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## Is the Connection Effective? Through the Maze of Section 864

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# Is the Connection Effective? Through the Maze of Section 864

*Alan B. Stevenson\**

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### I. INTRODUCTION

This article discusses certain of the rules under which foreign corporations and nonresident alien individuals may be subjected to United States federal income tax. It may at first be surprising that there are any situations in which the United States would attempt to tax the income of a nonresident alien or a foreign corporation. A moment's reflection, however, will reveal that in some situations it is quite logical that the United States should tax at least a portion of the income of such persons. For example, it seems reasonable that a corporation which conducts some minimum level of business in the United States should be subjected to United States tax on the income from that business regardless of whether the corporation is incorporated domestically or abroad. Similarly, if an alien individual, though not resident in the United States, conducts business here through agents or employees, should not the income of that business be subjected to United States tax?

As we shall see, "foreign persons" (foreign corporations and nonresident alien individuals) are subject to United States federal income tax on income arising from businesses they conduct in the United States.<sup>1</sup> The level of activity which is necessary for a foreign person to be considered to be "engaged in trade or business within the United

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<sup>1</sup> I.R.C. § 871 (1976 & Supp. V 1981) (tax on nonresident alien individuals); I.R.C. § 881 (1976) (tax on income of foreign corporations not connected with United States business); I.R.C. § 882 (1976 & Supp. V 1981 & West Supp. 1983) (tax on income of foreign corporations connected with United States business).

States"<sup>2</sup> for federal tax purposes is the primary subject of this article. For comparative purposes, the article also briefly discusses the rules under which foreign persons *not* engaged in trade or business in the United States may be subject to federal income tax. Finally, the article examines the rules governing the determination of the income which is considered to be "effectively connected with the conduct of a trade or business within the United States"<sup>3</sup> and, therefore, subject to the "normal" income tax rules applicable to United States citizens and domestic corporations.

## II. OVERVIEW

Citizens of the United States and domestic corporations are subject to United States federal income tax on their income from all sources whether domestic (within the United States) or foreign (without the United States).<sup>4</sup>

The United States federal income tax treatment of foreign persons on the other hand, depends on whether they are engaged in trade or business within the United States. Nonresident aliens and foreign corporations, that are engaged in trade or business within the United States at any time during the taxable year, are taxed in the same manner as citizens and domestic corporations but only on income which is effectively connected with the conduct of a trade or business within the United States.<sup>5</sup> Foreign persons that are *not* engaged in trade or business within the United States during the taxable year are, in general, still subject to a flat thirty percent tax but only on certain kinds of income which are specified in the statute and only when such income is from sources within the United States.<sup>6</sup> Applicable tax treaties will in

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<sup>2</sup> See I.R.C. § 864(c)(2)(1976). This section lists the factors to be used in determining whether income is effectively connected with the conduct of a trade or business within the United States, and thus subject to tax under section 871(a)(1) or 881(a) of the Code. I.R.C. §§ 871(a)(1), 881(a)(1976).

<sup>3</sup> See I.R.C. §§ 871(b)(1) (Supp. IV 1980), 881(a)(1976), 882(b)(1976).

<sup>4</sup> Treas. Reg. § 1.1-1(b), T.D. 7332, 1975-1 C.B. 204, 206 ("In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States. . . ."); Treas. Reg. § 1.11-1(a), T.D. 7293, 1973-2 C.B. 228, 230 (tax on corporations).

See also *Cook v. Tait*, 265 U.S. 47 (1924):

[T]he basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, it being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen.

*Id.* at 56.

<sup>5</sup> I.R.C. §§ 871(b) (1976 & Supp. V 1981), 882 (1976 & Supp. V 1981 & West Supp. 1983).

<sup>6</sup> I.R.C. §§ 871(a), 881(1976).

some cases reduce or eliminate this tax.<sup>7</sup> Since the tax on nonbusiness income is a tax on gross income, no deductions are allowed.<sup>8</sup> Generally, the tax is required to be withheld at the source of the income.<sup>9</sup>

A nonresident alien or foreign corporation engaged in trade or business in the United States at any time during the taxable year must file a return even if:

- (a) the foreign person has no income which is effectively connected with the conduct of a trade or business in the United States;
- (b) the foreign person has no income from United States sources; or
- (c) the income is exempt from taxation by reason of an income tax convention or any section of the Internal Revenue Code.<sup>10</sup>

If a foreign person engaged in trade or business in the United States has no gross income, a return must still be filed but the schedules are not required to be completed. Further, a statement must be filed with the return "indicating the nature of any exclusions claimed and the amounts of such exclusions to the extent such amounts are readily determinable."<sup>11</sup> In contrast, a nonresident alien or foreign corporation *not* engaged in trade or business within the United States during the taxable year need not file a United States federal tax return if the tax liability has been fully satisfied by withholding.<sup>12</sup> However, even where a return is not required, it may be necessary to file in order to reclaim tax that was withheld in excess of the tax due.

A foreign corporation is one which is not "created or organized in the United States or under law of the United States or any state."<sup>13</sup> "Every person born or naturalized in the United States and subject to its jurisdiction is a citizen."<sup>14</sup> A nonresident alien is an individual who is not a citizen and whose residence is not in the United States.<sup>15</sup> Whether an alien is a resident or nonresident is a question of fact, the resolution of which requires an examination of all relevant facts and circumstances.<sup>16</sup>

The federal income tax effects of engaging in trade or business in

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<sup>7</sup> I.R.C. § 894(a)(1976) provides: "Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle."

<sup>8</sup> Treas. Reg. § 1.871-7(a)(3) T.D. 7332, 1975-1 C.B. 204, 210, Treas. Reg. § 1.882-4(a)(1957).

<sup>9</sup> I.R.C. §§ 1441(a), 1442(a)(1976).

<sup>10</sup> Treas. Reg. § 1.6012-2(g)(1)(i), T.D. 7293, 1973-2 C.B. 228, 248-49.

<sup>11</sup> *Id.*

<sup>12</sup> Treas. Reg. §§ 1.6012-1(b)(2)(i)(1960), 1.6012-2(g)(2), T.D. 7293, 1973-2 C.B. 228, 248-49.

<sup>13</sup> I.R.C. §§ 7701(a)(4)(1976) (definition of "domestic"), 7701(a)(5)(1976) (definition of "foreign").

<sup>14</sup> Treas. Reg. § 1.1-1(c), T.D. 7332, 1975-1 C.B. 204, 206.

<sup>15</sup> Treas. Reg. § 1.871-2(a)(1957).

<sup>16</sup> *Adams v. Commissioner*, 46 T.C. 352, 358 (1966), *acq.* 1967-2 C.B. 1; *Jellinek v. Commis-*

the United States are not necessarily limited to the direct recipient of effectively connected income. Non-United States creditors and non-United States shareholders of a non-United States corporation may be surprised to learn that interest or dividends received from that corporation can be subject to United States tax. Interest and dividends paid by a non-United States corporation will be considered income from United States sources if, for the three years preceding the year in which the interest or dividends were paid, fifty percent or more of the corporation's gross income from all sources was effectively connected with the conduct of a trade or business in the United States.<sup>17</sup> Interest or dividend income from such a foreign corporation is taxable as United States source income to the foreign creditor or shareholder under the rules described in this article.<sup>18</sup>

It should also be noted here that income from sources outside the United States may under certain circumstances be subject to United States tax as effectively connected income if the recipient is engaged in trade or business within the United States. This point is discussed in further detail below.<sup>19</sup>

### III. NONBUSINESS INCOME OF FOREIGN PERSONS

#### A. In General

Prior to the enactment of the Foreign Investors Tax Act of 1966,<sup>20</sup> foreign persons were, as they now are, subject to United States federal

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sioner, 36 T.C. 826, 834 (1961), *acq.* 1964-1 C.B. 4. The regulations describe the necessary factual inquiry in the following terms:

An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section in the absence of exceptional circumstances.

Treas. Reg. § 1.871-2(b)(1957). For a recent example of "exceptional circumstances," see *Tong-sun Park v. Commissioner*, 79 T.C. 252 (1982). See also *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950), *cert. denied*, 341 U.S. 925 (1951).

<sup>17</sup> I.R.C. §§ 861(a)(1)(C)(1976) (interest), 861(a)(2)(B)(1976) (dividends).

<sup>18</sup> See, e.g., *infra* notes 259 to 274 and accompanying text.

<sup>19</sup> See, e.g., *infra* notes 292 to 332 and accompanying text.

<sup>20</sup> Pub. L. No. 89-809, 80 Stat. 1539(1966) (effective generally for tax years beginning after Dec. 31, 1966).

income tax on "fixed or determinable annual or periodical"<sup>21</sup> income and certain other kinds of income provided that the income was derived from United States sources. The rate at which such income was taxed depended primarily on whether the nonresident alien or foreign corporation was engaged in trade or business within the United States. Individuals not engaged in a United States trade or business were subject to a thirty percent tax on United States source nonbusiness income if the total of such income for the taxable year was less than \$21,200.<sup>22</sup> If the United States source nonbusiness income of such individuals exceeded \$21,200, they were taxed either at thirty percent or at the regular rates applicable to individuals, whichever produced the higher tax.<sup>23</sup> Foreign corporations not engaged in a United States trade or business were subject to the thirty percent tax on gross nonbusiness income from United States sources.<sup>24</sup> Thus, "one foreigner may [have been] taxed on investment income at regular individual or corporate rates while another, with an identical portfolio investment, [was] taxed on his investment income at the flat 30 percent [or lower treaty] rate."<sup>25</sup> Congress believed that it was "neither equitable nor logical for this substantial difference in tax treatment of investment income to depend on the presence or absence of an unrelated business."<sup>26</sup>

With the Foreign Investors Tax Act, Congress intended to subject business income of foreign persons to the same tax rates applicable to United States persons. Further, the new rules were intended to subject United States source investment income to the thirty percent flat rate withholding tax regardless of whether the recipient of the income is engaged in trade or business in the United States. From a United States point of view, taxing this income on a gross basis is consistent with the concept that deductions are not appropriate where income is not business income. The withholding requirement is the result of practical jurisdictional considerations.<sup>27</sup>

However, the manner in which foreign persons are taxed on non-business income from United States sources results in each item of income of one of the specified types being taxed separately. A collateral effect of combining this approach with the rules that deductions are not

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<sup>21</sup> See I.R.C. §§ 871(a)(1)(A), 881(a)(1)(1976).

<sup>22</sup> S. REP. NO. 1707, 89th Cong., 2d Sess. 3, *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 4446.

<sup>23</sup> *Id.* at 22-23, *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS at 4467-68.

<sup>24</sup> *Id.* at 32, *reprinted in* U.S. CODE CONG. & AD. NEWS at 4477.

<sup>25</sup> *Id.* at 18, *reprinted in* U.S. CODE CONG. & AD. NEWS at 4463.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 28-31, *reprinted in* U.S. CODE CONG. & AD. NEWS at 4473-75.

allowed and that a return is not generally required is that a foreign person not engaged in trade or business is not entitled to relief for losses.<sup>28</sup> United States tax may therefore be due even in a year in which realized losses from United States sources exceed realized gains from United States sources.

The statute specifies the kinds of United States source income which constitute nonbusiness income subject to the thirty percent tax. The most common kinds of nonbusiness income received by foreign persons are often referred to as a group as "fixed or determinable annual or periodical income."<sup>29</sup> This group includes "interest . . . dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income."<sup>30</sup>

The regulations take a broad view of what constitutes "fixed or determinable annual or periodical" income. For example, they provide that the term also includes royalties<sup>31</sup> and that the term "interest" includes "interest on certain deferred payments, as provided in Section 483 and the regulations thereunder."<sup>32</sup> Furthermore,

[t]he term 'fixed or determinable annual or periodical' income is merely descriptive of the character of a class of income. If an item of income falls within the class of income contemplated by the statute, it is immaterial whether payment of that item is made in a series of repeated payments or in a single lump sum.<sup>33</sup>

Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. . .<sup>34</sup>

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<sup>28</sup> I.R.C. § 871(a)(1)(1976); Treas. Reg. § 1.871-7(a)(3), T.D. 7332, 1975-1 C.B. 204, 210. Note, however, that section 871(a)(2) does provide for the recognition of capital losses but "only if, and to the extent that, they would be recognized and taken into account if such gains and losses were effectively connected with the conduct of a trade or business within the United States." Furthermore, a section 1202 capital gain deduction and a section 1212 capital loss carryover are not allowed.

<sup>29</sup> I.R.C. §§ 871(a)(1)(A), 881(a)(1)(1976).

<sup>30</sup> *Id.*

<sup>31</sup> Treas. Reg. §§ 1.871-7(b), T.D. 7332, 1975-1 C.B. 204, 210, 1.1441-2(a)(1), T.D. 6908, 1967-1 C.B. 222, 225-26.

<sup>32</sup> Treas. Reg. § 1.1441-2(a)(1), T.D. 6908, 1967-1 C.B. 222, 225-26.

<sup>33</sup> *Id.*

<sup>34</sup> Treas. Reg. § 1.1441-2(a)(2)(1956).



## B. Gains from Sales of Property

### 1. General Rule

The general rule is that the only kind of United States source income which is clearly not fixed or determinable annual or periodical income is "[i]ncome derived from the sale in the United States of property whether real or personal."<sup>35</sup> There are, however, several situations in which gains from sales of property by foreign persons not engaged in trade or business in the United States are subject to tax although withholding is not required under sections 1441 and 1442.<sup>36</sup>

### 2. Exceptions

#### a. Substantial Presence in the United States

The first exception to the general rule concerns individuals who are not classified as residents but who are present in the United States during more than half of the taxable year. If a nonresident alien not engaged in trade or business in the United States realizes net gains from the sale in the United States of property which constitutes a capital asset, such net gains will be subject to the flat thirty percent tax if the individual is present in the United States for 183 days or more during the taxable year.<sup>37</sup>

#### b. Certain Real Property Interests

A second exception to the general rule arises in connection with sales of real property or real property interests. Gain realized by a foreign person from the disposition of "an interest in real property (including in a mine, well or other natural deposit) located in the United States or in the Virgin Islands"<sup>38</sup> will be treated as income which is effectively connected with a trade or business within the United States even if the recipient of the income is not engaged in trade or business in the United States.<sup>39</sup>

Even without section 897, many foreign owners of real property situated in the United States would probably be regarded as being engaged in trade or business in the United States under the general prin-

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<sup>35</sup> Treas. Reg. § 1.1441-2(a)(3), T.D. 6908, 1967-1 C.B. 222, 226.

<sup>36</sup> I.R.C. §§ 1441, 1442(1976).

<sup>37</sup> I.R.C. § 871(a)(2)(1976).

<sup>38</sup> I.R.C. § 897(c)(1)(A) (Supp. V 1981).

