

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

Fundamental issues to consider for foreign persons:

- 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? Cf., “force of attraction” rule.**

Tax rule: §871(b)(1) (individuals) & §882(a)(1) (corporations) impose a net income tax on the U.S. business income realized by a foreign person. Cf., 30% gross tax for investment income.

U.S. Trade or Business, cf., “P.E.” under Tax Treaty

Code rules concerning U.S. income tax status:

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

Does not include shares owned in U.S. corp.

Tax treaty “P.E.” - a “fixed place of business.”

Performance of personal services as USTB - Code §864(b)(1); but, a *de minimis* rule applies. P.143

What about one U.S. based business meeting?

Trading in stocks, securities & commodities - Code §864(b)(2)(A)&(B). P.144.

U.S. Trading in Stocks & Securities

P.145

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). But, not if having a trading office in U.S. §864(b)(2)(C).

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

But, ETBUS if a securities dealer.

Similar exceptions for commodities trading, except for commodities dealers. §864(b)(2)(B).

ETBUS - Other Situations “Regular & Continuous”

Continental Trading (p. 146) - investment and limited trading; Panamanian corp. & Mexico City principal office.

Taxpayer position that activity is ETBUS and is entitled to deductions (for net basis taxation); 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 (& no investment expense deductions, e.g., interest).

Inverworld case

p.149

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 the conduct of a business?

Held: LTD (Cayman corp.) conducted activities in the U.S. directly and through agents. LTD's activity was making investments in the U.S. for Mexican clients. Activity was more than incidental record-keeping in the U.S. but was providing investment services in the U.S.

Exclusive Agency Situation

Rev. Rul. 70-424 p.152

Q, a domestic corporation, was agent for M, foreign corporation, for sales of products in the U.S.

Q assumed full responsibility for sales of M's products and Q acts as guarantor.

Held: Principal and agent relationship existed.

ETBUS of principal & M is subject to § 882 tax.

Cf., Code §864(c)(5)(A) - independent agent status is not attributed to the principal.

Note: Model Income Tax Treaty, Article 5(6) - no imputation from an independent agent.

Dependent Agent?

Was an NRA engaged in USTB? Were the cards bought in Canada for delivery into U.S.?

IRS says an agency relationship existed.

All cards were fully returnable & the petitioner would allow credit upon the return.

Held: News Company was an agent.

But, a consignment arrangement (bailment) existed; what U.S. tax effect of this arrangement (sale by principal through U.S. agent to U.S. customer)? Cf., “independent” agent status.

Partnerships and Trusts

p.157

Partnerships and trusts are conduit entities for federal income tax purposes.

Code §875(1) requires attribution of partnership activities to the partners (whether U.S. or foreign); and

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

Does a “trust” actually conduct business? If so, can it be treated as a “trust” under federal tax entity characterization rules?

Balanovski case

p.157

Attribution to Partners

Partners in an Argentine partnership.

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

Holding: CADIC (the partnership) was ETBUS and all the partners were taxable in U.S. on their shares of that partnership operating income.

Lower ct: Argentine partner had FDAP income.

Balanovski was not a mere purchasing agent in the U.S. (meaning CADIC would not be ETBUS).

Additional Partnership, etc., Issues

p.160

Disposition by foreign partner of an interest in a partnership which is ETBUS.

Rev. Rul. 91-32 – gain is considered as ECI with USTB for the foreign based partner as attributable to USTB property (only).

How collect tax on partnership income paid to foreigner? Withholding at source under §1446.

Cf., no foreign shareholders in an S corporation - §1361(b) specifies no foreign and no corporate shareholders in an S corporation.

Management of Real Property ETBUS – Gross or Net Taxation?

- 1) Lewenhaupt, p.161 – property sales gain;
regular management activities (by agent) - ETBUS.
- 2) Rev. Rul. 73-522, p.163 – gross, not net tax;
long-term “net leases” and not ETBUS.
- 3) Election available to enable ETBUS status P.465
 - a) §§871(d) & 882(d).
 - b) When make this election?
 - c) Limitations on election? Binding in the future.
Rev. Rul. 91-7 – some gross income required.

Determining the Total Amount to be Included in Gross Income

“Force of attraction” rule vs.

“Effectively connected income” rule

(or a “limited force of attraction” rule)

§864(c)(3) - a “limited force of attraction” rule
(but, not normally including investment income).

§864(c)(2) - When include investment income in ECI? i) asset use test (used in USTB?);
ii) business activity test (active business by an investment company?)

Defining Income Tax Base

Banking business impact for ECI income determination: U.S. branch of a foreign bank.

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

- 1) Negotiated loans – yes, ECI; U.S. branch solicits loans and does the credit analysis.**
- 2) Related party loans – not ECI, since the U.S. sub was a passive participant**
- 3) Loan participations – U.S. sub actively negotiated collateral & ECI for parent corp.**

Deferred Income & Look Back Rules

p.171

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

Foreign Source Income of a Foreign Person p.171

Is foreign source income included in the ECI of a USTB of a foreign person? §864(c)(4)(A) & (B).

