



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Transaction Unit

Unit Name	Gross Effectively Connected Income (ECI) of a Foreign Corporation (Non-Treaty)	
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Chapter	Non-Treaty U.S. Branch Allocations (General)

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Issue and Transaction Overview

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Note: This Practice Unit was updated to remove or update references to resources that are no longer current or available and to correct minor typographical or formatting errors. It supersedes the 02/08/2016 Practice Unit of the same title.

- Foreign Corporations (FC) earn taxable income in multiple foreign jurisdictions and may earn income in the U.S. These corporations may be operating in the U.S. directly, without forming a separate subsidiary, and be unaware that they have a U.S. income tax filing obligation. The FC may be filing a 1) Form 1120-F, 2) Form 1120-F on a protective basis or 3) not filing at all. In addition, the FC may have transactions with a related or non-related US corporation. FCs may be a start up or have been operating for many years in the U.S. This Practice Unit examines an FC engaged in a U.S. trade or business, the U.S. filing requirements, the items of U.S. source income that are, or are treated as, effectively connected income (ECI) and thus subject to U.S. taxation. In addition, the FC may earn certain limited types of foreign source income that can be ECI. Please refer to the Non-Services FDAP Income LB&I Transaction Unit which discusses U.S. source Fixed Determinable Annual or Periodical income (FDAP) subject to withholding tax, which is not addressed in this unit.
- In general, IRC Section 882 provides that an FC engaged in a trade or business within the United States during the taxable year is taxable under graduated corporate tax rates on its income effectively connected with the conduct of a trade or business within the U.S. IRC Section 864 covers the types of gross income that are treated as effectively connected with the conduct of a U.S. trade or business.
- The examiner should determine early on in the audit process if the FC is engaged in a trade or business within the U.S. based on the facts and circumstances of the case. This will assist the examiner in determining the gross income of the FC as well as the allowable deductions.
- This unit addresses ECI and filing requirements when FC is not a resident of treaty jurisdiction.

Transaction and Fact Pattern

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Diagram of Transaction	Facts
<p>The diagram is divided into two horizontal sections: 'Foreign' (top) and 'U.S.' (bottom), separated by a horizontal line. In the 'Foreign' section, there is a blue box labeled 'FC' and a blue box labeled 'OEM - foreign customers'. In the 'U.S.' section, there is a blue oval labeled 'U.S. Sales Office', a pink box labeled 'Technical Services', a pink box labeled 'Sales contract', a white box labeled 'OEM U.S. Customers', a white box labeled 'OEM - U.S. Contracting Party', and a blue box labeled 'U.S. Bank Account'. Arrows indicate the flow of income and services: an arrow points from 'FC' down to 'U.S. Sales Office'; an arrow points from 'U.S. Sales Office' up to 'FC'; an arrow points from 'Sales contract' down to 'OEM - U.S. Contracting Party'; an arrow points from 'OEM - U.S. Contracting Party' up to 'FC'; an arrow points from 'Technical Services' up to 'OEM - foreign customers'; and an arrow points from 'OEM U.S. Customers' up to 'Technical Services'.</p>	<ul style="list-style-type: none"> FC is a resident of a non-treaty foreign country. FC has a U.S. bank account and deposits income from 3rd party customers into the account. Interest income is earned on the bank account. FC is a global parts manufacturer, seller and servicer of equipment. All of FC's manufacturing is performed outside of the U.S. FC has a sales office in the U.S. that executes contracts with Original Equipment Manufacturers (OEM) for the delivery of parts to OEM U.S. customers (U.S. destinations) and OEM foreign customers (foreign destinations) FC has technicians that make appointments and perform services at OEM customer locations (U.S. and foreign) for after-sale servicing of parts

Summary of Potential Issues

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

<u>Issue 1</u>	Is the FC engaged in a trade or business within the U.S.?
<u>Issue 2</u>	What are the types of U.S. source or foreign source gross income that FC earns in the U.S. trade or business?
<u>Issue 3</u>	Is the income treated as effectively connected income (ECI)?

All Issues, Step 1: Initial Factual Development

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Foreign Corporations (FC) earn taxable income in multiple foreign jurisdictions and may earn income in the U.S. These corporations may be operating in the U.S. and be unaware that they have a U.S. income tax filing obligation. The FCs may be a start-up or have been operating for many years in the U.S. This Practice Unit examines an FC engaged in a U.S. trade or business, the U.S. filing requirements, the items of income treated as U.S. source income and the items of U.S. source income that are effectively connected income (ECI) and thus subject to U.S. taxation.