<sup>39</sup> I.R.C. § 897(a)(1) (Supp. V 1981). Section 897, which prescribes the tax treatment of these gains, entered the Code as a result of the Foreign Investment in Real Property Tax Act. Pub. L. No. 96-499, 94 Stat. 2682 (1980).

principles of section 864.<sup>40</sup> Alternatively, they could be so treated as a result of an election under section 871(d) or 882(d).<sup>41</sup> For such persons, the principal change brought by section 897 is that tax may also now be triggered by the disposition of "any interest" in a "United States Real Property Holding Corporation."<sup>42</sup> A corporation is a United States Real Property Holding Corporation if the fair market value of its United States property interests is equal to or greater than fifty percent of the sum of the fair market values of all of the assets used in or held for use in its trade or business including all of its interests in real property whether or not such property is situated within the United States.<sup>43</sup>

### c. Certain Intangible Property

A further exception to the general rule that gains from the sale of property do not constitute fixed or determinable annual or periodical income, concerns sales or exchanges of certain kinds of intangible property. The property to which this treatment applies includes "patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises, and other like property, or any interest in such property."<sup>44</sup> Gains from sales or exchanges of such property after October 4, 1966, are subject to the thirty percent flat rate tax "to the extent such gains are from payments which are contingent on the productivity, use or disposition of the property or interest sold or exchanged."<sup>45</sup> If more than fifty percent of the gain for any taxable year from the sale or exchange of any item of such property is contingent on productivity, use or disposition of the property, all gain from the sale or exchange of such property will be treated as contingent.<sup>46</sup>

Contrary to the general rule that tax is not required to be withheld when foreign persons not engaged in trade or business within the United States realize gains upon the disposition of property, tax must be withheld from contingent gains on dispositions of the specified types

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<sup>40</sup> Section 864(c)(4)(B) of the Code provides that income from sources outside the United States shall be treated as effectively connected with the conduct of a trade or business within the United States where the nonresident alien individual or foreign corporation has an office or other fixed place of business within the United States, and where the income attributable to that place of business consists of one or more of the three categories of income. I.R.C. § 864(c)(4)(B)(1976).

<sup>41</sup> I.R.C. §§ 871(d), 882(d)(1976) (election to treat real property income as income connected with United States business).

<sup>42</sup> I.R.C. §§ 897(a)(1), 897(c)(1)(A)(ii), 897(c)(2) (Supp. V 1981).

<sup>43</sup> I.R.C. § 897(c)(2) (Supp. V 1981).

<sup>44</sup> I.R.C. §§ 871(a)(1)(D), 881(a)(4)(1976).

<sup>45</sup> *Id.*

<sup>46</sup> I.R.C. § 871(c)(1)(1976).

of intangible property.<sup>47</sup> However, for purposes of determining the recipient's ultimate tax liability, amounts received as contingent payments are to be reduced by "amounts representing recovery of the taxpayer's adjusted basis in the property which is sold or exchanged."<sup>48</sup> Since the amount of tax required to be withheld is based on the amount paid, the recipient of such income who has a basis in the property disposed of must file a tax return in order to reclaim the excess tax withheld.

#### d. Debt Instruments

Sections 871(a)(1)(C) and 881(a)(3)<sup>49</sup> provide that certain gains realized by foreign persons from the sale or exchange of debt instruments such as bonds may constitute taxable nonbusiness income. The rules are based on the treatment of original issue discount under section 1232<sup>50</sup> of the Code, but are applied to nonresident aliens and foreign corporations in the following manner:

(1) The rules apply only to debt instruments issued after September 28, 1965;<sup>51</sup>

(2) Amounts which would be taxed as ordinary income under section 1232(a)(2)(B) are subject to the thirty percent tax on disposition of the "bond or other evidence of indebtedness;"<sup>52</sup>

(3) This rule applies even to instruments issued after May 27, 1969, when the method of taxing original issue discount was changed for domestic taxpayers;<sup>53</sup>

(4) Special rules apply in the case of debt obligations issued after March 31, 1972:

(a) On an obligation which is by its terms, payable more than six months after the original issue date (regardless of how long it is actually held by the taxpayer), original issue discount will be taxed along with any interest paid, but only to the extent of the interest less the tax on the interest;<sup>54</sup>

(b) Original issue discount arising on an obligation which, by its terms, matures in less than six months after the original issue date is not subject to tax in the hands of a foreign person

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<sup>47</sup> Treas. Reg. § 1.1441-2(b)(2)(iii), T.D. 6908, 1967-1 C.B. 222, 226.

<sup>48</sup> Treas. Reg. § 1.871-11(d)(1974).

<sup>49</sup> I.R.C. §§ 871(a)(1)(C), 881(a)(3)(1976).

<sup>50</sup> I.R.C. § 1232(1976 & Supp. V 1981).

<sup>51</sup> I.R.C. §§ 871(a)(1)(C)(i), 881(a)(3)(A)(1976).

<sup>52</sup> I.R.C. §§ 871(a)(1)(C)(ii), 881(a)(3)(B)(1967).

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

not engaged in trade or business in the United States.<sup>55</sup>

e. Miscellaneous

United States source gains realized by foreign persons from dispositions of timber, coal, or iron ore with a retained economic interest as described in sections 631(b) or (c)<sup>56</sup> of the Code is also subject to the thirty percent tax on nonbusiness income.<sup>57</sup> In addition, nonresident alien individuals not engaged in trade or business in the United States are subject to the thirty percent tax on the portion of a distribution from certain trusts<sup>58</sup> which would otherwise be treated as a capital gain under section 402(a)(2) or 403(a)(2)<sup>59</sup> of the Code.

#### IV. THE CONCEPT OF A UNITED STATES TRADE OR BUSINESS

Having discussed the United States federal tax treatment of non-business income of foreign persons in the preceding section, we turn now to an examination of the tax treatment of the business income of foreign persons. As noted in section II,<sup>60</sup> foreign persons engaged in trade or business in the United States are taxed on income which is effectively connected with a United States trade or business in the same manner that citizens and domestic corporations are taxed. The basic difference between the two tax regimes is that, as we have seen, the gross United States source nonbusiness income of foreign persons is taxed at a flat rate of thirty percent and no deductions are allowed, while citizens, residents and domestic corporations are taxed at graduated rates on such income after provision for any deductions allowed by the statute.

In order for a nonresident alien individual or a foreign corporation to be subject to United States tax at graduated rates on effectively connected taxable income the taxpayer must be "engaged in trade or business within the United States" during the taxable year. This section discusses the circumstances under which a nonresident alien or foreign corporation will be considered to be engaged in a trade or business in the United States within the meaning of sections 871(b) and

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<sup>55</sup> *Id.*

<sup>56</sup> See I.R.C. §§ 631(b)(1976) (disposal of timber with a retained economic interest), 631(c)(1976) (disposal of coal or domestic iron ore with a retained economic interest).

<sup>57</sup> I.R.C. §§ 871(a)(1)(B), 881(a)(2)(1976).

<sup>58</sup> I.R.C. § 871(a)(1)(B)(1976).

<sup>59</sup> See I.R.C. §§ 402(1976 & Supp. V 1981) (taxability of beneficiary of employees' trust), 403(1976 & Supp. V 1981) (taxation of employee annuities).

<sup>60</sup> See text accompanying note 5 *supra*.

882(a)(1).<sup>61</sup>

## A. The Statute

### 1. *In General*

The Internal Revenue Code does not explicitly define the term "engaging in trade or business." The term "trade or business" appears twice in the context of taxing nonresident aliens and foreign corporations: the first time to describe the taxpayer;<sup>62</sup> the second time to describe income as "effectively connected with the conduct of a trade or business within the United States."<sup>63</sup> No variation in meaning should be attributed to the term trade or business based on its distinct use in either of these contexts.<sup>64</sup>

It may also be useful to note that in order for income to be effectively connected, the foreign corporation or nonresident alien must be engaged in trade or business in or within the United States.<sup>65</sup> For example, goods manufactured and sold outside the United States will not necessarily give rise to effectively connected income even if the pur-

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<sup>61</sup> Section 871(b)(1) provides: "A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1, 55, or 402(e)(1) on his taxable income which is effectively connected with the conduct of a trade or business within the United States." I.R.C. § 871(b)(1)(Supp. V 1981).

Section 882(a)(1) provides: "A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11 or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States." I.R.C. § 882(a)(1)(Supp. V 1981).

<sup>62</sup> See *supra* note 61, I.R.C. § 871(b)(1)(Supp. V 1981).

<sup>63</sup> See *supra* note 61, I.R.C. § 882(a)(1)(Supp. V 1981).

<sup>64</sup> Although this point is not expressly made in the Code, the structure of the rules leaves little room for doubt that the drafters of the statute intended the term to have the same meaning in both contexts. For example, section 871(b)(1) provides that "a nonresident alien individual engaged in a trade or business within the United States during the taxable year shall be taxable . . . on his taxable income which is effectively connected with the conduct of a [trade or business within the United States]." I.R.C. § 871(b)(1)(Supp. V 1981). Other variations of "trade or business" are encountered throughout the Code. For example: "expenses incurred . . . in carrying on any trade or business," I.R.C. § 162 (1976 & Supp. V 1981 & West Supp. 1983); "property used in the trade or business," I.R.C. § 167 (1976 & Supp. V 1981 & West Supp. 1983); "losses incurred in a trade or business," I.R.C. § 165(c)(1) (1976); income from "the active conduct of a trade or business within a possession of the United States," I.R.C. § 936(a)(1)(A)(i) (Supp. V 1981); and "engaged in the active conduct of a trade or business," I.R.C. § 355(b) (1976). Used in these variations, however, the term "trade or business" does not necessarily carry precisely the same meaning that it does in the context of foreign corporations and nonresident aliens. See, e.g., *Herbert v. Commissioner*, 30 T.C. 26, 33-34 (1958), *acq.* 1958-2 C.B. 6. In *Herbert* the court held that the taxpayer, a British subject residing in England who owned a piece of property in Washington, D.C., was *not* engaged in a trade or business in the United States within the meaning of the income tax convention between the United States and the United Kingdom.

<sup>65</sup> I.R.C. §§ 871(b)(2), 882(a)(2)(1976).

chaser of the goods is a United States person who intends to distribute or use the goods exclusively in the United States.

## *2. Personal Services*

The index of the Internal Revenue Code suggests that section 864(b) provides a definition of the term "trade or business within the United States."<sup>66</sup> That section, however, offers only a limited, general rule and several detailed exceptions. The general rule is that personal services "performed within the United States at any time during the taxable year" are included within the term "trade or business within the United States" for purposes of sections 861 through 879 and sections 1441 through 1464.<sup>67</sup> The remainder of the section is devoted to explaining the exceptions to the general rule.

The first of the exceptions concerns personal services performed on a temporary basis for a foreign employer.<sup>68</sup> For purposes of this exception, a foreign employer may be either a foreign individual, corporation, or partnership which is not engaged in trade or business within the United States<sup>69</sup> or a foreign office or place of business of a United States citizen, resident, corporation, or partnership.<sup>70</sup> The foreign employer exception is limited to nonresident alien individuals who are present in the United States for not more than ninety days during the taxable year and whose compensation for the services performed in the United States does not exceed \$3,000.<sup>71</sup>

The second category of statutory exceptions to the general rule concerns trading in stocks, securities and commodities.<sup>72</sup> Trading in stocks or securities through a resident broker or other independent agent does not constitute engaging in trade or business within the United States.<sup>73</sup> Subject to the limitations described below, if the trading in stocks or securities is for the taxpayer's own account, it may be carried out by an employee or any agent of the taxpayer and the agent

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<sup>66</sup> Section 864 is entitled "Definitions" and is located in subchapter N, PART I: "DETERMINATION OF SOURCES OF INCOME." 26 U.S.C.S. at xxiv (1974) (there was no index included in the 1954 Code).

<sup>67</sup> I.R.C. § 864(b)(1976) provides: "For purposes of this part (§§ 861-864), part II (§§ 871-879), and chapter 3 (§§ 1441-1464), the term "trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year. . . ."

<sup>68</sup> I.R.C. § 864(b)(1)(1976).

<sup>69</sup> I.R.C. § 864(b)(1)(A)(1976).

<sup>70</sup> I.R.C. § 864(b)(1)(B)(1976).

<sup>71</sup> I.R.C. § 864(b)(1)(1976).

<sup>72</sup> I.R.C. § 864(b)(2)(1976).

<sup>73</sup> I.R.C. § 864(b)(2)(A)(i)(1976).

or employee may have "discretionary authority to make decisions in effecting the transactions."<sup>74</sup>

In both cases—that of the resident broker and that of the taxpayer's agent—the general rule is merely a restatement of the law prior to the enactment of the Foreign Investors Tax Act of 1966.<sup>75</sup> The additional language regarding the latter case specifically provides that the exercise of discretionary authority by the taxpayer's agent will not cause the taxpayer to lose the benefits of the exception. This language was added to the statute as a result of cases which held that the securities trading exception was not applicable where the agent was given discretionary authority.<sup>76</sup> This exception does not apply to a dealer in stocks or securities or to a corporation whose principal business is trading in stocks or securities and whose principal office is in the United States.<sup>77</sup>

The rules which exclude trading in commodities from being treated as a trade or business within the United States are similar to those which exclude certain trading activities in stocks and securities. However, unlike the stocks and securities trading exception, the commodities trading exception is available to a foreign corporation the principal business of which is trading in commodities and the principal office of which is in the United States. Such a corporation trading for its own account will not, solely on the basis of that activity, be considered to be engaged in a trade or business within the United States.<sup>78</sup> The commodities dealt in must, however, be "of a kind customarily dealt in on an organized commodity exchange" and the transactions must be "of a kind customarily consummated at such a place."<sup>79</sup> The term "commodity" specifically does not include "goods or merchandise in the ordinary channels of commerce."<sup>80</sup>

The general rule that trading in stocks, securities or commodities through an independent agent does not constitute a United States trade or business is subject to a further limitation. The exception does not apply if at any time during the taxable year the taxpayer has an "office

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<sup>74</sup> I.R.C. § 864(b)(2)(A)(ii)(1976).

<sup>75</sup> Pub. L. No. 89-809, 80 Stat. 1539 (1966).

<sup>76</sup> S. REP. NO. 1707, 89th Cong., 2d Sess. 3, *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 4446, 4461-62. *See* *Adda v. Commissioner*, 10 T.C. 273 (1948), *acq.* 1940-2 C.B. 1, *aff'd per curiam*, 171 F.2d 457 (4th Cir. 1948), *cert. denied*, 336 U.S. 952 (1949); *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950), *cert. denied*, 341 U.S. 925 (1951).

<sup>77</sup> S. REP. NO. 1707, 89th Cong., 2d Sess. 3, *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 4446, 4462.

<sup>78</sup> I.R.C. § 864(b)(2)(B)(1976).

<sup>79</sup> I.R.C. § 864(b)(2)(B)(iii)(1976).

<sup>80</sup> Treas. Reg. § 1.864-2(d)(3)(1968).

or other fixed place of business in the United States through which or by the direction of which the transactions . . . are effected.”<sup>81</sup> In this context the term “effecting of transactions” in stocks or securities includes:

buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer, and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading).<sup>82</sup>

Furthermore, “[t]he volume of stock or security transactions effected during the taxable year shall not be taken into account in determining under this subparagraph whether the taxpayer is engaged in a trade or business within the United States.”<sup>83</sup>

### B. Cases and Rulings

While the general rule and the exceptions discussed above may be helpful to some foreign persons they do not significantly further our understanding of the term “engaged in trade or business in the United States.” We turn now, therefore, to an examination of a sampling of cases and rulings which have addressed the issue of whether certain activities of foreign persons constituted engaging in trade or business in the United States.

A number of these cases have been decided under statutes which precede the 1954 Code. Some of the cases discussed did not entirely involve income tax issues. There is, however, nothing to suggest that Congress intended the meaning of the term “engaged in trade or business in the United States” to have more than one meaning in the context of taxing foreign persons. The question of whether a nonresident alien or foreign corporation is engaged in trade or business within the United States during any taxable year is a question of fact.<sup>84</sup> Furthermore, whether certain activities constitute engaging in business within the meaning of the federal tax law is a federal question which is not controlled by state law.<sup>85</sup>

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<sup>81</sup> I.R.C. § 864(b)(2)(C)(1976).

<sup>82</sup> Treas. Reg. § 1.864-2(c)(2)(1968).

<sup>83</sup> *Id.*

<sup>84</sup> *Lewenhaupt v. Commissioner*, 20 T.C. 151, 162 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955).

<sup>85</sup> *Lyeth v. Hoey*, 305 U.S. 188, 193-94 (1938).