U. S. office attracts that foreign income where (1) intangible royalties, (2) financial business interest or (3) inventory sale outside the U.S.

But, note Code §865(c)(4)(B)(iii) - sourcing rule for inventory sales – U.S. source, but a foreign office participation exception to U.S. source rule, then an exception from U.S. tax base inclusion. P.173.

Rev. Rul. 75-253

p.174

Foreign sub of U.S. bank making foreign loans.

Foreign sub has U.S. office handling elements of foreign based loan transactions.

U.S. office of foreign sub. handles negotiation of loans and only limited activities in the foreign country.

Foreign source interest income is ECI of USTB under §864(c)(4).

Deductions & Credits

§§873(a) & 882(c)(1) p.176

Deduction for the expenses connected with ECI is permitted. §873(a) and 882(c)(1).

Foreign tax credit is available - §906(a). For the foreign tax imposed on foreign source ECI; no credit for foreign tax on U.S. source income.

U.S. income tax return required to get deductions - §882(c)(2) & §874(c); therefore, tax on gross income if no tax return filing? Note Swallows Holding, Tax Court case – regs (p. 176) are invalid. But, 3rd Cir. reversed this decision (requiring a timely return).

Interest Expense Deduction

p.177

Interest expense deductions & allocation:

**fungibility concept applies and allocations
required. Reg. §1.882-5.**

**Loans can easily be structured to achieve tax
planning objective; but loans help all aspects of
the corporate enterprise.**

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

Problem

p.179

Re: Community Autos A.G.

What 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**

Re: African Art Traditions

a. No representation in the U.S.

No USTB - even if U.S. source income, no USTB;
and, also this is not FDAP subject to withholding
taxation under Code §881.

b. Periodic visits to the U.S. Are the activities
continuous, regular and considerable, i.e. USTB?
If so, then, U.S. sourcing? Where does title pass
when the inventory is sold? Note, the Code
§861(a)(6) title passage rule. & Reg § 1.861-7(c).
If title passage outside the U.S., then no U.S. tax.

Problem, cont.

p.180

- 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)-re office in the United States. Income is ECI under the “force of attraction” rule. §864(c)(3).
- 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. See §864(c)(5)(A) – the office of a U.S. independent agent is disregarded. Also, foreign based sales?

Problem, cont.

p.180

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 - where the activity occurs in the ordinary course of the agent's business.

Problem, cont.

p.180

f. Establish a 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) material participation of foreign office - §865(e)(2)(B).

Cf., if orders are accepted by U.S. employees – then income connected with USTB.

Tax Treaty Provisions p.181

Article 5 - P.E. Status

Article 5(1) – P.E. as a “fixed place of business.”

**Article 5(2) concerning various types of a P.E. –
what types of activities?**

**Article 5(4) re preparatory and auxiliary activities
(not causing P.E. status); e.g., storage or display
of goods.**

Article 5(5) re dependent agents – constitutes a P.E..

**Article 5(6) re independent agent – not P.E. for the
principal. Can include subsidiary of foreign co.**

Article 7 re determining the P.E.’s taxable income.

Simenon decision p.183

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.? Held: U.S. based P.E.

Note: Schedule C - Claimed depreciation deduction for his U.S. residence. Also, business expenses claimed. Note the eventual tax cost of claiming the “office in the home” income tax deduction!

Therefore, the tax treaty exemption for royalty (sourced to residence) was not applicable.

Taisei Fire and Marine Insurance Co. Ltd. p.186

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.; Fortress was an independent entity.

Legal and/or economic independence? Yes, both.

See reference to German Tax Court decision. P.193

Determining Taxable Profits

Model Art. 7 re allocable profits & Art 7(2).

See also Model Treaty 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 income derived from a specific activity. Art. 7(1).

Cf., limited “force of attraction” rule; see Code §864(c)(3).

National Westminster Bank

Article 7 Issue

p.197

Accuracy of the interest expense allocation on an intra-corporate loan (i.e., between bank branches). Disregard inter-branch transactions?

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 formula (premised upon being a business unit of a worldwide enterprise).

Treatment of Personal Services

p.211

Treaty Art. 14 (now Art. 7) - exemption for NRAs performing personal services of an independent character. Art. 7 re P.E. determinaton of business profits.

Note Rev. Rul. 2004-3 (p. 211) re cross-border service partnerships (law firms & accounting firms). Cf., Balanovski case.

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

Art. 15 – Corporate directors – tax on U.S. income.

Art. 16- “artistes and sportsmen” – U.S. tax on U.S. income (subject to \$ threshold).

Additional Treaty Provisions

p.212

Treaty Art. 19 – exemption for government employee services.

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

Treaty Art. 6(5) - Net basis (binding) election for real estate income – inclusion in current U.S. Model Treaty? (yes, even though a statute).

