U.S. International Tax Law - 5
U.S. Business Activities

Trade or business income -
§§871(b) & 882 – net income tax.
Issue concerning what is a “trade or business” in U.S. Personal services?
What income "effectively connected" with U.S. trade or business?
Also - “branch profits” tax is applicable.

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.

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

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).

Inverworld case
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.

Exclusive Agency Situation
Rev. Rul. 70-424

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).
Partnerships and Trusts

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.

Balanovski case

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: 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.

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
**Rev Rul. 86-154**

**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**

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

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. 3rd Cir. reversed.

Interest Expense

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.

Examples:

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?
Examples, cont.
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).

Examples, cont.
e. No sales office in the U.S. but a contract with an independent agent who markets and, additionally, accepts orders in U.S. on behalf of principal. See §864(c)(5)(A)(ii) – agent’s office not attributed to principal for purpose of making USTB determination?

Examples, cont.
f. Establish shop in US 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).
**Tax Treaty Provisions**

**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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**Author: Simenon decision**

**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.**

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.
**Tax on P.E. activities**
**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**

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**

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 &

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

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


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
2nd activity not P.E., but ECI USTB gain
3rd activity not P.E., but ECI USTB loss

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

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.
**Foreign Policy Exceptions**


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

Concept of restrictive sovereign immunity.

Note: Quantas Airlines decision.

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**Examples:**

**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**

**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.