1. *Real Estate Activities*

In an early case, *Neill v. Commissioner*<sup>86</sup> involving income for the year 1938, taxpayer Neill wanted to deduct interest paid on a mortgage for a building which she owned in Philadelphia. In order to avoid being taxed under section 211(a)(1) of the Revenue Act of 1938<sup>87</sup> on the gross rent received, she had to establish that she was "engaged in trade or business in the United States" or that she had "an office or place of business therein." Neill's only income from United States sources was the rent she received from the tenant who leased the Philadelphia building.<sup>88</sup> Neill admitted she did not "operate" the building, "such operation being by the tenant," but contended that mere ownership of the building constituted "the carrying on of business."<sup>89</sup> Referring to *Higgins v. Commissioner*,<sup>90</sup> the Board of Tax Appeals concluded that:

[t]he ownership of this property by petitioner is no more a business activity carried on within the United States than her ownership of stocks or bonds of American companies held for her by an American agent . . . . We think the rule is settled that mere ownership of property from which income is drawn does not constitute the carrying on of business within the purview of [section 211(b)].<sup>91</sup>

In a more recent case, *Herbert v. Commissioner*,<sup>92</sup> involving the years 1952 and 1953, the petitioner owned real property in Washington, D.C. which had been given to her by her father in 1907 or 1908 when she was quite young. The property had been rented to one tenant since 1940. Under the terms of the lease the tenant was responsible for the operation of the property and for all repairs except those which might be necessary to the foundation and outer walls. During the years in controversy the petitioner's sole activities in connection with the property consisted of the receipt of rents and the payment of taxes, insurance and principal and interest on the building's mortgage.<sup>93</sup>

Since the petitioner was a British citizen and was for all years concerned a resident of Britain, resolution of the case required an interpretation of the income tax convention then in effect between the United

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<sup>86</sup> 46 B.T.A. 197 (1942).

<sup>87</sup> I.R.C. § 211(a)(1)(1938) read:

There shall be levied, collected, and paid for each taxable year, in lieu of the tax imposed by sections 11 and 12, upon the amount received, by every nonresident alien individual not engaged in trade or business within the United States and not having an office or place of business therein, from sources within the United States as . . . rents . . . .

<sup>88</sup> 46 B.T.A. at 198.

<sup>89</sup> *Id.*

<sup>90</sup> 312 U.S. 212 (1940).

<sup>91</sup> 46 B.T.A. at 198 (citations omitted).

<sup>92</sup> 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; *see supra* note 65 and accompanying text.

<sup>93</sup> *Id.* at 28-32.

States and the United Kingdom.<sup>94</sup> For the three years prior to 1952, the petitioner had “elected” to file United States federal income tax returns as a nonresident alien engaged in trade or business in the United States. However, for 1952 and 1953 she claimed the benefits of a reduced rate of tax (fifteen percent) for rentals from real property in the United States where the recipient was “not engaged in trade or business in the United States.”<sup>95</sup> The Commissioner took the position that the taxpayer was engaged in trade or business through a permanent establishment in the United States and therefore did not qualify for the reduced rate of tax.

Article IX of the treaty<sup>96</sup> limited the rate of United States tax on rentals derived from real property located within the United States and paid to a resident of the United Kingdom who was not engaged in trade or business in the United States. Relying on this, the court found that:

The provisions of article IX clearly indicate the recognition by the United States that ownership and leasing of real property do not constitute per se engaging in trade or business . . . . If the ownership and leasing of real property were considered to constitute a trade or business, that provision would be meaningless since on this hypothesis no one could be not engaged in trade or business in the United States who received rentals from real estate located within the United States.<sup>97</sup>

The court then cited the *Neill* case<sup>98</sup> for the proposition that ownership and leasing of real property along with collection of rents and performance of “certain minimal acts customarily incident to the ownership of real property do not constitute engaging in trade or business.”<sup>99</sup> The court further noted that:

where the activities of the nonresident alien ‘are beyond the scope of mere ownership of real property, of the receipt of income from real property’

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<sup>94</sup> See Convention Between the United States and the United Kingdom Respecting Double Taxation and Taxes on Income, Apr. 16, 1945, United States-United Kingdom, 60 Stat. 1377, T.I.A.S. No. 1546 [hereinafter cited as 1945 United Kingdom Convention]. A new treaty was signed between these countries in 1975. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Dec. 31, 1975, United States-United Kingdom, — U.S.T. —, T.I.A.S. No. 9682, reprinted in 2 TAX TREATIES (CCH) ¶ 8103 A [hereinafter cited as 1975 United Kingdom Convention].

<sup>95</sup> 1945 United Kingdom Convention, *supra* note 94, art. IX(1), 60 Stat. at 1382, T.I.A.S. No. 1546 at 7, states:

The rate of United States tax on . . . rentals from real property from an interest in such property, derived from sources within the United States by a resident of the United Kingdom who is subject to United Kingdom tax with respect to such . . . rentals and not engaged in trade or business in the United States, shall not exceed 15 percent . . . .

<sup>96</sup> *Id.*

<sup>97</sup> 30 T.C. at 32-33.

<sup>98</sup> *Id.* at 33; see *supra* notes 86-91 and accompanying text.

<sup>99</sup> *Id.* at 33.

and are 'considerable, continuous, and regular' it has been held (although not in a case construing the provisions of the United States - United Kingdom tax convention) that such activities of the nonresident alien constitute engaging in a business.<sup>100</sup>

The court then held that within the meaning of article IX(1) of the United States-United Kingdom tax convention, since the activities of the petitioner which might be considered "beyond the scope of mere ownership of real property, or the receipt of income from real property" were sporadic rather than "continuous," were irregular rather than "regular," and were minimal rather than "considerable" petitioner was not engaged in trade or business in the United States during the taxable years in question.<sup>101</sup>

In *Lewenhaupt*,<sup>102</sup> a case relied upon by the court in *Herbert*, a citizen and resident of Sweden during 1946 realized capital gain from the sale of real property in the United States. Jan Casimir Lewenhaupt was engaged in the importing and exporting business in Sweden during 1946 and was present in the United States for only one month during the year. At one time or another during 1946 Lewenhaupt owned real property at four locations in California.<sup>103</sup> One of these, was a property in Modesto which Lewenhaupt acquired in 1941 and sold during 1946. The taxability of the capital gain he realized was at issue in this case.<sup>104</sup> Article IX of the United States-Sweden income tax treaty<sup>105</sup> provided that capital gains derived by a resident of one of the contracting states (i.e., Lewenhaupt) from sources within the other states (i.e., the United States) were taxable only where the recipient of the gain resided (i.e., Sweden) unless he had a permanent establishment in the other state (i.e., in the United States). Article V of the treaty<sup>106</sup> provided that gains from the sale of real property were taxable only in the contracting state in which the property was situated; the United States in this case. The court agreed with the Commissioner that article

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<sup>100</sup> *Id.* (citing *Lewenhaupt*, 20 T.C. 151 (1953)).

<sup>101</sup> *Id.*

<sup>102</sup> *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953).

<sup>103</sup> *Id.* at 153.

<sup>104</sup> *Id.* at 154.

<sup>105</sup> Convention for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance in the Case of Income and Other Taxes, Mar. 23, 1939, United States-Sweden, art. IX, 54 Stat. 1759, 1764, T.S. No. 958 at 6, states:

Gains derived in one of the contracting States from the sale or exchange of capital assets by a resident or a corporation or other entity of the other contracting State shall be exempt from taxation in the former State, provided such resident or corporation or other entity has no permanent establishment in the former State.

<sup>106</sup> *Id.*, art. V, 54 Stat. at 1762, T.S. No. 958 at 4, states: "Income of whatever nature derived from real property, but not including interest from mortgages or bonds secured by real property, shall be taxable only in the contracting State in which the real property is situated."

IX did not apply to Lewenhaupt and that taxation of the gain in question was governed by section 211 of the Internal Revenue Code.<sup>107</sup>

The issue thus became whether Lewenhaupt was, during the taxable year, "engaged in trade or business within the United States" within the meaning of section 211. If he was so engaged, the capital gain would be taxable under section 117<sup>108</sup> of the Code. Although he owned approximately \$100,000 worth of United States securities at the beginning of the year, his only securities transactions during the year consisted of purchasing additional securities with part of the proceeds from the sale of the Modesto property. The issue was thus further narrowed to the question of "whether his activities with respect to certain parcels of improved real estate constituted engaging in a trade or business."<sup>109</sup> At one time or another during the taxable year, Lewenhaupt owned improved commercial real estate at three locations in California, with an aggregate market value of approximately \$337,000. As noted, however, Lewenhaupt was present in the United States for only one month during the year. He had, however, in 1941 appointed La Montagne, a resident of California, as his agent for the purpose of managing his United States property holdings and had executed a power of attorney which conferred on La Montagne broad general powers.<sup>110</sup>

La Montagne's activities, during the taxable year, in the management and operation of petitioner's real properties included the following: executing leases and renting the properties, collecting the rents, keeping books of account, supervising any necessary repairs to the properties, paying taxes and mortgage interest, insuring the properties and executing an option to purchase an additional property which option was exercised in January 1947.<sup>111</sup> In addition, La Montagne conducted a regular correspondence with Lewenhaupt's father in England who held a power of attorney from petitioner identical to that given to La Montagne.<sup>112</sup> La Montagne also submitted monthly reports to Lewenhaupt's father and advised him of prospective and advantageous sales or purchases of property.<sup>113</sup> The correspondence with Lewen-

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<sup>107</sup> 20 T.C. at 162.

<sup>108</sup> *Id.* Section 117 (1953), provided for the taxability of capital gains. I.R.C. § 117 (1953). This section has been renumbered and now appears as sections 1221 and 1222 of the 1954 Code. I.R.C. §§ 1221(1976), 1222(1976 & Supp. IV 1980).

<sup>109</sup> 20 T.C. at 162.

<sup>110</sup> *Id.* at 152-53.

<sup>111</sup> *Id.* at 163.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

haupt's father was apparently pursuant to an understanding that "La Montagne was to take no important action regarding petitioner's United States property, such as purchasing and selling real estate, without first consulting either petitioner or petitioner's father."<sup>114</sup>

The court found that the activities of La Montagne on Lewenhaupt's behalf "are beyond the scope of mere ownership of real property or the receipt of income from real property. The activities were considerable, continuous, and regular and, in [the opinion of the court], constituted engaging in a business within the meaning of section 211(b) of the Code."<sup>115</sup> As a result of the activities carried on in his behalf with respect to his United States real property holdings, the court held that Lewenhaupt was, engaged in a United States trade or business and that, therefore, his income from United States sources, including the capital gain, was taxable under section 211(b).<sup>116</sup>

A determination that a nonresident alien was engaged in trade or business in the United States may have effects outside the area of income tax. An estate tax effect of such a determination is illustrated by *Pinchot v. Commissioner*,<sup>117</sup> which was cited in *Lewenhaupt* for the proposition that federal rather than state law controls the determination of whether a nonresident alien is engaged in a United States trade or business for federal income tax purposes.<sup>118</sup> The case is discussed here because it involves activities with respect to real property. Pinchot was the ancillary executor for Johnstone, a British subject not resident in the United States. Johnstone did, however, have United States property holdings consisting in part of an interest in eleven parcels of New York City real estate valued at about one million dollars which were managed by Pinchot.<sup>119</sup> Under section 302(e)<sup>120</sup> of the Revenue Act of 1926,<sup>121</sup> if Johnstone were not engaged in trade or business in the

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<sup>114</sup> *Id.* at 154.

<sup>115</sup> *Id.* at 163.

<sup>116</sup> *Id.*

<sup>117</sup> 113 F.2d 718 (2nd Cir. 1940).

<sup>118</sup> 20 T.C. at 163; *see also* *Lyeth v. Hoey*, 305 U.S. 188 (1938).

<sup>119</sup> 113 F.2d at 719.

<sup>120</sup> Section 302 stated, in part:

The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

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- (e) To the extent of the interest therein held as joint tenants by the decedent and any other person, or as tenants by the entirety by the decedent and spouse, or deposited, with any person carrying on the banking business, in their joint names and payable to either or the survivor . . . .

I.R.C. § 302 (1926).

<sup>121</sup> Pub. L. No. 69-20, § 302(e), 44 Stat. 9, 71 (1926).

United States at the time of her death on July 1, 1934, her United States bank deposits would not be deemed property within the United States and would therefore not be subject to United States estate tax.

Pinchot was Johnstone's brother and together they owned the New York properties in common with their other brother. According to the stipulated facts in the case, Pinchot "bought and sold property for the co-owners in his discretion without consulting the decedent who did not personally take part in the transactions."<sup>122</sup> In addition, he managed the properties. His responsibilities included leasing and renting the properties when they became idle, collecting rents, and paying operating expenses, taxes and mortgage interest.<sup>123</sup> Five parcels of real estate were sold and five purchased over a period of fifteen years but there were no purchases or sales during the three years before Johnstone's death. The court concluded that:

[w]hat was done was more than investment and reinvestment of funds in real estate. It was management of the real estate itself for profit . . . . It necessarily involved alterations and repairs commensurate with the value and number of buildings cared for and such transactions as were necessary [to] constitute a recognized form of business. The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts; and many other things which come within the definition of business in *Flint v. Stone Tracy Co.*, and within the commonly accepted meaning of that word . . . .<sup>124</sup>

The court therefore affirmed the holding of the Board of Tax Appeals that Johnstone was, through her agent, engaged in business in the United States at the time of her death.<sup>125</sup>

## 2. *Securities Transactions*

Unlike the cases discussed above, *Adda v. Commissioner*<sup>126</sup> involved investments in securities rather than real estate. Adda was an Egyptian who resided in France during the taxable year 1941. Because of his fears that the war might hamper his ability to communicate with brokers in the United States, he empowered his brother, a United States resident, to trade in commodity futures for him through brokers

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<sup>122</sup> 113 F.2d at 719.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.* (citation omitted).

<sup>125</sup> *Id.*

<sup>126</sup> 10 T.C. 273, *acq.* 1940-2 C.B. 1, *aff'd per curiam*, 171 F.2d 457 (4th Cir. 1948), *cert. denied*, 336 U.S. 952 (1949).

resident in the United States.<sup>127</sup> Adda gave his brother "full and complete authority in dealing for [him] in commodities to use his own discretion and judgment as to when to buy or sell for the petitioner's account and the prices at which the sales or purchases were to be made."<sup>128</sup>

The primary issue in the case was whether Adda was "engaged in trade or business in the United States or had an office or place of business therein"<sup>129</sup> within the meaning of section 211 of the Internal Revenue Code as applicable in 1941. Section 211(b) provided that engaging in trade or business within the United States did not include the effecting of transactions in the United States in stocks, securities, or commodities through a resident broker, commission agent, or custodian.<sup>130</sup> The court concluded that:

[i]t seems obvious from a reading of the statute [the Revenue Act of 1936] that the Congress, in allowing nonresident aliens to effect transactions with brokers directly from abroad without being taxed on their gains, did not intend to permit a nonresident alien to establish an agent in the United States to effect transactions for his account and escape taxation of the profits.<sup>131</sup>

Although the reported decision does not indicate the number of transactions executed and the total amount of money involved, the court believed it was apparent that many transactions were involved and that the gains and losses were substantial. "This evidence shows that the trading was extensive enough to amount to a trade or business, and the petitioner does not contend, nor has he shown, that the transactions were so infrequent or inconsequential as not to amount to a trade or business."<sup>132</sup>

In the view of the court, Adda was attempting to accomplish through his brother as his agent what he could not do himself, namely, "to effect transactions by decisions made in the United States by one who is not a resident broker, commission agent or custodian, and not be taxed on the gains . . . . [T]he effect of the arrangement between the petitioner and his brother, from a tax standpoint, was the same as if

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<sup>127</sup> *Id.* at 274.

