Kates Holding Co. v. Commissioner, 81 T. C. 708 (1983)

Income from a sale of personal property is sourced where title and risk of loss pass from the seller to the buyer, not where the goods are ultimately delivered.

Summary

In Kates Holding Co. v. Commissioner, the Tax Court ruled that Federal International, Inc. did not qualify as a Western Hemisphere trade corporation for tax deduction purposes. The key issue was whether Federal's income from selling steel to Jordan International Co. , Inc. , which then sold it to Brazilian buyers, was sourced outside the U. S. The court held that the income was sourced in the U. S. because title and risk of loss passed to Jordan in Philadelphia under C. & F. terms, not in Brazil where the steel was delivered. This decision hinges on the interpretation of U. C. C. rules on passage of title and risk of loss, impacting how similar transactions are taxed.

Facts

Federal International, Inc. sold steel to Jordan International Co. , Inc. in Philadelphia. Jordan then shipped this steel to Brazilian purchasers under C. & F. terms, which required Jordan to deliver the steel to a carrier in Philadelphia and prepay freight to Brazil. The Brazilian purchasers paid Jordan via letters of credit, and Jordan insured the steel during transit. Federal and Jordan claimed to be engaged in a joint venture to sell steel to Brazil, with profits split equally after costs. The Internal Revenue Service (IRS) challenged Federal's claim for a special deduction as a Western Hemisphere trade corporation, asserting that Federal's income was sourced within the U. S.

Procedural History

The IRS determined a tax liability against Kates Holding Co. , Inc. , as the transferee of Federal International, Inc. 's assets, for the taxable year ending June 30, 1974. Kates Holding Co. , Inc. contested this determination, leading to a hearing before the U. S. Tax Court. The Tax Court reviewed the case to determine whether Federal qualified for the special deduction under section 922(a) of the Internal Revenue Code.

Issue(s)

1. Whether Federal International, Inc. derived more than 95 percent of its gross income from sources without the United States under section 921(1) of the Internal Revenue Code.
2. Whether the sale of steel by Jordan International Co. , Inc. to Brazilian purchasers was a C. & F. contract under the Uniform Commercial Code.

Holding

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1. No, because Federal’s income was sourced in the U. S. where title and risk of loss passed to Jordan in Philadelphia.
2. Yes, because the terms on Jordan’s invoices and the nature of the transaction indicated a C. & F. contract under U. C. C. section 2-320.

Court’s Reasoning

The court focused on the passage of title and risk of loss as defined by the U. C. C. and IRS regulations. The court determined that the transaction between Jordan and the Brazilian purchasers was a C. & F. contract, as evidenced by the invoices showing the steel’s destination and prepaid freight. Under U. C. C. section 2-509, risk of loss passes to the buyer when goods are delivered to a carrier, which occurred in Philadelphia. The court rejected Kates’ arguments that the sale occurred in Brazil, finding that the C. & F. terms and the use of letters of credit indicated that title and risk of loss passed in Philadelphia. The court emphasized that for tax purposes, the source of income is where title and risk of loss pass, not where goods are ultimately delivered. The court also noted that Federal’s income from the joint venture, if it existed, was sourced within the U. S.

Practical Implications

This decision clarifies that for tax purposes, the source of income from sales of personal property is determined by where title and risk of loss pass under U. C. C. rules, not by the final destination of the goods. Businesses engaged in international trade must carefully structure their transactions to ensure that the passage of title and risk of loss aligns with their intended tax treatment. This ruling may influence how companies structure their sales contracts, particularly those involving C. & F. or similar terms, to optimize tax outcomes. Subsequent cases, such as Miami Purchasing Service Corp. v. Commissioner, have reinforced this principle, emphasizing the importance of contract terms in determining the source of income for tax purposes.

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