Fact Element	Resources
<ul style="list-style-type: none">▪ Determine the sales offices and locations within the U.S.	<ul style="list-style-type: none">▪ Internet search of FC's website focusing on FC's global lines of business, foreign offices and financial statements.▪ Online Database search of FC's U.S. officers' names and office addresses.▪ Industry Online Database search for industry information on competitors.
<ul style="list-style-type: none">▪ Determine the U.S. locations where FC is providing after-sale technical support services▪ Determine whether technical service personnel are U.S. employees or agents of the FC▪ Determine identity and location of FC's U.S. bank account	<ul style="list-style-type: none">▪ Request and/or review:<ul style="list-style-type: none">– Legal entity organizational charts– Function organization charts– Taxpayer global financial statements– Functions of all employees at the U.S. office

Issue 1, Step 2: Review Potential Issues

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 1

Is the FC engaged in a trade or business within the U.S.?

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ The code and regulations do not define what constitutes a U.S. trade or business. In addition, the IRS will generally not rule on whether a taxpayer is engaged in a U.S. trade or business.▪ However, there are certain activities that a foreign corporation can engage in and not be considered engaged in a U.S. Trade or Business, i.e., trading in stocks or securities or commodities for one's own account.▪ Generally, if a foreign corporation performs an activity that is conducted on a regular, continuous, and substantial basis in the U.S., it is considered to be engaged in a U.S. trade or business.	<ul style="list-style-type: none">▪ IRC 864▪ IRC 882▪ Rev. Proc. 2013-7▪ Treas. Reg. 1.864-2(a)▪ Treas. Reg. 1.864-2(c)(1)▪ Treas. Reg. 1.864-2(d)(1)▪ <i>Spermacet Whaling & Shipping Co S.A. v. Commissioner</i>, 30 T.C. 618 (1958)▪ <i>European Naval Stores Co., S.A. v. Commissioner</i>, 11 T.C.127 (1948)

Issue 1, Step 2: Review Potential Issues (cont'd)

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 1

Is the FC engaged in a trade or business within the U.S.?


Explanation of Issue	Resources
<ul style="list-style-type: none">▪ The issue is whether sales contracts, solicited, negotiated or executed by U.S. office personal and the performance of technical services by employees or agents in the U.S. create a U.S. trade or business. In all instances, this is a facts and circumstances test.	<ul style="list-style-type: none">▪ Scottish American Investment Co. Ltd. v. Commissioner, 12 T.C. 49 (1949)▪ Linen Thread Co., Ltd., v. Commissioner, 14 T.C. 725 (1950)▪ InverWorld, Inc. v. Commissioner, T.C. Memo 1996-301

Issue 1, Step 3: Additional Factual Development

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 1

Is the FC engaged in a trade or business within the U.S.?


Fact Element	Resources
<ul style="list-style-type: none">▪ Confirm that personnel in the U.S. sales office solicit, negotiate or execute contracts with OEM▪ Confirm the location where the technical service employees provide technical services to OEM customers▪ Verify that the technical employees are employees of the FC and not independent contractors	<ul style="list-style-type: none">▪ Request copies of:<ul style="list-style-type: none">– Signatory on lease agreement for U.S. sales office.– Copies of parts and service agreement contracts between FC and OEM.– Contracts of employment and/or other agreements for the technical employees and FC.
 CONSULTATION: If foreign based evidence is difficult to obtain under normal IDR process, please refer to the Information Gathering Practice Network for reference and resource materials.	

Issue 1, Step 4: Develop Arguments

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 1

Is the FC engaged in a trade or business within the U.S.?

Explanation of Adjustment	Resources
<ul style="list-style-type: none">▪ If the facts imply that the FC is engaged in activities on a regular, continuous and substantial basis, then you should proceed to Issue 2 to determine the types of U.S. source or foreign source gross income FC earns from those activities.	<ul style="list-style-type: none">▪ Lewenhaupt v. Commissioner, 20 T.C. 151 (1953)▪ De Amodio v. Commissioner, 34 T.C. 894 (1960)▪ U.S. v. Balanovski, 49 A.F.T.R. 2007 (N.Y. C.A. 2, 1956)▪ Pinchot v. Commissioner, 25 A.F.T.R. 447 (NY C.A.2, 1940)
 CONSULTATION: Counsel should be consulted as necessary for assistance in evaluating whether a taxpayer is engaged in a U.S. trade or business.	

Issue 2, Step 2: Review Potential Issues

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 2

What are the types of U.S. source or foreign source income that FC earns in the U.S. trade or business?