<sup>128</sup> *Id.* at 275.

<sup>129</sup> *Id.* at 276.

<sup>130</sup> Section 211(b)(1942) provided: "Such phrase ["engaged in trade or business within the United States"] does not include the effecting, through a resident broker, commission agent, or custodian, of transactions in the United States in commodities . . . , or in stocks or securities." The provisions of section 211(b) have changed substantially and now appear in section 871 of the 1954 Code. I.R.C. § 871 (1976 & Supp. V 1981).

<sup>131</sup> *Id.* at 277.

<sup>132</sup> *Id.*

the petitioner were in the United States and directly engaged in the business of trading commodities.”<sup>133</sup> The court therefore concluded that “[i]n effect he is engaging by his agent, in trade or business in the United States.”<sup>134</sup>

The rationale of *Adda* was taken one logical step further in *Commissioner v. Nubar*.<sup>135</sup> Nubar, an Egyptian, was present in the United States from 1939 to 1945 on a visitor’s visa which was extended from time to time because of the dangers of foreign travel during the war. During the years 1941 through 1944 he effected through brokers over 900 securities transactions which resulted in net gains of over \$500,000.<sup>136</sup> During the same years, the taxpayer was dealing in commodities futures and realized net gains of over \$60,000.<sup>137</sup>

Having determined that Nubar was a resident of the United States during the years in question,<sup>138</sup> the court of appeals believed that it was:

equally clear that taxpayer was engaged in business within the United States within the meaning of the statute and was not taken out of that category because the business resulted in purchases and sales effected through resident brokers . . . . The brokers merely carried out for the taxpayer the purchases and sales which he determined upon in the course of the trading in which he himself was engaged. This involved, not merely purchases and sales of securities and commodities, but the forming of judgments and the making of decisions with regard thereto; and these were made by the taxpayer in the exercise of his business judgment . . . before the orders to buy or sell were communicated to the brokers.<sup>139</sup>

Then citing *Adda*, the court concluded that “[i]t would be absurd to hold that an alien is taxable on gains derived from business carried on by an agent in this country but is not taxable if he himself carries on the business.”<sup>140</sup> Although the Foreign Investors Tax Act of 1966<sup>141</sup> changed the result in *Adda*, the result in *Nubar* would not be different under the new law. Since he was a resident for tax purposes, Nubar would have been subject to United States tax on the gains from his securities and commodities transactions in any event. Even though these cases may have been influenced by changes in the law, they are

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<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> 185 F.2d 584 (4th Cir. 1950), *rev'g* 13 T.C. 566 (1950), *cert. denied*, 341 U.S. 925 (1951).

<sup>136</sup> *Id.* at 585.

<sup>137</sup> *Id.* at 586.

<sup>138</sup> *Id.* at 588.

<sup>139</sup> *Id.*

<sup>140</sup> *Id.* at 589.

<sup>141</sup> Pub. L. No. 89-809, 80 Stat. 1539 (1966) (codified as amended at scattered sections of 26 U.S.C.)



still of some utility to our inquiry because, like the real estate cases discussed in the preceding section, these cases suggest that the quantum of activity in the United States is relevant to the factual question of whether the taxpayer is engaged in trade or business in the United States.

The case of *Scottish American Investment Co.*<sup>142</sup> suggests, however, that the type of activity in which the taxpayer is engaged is also an important factor in determining whether a foreign person is engaged in trade or business in the United States. In 1936, the petitioners established an office in the United States "to enable [them] to keep in closer touch with their large United States investments, to do themselves what had formerly been done for them by others, and to gain certain tax advantages."<sup>143</sup> The United States office was managed by a member of an accounting firm who was appointed an assistant secretary of each of the trusts. Each trust conferred upon the assistant secretary "general authority to attend to its United States affairs and represent its interests in this country . . . ."<sup>144</sup> The assistant secretary also had specific authority to collect interest and dividends and deposit such income in bank accounts; maintain records of all transactions; execute and file proxies; make periodic reports to the home office of developments in the United States; pay local expenses and file local tax returns.<sup>145</sup> Prior to the opening of the United States office these functions were performed for petitioners by banks.

All judgments as to investments, the purchase and sale of securities, and substantially all other major policy decisions were made by officers in the home office of the trusts situated outside the United States; orders for purchase and sale of securities were executed by petitioners directly through resident banks in the United States . . . .<sup>146</sup>

The Court concluded on the basis of these facts that:

the real business of petitioners, the doing of what they were principally organized to do in order to realize profit, was the cooperative management in Scotland of British capital . . . . To this business of petitioners, the business activities of the America office were merely helpfully adjunct. No consequential transactions were effected through or by the direction of the Jersey City office. It functioned primarily as a clerical department performing a number of useful routine and incidental services for petitioners. But it cannot be said here that the local office . . . was doing what was principally required to be done by petitioners in order to

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<sup>142</sup> 12 T.C. 49 (1949).

<sup>143</sup> *Id.* at 50 (quoting *Scottish-American Inv. Co. v. Commissioner*, 47 B.T.A. 474 (1943)).

<sup>144</sup> 12 T.C. at 51.

<sup>145</sup> *Id.*

<sup>146</sup> *Id.* at 55.

realize profit, or that its activities constituted a business which petitioners carried on within the United States.

In cases such as these, it is a matter of degree, based upon both a quantitative and a qualitative analysis of the services performed, as to where the line of demarcation should be drawn. It is not so much the volume of activities of the Jersey City office, although volume of activities may, in some cases, be a factor, but rather their character and the purpose for which the office is established that we believe are determinative . . . . We are not convinced that the services of this local office, quantitatively extensive and useful as they may have been approached that quality which is necessary in order that petitioners can be characterized as having engaged in business in the United States . . . within the meaning of Section 231(b).<sup>147</sup>

### 3. *Personal Services*

A nonresident alien can be engaged in trade or business in the United States as a result of the activities of an agent of the alien who performs personal services in the United States for foreign customers of the alien on the alien's account. *Helvering v. Boekman*<sup>148</sup> is cited in *Adda*<sup>149</sup> for this proposition. The fact pattern in *Boekman* differs somewhat from the cases previously discussed in that here the nonresident alien was found to be performing personal services in the United States through his agent and it was the taxability of the compensation for these services that was in issue.<sup>150</sup> In the cases previously discussed the activities of the agent which were attributed to the nonresident principal were directed toward the production of income from purchases, sales or rentals of property, rather than income from the rendering of the service.

Boekman was a nonresident alien who traded commodities for foreign customers through resident brokers. Because he was also a member of the exchange on which the orders were executed the brokers through whom he dealt charged him only one-half the normal commission. He in turn charged his customers the full, normal commission. During the period with which the case dealt, Boekman employed a clerk in the United States to whom he cabled orders from Amsterdam which were then relayed to the resident brokers for execution. The brokers confirmed execution to the clerk who then cabled the confirmation to Amsterdam. All cash related to the trading was transmitted directly between Amsterdam and the United States broker. The clerk did

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<sup>147</sup> *Id.* at 59.

<sup>148</sup> 107 F.2d 388 (2nd Cir. 1939).

<sup>149</sup> 10 T.C. 273 (1948); see *supra* notes 126-134 and accompanying text.

<sup>150</sup> 107 F.2d at 389.

not handle any cash.<sup>151</sup>

The Board of Tax Appeals found persuasive Boekman's contention that the personal services he furnished his customers in connection with the commodities trades were performed in Europe rather than in the United States.<sup>152</sup> Reversing the Board, the court of appeals held that it is the nature of the services and not the fact that the taxpayer performs them which determines whether they are personal services.<sup>153</sup> Since the services performed by the clerk in New York were personal services performed in the United States, the compensation for those services which Boekman received in the form of commissions from his customers was taxable to him subject to apportionment under the regulations.

#### 4. *Entities and Their Agents*

The relationship between a partnership as an entity and its partners as individuals presents an interesting "doing business" issue which is partially resolved by statute. The Internal Revenue Code specifically provides that: "a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged . . . ."<sup>154</sup> In some cases the reverse may be true; that is, the activities of the partner may cause the partnership to be engaged in trade or business in the United States. For example, in *United States v. Balanovski*,<sup>155</sup> Balanovski was an eighty percent partner in an Argentine partnership, the remaining twenty percent interest being held by another Argentine.<sup>156</sup> Balanovski came to the United States on December 20, 1946, and remained for approximately ten months with the exception of a few weeks which he spent in Argentina. He came to the United States to conduct partnership business. His activities on behalf of the partnership included: conferring and bargaining with United States bankers, purchasing and inspecting goods and attempting to develop other business for the partnership. He hired a secretary in the United States and they used a hotel room in the United States as an office until the secretary opened another office which Balanovski also used. He used the address of the hotel on documents and his suppliers contacted him there. His correspondence was

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<sup>151</sup> *Id.*

<sup>152</sup> *Boekman v. Commissioner*, 38 B.T.A. 541 (1938), *nonacq.* 1938-2 C.B. 1.

<sup>153</sup> 107 F.2d at 389.

<sup>154</sup> I.R.C. § 875(1)(1976).

<sup>155</sup> 236 F.2d 298 (2nd Cir. 1956), *cert. denied*, 352 U.S. 968 (1957).

<sup>156</sup> *Id.* at 300.

typed at the hotel and his business appointments were arranged and kept there. When he left the country he gave the secretary a power of attorney which gave her "wide latitude in arranging for shipment of goods and in signing his name to all sorts of documents including checks."<sup>157</sup> She used these powers during 1947 to "arrange for and complete the shipments of goods and bank the profits."<sup>158</sup>

The result of all of this activity was that during 1947 twenty-four purchases and sales of equipment were effected yielding profits of over \$7.5 million for the partnership.<sup>159</sup> The district court<sup>160</sup> held that the partnership was not engaged in trade or business within the United States within the meaning of section 219 of the 1939 Internal Revenue Code<sup>161</sup> but that Balanovski was so engaged as an individual and was therefore subject to tax under section 211(b).<sup>162</sup> The Argentine partner who did not come to the United States was held by the district court to have received "fixed or determinable annual or periodical gains, profits, and income" within the meaning of section 211(a)(1)(A) and (c).<sup>163</sup>

The district court found that Balanovski was a mere purchasing agent, therefore, his presence was insufficient to justify a finding that the partnership was doing business in the United States. The court of appeals did not accept this view.<sup>164</sup> "Acting for [the partnership] he engaged in numerous transactions wherein he both purchased and sold goods in this country, earned his profits here, and participated in other activities pertaining to the transaction of business."<sup>165</sup> The court of appeals therefore held that the partnership was engaged in business in the United States and the two copartners were subject to tax on their respective shares of the profits of the partnership from sources within the

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<sup>157</sup> *Id.* at 301.

<sup>158</sup> *Id.*

<sup>159</sup> *Id.* at 300.

<sup>160</sup> *United States v. Balanovski*, 131 F. Supp. 898, 903-04 (S.D.N.Y. 1955).

<sup>161</sup> Section 219 (1942) provided: "For the purpose of this chapter, a nonresident alien individual shall be considered as being engaged in a trade or business within the United States if the partnership of which he is a member is so engaged." This section has been renumbered section 875(1) and remains substantially unchanged. I.R.C. § 875(1)(1976). *See supra* note 154 and accompanying text.

<sup>162</sup> 131 F. Supp. at 904.

<sup>163</sup> I.R.C. § 211(a)(1)(A)(1959) provides:

There shall be levied, collected, and paid for each taxable year . . . upon the amount received, by every nonresident alien individual not engaged in trade or business within the United States, from sources within the United States, as . . . fixed or determinable annual or periodical gains, profits, and income, a tax of 30 percentum of such amount . . . .

This section has been replaced by section 871(a)(1)(A) of the 1954 Code and is substantially unchanged. I.R.C. § 871(a)(1)(A)(1976).

<sup>164</sup> 236 F.2d at 304.

<sup>165</sup> *Id.*

United States.<sup>166</sup>

The determination of the United States tax status of foreign partners by reference to the United States activities of the partnership should not be surprising given the treatment of partnerships as transparent for United States tax purposes. Nor should it be surprising that the tax status of a corporation will not determine the tax status of its shareholders. Only in "justifiable instances" have the courts and the Board of Tax Appeals disregarded the separateness of the corporate entity from its stockholders.<sup>167</sup> In *Tarafa*, the taxpayer was the sole shareholder of the Central Cuba Sugar Co. which was organized in 1911 under the laws of New York. The company never owned property in the United States and its business was "conducted and carried on in Cuba, where all of its properties and assets [were] situated, its business records and accounts [were] kept, its principal business office [was] located, and its executive officers reside[d]."<sup>168</sup> The company maintained a statutory agent in New York who was also its secretary and in whose custody its minute books were kept. In an estate tax context, the Commissioner contended that Tarafa had been engaged in business in the United States at the time of his death. This contention was based "solely upon the ground that decedent was the sole stockholder of the Central Cuba Sugar Co."<sup>169</sup> which was a United States corporation. The court disagreed with the Commissioner holding that "[t]he domestication of a corporation does not domesticate its nonresident stockholders to the extent of causing them to be in business in the United States if they are not otherwise engaged in business in the United States."<sup>170</sup> In another estate tax case *Estate of Bozo Banac*,<sup>171</sup> the Commissioner argued that the decedent, a citizen of Yugoslavia present in the United States at the time of his death under a visitor's permit, was engaged in trade or business in the United States "through trusted lieutenants" and through his sole ownership of shares in a United States corporation.<sup>172</sup> The Tax Court first concluded that there was nothing in the record to show that the directors and officers of the United States company in carrying on the business of the companies

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<sup>166</sup> *Id.*

<sup>167</sup> See *Tarafa v. Commissioner*, 37 B.T.A. 19 (1938) (citing *Burnet v. Commonwealth Improvement Co.*, 287 U.S. 415 (1932)).

<sup>168</sup> *Id.* at 22.

<sup>169</sup> *Id.* at 23.

<sup>170</sup> *Id.*

<sup>171</sup> 17 T.C. 748 (1951).

<sup>172</sup> *Id.* at 753-54.

were agents of the decedent.<sup>173</sup> The stock ownership issue was dealt with by reference to *Tarafa*.<sup>174</sup>

In *Jorge Pasquel v. Commissioner*,<sup>175</sup> the Commissioner took the position that a nonresident alien who in 1947 lent money to a United States company for a specific project was involved in a joint venture to be treated for tax purposes as a partnership as defined by section 3797(a)(2) of the Internal Revenue Code of 1939.<sup>176</sup> A United States company had contracted to purchase two ships which it hoped to resell at a profit but it needed additional capital to complete the transaction.<sup>177</sup> In June 1947, Higgins, a vice-president of the company, traveled to Mexico to discuss the transaction with Pasquel. Pasquel agreed to furnish \$100,000 needed to complete the transaction, which involved the purchase and resale of two ships and in turn he was to receive one-half of the profits from the transaction. Pasquel was orally assured by Higgins that he would suffer no loss and that he would earn no less than \$25,000.<sup>178</sup> Higgins regarded the money he received from Pasquel as a loan and even arranged for a mortgage in the amount of \$125,000 to be recorded against one of the ships to protect Pasquel, although Pasquel was not told of this arrangement. In August 1947, the vessels were sold and Pasquel's \$100,000 was returned to him along with \$75,000 representing his share of the profits. The company withheld \$22,500 (from the \$75,000) which it remitted to the United States government as tax withheld at source.<sup>179</sup>

The court was of the view that the company had brought Pasquel into the transaction "only as an expedient means of financing an existing commitment which it could not meet by itself"<sup>180</sup> and it distinguished the arrangement from "the ordinary case in which two or more parties agree initially to undertake a joint project."<sup>181</sup> Accordingly, it held that "petitioner's participation in this single and isolated transaction does not amount to engaging in trade or business in the United

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<sup>173</sup> *Id.* at 754.

