Fundamental issues to consider:

1) U.S. source for the income?

2) Does a U.S. trade or business (USTB) exist?

A. If so, then §871(b)(1) and §882(a)(1) impose a net income tax on income that is “effectively connected” (ECI) with the that US trade or business. The sourcing of the income (Chapter 2) makes a difference in this ECI inquiry.

B. If not, then US withholding taxes may be imposed on US source income that is Fixed, Determinable, Periodical, or Annual (“FDAP”). So again, sourcing of the income makes a difference to the US withholding inquiry.
**U.S. Trade or Business or “Permanent Establishment”**

**Code** rule concerning U.S. income tax status:


2. Performance of personal services – Code §864(b)(1); but, de minimis rule.


Treaty rule concerning US income tax status: uses the concept of “permanent establishment” which exists if there is a “fixed place of business.”

Exception: Nonresident alien individual is not subject to US In US not more than 90 days and receives no more than $3,000 does not constitute a US business for the nonresident alien individual. See §864(b)(1). But, this exception is strictly construed. See Rev. Rul. 64-184.
Broad Safe-Harbor: Foreign persons can trade in stocks or securities on U.S. markets without having a U.S. trade or business. See §864(b)(2)(A).

1. But, the foreign person must not have a trading office of its own in the United States to avail itself of this safe-harbor. See §864(b)(2)(C).

2. A broker, employee, or commission agent can exercise discretionary authority to trade stocks, securities, or commodities without creating a US trade or business. See §864(b)(2)(A) and (B).
Continental Trading (p. 131) – investment and limited trading; Panamanian Corp. and Mexico City principal office.

1. Odd Fact pattern. It was the taxpayer, not the IRS, that wanted to have a US trade or business. Why? Because the taxpayer could deduct expenses and not be subject to gross withholding taxes if it had a US trade or business. IRS asserts no US trade or business claiming that the business activities were isolated and noncontinuous transactions.

2. Activities relate to investment in stocks and to borrowing funds, not an active business.

Court Holding: Not sufficient activity to create a US trade or business. The effect was that the taxpayer was unable to deduct investment expenses (such as interest) and thus subject to US withholding taxes.
LTD, a Cayman Islands corporation, holds stock of Holdings (U.S.) which holds stock of Inc. (U.S.)

Merely ministerial activities by Inc. for LTD in U.S. or conduct of a business?

Held: LTD conducted activities in the U.S. directly and through the employees of its agent, Inverworld Inc. The court believed that the activities of InverWorld Inc. constituted investment advisory services conducted for Mexican clients conducted in the United States and that this created a US trade or business.
Q, a domestic corporation, as agent for M, foreign corporation, for sales of products in the United States.

Q assumed full responsibility for sales of M’s product and acts as guarantor.

Held: Principal and agent relationship existed. US trade or business; subject to Code §882 tax.

Cf., Code §864(c)(5)(A) – independent agent; and Model Tax Treaty, Article 5(6).
Issue: Was Handfield (a nonresident corporation) engaged in US trade or business?

Factual Determination: Were cards purchased by American News for resale?

1. Handfield says “yes” and therefore no agency existed.
2. IRS says “no” and that the substance of the arrangement was an agency relationship.

Held: News Company was an agent. American News did not have principle risk on merchandize. Thus, a consignment arrangement existed with the consequence that Handfield had an agent with a stock of merchandize that constituted a US trade or business.
Partnerships and trusts are conduit entities for federal income tax purposes.

1. Code §875(1) requires attribution of partnership activities to the partners

2. Code §875(2) – trust’s activities are attributed to the trust beneficiaries.

Does a ‘trust” conduct business? If so, can it be treated as a “trust” under federal tax entity characterization rules?
Partners in an Argentine partnership.

Balanovski came to U.S. to transact partnership business. Significant purchasing activities through a NYC office.

Holding: CADIC (partnership), due to the actions of its partner Bolanovski, was US trade or business and all the partners were taxable in U.S. on their partnership income.

Balanovski was not a mere purchasing agent in the U.S.
Management of Real Property US trade or business
Gross or Net Taxation

1) Lewenhaupt (p. 161) continuous real estate activities (by agent) created US trade or business for nonresident alien.

2) Rev. Rul. 73-522 (p. 163) long term “net leases” and not a US trade or business.

3) Election available to enable US trade or business status (p. 165)
   a) §§871(d) and 882(d)
   b) When make this election?
   c) Limitations on this election?
      i. Binding once made
      ii. Rev. Rul. 91-7 – gross income required
U.S. Trade or Business: "Red Flags" versus "Green Flags"

**Red Flags**
1. Fixed office with employees
2. Store goods for sell into U.S. economy
3. Solicit Orders Dependent Agent
4. Logistics Support for Export Business
5. Management of U.S. Real Estate Business
6. Active loan management activities

**Green Flags**
1. Storage for export
2. Purchasing Agent solely provides purchasing activities
3. Non-dealer stocks, securities and commodities trading
4. Purely investing activity
Determining the **Total** Amount to be Included in Gross Income

“Force of attraction” rule vs. “Effectively connected income” rule (or *limited force of attraction* rule)

§864(c)(3) – a “*limited force of attraction*” rule (not including investment income).