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ Once it has been determined that the FC is engaged in a U.S. trade or business, FC will be taxed in the U.S. on its income effectively connected to the U.S. trade or business.▪ Income from services performed in the U.S. is always ECI from a trade or business. U.S. source income that is either FDAP or capital gain is ECI only if it is attributable to assets of the U.S. business or if activities of the business are a material factor in generating the income. Income from the sale of inventory is ECI if the income is from sources within the U.S.▪ Foreign source income is ECI only in limited situations. Relevant to this example, foreign source income derived from the sale of inventory outside the U.S. may be ECI, but only if attributable to a U.S. office and the property is not for consumption or use outside the U.S. and no foreign office participated materially in the sale.	<ul style="list-style-type: none">▪ IRC 881▪ IRC 882▪ IRC 864(c)(1), (2), (3), and (4)▪ IRC 861(a)(1) and (a)(3)▪ Treas. Reg. 1.861-2▪ Treas. Reg. 1.861-4(b)▪ IRC 863(a) and (b)(1) and (b)(2)▪ IRC 865(e)(2)▪ IRC 864(c)(4)(B)(iii)

Issue 2, Step 3: Additional Factual Development

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 2

What are the types of U.S. source or foreign source income that FC earns in the U.S. trade or business?


Fact Element	Resources
<ul style="list-style-type: none">▪ Determine if sales to U.S. OEMs are made through a U.S. office. If the sales are not made through a U.S. office, determine if the rights, title and interest pass to the buyer in the U.S.▪ Confirm that the FC has a U.S. bank account used to deposit revenue.▪ Determine how much interest income is received from U.S. banks.▪ Confirm that FC has technical personnel in the U.S. performing services at U.S. OEM customer locations	<ul style="list-style-type: none">▪ Review the invoices for address of seller.▪ Review Bill of Lading and other documents for shipping terms and other terms of sale including risk of loss.▪ Obtain copies of all bank statements.▪ Review bank and brokerage statements to determine if the securities are generating interest income.▪ Obtain the project logs or work orders of the technical personnel.

Issue 2, Step 4: Develop Arguments

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 2

What are the types of U.S. source or foreign source income that FC earns in the U.S. trade or business?

Explanation of Adjustment	Resources
<ul style="list-style-type: none">▪ The sale of inventory produces U.S. source income if it is sold in the U.S. It is sold in the U.S. if the rights, title, and interest of the seller in the property are transferred to the buyer in the U.S.▪ The sale of inventory that would otherwise generate foreign source income because the seller is a nonresident may still be treated as U.S. source income if the sale is attributable to a U.S. office and the U.S. sales office is a material factor in the realization of income from the sale of inventory.	<ul style="list-style-type: none">▪ IRC 861(a)(6)▪ Treas. Reg. 1.861-7(c)▪ IRC 865(e)(2) and (e)(3)▪ IRC 864(c)(5)▪ IRC 863(a) and 863(b)(2)
 CONSULTATION: Counsel should be consulted as necessary for a determination of the amount of gross sales income that is U.S. source as it applies to the facts of your case.	

Issue 2, Step 4: Develop Arguments (cont'd)

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 2

What are the types of U.S. source or foreign source income that FC earns in the U.S. trade or business?

Explanation of Adjustment	Resources
<ul style="list-style-type: none">▪ Pursuant to the review of taxpayer records, including project logs and work orders of the technical personnel, determine which activities were performed in the U.S. and which activities were performed in a foreign jurisdiction.▪ Allocate gross income accordingly between U.S. and Foreign source income for the performance of services.▪ Income from services performed in the U.S. is U.S. source income.	<ul style="list-style-type: none">▪ IRC 861(a)(3)▪ IRC 862(a)(3)▪ IRC 863(b)(1) ▪ Treas. Reg. 1.861-4(b)(1)

Issue 3, Step 2: Review Potential Issues

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 3

Is the income treated as effectively connected income (ECI)?

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ After determining that FC is engaged in a U.S. trade or business, all income from U.S. sources is ECI, other than FDAP income. This is known as the “limited force of attraction” doctrine. ECI could include other U.S. source business income of FC, such as U.S. source income from the sale of inventory not connected to any U.S. office, but not FDAP income.▪ If the FC has gross income that is ECI, deductions connected to the gross income are generally allowed and the net income is subject to U.S. taxation at graduated rates.▪ The determination of whether U.S. source FDAP income is ECI requires a separate analysis, considering both the “asset use” and “business activities test.”	<ul style="list-style-type: none">▪ IRC 864(c)(3)▪ IRC 882(a)▪ IRC 864(c)(2)(A)▪ IRC 864(c)(2)(B)▪ IRC 882(c)(2)▪ Treas. Reg. 1.864-4(c)(2)▪ Treas. Reg. 1.864-4(c)(3)

Issue 3, Step 3: Additional Factual Development

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 3

Is the income treated as effectively connected income (ECI)?