<sup>174</sup> *Id.*; see *supra* notes 167-170 and accompanying text.

<sup>175</sup> 23 T.C.M. (P-H) (1953).

<sup>176</sup> Section 3797(a)(2)(1951) provides: "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation . . ." This section has been renumbered section 7701(a)(2) in the 1954 Code and is unchanged. I.R.C. § 7701(a)(2)(1976).

<sup>177</sup> 23 T.C.M. at 8.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* at 9.

<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

States as contemplated by Section 211(b) of the Code.”<sup>182</sup> In what was probably dictum, the court stated that “even if we assume that the transaction was in fact a joint venture . . . we think that the petitioner was not engaged in a trade or business within the United States within the meaning of Section 211(b).”<sup>183</sup> Section 875 apparently would require a different conclusion today.<sup>184</sup>

In *Linen Thread Co., Ltd. v. Commissioner*,<sup>185</sup> a foreign corporation claimed it was engaged in trade or business in the United States during 1943 and 1944, and therefore was entitled to be taxed under section 231(b) of the Code as a resident foreign corporation.<sup>186</sup> Linen Thread Co. and the Commissioner had previously litigated the same issue for other years. The earlier cases, which involved the years 1937 through 1940, dealt with the issue of whether the company had an “office or other place of business” in the United States since in those years the company did not carry on business activities in the United States.<sup>187</sup> The Tax Court found that the company’s “activities in the United States in 1943 did not differ discernibly from its activities in 1937 through 1941 except as to two transactions occurring in 1943.”<sup>188</sup> One of the two transactions was a sale of crochet thread as a result of an order sent to the company’s home office in Scotland. The New York office had nothing to do with soliciting the sale and learned of its existence only by a letter from the home office. The thread was shipped to the New York office for delivery to the customer and collection of the proceeds (\$129.54). The only other sale made by the company in the United States during 1943 was three cases of thread to its United States subsidiary. The resident agent had nothing to do with soliciting the sale. The goods were shipped directly to the subsidiary and the New York office handled only the paper work.<sup>189</sup> As to 1944, the company maintained that:

it had the intent to do business within the United States during 1944, that it was prevented from doing so only by wartime restrictions, that there

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<sup>182</sup> *Id.* at 10.

<sup>183</sup> *Id.* at 9.

<sup>184</sup> See *supra* note 154 and accompanying text.

<sup>185</sup> 14 T.C. 725 (1950).

<sup>186</sup> Section 231(b)(1950) provided that: “A foreign corporation engaged in trade or business within the United States shall be taxable as provided in section 13 and section 15 (as a resident corporation).” This provision has been changed and is renumbered as section 882(a) in the 1954 Code. I.R.C. § 882(a)(1976 & Supp. V 1981).

<sup>187</sup> *Linen Thread Co., Ltd. v. Commissioner*, 4 T.C. 802 (1945), *aff’d*, 152 F.2d 625 (2d Cir. 1945); *Linen Thread Co., Ltd. v. Commissioner*, 128 F.2d 166 (2d Cir. 1942), *crt. denied*, 317 U.S. 673 (1942).

<sup>188</sup> 14 T.C. at 734.

<sup>189</sup> *Id.* at 734-35.

was a pattern of doing business from 1943 through 1946, and that therefore it was engaged in trade or business within the United States during the taxable year 1944.<sup>190</sup>

Aside from the income from the two sales, the only other item of income reported by the company for the calendar year 1943 was dividends amounting to \$632,500. Until 1943, the company's entire reported income for federal income tax purposes was dividends and interest.<sup>191</sup> In the view of the court:

[p]etitioner's American Office from its inception was used for the purpose of collecting interest and dividends from American investments. The office was small, was not equipped for selling, and employed no salesmen. The resident agent had no instructions to go out and make sales . . . . It was clearly not the purpose for which the American Office was established to make sales in the United States. The character of the activities of that office and the purpose for which that office was established are determinative of whether petitioner was engaged in trade or business within the United States.<sup>192</sup>

The court concluded that:

even if we were to assume that petitioner had a business purpose in involving its American office in these two sales, it would still be our conclusion that these two isolated transactions, profits from which constituted such a minute part of the petitioner's total income from American sources in 1943, did not constitute engaging in trade or business in the United States within the meaning of section 231(a) of the code. The test is both a quantitative and qualitative one.<sup>193</sup>

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Not having the status of being engaged in trade or business within the United States in 1943, petitioner did not acquire that status by mere intent to so engage in 1944. Actually engaging in business is essential.<sup>194</sup>

Two other factors were involved in *Linen Thread* which, although neither strictly legally relevant nor necessary to the decision in that case, may be influential in other cases. The first of these factors is that the company was not authorized to do business in New York in 1943, the year in which the two transactions took place which the company put forward as evidence to show that it was engaged in trade or business in the United States. The company had applied in the latter part of 1943 for a New York license but its application was rejected because of the similarity of the company's home with that of its wholly owned United States subsidiary.<sup>195</sup> The court in *Linen Thread* attached signif-

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<sup>190</sup> *Id.* at 734.

<sup>191</sup> *Id.* at 736.

<sup>192</sup> *Id.* (citing *Scottish-American Inv. Co. v. Commissioner*, *supra* note 143, at 9).

<sup>193</sup> 14 T.C. at 736.

<sup>194</sup> 14 T.C. at 738.

<sup>195</sup> 14 T.C. at 726.



icance to the fact that a company claiming to do business in New York had failed to substantially comply with the legal requirements of the state regarding qualifying to do business.<sup>196</sup>

The other factor which might have influenced the decision had the case been a closer one was that on its tax returns for both years in question the taxpayer had taken the position that it was not brought within the purview of the capital stock provisions of the Revenue Act. The company argued it "was unable to transact business in the commercial sense . . . due to war conditions beyond its control."<sup>197</sup> The court concluded that "the test of liability for income tax, excess profits tax, and capital stock tax, in so far as such taxes are based upon or measured by, engaging in or doing business within the United States, is identical."<sup>198</sup> Although the capital stock provisions referred to are no longer relevant, it seems likely that taking inconsistent positions on the taxpayer's return will disadvantage the taxpayer even though arguably the inconsistencies are not clearly legally relevant.

In Revenue Ruling 62-31,<sup>199</sup> a United Kingdom corporation opened an office in the United States "for the purpose of promoting its sales of British merchandise."<sup>200</sup> The employees of the United States office were salesmen and general clerks. They were empowered "only to run the office, to arrange for the appointment of distributing agents for the merchandise offered by the company, and to solicit orders generally."<sup>201</sup> The appointment of distributors was subject to approval or disapproval by the corporation, presumably at its home office. Although the employees in the United States were empowered to solicit orders for the company's products, they did not have the authority to negotiate and conclude contracts on behalf of the corporation. Nor did they have a stock of merchandise from which to fill orders. Referring to the tax treaty then in effect between the United States and the

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<sup>196</sup> 14 T.C. at 737. The court stated:

The petitioner was not shown to be qualified to do business in New York under its law. True, as petitioner suggests, business may be done in fact regardless of legal right, but we find meaning in the dearth of showing of compliance with such legal requirements by an old established institution doing as much "business" as contended for by petitioner. We hesitate to believe that it intentionally violated the New York law, or that, if it had an agent doing its business in New York, it was not advised of so simple a fact as necessity for compliance with state laws.

*Id.* (citing *Amalgamated Dental Co. v. Commissioner*, 6 T.C. 1009, 1017 (1946)).

<sup>197</sup> 14 T.C. at 730, citing Gen. Couns. Mem. 17014, 15-2 C.B. 317 (1936).

<sup>198</sup> 14 T.C. at 737.

<sup>199</sup> Rev. Rul. 62-31, 1962-1 C.B. 367.

<sup>200</sup> *Id.* at 367.

<sup>201</sup> *Id.*

United Kingdom,<sup>202</sup> the Internal Revenue Service concluded that the maintenance of the United States office constituted engaging in trade or business in the United States through a permanent establishment within the meaning of the treaty.<sup>203</sup> The office, which was clearly a fixed place of business, was not excluded from the definition of a permanent establishment by any of the exceptions.<sup>204</sup>

Revenue Ruling 62-31 specifically overruled Revenue Ruling 54-588.<sup>205</sup> The earlier ruling involved a United Kingdom subsidiary of another United Kingdom company. The United States office of the subsidiary served as a showroom where salesmen employed by the subsidiary solicited orders for merchandise produced by the parent. The orders were mailed directly to the parent company which then shipped the merchandise directly to the customer who then paid the parent. The parent paid its subsidiary a commission on sales made by the subsidiary. Neither company maintained a stock of goods in the United States from which orders were filled.<sup>206</sup> Relying on the same United States - United Kingdom tax treaty as in its later ruling, the Internal Revenue Service held that the activities conducted by the subsidiary in its United States office did not constitute engaging in a trade or business through a permanent establishment. Therefore, the commissions were not subject to United States tax.<sup>207</sup>

The holding in Revenue Ruling 54-588 was based on the definition of "permanent establishment" which provides that an agent does not constitute a permanent establishment of the principal unless the agent "has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of the principal or has a stock of merchandise from which he regularly fills orders on its behalf."<sup>208</sup> In Revenue Ruling 62-31, the service concluded that this provision would have been

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<sup>202</sup> See *supra* note 94.

<sup>203</sup> 1962-1 C.B. at 368.

<sup>204</sup> Article III of the 1945 United Kingdom Convention states that only United Kingdom enterprises which operate through permanent establishments will be subject to taxation by the United States. 1945 United Kingdom Convention, *supra* note 94, art. III, 60 Stat. at 1380, T.I.A.S. No. 1546. Article II(1)(l) states that, "a fixed place of business exclusively for the purchase of goods or merchandise shall not of itself constitute such fixed place of business a permanent establishment of such enterprise." 1945 United Kingdom Convention, *supra* note 94, art. II(1)(l), 60 Stat. at 1379, T.I.A.S. No. 1546. For example, a United Kingdom corporation which maintained a showroom in the United States that purchased goods but performed no sales promotion would not be taxed by the United States. 1962-1 C.B. at 368.

<sup>205</sup> 1962-1 C.B. at 369; Rev. Rul. 54-588, 1954-2 C.B. 657.

<sup>206</sup> 1954-2 C.B. at 658.

<sup>207</sup> *Id.* 1945 United Kingdom Convention, *supra* note 94.

<sup>208</sup> 1945 United Kingdom Convention, *supra* note 94, art. II(1)(l), 60 Stat. at 1379, T.I.A.S. No. 1546; see also *supra* note 204.

relevant in the earlier ruling had the inquiry been whether the United States office of the subsidiary constituted a permanent establishment of the parent. Since the actual inquiry was whether the subsidiary had "a fixed place of business in the United States, constituting a permanent establishment within the meaning of the convention," the earlier ruling was deemed erroneous. Although the ruling does not specifically say so, it should be clear that the United States office of the subsidiary in Revenue Ruling 54-588 could only be a permanent establishment of the parent if it were so considered under the agency rules of the treaty.<sup>209</sup> On the facts presented in the ruling, it appears that the United States employees of the subsidiary did not have sufficient authority to be considered a permanent establishment of the parent.<sup>210</sup>

Revenue Ruling 76-322<sup>211</sup> concerned the issue of whether an Australian corporation which shipped goods on a consignment basis to the United States for sale in the United States was subject to United States federal income tax with respect to sales of those goods. The United States distributor was a wholly owned United States subsidiary of the Australian corporation. The products of the parent were sold to the subsidiary at "arm's length price." The subsidiary, *on its own behalf*, then sold the products at prices which it set to "independent retailers and wholesalers throughout the United States."<sup>212</sup> Under the agreement between the Australian parent and its United States subsidiary,

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<sup>209</sup> 1962-1 C.B. at 369.

<sup>210</sup> Treas. Reg. §§ 7.516(b) & (c), T.D. 5569, 1947-2 C.B. 100, 112. Subsection (b) provides:

A nonresident alien individual who is a resident of the United Kingdom or a foreign corporation managed and controlled in the United Kingdom, having no permanent establishment in the United States, is not . . . subject to United States income tax . . . . For example, if such United Kingdom enterprise sells . . . merchandise . . . through a bona fide commission agent or broker in the United States acting in the ordinary course of his business as such agent or broker, the resulting profits are, under the terms of Article III of the convention, exempt from United States income tax. Likewise no permanent establishment exists if such enterprise, through its sales agents in the United States, secures orders for its products, the sales being made in the United Kingdom.

Subsection (c) provides, in part:

A nonresident alien (including a nonresident alien individual, fiduciary, or partnership) who is a resident of the United Kingdom or a foreign corporation managed and controlled in the United Kingdom, having a permanent establishment in the United States, is subject to tax upon industrial and commercial profits from sources within the United States . . . . [F]or example, if a United Kingdom enterprise having a permanent establishment in the United States sells in the United States, through a commission agent therein, goods produced in the United Kingdom, the resulting profits derived from United States sources from such transactions are allocable to such permanent establishment even though such transactions were carried on independently of such establishment . . . . The industrial or commercial profits of the permanent establishment shall be determined as if the establishment were an independent enterprise engaged in the same or similar activities and dealing at arm's length with the enterprise of which it is a permanent establishment.

<sup>211</sup> Rev. Rul. 76-322, 1976-2 C.B. 487.

<sup>212</sup> *Id.* The parent also sold its products at arm's length to other unrelated and independent U.S. distributors who did not constitute U.S. permanent establishments of the parent.

the parent was to deliver products to a common carrier at the parent's plant in Australia "to be forwarded by such a carrier for and on behalf of and at the expense and risk of [the subsidiary] to such point or points in the United States as [the subsidiary] may designate."<sup>213</sup> The subsidiary assumed all responsibility for the products at point of shipment and was permitted under the agreement to move the products without notifying the parent or obtaining its consent. Title to the products, however, was retained by the parent in accordance with the agreement. The actual purchase of the parent's products by the subsidiary took place immediately prior to resale of the products by the subsidiary. Until the resale, the subsidiary held the products on consignment.<sup>214</sup> The subsidiary was, however, under no obligation to purchase the consigned products and did not have to account to the parent for the proceeds of sales made. The parent had the right to recall any consigned products "prior to the time of their purchase by [the subsidiary]."<sup>215</sup> The parent had no employees in the United States and conducted no other business in the United States. The Internal Revenue Service applied the United States-Australia tax treaty<sup>216</sup> in the following manner:

[u]nder the concepts of the Convention, the absence of a permanent establishment, on the part of an enterprise having business dealings in the country concerned, is based in part upon the premise that such business dealings are handled through a commission agent, broker or other independent agent. A subsidiary corporation will be treated as an independent agent, as distinguished from an agent of the parent, under similar circumstances. The subsidiary corporation's presence in the country concerned, where it is engaged in trade or business, is by itself no basis to hold that the parent corporation has a permanent establishment in such country, unless the subsidiary has and habitually exercises a general authority to contract for its [*sic*] parent, or as an agent of the parent regularly fills orders of goods on behalf of the parent from a stock of the parent's goods located in such country.

Under the agreement in the instant case, neither a limited agency nor a general agency is established. The relationship between parent and subsidiary is that of seller and purchaser, since the power [the subsidiary] has

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<sup>213</sup> *Id.*

<sup>214</sup> *Id.* The agreement also provided that during the period the products were held on consignment the subsidiary was responsible to the parent for damage, destruction, theft or loss of the goods prior to their purchase by the subsidiary. The subsidiary also bore the cost of insuring the consigned goods with loss payable to the parent. The subsidiary would, on request, furnish the parent with an inventory of all products held on consignment.

