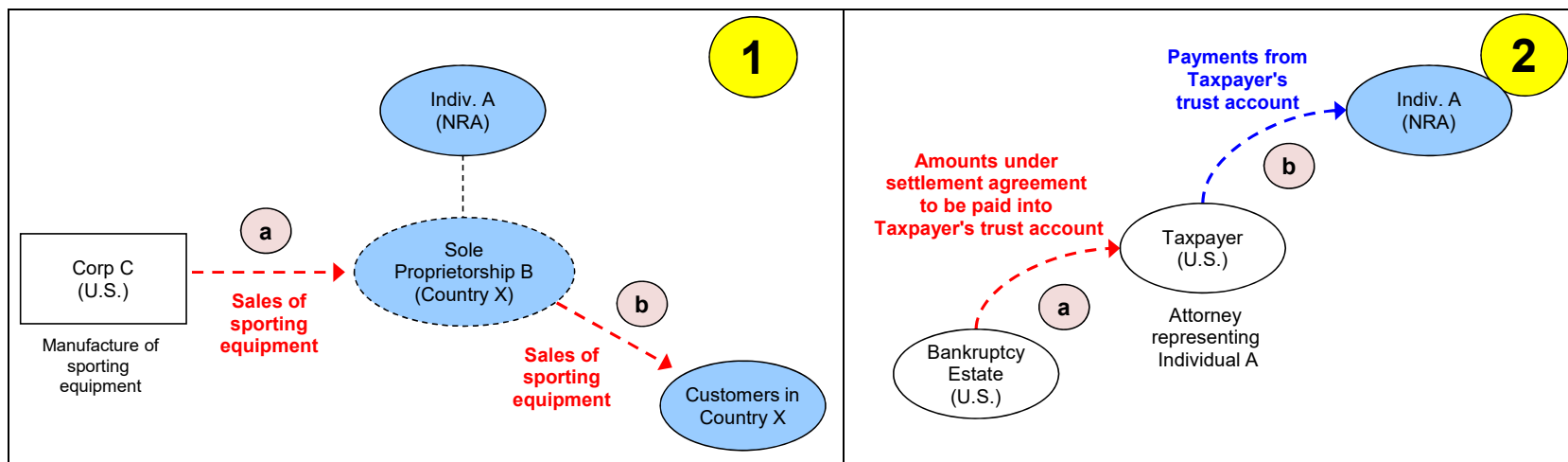


**Breach of Contract Payments Were Foreign Source  
Income Under the Origin of the Claim Doctrine**

**Pre-Contract Termination Arrangement**

**Bankruptcy Estate Settlement Payment**



Individual A is a nonresident alien, who operates and owns Sole Proprietorship B in Country X. Sole Proprietorship B imports sporting goods for sale and use solely in Country X. Sole Proprietorship B has never engaged in a U.S. trade or business. Corporation C, a domestic corporation, entered into a contract with Sole Proprietorship B under which Sole Proprietorship B was the exclusive distributor of Corporation C's sporting equipment in Country X. Corporation C's assets were acquired by Corporation D, a domestic corporation. At a later date, Corporation D terminated the agreement and filed for bankruptcy. Individual A filed a claim in the bankruptcy case for breach of contract.

Under a settlement agreement, Individual A will receive a cash settlement in complete satisfaction of their claims. Amounts owed to Individual A under the bankruptcy settlement agreement will be paid into Taxpayer's trust account. Taxpayer is the attorney representing Individual A in the bankruptcy settlement. With regard to the taxation of a settlement payment made to a nonresident alien individual, the nature of the item for which the settlement payment is substituted controls the characterization of the payment. *U.S. v. Gilmore*, 372 U.S. 39 (1963). Similarly, the source of the item for which a settlement payment is substituted controls the source of the payment. Rev. Rul. 83-177.

Section 862(a)(6) provides that gains, profits, and income derived from the purchase of inventory property within the U.S. and its sale or exchange without the U.S. shall be treated as an income from sources without the U.S. The ruling concludes that payments of principal received by Individual A under the settlement agreement are foreign source income under section 862(a)(6) and, therefore, are neither subject to tax under section 871(a) nor to withholding at source under section 1441(a). The interest portion of the payment is sourced according to the source of interest rules.