

Chapter 3 Foreign Persons:  
U.S. Trade or Business Income

**Fundamental issues to consider:**

- 1) U.S. source for the income?
- 2) Does a U.S. trade or business (USTB) exist?
- 3) Is the income “effectively connected” (ECI) with the USTB?

§871(b)(1) & §882(a)(1) impose a net income tax on U.S. business income.

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U.S. Trade or Business  
or “Permanent Establishment”

Code rules concerning U.S. tax status:

U.S. taxation if regular and continuous business activities - See Code §864(b).

Performance of personal services - Code §864(b)(1); de minimis rule.

Trading in stocks, securities & commodities- Code §864(b)(2)(A)&(B).

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Trading in Stocks & Securities  
P. 129

**Not ETBUS:** Foreign persons can trade in stocks or securities on U.S. markets without having a U.S. trade or business.

Code §864(b)(2)(A).

Not if a trading office in U.S. §864(b)(2)(C).

Exercise of discretionary authority by the broker in U.S. does not cause ETBUS.

Similar exceptions for commodities trading.

§864(b)(2)(B).

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## ETBUS - Other Situations

**Continental Trading (p. 131) - investment and limited trading; Panamanian Corp. & Mexico City principal office.**

**Taxpayer position that ETBUS and is entitled to deductions; but, IRS asserts not ETBUS, i.e., isolated & noncontinuous transactions.**

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

**Held: Not ETBUS.**

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Inverworld case p.134  
Parent Corp. & ETBUS

**LTD, a Cayman Islands corporation, holds stock of Holdings (US) which holds stock of Inc. (US).**

**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 agents. LTD activity was making investments in the U.S. for Mexican clients.**

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**Exclusive Agency Situation**  
Rev. Rul. 70-424 p. 138

**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. ETBUS; subject to Code § 882 tax.**

**Cf., Code §864(c)(5) - independent agent; and Model Tax Treaty Article 5(6).**

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Handfield case p. 139  
Dependent Agent?

Was an NRA engaged in USTB?  
Were cards purchased in Canada for delivery into the U.S.?  
IRS says an agency relationship existed.  
All cards were fully returnable & the petitioner would allow credit.  
Held: News Company was an agent.  
Consignment arrangement existed; U.S. tax effect of this arrangement?

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Partnerships and Trusts  
p. 142

Partnerships and trusts are conduit entities for federal income tax purposes.  
Code §875(1) requires attribution of partnership activities to the partners; and  
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.

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Balanovski case p.142  
Attribution to Partners

Partners in an Argentine partnership.  
Balanovski came to U.S. to transact partnership business. Significant purchasing activities through a NYC office.  
Holding: CADIA (partnership) was ETBUS and all the partners were taxable in US on their partnership shares of that income.  
Balanovski was not a mere purchasing agent in the U.S.

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Management of Real Property  
ETBUS – Gross or Net Taxation?

- 1) Lewenhaupt, p. 146  
continuous activities (by agent) and ETBUS.
- 2) Rev. Rul. 73-522, p. 147  
long-term “net leases” and not ETBUS.
- 3) Election available to enable ETBUS status
  - a) §§871(d) & 882(d).
  - b) When make this election?
  - c) Limitations on this election? Binding & Rev. Rul. 91-7 gross income required.

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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

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Rev Rul. 86-154 p. 152  
Defining Income Tax Base

- Banking business impact for ECI income  
determination: U.S. branch of foreign bank.  
Types of securities producing effectively  
connected income in the U.S.:
- 1) Negotiated loans
  - 2) Related party loans
  - 3) Loan participations - actively negotiated  
collateral.

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## Deferred Income & Look Back Rules

- 1) **Deferred Income Rule** – cannot avoid ETBUS categorization by postponing receipt of operating income from a current ETBUS year to a non-ETBUS year. §864(c)(6).
- 2) **Look Back Rule** – 10 year “claw-back rule” for income derived from the sale of ETBUS related property. §864(c)(7).

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## Foreign Source Income p. 155

Is foreign source income included in the ECI of a USTB of a foreign person?

Code §§864(c)(4)(A) & (B).

U. S. office to be a “material factor.”

Note Code §865(e)(2) - sourcing rule for inventory sales – U.S. source, but a foreign office participation exception.

Rev. Rul. 75-253 p. 157 - Banking & securities income - USTB.

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## Deductions & Credits §§873(a) & 882(c)(1) p.159

Foreign tax credit available - §906(a).  
foreign tax imposed on foreign source treated as ECI in the U.S.

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

Cf., Swallows Holding Tax Court case  
– regs are invalid. 3<sup>rd</sup> Cir. reversed.

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Interest Expense Deduction p. 160

Interest expense deductions - fungibility concept applies and allocations required. Reg. §1.882-5.

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.

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Problem p.162  
Re: Community Autos A.G.

Re: allocation of interest expense to the U.S. trade or business.