§864(c)(2) – when include investment income in ECI? i) asset use test; ii) business activity test.
Banking business impact for ECI income determination: U.S. branch of foreign bank.

Types of “securities” transactions – effectively connected income in the U.S.?

1) Negotiated loans – yes, ECI

2) Related party loans – not ECI. Mere funding is not material participation

3) Loan participations – actively negotiated collateral represents material participating and thus ECI
1) Deferred Income Rule – cannot avoid US trade or business categorization by postponing receipt of operating income from a current US trade or business year to a non-US trade or business year. §864(c)(6).

2) Look Back Rule – 10 year “claw-back rule” for income derived from the sale of US trade or business related property. §864(c)(7).
Is foreign source income included as “effectively connected income” of a US trade or business of a foreign person? See Code §§864(c)(4)(A) and (B).

General Rule: Foreign Source Income is Not Effectively Connected

Exception: U.S. office to be a “material factor” in producing foreign source income.

Inventory Exception:

Code §865(e)(2) – foreign source income from inventory sales will still be considered as effectively connected income unless a foreign office materially participates in its sale to customers.

Rev. Rul. 75-253 (p. 174) US office materially participated in loan origination activities and thus income was effectively connected to the conduct of US trade or business.
Foreign tax credit available - §906(a). Allows foreign tax credits for foreign taxes imposed on foreign source income that is treated as effectively connected income.

U.S. income tax return required to get deductions - §882(c)(2) and §874(a); therefore, tax on gross income?

Cf., Swallows Holding Tax Court case – regs (p. 160) are invalid. But 3rd Cir. reversed this decision.

Loans can easily be structured to achieve tax planning objective.

§864(e)(2) – provides for allocation of interest expense on the basis of assets – rather than gross income.

1. Determine Average US Asset Value
2. Determine Amount of Liabilities Connected with US trade or business
3. Two allocation methods:
   i. Adjusted US-booked liabilities method
   ii. Separate currency pools method
Re: Allocation of interest expense to the U.S. trade or business:

1) Average value of U.S. assets?

2) Liabilities connected with U.S. assets?

3) Allocation, based on (a) “adjusted U.S. booked liabilities method” or (b) separate currency pools method.
a) No representation in U.S.

No US trade or business even if U.S. source income, and this income is not FDAP subject to Code §881.

b) Periodic visits to the U.S. Are the activities continuous, regular and considerable; i.e., sufficient to create US trade or business? If so, then, sourcing. Where does title pass when the inventory is sold? Note, Code §861(a)(6) title passage rule.
c) U.S. permanent sales office but no warehouse. Goods are shipped directly from foreign country. U.S. sales office constitutes a USTB. §865(e)(2).

d) No sales office in the U.S. but a contract with an independent agent marketing and selling in U.S. on behalf of Traditions. §864(c)(5)(A).
e) No sales office in the U.S. but Traditions has a contract with an independent agent who markets and, additionally, accepts orders in U.S. on behalf of Traditions.

See §864(c)(5)(A)(ii) – the agent’s office is not attributed to Traditions for purpose of making the USTB determination.
f) Establish shop in NYC with inventory. Direct sales and mail order fulfillment and sending order to home country for fulfillment.

Inventory would generate U.S. source income. §865(e)(2)(A).

Orders by mail – also USTB? Not if (real) participation of foreign office - §865(e)(2)(B).
Article 5(1) – P.E. as a “fixed place of business”.

Article 5(2) concerning types of a P.E.

Article 5(4) re preparatory and auxiliary activities (not as being P.E.)

Article 5(5) re dependent agents.

Article 5(6) re independent agent.

Article 7 re scope of P.E. taxable income.
Did the author have a U.S. office which was a U.S. permanent establishment?

Issue: Were royalties associated (or not associated) with a P.E. in the U.S.?

Note: Schedule C – Claimed depreciation deduction for his U.S. residence. Also, business expenses claimed. Note the eventual cost of claiming the “office in the home” income tax deduction!
Did Japanese taxpayers have a P.E. in the U.S. (under the Japan-U.S. income tax treaty) because of their relations with Fortress RE (not a subsidiary) and its U.S. activities?

Issue under P.E. treaty article is whether Japanese companies had a P.E. because of dependent agent status, or was Fortress an independent agent. Answer: No P.E.

Legal and/or economic independence?
Model Art. 7 re allocable profits and Art. 7(2).

See also Model Article 13(3) re gains from the sale of personal property attributable to a permanent establishment.

Article 7(3) – Availability of deductions, including for general and administrative expenses and for R&D expenses.

Result: Net income tax for a specific activity.
Accuracy of the interest expense allocation.


Relying on OECD materials the Court determines that income determination of the U.S. branch can be based (1) on its books of account, with adjustments, as if a separate enterprise, and (2) not on a regulatory formulae (premised upon being a unit of a worldwide enterprise).
Treaty Art. 7 – exemption for NRAs performing personal services of an independent character.


Art. 14 – limited exemption for dependent personal services; Cf., §861(a)(3).