Treaty Art. 13(1) – U.S real estate gains – taxed in U.S. (under Code §897) – whether or not a USTB.

Relation of Tax Treaty & Code Provisions p.213

Rev. Rul. 84-17 - Polish corporation inbound into the United States with two activities.

Elect (1) part P.E. income tax treaty status (for non-P.E. income (B)) and (2) part Code status – ETBUS -ECI (for non-P.E. loss (C))? No

1st activity (A) P.E. product A gain

2nd activity (B) no P.E., but ECI USTB gain

3rd activity (C) no P.E., but ECI USTB loss

Treatment re non-P.E. activities to be consistent (i.e., Code or tax treaty).

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

Rev. Rul. 90-80 & barter income p.216

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 (proportionately) taxable to the foreign partner.

Situation Two: Dependent agent; attribution to the principal; P.E. exists (Art. 5(5)); NRA is taxed.

See Unger case (p. 218 & 220) re real estate partnership and foreign limited partners.

Problem 1 – Tax Treaty PE Status Requirement p.220

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 – yes (sales office as P.E.);
d & e – independent agent & no P.E.; f – P.E.
status**

Problem 2

p.220

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

Problem 2, cont.

p. 220

- d) Market research/advertising office in U.S. - Article 5(4)(d) provides an exemption from P.E. for “collecting information”? Similarity to enable exemption?
- e) Power to negotiate contracts in the U.S. - sales activities sufficient to supersede any other exceptions & a P.E. exists. See Art. 5(5) of the U.S. Model Treaty.

Problem 3

Agency Status

p.221

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.

What if the agent were independent? Then, no P.E. for the principal.

Treaty Article 5(5) & (6).

Problem 4

p.221

Inbound Individual (NRA)

Consultant or employee? Issue re U.S. tax treatment of income earned in U.S. (not outside the U.S.).

If employee, see Article 14 (2006 Model). Taxed in U.S. because remuneration paid by an employer who is a resident in U.S.

If an “independent consultant,” see Art. 5 (2006 Model). No income tax in the U.S. since no U.S. P.E. (prior, no fixed base in U.S.)

Query: Is this individual really independent?

Problem 5

p.221

Foreign Lawyer in the U.S.

Sally S.: 30 days in U.S. working on deal for foreign law firm; she earns 10k; her firm receives 30k.

Employee taxation: protected from U.S. tax under Art. 14(2) (2006 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.**

**Working from the law firm office in NYC? P.E.
and U.S. tax (unless her remuneration is not borne by P.E.)**

Problem 6

p.221

Electronic Website

Electronic publishing; independent web site in the U.S. (i.e., an ISP).

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

No U.S. P.E.? See p. 194, note 2, indicating probably no P.E. existing (and, therefore, no U.S. income tax even though extensive sales into U.S.).

Branch Profits Tax p.222

Division of a Foreign Corp

Code §884 30% tax on a “dividend equivalent amount” (in addition to regular corporate tax).

Tax applies currently and without any actual funds repatriation: 100x less 35% (Corp. tax) = 65x times 30% (Br. Tax) = 19.5x = 54.5 total tax.

Concept of “effectively connected E&P” is:

- 1) Reduced by an increase in branch equity; and,
 - 2) Increased by any reduction in branch equity
- to determine the branch tax taxable amount.

Branch Profits, cont.

The “2nd dividends tax” is not to apply when the branch profits tax is 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 a U.S. subsidiary to the foreign shareholder in recipient treaty country.

§884(e) – a “treaty shopping” limitation is applicable. Necessity for a “qualified resident” in the recipient country to get these treaty benefits.

Branch Profits Tax

Problem 1

p.225

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 net \$500,000.

“Dividend equivalent amount” is \$150,000:
\$650,000 (1 mil. less 350x tax) less net branch equity increase of \$500,000 = \$150,000.

Branch profits tax is \$45,000 (150,000 x 30%).

Branch Profits Tax

Problem 2

p.225

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 still incurred: 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 then \$135,000 ($450 \times 30\%$).

Branch Profits Tax

Problem 2, part 2

p.225

After tax profit of U.S. branch is \$650,000.

Adjusted basis of the branch assets is increased by \$2.5 million, but a liability of \$1.8 million is incurred: 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.

Foreign Policy Exceptions

p.226

Code §892 exemption for foreign government for U.S. source investment income (i.e., foreign government sovereign immunity), and

Code §893 exemption for govt. employee (reflecting diplomatic immunity; conditioned on reciprocity).

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

But, concept of restrictive sovereign immunity.

Note: **Quantas Airlines decision.**

Problem 1

p.227

Currency (?) Production

Gold coins marketing by foreign govt.

**Coins are legal tender but have a much higher
“numismatic value,” or “financial instruments”?**

**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 since the coins have a “numismatic” value?**

Problem 2

p.227

Govt. Employee Income

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

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

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