<sup>215</sup> 1976-2 C.B. at 487.

<sup>216</sup> Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, May 14, 1953, United States-Australia, 4 U.S.T. 2274, T.I.A.S. No. 2880, *reprinted in* 1 TAX TREATIES (CCH) ¶ 403P *et seq.* A new tax treaty between these countries has been signed but is not in effect. For text of the proposed Convention see 1 TAX TREATIES (CCH) ¶ 402A *et seq.*

in determining when title to the consigned goods passes from [the parent] is exercisable only as a purchaser . . . . Further, since [the subsidiary] is not considered [the parent's] agent, although [the parent] has a 'stock of goods' in the United States [the parent] has no employee or agent in the United States that could fill orders from such stock of goods.<sup>217</sup>

The ruling concludes that the parent did not have a permanent establishment in the United States within the meaning of the treaty and, therefore, income derived by the parent from its sales to its subsidiaries was not subject to federal income tax.<sup>218</sup> The ruling cites Revenue Ruling 63-113,<sup>219</sup> which deals with an almost identical consignment arrangement between a Canadian corporation and an apparently independent United States trading company. That ruling held that in the context of the United States-Canada income tax treaty<sup>220</sup> the Canadian corporation was not subject to federal income tax because it did not have a permanent establishment in the United States.<sup>221</sup>

Where a treaty is in effect, the treaty normally precludes one state from taxing the business profits of an enterprise of the other state unless the profits are attributable to a permanent establishment of the enterprise maintained in the first state. Thus a finding of no permanent establishment usually makes the question of whether the activities in question constitute a trade or business moot. However, a finding that the United States activities of a foreign person are not sufficient to constitute a permanent establishment will not necessarily preclude a finding that the person is engaged in trade or business within the United States.

For example, in Revenue Ruling 55-617,<sup>222</sup> a Belgian corporation conducted extensive business in the United States through a commission agent. The Service ruled the corporation was engaged in a trade or business within the United States as defined by section 871(c) of the Internal Revenue Code of 1954.<sup>223</sup> Article II(1)(f) of the United States-Belgium income tax convention provided that:

[a]n enterprise of one of the contracting states shall not be deemed to have a permanent establishment in the other contracting State merely because it carries on business dealings in such other contracting State through a bona fide commission agent or broker acting in the ordinary course of his

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<sup>217</sup> 1976-2 C.B. at 488.

<sup>218</sup> *Id.*

<sup>219</sup> Rev. Rul. 63-113, 1963-1 C.B. 410.

<sup>220</sup> Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Mar. 4, 1942, United States-Canada, 56 Stat. 1399, T.S. No. 983, 989, *reprinted in* 1 TAX TREATIES (CCH) ¶ 1205 *et seq.*

<sup>221</sup> 1963-1 C.B. at 411.

<sup>222</sup> Rev. Rul. 55-617, 1955-2 C.B. 774.

<sup>223</sup> *Id.* at 774.

business.<sup>224</sup>

Thus, the Internal Revenue Service ruled the corporation did not have a permanent establishment in the United States and therefore was exempt from United States tax on the income derived from its United States business activities.<sup>225</sup>

Revenue Ruling 70-424<sup>226</sup> concerned an exclusive sales arrangement between a foreign corporation and a domestic corporation. Under the agreement, the foreign corporation gave the domestic corporation "the sole agency" for the sales of the foreign corporation's products in the United States.<sup>227</sup> The domestic corporation agreed to sell the products in the United States and not to sell similar products of another company without first having secured the permission of the foreign corporation. The domestic corporation was to receive compensation for its efforts in the form of "a commission based on a graduated percentage of the selling price of the products."<sup>228</sup> Although the domestic corporation assumed "full responsibility" for the sales of the products and acted as a guarantor, the foreign corporation agreed to share equally with the domestic corporation "any loss incurred up to a specified amount in any one year during the life of the agreement."<sup>229</sup>

The Internal Revenue Service ruled that "the arrangement is one of ordinary principal and agent through which [the foreign corporation] carries on its activities in the United States and is thus engaged in trade or business within the United States" and is therefore subject to the provisions of Section 882 of the Internal Revenue Code of 1954.<sup>230</sup>

### 5. Conclusion

From the above discussion, it should be clear that cases and rul-

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<sup>224</sup> Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Oct. 28, 1948, Protocol, Sept. 9, 1952, United States-Belgium, 4 U.S.T. 1647, T.I.A.S. No. 2833, reprinted in 1 TAX TREATIES (CCH) ¶ 603 *et seq.* A new tax treaty between these countries was signed in 1970 and became effective Jan. 1, 1971. Convention for the avoidance of Double Taxation and the Prevention of Fiscal Evasion, July 9, 1970, United States-Belgium, 23 U.S.T. 2687, T.I.A.S. No. 7463, reprinted in 1 TAX TREATIES (CCH) ¶ 587 *et seq.* (the old treaty is still in effect for Kinshasa, the Republic of Rwanda and the Republic of Burundi). The new Convention contains a more extensive description than the old Convention as to what fixed places of business will not constitute a permanent establishment. Convention, July 9, 1970, United States-Belgium, art. 5(3), 23 U.S.T. at 2693-94, T.I.A.S. No. 7463, reprinted in 1 TAX TREATIES (CCH) at ¶ 587E.

<sup>225</sup> 1955-2 C.B. at 774-75.

<sup>226</sup> Rev. Rul. 70-424, 1970-2 C.B. 150.

<sup>227</sup> *Id.* at 150-51.

<sup>228</sup> *Id.* at 151.

<sup>229</sup> *Id.*

<sup>230</sup> *Id.* Internal Revenue Code of 1954, ch. 736, § 882, 68A Stat. 3, 282 (1954) (current version codified at I.R.C. § 882 (1976 & Supp. V 1981)).

ings which have addressed the meaning of trade or business in the context of the United States activities of foreign persons necessarily rely heavily on the facts of each case. However, there does seem to be a common thread which runs through all of the above cases. The determination of whether a foreign person is engaged in trade or business in the United States must be based on both quantitative and qualitative considerations. For example, the opinion of the Tax Court in *Spermacet Whaling & Shipping Co. S/A v. Commissioner*<sup>231</sup> contains the statement that the court has: "consistently held that before a taxpayer can be found to be 'engaged in trade or business within the United States' it must, during some substantial portion of the taxable year, have been regularly and continuously transacting a substantial portion of its ordinary business in this country."<sup>232</sup> It should be pointed out, however, that in Revenue Ruling 58-61<sup>233</sup> the Internal Revenue Service took the position that "entering a horse in a race in this country on a single occasion constitutes being 'engaged in trade or business' within the meaning of Section 871(c) of the Internal Revenue Code of 1954."<sup>234</sup> A citizen and resident of France who operated a horse racing stable in France for profit was invited to enter "an outstanding horse" in a race in the United States. The horse won the race and the owner received the winner's purse. However, "a nonresident alien individual does not have a permanent establishment in the United States merely by entering a race horse in a single race in the United States and coming to the United States to view the race and to participate in the social events connected therewith."<sup>235</sup> And, since "the winner's purse received by the owner of a racing stable operated for profit constitutes industrial or commercial profits,"<sup>236</sup> the income was ruled exempt from federal income tax under Article 3 of the United States-France income tax convention.<sup>237</sup> The Service cited no authority for the conclusion that the entry of a single horse in a single race constitutes engaging in trade or business in the United States, and the cases discussed above suggest that a contrary result would be reached if the issue were litigated. The

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<sup>231</sup> *Spermacet Whaling & Shipping Co. S/A v. Commissioner*, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960).

<sup>232</sup> *Id.* at 634.

<sup>233</sup> Rev. Rul. 58-63, 1958-1 C.B. 624.

<sup>234</sup> *Id.* at 624. Internal Revenue Code of 1954, ch. 736, § 871(c), 68A Stat. 3, 279-80 (1954) (current version codified at I.R.C. § 871(c)(1976)).

<sup>235</sup> 1958-1 C.B. at 625.

<sup>236</sup> *Id.*

<sup>237</sup> *Id.*; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, July 25, 1939, United States-France, art. 3, 59 Stat. 893, 895-96, T.S. No. 988, *reprinted in* 1 TAX TREATIES (CCH) ¶ 2841, ¶ 2841D.

taxpayer involved in Revenue Ruling 58-63 had no interest in litigating the issue since the income was held to be exempt under the treaty in any event. In fact, it may have been much to the owner's advantage that the Service reached the conclusion it did, thereby avoiding an examination of whether the winner's purse might otherwise have constituted fixed or determinable annual or periodical income within the meaning of section 871(a)(1).<sup>238</sup> Income to which section 871(a)(1) applied would have been taxed at a thirty percent rate, unless exempted under some other provision of the treaty.

Revenue Ruling 58-63 may also be factually distinguishable from some of the above cases. The ruling stipulates that the citizen and resident of France engaged in the operation of a racing stable in France for profit.<sup>239</sup> Because he was clearly engaged in the horse racing business, it may have been reasonable to conclude that entering a race in the United States would be sufficient to constitute engaging in the horse racing business here. It may even be that the single race represented a substantial portion of "the business" for that particular year.

## V. EFFECTIVELY CONNECTED INCOME

Effectively connected income is, in one sense, simply a term used to describe that portion of a nonresident alien's or foreign corporation's business income which is subject to federal income tax under the normal rules applicable to domestic corporations or to United States citizens and residents.<sup>240</sup> In order to have effectively connected income, the foreign person must be engaged in trade or business in the United States.<sup>241</sup> The rules for determining whether a foreign person is so engaged have been discussed in the preceding section of this article.<sup>242</sup> United States source income which is not effectively connected is taxed in the manner described in the second section of the article.<sup>243</sup> Unlike the issue of whether or not a certain fact pattern results in a foreign person being engaged in trade or business in the United States, the issues which arise in connection with the determination of effectively connected income have not been extensively litigated. Thus, taxpayers

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<sup>238</sup> Internal Revenue Code of 1954, ch. 736, § 871(a)(1), 68A Stat. 3, 278 (1954) (current version codified at I.R.C. §§ 871(a)(1) & (a)(1)(A)(1976)).

<sup>239</sup> 1958-1 C.B. at 624.

<sup>240</sup> See generally P. POSTLEWAITE & M. COLLINS, INTERNATIONAL INDIVIDUAL TAXATION 65-84 (1982); P. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION 40-46 (1980)

<sup>241</sup> I.R.C. § 864(c)(1)(B)(1976); Treas. Reg. § 1.864-3(a)(1972), 6 STAND. FED. TAX REP. (CCH) ¶ 4105 (1983). For two exceptions to this rule, see I.R.C. §§ 882(d) & (e)(1976).

<sup>242</sup> See *supra* Section IV.

<sup>243</sup> See *supra* notes 4 through 19 and accompanying text.



seeking to comply with the statute have had only the regulations for guidance. This state of affairs may be largely due to the fact that the term "effectively connected income" did not come to be a part of the law until the Foreign Investors Tax Act of 1966.<sup>244</sup> The brief discussion of the framework of the Act which follows may be helpful in understanding the regulations regarding effectively connected income. The remainder of this section will be devoted to a discussion of the determination of effectively connected income in accordance with the statute and the regulations.

#### A. The Foreign Investors Tax Act

Prior to the Foreign Investors Tax Act of 1966, the manner in which foreign corporations and nonresident alien individuals were subjected to United States tax depended entirely on whether they were engaged in trade or business in the United States.<sup>245</sup> A foreign person engaged in trade or business in the United States had been subject to tax on all income from United States sources at the regular rates applicable to domestic corporations and United States citizens. On the other hand, United States source income of foreign persons not engaged in trade or business in the United States was subject to tax at a flat thirty percent rate or at a lower treaty rate if applicable.<sup>246</sup> Congress was concerned that identical portfolio investments might be taxed differently in the hands of a foreign recipient depending on whether the foreign recipient was engaged in trade or business in the United States. The Report of the Senate Finance Committee on the Foreign Investors Tax Act contains the following statement: "it is neither equitable nor logical for this substantial difference in tax treatment of investment income to depend on the presence or absence of an unrelated business."<sup>247</sup> In addition, the Committee stated that "the present scheme

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<sup>244</sup> Foreign Investors Tax Act, Pub. L. No. 89-809, 80 Stat. 1539 (1966) (codified as amended in scattered sections of 26 U.S.C.).

<sup>245</sup> S. REP. NO. 1707, 89th Cong. 2d Sess. 17 (1966) [hereinafter cited as SENATE REPORT]. Prior to 1942, the United States tax status of foreign persons depended on whether they were engaged in trade or business or had an office or place of business in the United States. *See* *Scottish American Inv. Co. v. Commissioner*, 12 T.C. 49 (1949).

<sup>246</sup> I.R.C. § 871 (1976).

<sup>247</sup> SENATE REPORT *supra* note 245, at 17-18. On October 2, 1963, the President appointed a task force on "Promoting Foreign Investments in U.S. Corporate Securities and Increased Financing for U.S. Corporations Operating Abroad." The report of the task force, issued April 27, 1963, contained recommendations including a series of proposals for modifying the United States taxation of foreign investors. These recommendations, though modified in the legislative process, were apparently the initial impetus in the passage of the Foreign Investors Tax Act. SENATE REPORT *supra* note 245, at 9.

deters foreign businessmen operating in the United States, and also deters foreigners already investing in the United States from commencing a trade or business here.”<sup>248</sup> The concept of “effectively connected income” is at the heart of the remedy Congress selected. Under the provisions of the Foreign Investors Tax Act, the United States tax liability of foreign persons no longer turns entirely on whether the recipient of the income is engaged in trade or business in the United States, although the determination must still be made.<sup>249</sup> Rather, the ultimate determinant of the manner in which income will be taxed in the hands of a foreign person is now whether the income is effectively connected with a United States trade or business. The determination of whether the taxpayer is engaged in trade or business within the United States is of course an essential part of the process because there must be a trade or business if there is to be income which is effectively connected with a trade or business.

## B. Computing Taxable Income

### 1. Gross Income

Since effectively connected income is taxed under the rules applicable to domestic taxpayers, it is necessary to determine effectively connected taxable income.<sup>250</sup> The first step in this process is the determination of effectively connected gross income.<sup>251</sup> In the case of a nonresident alien individual, the statute clearly provides that for purposes of computing effectively connected taxable income, gross income includes only income which is “effectively connected with the conduct of the trade or business within the United States.”<sup>252</sup> The statutory provisions which apply to foreign corporations are somewhat more complicated. Section 882(a)(2) straightforwardly provides that for purposes of computing effectively connected taxable income, “gross income includes only gross income which is effectively connected with the conduct of the trade or business within the United States.”<sup>253</sup> Section 882(b),<sup>254</sup> however, introduces some confusion by providing that in the case of a foreign corporation gross income includes gross income which is *not* effectively connected, but which is derived from sources within the United States. It also includes income which is effectively

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<sup>248</sup> SENATE REPORT *supra* note 245, at 18.

<sup>249</sup> SENATE REPORT *supra* note 245, at 18-19.

<sup>250</sup> I.R.C. § 63(a), (b)(1976).

<sup>251</sup> I.R.C. §§ 871(b)(1)(Supp. V 1981), 882(a)(1) (Supp. V 1981).

<sup>252</sup> I.R.C. § 871(b)(2)(1976).

<sup>253</sup> I.R.C. § 882(a)(2)(1976).