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Problems p.163  
Re: African Art Traditions

a. No representation in the U.S.  
No USTB - even if U.S. source income, no USTB, and this is not FDAP subject to Code §881.

b. Periodic visits to the U.S. Are the activities continuous, regular and considerable, i.e. USTB? If so, then, sourcing. Where does title pass when inventory is sold?

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**Problem, cont. p.163**

**c. Permanent sales office but no warehouse. Goods are shipped directly from foreign country. 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).**

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**Problem, cont. p.164**

**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) – agent’s office not attributed to Traditions for purpose of making USTB determination?**

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**Problem, cont. p.164**

**f. Establish shop in NYC with inventory. Direct sales and mail order fulfillment and sending orders 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).**

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Tax Treaty Provisions p.164  
Article 5 - P.E. Status

- 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 P.E.).
- Article 5(5) re dependent agents.
- Article 5(6) re independent agent.
- Article 7 re scope of P.E. taxable income.

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Simenon decision p.166  
P.E. Status for an Individual?

- 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!

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Taisei Fire and Marine Insurance Co. Ltd. p.169

- Did Japanese taxpayers have a P.E. in the United States (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 Fortress as an independent agent. Answer: No P.E.

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Tax on P.E. activities p.177  
Determining Taxable Profits

Model Art. 7 re allocable profits & 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.

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National Westminster Bank  
Article 7 Issue p.179

Accuracy of the interest expense allocation.

Is Reg. §1.882-5 inconsistent with the UK-US Income Tax Treaty? Yes.

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).

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Treatment of Personal Services p.192

Treaty Art. 14 (now 7) - exemption for NRAs performing personal services of an independent character.

Note Rev. Rul. 2004-3 re cross-border service partnerships (law firms & accounting firms). Cf., Balanovski case.

Art. 15 (now 14)- limited exemption for dependent personal services; cf., §861(a)(3).

Art. 17 (now 16)- “artistes and sportsmen.”

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## Additional Treaty Provisions p.193

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).

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## Relation of Tax Treaty & Code Provisions p.194

Rev. Rul. 84-17 - Polish corporation inbound into the United States. p. 194

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

2nd activity not P.E., but ECI USTB gain

3rd activity not P.E., but ECI USTB loss

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## Partnerships and Trusts - under the P.E. clause of tax treaties

Rev. Rul. 90-80 p.197

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.

Rev. Rul. 2004-3, p. 192 (Art.14 – fixed base).

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Problem 1 – Tax Treaty p.200  
PE Status Requirement

Traditions problem (page 163) - 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 – yes (sales office as P.E.); d & e – independent agent & no P.E.; f – P.E. status

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Problem 2 p.200  
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 & showroom, including for delivery; no P.E.; Article 5(4)(a) &(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?

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Problem 2, cont.  
p. 201

- 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 & P.E. exists. See Art. 5(5).
- f) Agent with limited authority -independent agent and, therefore, no Traditions P.E.? Article 5(6)?

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Problem 3 p.201  
Agency Status

Handfield case revisited - p. 139  
consignment of goods situation.  
P.E. exists because the U.S. agent has a  
stock of merchandise to fill orders.  
What if the agent were independent?  
then no P.E. for the principal.  
Treaty Article 5(5) & (6).

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Problem 4 p.201  
Inbound Individual

Consultant or employee? Issue re U.S. tax  
treatment of income earned in U.S.  
If employee, see Article 15 (1996 Model).  
Taxed in U.S. because remuneration paid  
by employer who is a resident in U.S.  
If an independent consultant, see Art. 14  
(1996 Model). No tax in the U.S. since no  
fixed base in U.S. Query: Is the individual  
really independent?

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Problem 5 p. 201  
Foreign Lawyer in the U.S.

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. 15(2) (1996 Model), 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.

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Problem 6 p.201  
Electronic Website

Electronic publishing; independent web site in the U.S.

Global History: Regular, continuous activities in the U.S. & exploiting the U.S. market.

No U.S. P.E.? See p. 177, note 2, indicating probably no.

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Branch Profits Tax p.202  
Division of Foreign Corp

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.

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Branch Profits, cont.

The 2nd dividends tax is not to apply when the branch profits tax applicable - §884(e)(3).

§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) – a “treaty shopping” limitation is applicable.

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Branch Profits Tax  
Problem 1 p.205

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.

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Branch Profits Tax  
Problem 2 p.205

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.

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Branch Profits Tax  
Problem 2, part 2 p.205

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.

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## Foreign Policy Exceptions

Code §892 exemption for foreign government for U.S. source investment income and §893 (govt. employee).

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

Concept of restrictive sovereign immunity.

Note: Quantas Airlines decision.

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## Problem 1 p.206 Currency (?) Production

Gold coins marketing by foreign govt.

Coins are legal tender but have a much higher numismatic value.

Is this a commercial or a governmental activity under Code §892(a)?

Minting of coins is a governmental activity. But, is this engaging in a trade or business in the United States?

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## Problem 2 p.207 Govt. Employee Income

Code §893(a). Salary as ambassador is excluded from U.S. tax applicability.

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

No income taxation for the foreign source income, however, since not a U.S. resident - having foreign governmental status.

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