12 T.C. 880 (1949)

The source of income for a foreign corporation not engaged in trade or business within the United States is determined by the location of the activities that generated the income, not necessarily where the sale of goods occurs.

Summary

British Timken, a British corporation, received payments from an American company (American Timken) for orders of bearings shipped directly from the U.S. to British Timken's customers abroad. The Tax Court held that these payments were income from sources outside the United States because they compensated British Timken for its sales activities and exclusive market rights in its territory, not for sales occurring within the U.S. This meant the income was not taxable under U.S. tax law applicable to foreign corporations not engaged in trade or business within the U.S.

Facts

British Timken had an agreement with American Timken that granted it exclusive rights to sell Timken bearings in certain territories. Prior to WWII, British Timken purchased bearings from American Timken for resale. Due to wartime disruptions, American Timken began shipping directly to British Timken's customers, crediting British Timken with the difference between the price charged to customers and the normal price charged to British Timken. Later, a flat percentage of gross sales was used. British Timken maintained sales organizations in its territory, incurring expenses to promote Timken bearings.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies and penalties against British Timken for failing to file U.S. income tax returns. British Timken petitioned the Tax Court for a redetermination of these deficiencies. The Tax Court ruled in favor of British Timken, finding that the income was from sources outside the United States.

Issue(s)

1. Whether the payments received by British Timken from American Timken constituted "fixed or determinable annual or periodical" income from sources within the United States under Section 231(a) of the Internal Revenue Code.

Holding

1. No, because the source of the income was the sales activities and market rights of British Timken in its territory, which were located outside the United States.

Court’s Reasoning

The Tax Court reasoned that the location of the sale (f.o.b. Canton, Ohio) was not determinative of the *source* of British Timken’s income. The court emphasized that British Timken’s income was not directly tied to American Timken’s profit from the sales, but rather represented compensation for British Timken’s established sales force, marketing efforts, and exclusive territorial rights. The court stated, “It is the situs of the activity or property which constitutes the source of the compensation paid and not the situs of the sales by which it is measured that is of critical importance.” The court noted that American Timken could not have sold the bearings without British Timken’s consent, due to their agreement. The sums paid were in recognition of British Timken’s activities and exclusive rights.

Practical Implications

This case clarifies that the source of income for a foreign corporation is not always where the sale of goods physically occurs. It depends on the substance of the transaction and the activities that generate the income. Attorneys must look beyond the mere transfer of goods and consider where the economic activity that gives rise to the income takes place. This case highlights the importance of analyzing agreements and business relationships to determine the true source of income, especially when dealing with international transactions and foreign corporations. Later cases would likely distinguish British Timken if the foreign corporation had significant activities within the United States related to the income.