<sup>254</sup> I.R.C. § 882(b)(1976).

connected with the conduct of a trade or business within the United States. The Senate Report on the Foreign Investors Tax Act makes it clear that for purposes of determining taxable income which is to be taxed as effectively connected income, only effectively connected income is included in gross income.<sup>255</sup>

a. United States Source Income

(1) *General*

The statute approaches the determination of the income which is to be considered effectively connected by looking first to income derived by the taxpayer from United States sources. Fixed or determinable annual or periodical income and the other kinds of nonbusiness income described in sections 871(a)(1) and 881(a)<sup>256</sup> which are from United States sources and are taxable to foreign persons not engaged in trade or business in the United States will be considered effectively connected only if there is a factual relationship between the income and the United States trade or business.<sup>257</sup> Absent a factual connection, such income is considered nonbusiness income subject to the flat rate thirty percent tax.<sup>258</sup>

All other United States source income is considered effectively connected income regardless of the existence or absence of a factual relationship to the United States trade or business.<sup>259</sup> Thus, the tax treatment of income which is from United States sources and which is not fixed or determinable annual or periodical income is determined in approximately the same manner as it was prior to the Foreign Investors Tax Act; that is, on the basis of whether the foreign recipient is engaged in trade or business within the United States. The United States source income which was affected by the Foreign Investors Tax Act is non-business income or fixed or determinable annual or periodical income.

(2) *Fixed or Determinable Annual or Periodical Income and Capital Gains and Losses from U.S. Sources*

Section 864(c)(2) provides rules for determining whether United States source income of the types described in section 871(a)(1) or section 881(a) is effectively connected with the conduct of a trade or busi-

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<sup>255</sup> SENATE REPORT *supra* note 245, at 904.

<sup>256</sup> I.R.C. §§ 871(a)(1), 881(a)(1976).

<sup>257</sup> I.R.C. § 864(c)(2)(1976).

<sup>258</sup> See *supra* note 256.

<sup>259</sup> I.R.C. § 864(c)(3)(1976).

ness within the United States.<sup>260</sup> Capital gains and losses also may be characterized as effectively connected income under these rules. For purposes of determining whether such income is effectively connected: “the factors taken into account shall include whether—(A) the income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business, or (B) the activities of such trade or business were a material factor in the realization of the income, gain or loss.”<sup>261</sup> In considering these factors “due regard shall be given to whether or not such asset or such income, gain, or loss was accounted for through such trade or business.”<sup>262</sup>

The regulations explain that the “asset-use test”<sup>263</sup> will ordinarily be applied in determining whether “income, gain, or loss of a passive type” is effectively connected.<sup>264</sup> That is, the asset-use test is applied: where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss. . . . The asset-use test is of primary significance where, for example, interest or dividend income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States.<sup>265</sup>

The regulations further provide that an asset held in a direct relationship to the trade or business will be treated as if used in or held for use in the conduct of the trade or business.<sup>266</sup> An asset will be considered to be held in “direct relationship” to the trade or business if it “is held to meet the present needs of that trade or business and not its anticipated future needs.”<sup>267</sup> In addition, an asset generally will be:

treated as held in a direct relationship to the trade or business if (1) the asset was acquired with funds generated by that trade or business, (2) the income from the asset is retained or reinvested in that trade or business,

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<sup>260</sup> See *supra* note 256.

<sup>261</sup> I.R.C. § 864(c)(2)(1976).

<sup>262</sup> *Id.*

<sup>263</sup> See P. POSTLEWAITE & M. COLLINS, INTERNATIONAL INDIVIDUAL TAXATION 67-68 (1982); P. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION 41-42 (1980).

<sup>264</sup> Treas. Reg. § 1.864-4(c)(2)(i)(1972).

<sup>265</sup> *Id.*

<sup>266</sup> Treas. Reg. § 1.864-4(c)(2)(ii)(1972). The regulation provides that:

[o]rdinarily, an asset shall be treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is—

- (a) Held for the principal purpose of promoting the present conduct of the trade or business in the United States, as, for example, in the case of stock acquired and held to assure a constant source of supply for the trade or business, or
- (b) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business, or
- (c) Otherwise held in a direct relationship to the trade or business conducted in the United States. . . .

<sup>267</sup> Treas. Reg. § 1.864-4(c)(2)(iii)(1972).

and (3) personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.<sup>268</sup>

The "business-activities test" is of primary significance in determining whether income which is "generally of a passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States" and is therefore effectively connected with that trade or business under section 864(c)(2).<sup>269</sup> For example, the business-activities test is of primary significance where:

- (a) dividends or interest are derived by a dealer in stocks or securities,
- (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, [or]
- (c) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property . . . .<sup>270</sup>

As indicated above, accounting procedures may have an impact on whether passive income is considered to be effectively connected with a United States trade or business.<sup>271</sup> Special rules are provided for determining whether income from stocks or securities is effectively connected with the active conduct of a "banking, financing, or similar business."<sup>272</sup>

If a nonresident alien individual performs personal services in the United States during the taxable year and those services constitute engaging in a trade or business under section 864(b), "wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses" received by the individual for performance of those services are effectively connected income.<sup>273</sup> In addition, "pensions and retirement pay attributable to such personal services" constitute effectively connected income if the individual is "engaged in a trade or business in the United States at some time during the taxable year in which such income is received."<sup>274</sup>

If a nonresident alien individual is engaged in a trade or business in the United States during the taxable year solely by reason of performing personal services in the United States, however, passive income and capital gains and losses from United States sources will not

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<sup>268</sup> Treas. Reg. § 1.864-4(c)(2)(iii)(b)(1972).

<sup>269</sup> Treas. Reg. § 1.864-4(c)(3)(i)(1972).

<sup>270</sup> *Id.*

<sup>271</sup> Treas. Reg. § 1.864-4(c)(4)(1972).

<sup>272</sup> Treas. Reg. § 1.864-4(c)(5)(1972).

<sup>273</sup> Treas. Reg. § 1.864-4(c)(6)(ii)(1972).

<sup>274</sup> *Id.*

be effectively connected income. An exception to this rule occurs when "there is a direct economic relationship between his holding of the asset from which the income, gain, or loss results and his trade or business of performing the personal services."<sup>275</sup> A direct economic relationship would exist if, for example, the individual purchased stock in a domestic corporation to assure the opportunity of performing personal services in the United States for that corporation.

### (3) *Other United States Source Income*

If a nonresident alien or a foreign corporation is engaged in a trade or business within the United States, all income from United States sources which is not nonbusiness income, as described in sections 871(a)(1) and 881(a),<sup>276</sup> or capital gains is effectively connected income.<sup>277</sup> This income is treated as effectively connected regardless of "whether or not the income, gain, or loss is derived from the trade or business being carried on in the United States during the taxable year."<sup>278</sup>

An example in the regulations<sup>279</sup> describes a foreign corporation which is engaged in the business of manufacturing machine tools in a foreign country. The company has a United States branch office through which it solicits orders for its products from United States customers. All negotiations with respect to resulting sales are carried on in the United States. By reason of this activity, the corporation is engaged in business within the United States and the United States source income or loss from such sales is effectively connected with the conduct of the United States business.<sup>280</sup> Occasionally, United States customers write directly to the home office of the company in the foreign country and the home office makes sales directly to such customers without routing the transaction through its United States branch office. The United States source income or loss from these occasional direct sales by the home office is also treated as effectively connected income.<sup>281</sup>

Only that portion of the income which the corporation in the above example derives from its sales to United States customers and which is income from United States sources will be effectively connected income. If the property sold was produced in a foreign country

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<sup>275</sup> Treas. Reg. § 1.864-4(c)(6)(1972).

<sup>276</sup> I.R.C. §§ 871(a)(1), 881(a)(1976).

<sup>277</sup> I.R.C. § 864(c)(3)(1976).

<sup>278</sup> Treas. Reg. § 1.864-4(b)(1972).

<sup>279</sup> Treas. Reg. § 1.864-4(b)Example (1) (1972).

<sup>280</sup> *Id.*

<sup>281</sup> *Id.*

and sold in the United States the portion of the taxable income attributable to sources within the United States "may be determined by processes or formulas of general apportionment prescribed by the secretary."<sup>282</sup> If such sales take place at the home office in the foreign country, no income will be effectively connected because there will be no income derived from United States sources under the sourcing rules.<sup>283</sup> As discussed later in this section, the result might be different if the United States office were involved in the sales.

The broad sweep of this vestige of "force of attraction"<sup>284</sup> is further illustrated by another example in the regulations.<sup>285</sup> The example describes a foreign corporation which is engaged in the business of purchasing and selling electronic equipment. The home office of the corporation is also engaged in the business of buying and selling vintage wines. The corporation has a branch office in the United States which sells equipment to customers in the United States and abroad. The branch "is not equipped to sell, and does not participate in sales of, wine purchased by the home office."<sup>286</sup> By reason of the activity of the United States branch the corporation is engaged in business in the United States.

As a result of advertisements which the home office . . . places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine . . . directly to such customers without routing the transactions through its branch office in the United States.<sup>287</sup>

United States source income from the sales of equipment by the branch and sales of wine by the home office is treated as effectively connected income. The sourcing rules in sections 861 through 863 of the Code<sup>288</sup> will be applicable in determining the amount, if any, of income from the sales of wine which will be effectively connected.

## b. Non-United States Source Income

### (1) *In General*

The preceding paragraphs have been concerned with the rules for

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<sup>282</sup> I.R.C. § 863(b)(2)(1976). The rules for the allocation are set forth in Treasury Regulation § 1.863-3(b) (1957) & T.D. 7456, 1977-1 C.B. 200, 226.

<sup>283</sup> I.R.C. §§ 861(1976 & Supp. V 1981), 862(1976 & Supp. V 1981), 863(1976). See Treasury Regulation § 1.861-7(c)(1957) for rules used in determining the place of sale.

<sup>284</sup> See P. POSTLEWATE, *INTERNATIONAL CORPORATE TAXATION* 43 (1980).

<sup>285</sup> Treas. Reg. § 1.864-4(b)*Example (3)*(1972).

<sup>286</sup> *Id.*

<sup>287</sup> *Id.*

<sup>288</sup> I.R.C. §§ 861(1976 & Supp. V 1981), 862(1976 & Supp. V 1981), 863(1976).

determining whether United States source income of a nonresident alien or foreign corporation engaged in a trade or business within the United States is effectively connected income. We turn now to a consideration of the circumstances in which income not derived from United States sources will be considered effectively connected with a United States trade or business.

Although it may seem reasonable that the United States should tax income from United States sources, regardless of whether the income is realized in connection with a trade or business conducted in the United States, it may not seem reasonable that the non-United States source income of a foreign person should be subject to United States tax. In order to better understand the rules regarding effective connection of income from non-United States sources with a United States trade or business, it is helpful to consider the Congressional concerns which led to enactment of these rules as part of the Foreign Investors Tax Act. Congress was concerned that under prior law a corporation which was not subject to tax in its home jurisdiction with respect to foreign source income could use the United States as a tax haven.<sup>289</sup> Such a corporation could establish a United States sales office to sell its products to customers in other countries. If title to the goods passed outside the United States the resulting income would not be subject to tax in the United States.<sup>290</sup>

Furthermore, the income might not be taxable in the country for which the goods were destined, assuming that the selling corporation did not have an office or permanent establishment in the destination country. In such cases the income would not have been taxed anywhere. The interaction of the title transfer rule and the income sourcing rules allowed foreign corporations to escape United States tax on sales of goods arranged by their United States offices even where the goods were destined for use or consumption in the United States. The Senate Finance Committee concluded:

[y]our committee agrees with the House that foreign corporations carrying on substantial business activities in the United States in such cases should not be able to cast their transaction in such a form as to avoid both all U.S. taxes and most foreign taxes. Also it is believed that foreign corporations should pay U.S. tax on the income generated from U.S. business activities. There appears to be no national policy to be served by allowing foreign persons to operate in this country without paying their

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<sup>289</sup> See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 17-18 (4th ed. 1979).

<sup>290</sup> *Treas. Reg. § 1.861-7(c)(1957)*. See also B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 17-8 n.19 (4th ed. 1979).



share of our government expenses.<sup>291</sup>

In order for foreign (i.e. non-United States) source income of a foreign person to be effectively connected with a United States trade or business the nonresident alien or foreign corporation must have "an office or other fixed place of business within the United States to which such income, gain, or loss is attributable. . . ." <sup>292</sup> In addition, the income must be of a type specified in section 864.

(2) *United States Office or Fixed Place of Business*

The regulations provide detailed guidance on when a nonresident alien individual or foreign corporation engaged in a trade or business within the United States has an office or fixed place of business in the United States for the purpose of determining whether foreign source income can be effectively connected with the trade or business.<sup>293</sup> The rules set forth in the regulations also apply for the purpose of determining whether a taxpayer has an office or fixed place of business outside the United States, a fact which will be of importance in determining whether income, gain, or loss from sales of goods or merchandise for use, consumption, or disposition outside the United States will be effectively connected.<sup>294</sup>

Two general rules are provided in the regulations. First, in determining whether the taxpayer has an office or other fixed place of business in the United States "due regard shall be given to the facts and circumstances of each case, particularly to the nature of the taxpayer's trade and the physical facilities actually required by the taxpayer in the ordinary course of the conduct of [the] trade or business."<sup>295</sup> The second general rule is that United States law, and not the law of a foreign country, controls in determining whether the taxpayer has an office or fixed place of business either in the United States or outside the United States.<sup>296</sup>

An office or fixed place of business generally will be a place, site or structure through which the taxpayer engages in a trade or business. An office, factory, store or other sales outlet, workshop, mine, quarry, or other place where natural resources are extracted are all examples of a fixed place of business. A place, site, or structure need not be continuously used by the nonresident alien or foreign corporation in order to

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<sup>291</sup> SENATE REPORT *supra* note 245, at 888.

<sup>292</sup> I.R.C. § 864(c)(4)(B)(1976).

<sup>293</sup> Treas. Reg. § 1.864-7(a)(1)(1972).

<sup>294</sup> *Id.*

<sup>295</sup> Treas. Reg. § 1.864-7(a)(2)(1972).

<sup>296</sup> Treas. Reg. § 1.864-7(a)(5)(1972).

be considered an office or fixed place of business.<sup>297</sup> If the taxpayer conducts a trade or business through another person's office or fixed place of business, the office or fixed place of business will not be considered the taxpayer's if the activities of the taxpayer in that office or fixed place of business are "relatively sporadic or infrequent, taking into account the overall needs and conduct of that trade or business."<sup>298</sup> The fixed place of business of a person who controls a corporation will not be considered a fixed place of business of the corporation merely because of the control relationship. Nor shall a foreign corporation be considered to have a fixed place of business in a country merely because "top management decisions affecting the foreign corporation" are made in the country.<sup>299</sup>

These rules are illustrated by an example<sup>300</sup> in which a foreign sales corporation is owned by a domestic parent. The foreign sales corporation will not be considered to have a fixed place of business in the United States merely because officers of the domestic parent who are generally responsible for policy decisions affecting the foreign sales corporation are present in the United States. This rule is subject to the proviso that the foreign sales corporation has a chief executive officer who conducts the day-to-day trade or business of the foreign sales corporation from a foreign office.<sup>301</sup> The result would not change if the chief executive officer of the foreign sales corporation is also an officer of the domestic parent and if he regularly confers with other officers of the domestic parent, occasionally visits the domestic parent's United States office and temporarily conducts the foreign sales corporation's business from the domestic parent's United States office during these visits.<sup>302</sup> Note, however, that if all orders received by the foreign sales corporation were subject to review by a United States based officer of the domestic parent, the foreign sales corporation would have a United States business office.<sup>303</sup>

In many cases it will be clear that the foreign taxpayer has an office or other fixed place of business in the United States. Where the taxpayer does not have a United States office or fixed place of business, the office or fixed place of business of an agent may be considered to be

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<sup>297</sup> Treas. Reg. § 1.864-7(b)(1)(1972).

<sup>298</sup> Treas. Reg. § 1.864-7(b)(2)(1972).