Fact Element	Resources
<ul style="list-style-type: none">▪ With regard to technical services income, such income is sourced in the US based on where the services are performed.▪ With regard to interest income, develop facts to determine if the interest income satisfies the asset use test, e.g., whether the cash was used for ordinary and necessary business expenses of the U.S. business, rather than as a long-term investment of excess cash of the FC.	<ul style="list-style-type: none">▪ IRC 861(a)(3)▪ IRC 864(c)(3)▪ Treas. Reg. 1.861-4(a) and (b)▪ Review the cash receipts and cash disbursements journals and other periodic cash flow reports

Issue 3, Step 4: Develop Arguments

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 3

Is the income treated as effectively connected income (ECI)?

Explanation of Adjustment	Resources
<ul style="list-style-type: none">▪ If the sale takes place in the U.S. because FC transfers all rights, title and interest in the property to the OEMs in the U.S., the income is U.S. source, whether or not attributable to a U.S. office.▪ If there is no transfer of rights in the U.S., but the negotiation or execution of contracts by FC personnel (e.g. the activities are a material factor in the realization of the sales income) takes place at a U.S. office, the sales would be attributable to the U.S. office, and the income from the sales may still be U.S. source, even though FC is not a U.S. resident▪ Assuming the bank account is held for use for the present needs of the business and not the future needs, the U.S. source interest would be ECI. If it does not meet this test (or the business activities test), the interest income from bank deposits is exempt from U.S. tax.	<ul style="list-style-type: none">▪ IRC 864(c)(3)▪ Treas. Reg. 1.864-4(b)▪ Treas. Reg. 1.861-7(c)▪ IRC 865(e)(2)▪ IRC 864(c)(2)(A)▪ Treas. Reg. 1.864-4(c)(2)(i)▪ IRC 871(i)(2)(A)

Issue 3, Step 4: Develop Arguments (cont'd)

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Issue 3

Is the income treated as effectively connected income (ECI)?

Explanation of Adjustment	Resources
<ul style="list-style-type: none">▪ Income from the performance of technical services in the U.S. meets the business activities test if the service fees are derived in the active conduct of performing post-sale support. Thus, the US source service fee is ECI.▪ ECI should be taxable to FC on a net income basis at regular corporate tax rates. If ECI is not properly reported on FC's Form 1120-F for that year or if FC filed a return late, adjustments to taxable income should be documented on Form 886-A.▪ In addition, the disallowance of expenses may be appropriate if the return is filed 18 months after the due date.	<ul style="list-style-type: none">▪ Treas. Reg. 1.864-4(c)(3)(i)▪ Treas. Reg. 1.864-4(c)(6)(i)▪ IRC 864(c)(2)(B)▪ IRC 882(c)(2)▪ Treas. Reg. 1.882-4(a)(3)▪ Form 1120-F▪ Form 886-A

Index of Referenced Resources

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)	
Form 1120-F	
Form 886-A	
IRC 861	
IRC 862	
IRC 863	
IRC 864	
IRC 865	
IRC 871	
IRC 881	
IRC 882	
Treas. Reg. 1.861-2	
Treas. Reg. 1.861-4	
Treas. Reg. 1.861-7	
Treas. Reg. 1.864-2	
Treas. Reg. 1.864-4	
Treas. Reg. 1.882-4	

Index of Referenced Resources (cont'd)

Gross Effectively Connected Income of a Foreign Corporation (Non-Treaty)

Rev. Proc. 2013-7

De Amodio v. Commissioner, 34 T.C. 894 (1960)

European Naval Stores Co., S.A. v. Commissioner, 11 T.C.127 (1948)

Lewenhaupt v. Commissioner, 20 T.C. 151 (1953)

Linen Thread Co., Ltd., v. Commissioner, 14 T.C. 725 (1950)

Scottish American Investment Co. Ltd. v. Commissioner, 12 T.C.49 (1949)

Spermacet Whaling & Shipping Co S.A. v. Commissioner, 30 T.C. 618 (1958)

InverWorld, Inc. v. Commissioner, T.C. Memo 1996-301

U.S. v. Balanovski, 49 A.F.T.R. 2007 (N.Y. C.A. 2, 1956)

Pinchot v. Commissioner, 25 A.F.T.R. 447 (NY C.A.2, 1940)

Glossary of Terms and Acronyms

Term/Acronym	Definition
ECI	Effectively Connected Income
FC	Foreign Corporation
FDAP	Fixed Determinable Annual or Periodical
OEM-US	Original Equipment Manufacturer

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9421	General Deductions of a Foreign Corporation Engaged in a U.S. Trade or Business (Non-Treaty)
9421	Interest Expense of U.S. Branch of a Foreign Bank (Non-Treaty)
9421	Interest Expense of a Foreign Corporation Engaged in a U.S. Trade/Business (Non-Bank, Non-Treaty)
9421	Section 861 – Home Office and Stewardship Expenses
9424	Non-Services FDAP Income