alien from a U.S. corporation, based on sales of a product manufactured and sold in the U.S. but used in foreign countries, constitute income from sources within the United States.

2. Whether royalties earned in 1939 but received in 1940 are includible in a cash-basis taxpayer's 1939 income.

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Holding

1. Yes, because the payments were derived from a contract with a U.S. corporation, and the sales were consummated within the United States.

2. No, because the taxpayer was on a cash basis, and the income was not constructively received in 1939 as it was not credited to his account or set apart for him without restriction.

Court's Reasoning

The court emphasized that Sanchez's contractual relationship was with a U.S. corporation, and payments were made to him in the U.S. from funds held by that corporation. The court stated, "His contractual relationship out of which his income here in question was derived was with an American corporation, Sucro-Blanc, Inc., which disposed of the use of the process in this country and made the product necessary to the process in this country."

The court found that Sucro-Blanc, Inc. chose not to charge for the patented process itself, but rather derived its income from the sales of the product. Therefore, the source of Sanchez's income was determined by the location where the sales were consummated, which was the U.S. Even though the product was ultimately used in foreign countries, the sales occurred in the U.S.

Regarding the constructive receipt issue, the court noted that the royalties were not credited to Sanchez's account in 1939, nor was the amount determinable before the year's end. The court also pointed out that while Sanchez was an officer of Sucro-Blanc, Inc., the checks required two signatures, so he did not have complete control over the funds. The court reiterated that the doctrine of constructive receipt should be applied sparingly.

Practical Implications

This case clarifies that the source of income for nonresident aliens is determined by the location of the transaction that generates the income, not necessarily the location where the product or service is ultimately used. For businesses dealing with nonresident aliens, it's crucial to structure transactions so that sales are clearly consummated within a specific jurisdiction. The case serves as a reminder that, for cash-basis taxpayers, income is taxed when actually or constructively received, with constructive receipt requiring unrestricted access and control over the funds. This decision helps attorneys advise clients on tax planning related to international transactions and the timing of income recognition.

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