<sup>299</sup> Treas. Reg. § 1.864-7(c)(1972). *See also* Treas. Reg. § 1.864-7(f)(1972).

<sup>300</sup> Treas. Reg. § 1.864-7(g)Example (1)(1972).

<sup>301</sup> Treas. Reg. § 1.864-7(c)(1972).

<sup>302</sup> *Id.*

<sup>303</sup> Treas. Reg. § 1.864-7(g)Example(3)(1972).

a United States office or fixed place of business of the taxpayer.<sup>304</sup> The Code provides that for purposes of determining whether the taxpayer has a United States office or fixed place of business, the office or fixed place of business of an agent will, under certain circumstances, be disregarded. The clear negative implication of these rules is that a United States office or fixed place of business of the agent will be considered the taxpayer's if the agent "is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business,"<sup>305</sup> and if

(a) the agent has "the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation and regularly exercises that authority,"<sup>306</sup> or

(b) the agent "has a stock of merchandise from which he regularly fills orders on behalf" of the individual or foreign corporation.<sup>307</sup>

A wholly owned domestic subsidiary of a foreign corporation which purchases goods from its parent and resells them will not necessarily be treated as an agent of its parent. The domestic subsidiary's United States office or fixed place of business will be treated as a fixed place of business of the parent if the subsidiary (1) regularly negotiates and concludes contracts in the name of its foreign parent, or (2) maintains a stock of merchandise from which it regularly fills orders on behalf of its foreign parent.<sup>308</sup>

The fixed place of business of an independent agent will not be considered a fixed place of business of the taxpayer even if the agent conducts activities which would cause the fixed place of business of a non-independent agent to be considered a fixed place of business of the taxpayer.<sup>309</sup> An independent agent is defined as "a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity."<sup>310</sup> An agent may be independent even if related to the taxpayer.<sup>311</sup> The fact that an independent agent acts in that capacity exclusively or almost exclusively for one principal who is a nonresident alien or foreign corporation does not prohibit the agent from being considered an independent agent.<sup>312</sup>

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<sup>304</sup> I.R.C. § 864(c)(5)(A)(1976).

<sup>305</sup> I.R.C. § 864(c)(5)(A)(ii)(1976).

<sup>306</sup> I.R.C. § 864(c)(5)(A)(i)(1976).

<sup>307</sup> *Id.*

<sup>308</sup> Treas. Reg. § 1.864-7(d)(1)(i)(1972).

<sup>309</sup> Treas. Reg. § 1.864-7(d)(2)(1972).

<sup>310</sup> Treas. Reg. § 1.864-7(d)(3)(i)(1972).

<sup>311</sup> Treas. Reg. § 1.864-7(d)(3)(ii)(1972).

<sup>312</sup> Treas. Reg. § 1.864-7(d)(3)(iii)(1972).

(3) *Attribution of Income to United States Office or Fixed Place of Business*

The second requirement which must be met, in order for foreign source income to be effectively connected with a United States trade or business, is that it must be attributable to the United States office or fixed place of business of the foreign person.

[I]ncome, gain, or loss shall not be considered as attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of such income, gain, or loss and such office or fixed place of business regularly carries on activities of the type from which such income, gain, or loss is derived . . . .<sup>313</sup>

In order for the activities of the United States office or fixed place of business to be considered a material factor in the realization of income, gain, or loss those activities must “provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss.”<sup>314</sup> For example, “meetings in the United States of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income, gain, or loss.”<sup>315</sup> The United States office or fixed place of business need not, however, be a major factor in the realization of income, gain, or loss.<sup>316</sup>

Only certain specified categories of income from foreign sources can be effectively connected with the United States trade or business of a foreign person:

(a) rents or royalties for the use of or privilege of using various kinds of intangible property or any gain or loss realized on the sale or exchange of such property, where such income, gain, or loss is “derived in the active conduct of such trade or business;”<sup>317</sup>

(b) dividends, interest, or gain or loss from the sale or exchange of stocks or securities where such income, gain, or loss is “derived in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stocks or securities for its own account;”<sup>318</sup> or

(c) income, gain, or loss from the sale or exchange of stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business where such sales are made outside the

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<sup>313</sup> I.R.C. § 864(c)(5)(B)(1976).

<sup>314</sup> Treas. Reg. § 1.864-6(b)(1)(1972).

<sup>315</sup> *Id.*

<sup>316</sup> *Id.*

<sup>317</sup> I.R.C. § 864(c)(4)(B)(i)(1976).

<sup>318</sup> I.R.C. § 864(c)(4)(B)(ii)(1976).

United States but through the United States office or fixed place of business; provided that such income, gain, or loss will however, not be effectively connected "if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office of the taxpayer outside the United States participated materially in [the] sale."<sup>319</sup>

The taxpayer's office or fixed place of business in the United States will be considered a material factor in the realization of rents, royalties or gains or sales of intangible property:

if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange the lease, license, sale, or exchange from which such income, gain, or loss is derived or [if it] performs significant services incident to such lease, license, sale, or exchange.<sup>320</sup>

The regulation also provides that a United States office or fixed place of business will *not* be considered a material factor in the realization of rents, royalties or gains from sales of intangible property merely because one or more of the following activities is conducted by the office or fixed place of business:

(a) development or creation of, or acquisition and addition of substantial value to the property from which the income arises;

(b) collection of the rents, royalties or gains, or performance of clerical functions incident to the sale or exchange; or

(c) exercise of general supervision over the activities of persons who solicit, negotiate or perform other activities required to arrange the lease, license or sale which gives rise to the income, gain or loss or final approval over the transaction.<sup>321</sup>

The rules regarding when a United States office or fixed place of business will be considered a material factor in the realization of dividends, interest and gains and losses from sales of stock or securities are similar to the rules discussed above in connection with the realization of rents, royalties and gains from sales of intangible property.<sup>322</sup> Special rules apply in determining whether such income is effectively connected with the active conduct of a banking, financing, or similar business.<sup>323</sup>

In the case of income, gain or loss derived from sales of stock in trade or other property held primarily for sale to customers in the ordi-

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<sup>319</sup> I.R.C. § 864(c)(4)(B)(iii)(1976).

<sup>320</sup> Treas. Reg. § 1.864-6(b)(2)(i)(1972).

<sup>321</sup> *Id.*

<sup>322</sup> Treas. Reg. § 1.864-6(b)(2)(ii)(a)(1972).

<sup>323</sup> Treas. Reg. § 1.864-6(b)(2)(ii)(b)(1972).

nary course of the trade or business, the office or fixed place of business will be considered a material factor in the realization of income "if the office or . . . fixed place of business actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of separate agreement between the seller and the buyer."<sup>324</sup> When income, gain, or loss arises as a result of a sales order received at an office or fixed place of business, the office or fixed place of business will be considered a material factor in the realization of that income unless the order is received unsolicited at that location and that location is not held out to potential customers as the place to which orders should be sent.<sup>325</sup>

Foreign source income, gain or loss from the sale of goods or merchandise will not be attributed to an office or other fixed place of business in the United States unless it is realized in the ordinary course of the trade or business carried on through the office or other fixed place of business. For example, when a foreign corporation is engaged solely in the business of manufacturing in the United States, income derived by its United States office as a result of an occasional sale outside the United States is not attributable to the United States office if the corporation's sales office is located outside the United States.<sup>326</sup> An office or other fixed place of business in the United States will not be considered a material factor in the realization of income, gain or loss from the sale of stock in trade or inventory merely because of one or more of the following facts:

- (a) the sale is made subject to the final approval of such office or other fixed place of business, (b) the property sold is held in, and distributed from, such office or other fixed place of business, (c) samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of business, or (d) such office or other fixed place of business performs merely clerical functions incident to the sale.<sup>327</sup>

If a nonresident alien or foreign corporation does not have a fixed place of business in a country but does have an employee in the country, the employee will ordinarily be considered a dependent agent and the fixed place of business of the employee will be treated as a fixed place of business of the employer. The employee must also regularly exercise the authority to negotiate and conclude contracts on behalf of the employer, or have a stock of goods from which he regularly fills

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<sup>324</sup> Treas. Reg. § 1.864-6(b)(2)(iii)(1972).

<sup>325</sup> *Id.*

<sup>326</sup> *Id.*

<sup>327</sup> *Id.*

orders on behalf of the employer.<sup>328</sup> If the employer has a fixed place of business through which the employee in the ordinary course of his duties carries on the business of the employer, however, the fixed place of business will be considered to be that of the employer.<sup>329</sup> Thus, the employer cannot avoid having a fixed place of business in a country by staffing an office with employees who have limited authority.

If, under the rules discussed above, an item of income is attributed to the United States office or fixed place of business of a nonresident alien or foreign corporation, that item of income will be allocable in its entirety to the office of fixed place of business.<sup>330</sup> It should be borne in mind, however, that even if a nonresident alien or foreign corporation maintains an office or other fixed place of business in the United States, no income from sources outside the United States may be attributed to that office or fixed place of business unless the taxpayer is at some point during the taxable year engaged in a trade or business within the United States.<sup>331</sup> A special limitation is applicable to sales of stock in trade or inventory in the ordinary course of the taxpayer's trade or business where the sale is outside the United States but through the taxpayer's fixed place of business in the United States. The income from such sales which is attributable to the fixed place of business in the United States may not exceed the amount of income which would have been treated as income from United States sources had the sale taken place in the United States.<sup>332</sup> The source of income is determined by reference to sections 861 through 863 of the Code.<sup>333</sup>

## 2. *Deductions and Returns*

In general, nonresident aliens and foreign corporations are allowed the benefit of deductions and credits in computing their United States federal income tax liability *only* if they are engaged in a trade or business within the United States *and* if so engaged *only* to the extent such deductions and credits are connected with income which is "effectively connected with the conduct of a trade or business within the United States."<sup>334</sup> A deduction is allowed for charitable contributions to the extent provided by section 170,<sup>335</sup> regardless of whether the de-

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<sup>328</sup> See Treas. Reg. § 1.864-7(d)(1972).

<sup>329</sup> Treas. Reg. § 1.864-7(e)(1972).

<sup>330</sup> Treas. Reg. § 1.864-6(c)(1)(1972).

<sup>331</sup> *Id.*

<sup>332</sup> Treas. Reg. § 1.864-6(c)(2)(1972).

<sup>333</sup> I.R.C. §§ 861(1976 & Supp. V 1981), 862(1976 & Supp. V 1981), 863(1976).

<sup>334</sup> I.R.C. §§ 873(a), 882(c)(1)(A)(1976).

<sup>335</sup> I.R.C. § 170(1976 & Supp. V 1981).

duction is connected with income which is effectively connected.<sup>336</sup> In addition, nonresident alien individuals engaged in a trade or business within the United States are allowed a deduction under section 165(c)(3)<sup>337</sup> for casualty losses in connection with property not connected with the United States trade or business if the property is located in the United States at the time of the loss.<sup>338</sup> Nonresident alien individuals engaged in a trade or business within the United States are also allowed one personal exemption deduction under section 151.<sup>339</sup> Deductions and credits will be disallowed if the nonresident alien or foreign corporation fails to file "a true and accurate return, in the manner prescribed . . . including therein all the information which the Secretary may deem necessary for the calculation of such deductions and credits."<sup>340</sup>

The Code offers no guidance in determining which expenses are connected with effectively connected income. Section 1.861-8 of the regulations is applicable for purposes of determining the deductions taken into account in computing effectively connected taxable income.<sup>341</sup> The section 1.861-8 regulations require the taxpayer to relate deductions to the activity or transaction which gave rise to the deductions. For the purpose of determining effectively connected taxable income, these rules would require the taxpayer first to allocate deductions to the "class of gross income" to which the deductions are "definitely related."<sup>342</sup> The term "class of gross income" is defined in the following circular manner: "[T]he gross income to which a specific deduction is definitely related is referred to as a 'class of gross income' and may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61 . . . ."<sup>343</sup> Included in section 61 as items of gross income are compensation for services, income derived from dealings in property, interest, rents, royalties and dividends.<sup>344</sup>

After deductions are allocated to classes of income, they are ap-

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<sup>336</sup> I.R.C. §§ 873(b)(2), 882(a)(2)(1976).

<sup>337</sup> I.R.C. § 165(c)(3)(Supp. V 1981).

<sup>338</sup> I.R.C. § 873(b)(1)(1976).

<sup>339</sup> I.R.C. § 151(1976 & Supp. V 1981); *see* I.R.C. § 873(b)(3)(1976).

<sup>340</sup> I.R.C. §§ 874(a)(West Supp. 1983), 882(c)(2)(1976).

<sup>341</sup> Treas. Reg. § 1.861-8(f)(1)(iv), T.D. 7749, 1981-1 C.B. 390, 393.

<sup>342</sup> Treas. Reg. § 1.861-8(b)(1), T.D. 7456, 1977-1 C.B. 200, 202.

<sup>343</sup> Treas. Reg. § 1.861-8(a)(3), T.D. 7456, 1977-1 C.B. 200, 202.

<sup>344</sup> Treasury Regulation § 1.861-8(b)(2), T.D. 7456, 1977-1 C.B. 200, 202-03, states: "A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to an activity or in connection with property from which such class of gross income is derived." Treasury Regulation § 1.861-8(b)(5), T.D. 7456, 1977-1 C.B. 200, 203, states: "If a deduction does not bear a definite relationship to a class of gross



portioned between gross income which is effectively connected with a United States trade or business and gross income which is not effectively connected.<sup>345</sup> Deductions are to be apportioned "in a manner which reflects to a reasonably close extent to the factual relationship between the deduction and the grouping of gross income."<sup>346</sup> The regulations suggest several factors which should be considered in determining the method of apportionment. The rules referred to above for allocating certain specified expenses also cover apportionment of those expenses.<sup>347</sup> Deductions which are not definitely related to a class of gross income are to be ratably apportioned between effectively connected income and income which is not effectively connected.<sup>348</sup>

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income consisting of less than all gross income it shall ordinarily be treated as definitely related and allocable to all of a taxpayer's gross income . . . ."

The regulations specify five classes of deductions which "shall generally be considered as not definitely related to any gross income . . . ." Treas. Reg. § 1.861-8(e)(9), T.D. 7456, 1977-1 C.B. 200, 211. With the possible exception of the deduction for charitable contributions all of these deductions are personal in nature. Special rules are provided for the allocation of interest, Treas. Reg. § 1.861-8(e)(2), T.D. 7456, 1977-1 C.B. 200, 204-06, T.D. 7749, 1981-1 C.B. 390, 392-93; research and experimental expenditures, Treas. Reg. § 1.861-8(e)(3), T.D. 7456, 1977-1 C.B. 200, 206-10; stewardship expenses attributable to dividends received, Treas. Reg. § 1.861-8(e)(4), T.D. 7456, 1977-1 C.B. 200, 210; professional fees, Treas. Reg. § 1.861-8(e)(5), T.D. 7456, 1977-1 C.B. 200, 210-11; income taxes, Treas. Reg. § 1.861-8(e)(6), T.D. 7456, 1977-1 C.B. 200, 211; and certain losses, Treas. Reg. § 1.861-8(e)(7) & (8), T.D. 7456, 1977-1 C.B. 200, 211. Some deductions may be allocable to all gross income rather than to any class of gross income. Treas. Reg. § 1.861-8(b)(1), T.D. 7456, 1977-1 C.B. 200, 202.

<sup>345</sup> Treas. Reg. § 1.861-8(c)(1), T.D. 7456, 1977-1 C.B. 200, 203.

<sup>346</sup> *Id.*

<sup>347</sup> See *supra* note 343.

<sup>348</sup> Treas. Reg. § 1.861-8(c)(2), T.D. 7456, 1977-1 C.B. 200, 204.