Art. 16 – “artistes and sportsmen.”
Treaty Art. 19 – exemption for government employee services.

Treaty Art. 20 – foreign sourced scholarship to U.S. student not subject to U.S. tax.

Treaty Art. 6(5) – net basis election for real estate income – inclusion in current U.S. Model Treaty? (Yes, even though statute.)
Rev. Rul. 84-17 – Polish corporation inbound into the United States.

Elect part P.E. income tax treaty status (for non-P.E. income) and part Code status – ETBUS – ECI (for non-P.E. loss)? No

1st Activity  P.E.  Product A  Gain  Treaty

2nd Activity  Not P.E.  But ECI US T.o.B.  Gain  Treaty

3rd Activity  Not P.E.  But ECI US T.o.B.  Loss  Code
Rev. Rul. 90-80

Situation One: Partnership has U.S. P.E.

Activities of partnership attributable to the partners. The foreign partner has a P.E. in the United States. Income attributable to the P.E. is taxable to the foreign partner.

Situation Two: Dependent agent; attribution to the principal; P.E. exists; NRA is taxed.

Traditions problem (page 180) – In the income tax treaty context. No U.S. income tax liability arises unless a P.E. exists in the U.S.

P.E. status:
- a & b – no;
- c - (unclear but perhaps “no”);
- d & e – independent agent and no P.E.;
- f – P. E. status, but would not be a pe if the foreign office concluded the contracts
Problem 2
Tax Treaty Applicability

Factual variations:

a) Acceptance at the home office; no P.E. since no fixed place of business in the U.S.

b) Warehouse and showroom, including for delivery; no P.E.; Article 5(4)(a) and (b).

c) Manufacturing in the U.S.? But completed by a third (independent) party. Are Article 5(4)(c) – processing by another – and Article 5(4)(e) – auxiliary activity – applicable to enable tax exemption?

d) Market research/advertising office in U.S. – Article 5(4)(d) provides an exemption from P.E. for “collecting information”?

e) Power to negotiate contracts in the U.S. – sales activities and P.E. exists. See Art. 5(5).
Handfield case revisited – p. 153
Consignment of goods situation.

P.E. exists because the U.S. agent has a stock of merchandise to fill orders.

Model Treaty: 1. If the agent were independent, then no P.E. per Article 5(6).
2. If the agent were dependent, then a P.E. only if the agent conclude contracts “that are binding on” the principle per Article 5(5).
Key Issue: Is the individual a “consultant” or an “employee”?

If employee, see Article 14 causes the income to be taxed in U.S. because the remuneration is paid by an employer who is a resident in U.S.

If an independent consultant, then Article 5 applies. It would seem that no tax would be due as long as there is no fixed base in U.S.

Key question: would the individual really be independent “legally and economically”? 
Sally Suarez: 30 days in U.S. working on a deal for foreign law firm; she earns 10k; her firm receives 30k.

Employee taxation: Protected from U.S. tax under Art. 14(2), unless working from a P.E. in the U.S.

Firm taxation: No U.S. tax unless a P.E. in the U.S. The hotel room is not a P.E.
Electronic publishing; independent website in the U.S.

Global History: Regular, continuous activities in the U.S. and exploiting the relevant U.S. market; but delivery from India.

Code §884 30% tax on a “dividend equivalent amount” (in addition to regular corporate tax). Tax applies currently and without actual funds repatriation.

Concept of “effectively connected E&P”

1) Reduced by an increase in branch equity; and
2) Increased by any reduction in branch equity.

§884(e)(2) – the amount of branch tax is reduced to the treaty dividend withholding rate on dividend payments upstream from U.S. subsidiaries to foreign shareholders.

§884(e) – “treaty shopping” limitation is applicable.
The after tax profit of the U.S. branch is $650,000.

The adjusted basis of the branch assets is increased by $2.3 million, but liability of $1.8 million is incurred; and therefore, the net branch equity increase is $500,000.

Dividend equivalent amount is $150,000: $650,000 less net branch equity increase of $500,000. Branch profits tax is $45,000.
The after tax profit of the U.S. branch is $650,000.

Adjusted basis of the branch assets is increased by only $2.0 million, but liability of $1.8 million is incurred; and, therefore, the net branch equity increase is $200,000.

Dividend equivalent amount is $450,000: $650,000 less net branch equity increase of $200,000. Branch profits tax is $135,000.
After tax profit of U.S. branch is $650,000.

Adjusted basis of the branch assets is increased by $2.5 million, but liability of $1.8 million is incurred; and, therefore, the net branch equity increase is $700,000.

Dividend equivalent amount is $0: $650,000 less the net branch equity increase of $700,000. Branch profits tax is $0.

Code §892(a)(2) – no exemption for commercial activities of government.

Concept of restrictive sovereign immunity.

Note: Qauntas Airlines decision.
Code §893(a). Salary as ambassador is excluded from U.S. income tax applicability.

No protection from U.S. income tax is available for consulting activity income. §871(b).

No U.S. income taxation for the foreign source income; however, since not a U.S. resident, i.e., foreign governmental status.