

## LB&I International Practice Service Transaction Unit

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<b>Shelf</b>	N/A	Business Inbound	–	–
<b>Volume</b>	6	Inbound Income Shifting	Level 1 UIL	9422
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<b>Sub-Chapter</b>	6.1.1.1	Determination of Gross Income of a Foreign Corporation	–	–

<b>Unit Name</b>	Gross Effectively Connected Income (ECI) of a Foreign Corporation (Non-Treaty)
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# Issue and Transaction Overview

## 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. 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. FC's may be a start up or been operating for many years in the US. This Practice Unit examines a FC engaged in a US trade or business, the US filing requirements, the items of U.S. source income that are, or are treated as, effectively connected income (ECI) and thus subject to US 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 IPS 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 a 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><b>Foreign</b></p> <p>The diagram is divided into two horizontal sections: Foreign (top) and U.S. (bottom). In the Foreign section, a blue box labeled 'FC' has a downward arrow pointing to a blue oval labeled 'U.S. Sales Office'. To the right, a blue box labeled 'OEM - foreign customers' has an upward arrow pointing to a pink box labeled 'Technical Services'. In the U.S. section, a pink box labeled 'Sales contract' has a downward arrow pointing to a white box labeled 'OEM - US Contracting Party'. To the right, a white box labeled 'OEM US Customers' has an upward arrow pointing to the 'Technical Services' box. At the bottom right, a blue rounded rectangle labeled 'U.S. Bank Account' is shown.</p>	<ul style="list-style-type: none"> <li>▪ FC is a resident of a non-treaty foreign country.</li> <li>▪ FC has a U.S. bank account and deposits income from 3<sup>rd</sup> party customers into the account.</li> <li>▪ Interest income is earned on the bank account.</li> <li>▪ FC is a global parts manufacturer, seller and servicer of equipment.</li> <li>▪ All of FC's manufacturing is performed outside of the U.S.</li> <li>▪ FC has a sales office in the U.S. that executes contracts with Original Equipment Manufacturers (OEM) for the delivery of parts to OEM US customers (US destinations) and OEM foreign customers (foreign destinations)</li> <li>▪ FC has technicians that make appointments and perform services at OEM customer locations (US and foreign) for after-sale servicing of parts</li> </ul>	

# Summary of Potential Issues

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

<a href="#"><u>Issue 1</u></a>	Is the FC engaged in a trade or business within the U.S.?
<a href="#"><u>Issue 2</u></a>	What are the types of U.S. source or foreign source gross income that FC earns in the U.S. trade or business?
<a href="#"><u>Issue 3</u></a>	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 FC's may be a start-up or been operating for many years in the US. This Practice Unit examines a FC engaged in a US trade or business, the US 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 US taxation.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Determine the sales offices and locations within the U.S.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Internet search of FC's website focusing on FC's global lines of business, foreign offices and financial statements.</li> <li>▪ Online Database search of FC's U.S. officers names and office addresses.</li> <li>▪ Industry Online Database search for industry information on competitors</li> </ul>	
<ul style="list-style-type: none"> <li>▪ Determine the US locations where FC is providing after-sale technical support services</li> <li>▪ Determine whether technical service personnel are US employees or agents of the FC</li> <li>▪ Determine identity and location of FC's U.S. bank account</li> </ul>	<ul style="list-style-type: none"> <li>▪ Request and/or review:               <ul style="list-style-type: none"> <li>– Legal entity organizational charts</li> <li>– Function organization charts</li> <li>– Taxpayer global financial statements</li> <li>– Functions of all employees at the U.S. office</li> </ul> </li> </ul>	

# 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"><li>▪ The code and regulations do not define what constitutes a US trade or business. In addition, the IRS will generally not rule on whether a taxpayer is engaged in a U.S. trade or business.</li><li>▪ 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.</li><li>▪ 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.</li></ul>	<ul style="list-style-type: none"><li>▪ IRC §864</li><li>▪ IRC §882</li><li>▪ Rev Proc 2013-7</li> <li>▪ Treas. Reg. 1.864-2(a)</li><li>▪ Treas. Reg. 1.864-2(c)(1)</li><li>▪ Treas. Reg. 1.864-2(d)(1)</li> <li>▪ Spermacet Whaling &amp; Shipping Co S.A. v. Commissioner- 30 T.C. 618 (1958)</li><li>▪ European Naval Stores Co.,S.A. v. Commissioner - 11 T.C.127 (1948)</li></ul>

# 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"><li>▪ 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 US create a U.S. trade or business. In all instances, this is a facts and circumstances test.</li></ul>	<ul style="list-style-type: none"><li>▪ Scottish American Investment Co. Ltd. v. Commissioner- 12 T.C.49 (1949)</li><li>▪ Linen Thread Co., Ltd., v. Commissioner 14 T.C. 725 (1950)</li><li>▪ InverWorld, Inc. v. Commissioner, T.C. Memo 1996-301</li></ul>




# 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	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Confirm that personnel in the US sales office solicit, negotiate or execute contracts with OEM</li> <li>▪ Confirm the location where the technical service employees provide technical services to OEM customers</li> <li>▪ Verify that the technical employees are employees of the FC and not independent contractors</li> </ul>	<ul style="list-style-type: none"> <li>▪ Request copies of:                             <ul style="list-style-type: none"> <li>- Signatory on lease agreement for US sales office.</li> <li>- Copies of parts and service agreement contracts between FC and OEM.</li> <li>- Contracts of employment and/or other agreements for the technical employees and FC.</li> </ul> </li> </ul>	
 <p><b>CONSULTATION:</b> If foreign based evidence is difficult to obtain under normal IDR process, please refer to the Information Gathering IPN for reference and resource materials.</p>		

# 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	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ If the facts imply that the FC is engaged in activities on a regular, continuous and substantial basis, then 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.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lewenhaupt v. Commissioner 20 T.C. 151 (1953)</li> <li>▪ De Amodio v. Commissioner 34 T.C. 894 (1960).</li> <li>▪ U.S. v. Balanovski, 49 A.F.T.R. 2007, (N.Y. C.A. 2, 1956)</li> <li>▪ Pinchot v. Commissioner 25 A.F.T.R. 447, ( NY C.A.2, 1940)</li> </ul>	
 <p><b>CONSULTATION:</b> Counsel should be consulted as necessary for assistance in evaluating whether a taxpayer is engaged in a US trade or business.</p>		

# 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"> <li>▪ Once it has been determined that the FC is engaged in a US trade or business, FC will be taxed in the U.S. on its income effectively connected to the US trade or business.</li> <li>▪ 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.</li> <li>▪ Foreign source income is ECI only in limited situations. Relevant to this example, foreign source income derived from the sale of inventory outside the US may be ECI, but only if attributable to a U.S. office and the property is not for consumption or use outside the US and no foreign office participated materially in the sale.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 881</li> <li>▪ IRC 882</li> <li>▪ IRC 864(c)(1), (2), (3), and (4)</li> <li>▪ IRC 861(a)(1) and (a)(3)</li> <li>▪ Treas. Reg. 1.861-2</li> <li>▪ Treas. Reg. 1.861-4(b)</li> <li>▪ IRC 863(a) and (b)(1) and (b)(2)</li> <li>▪ IRC 865(e)(2)</li> <li>▪ IRC 864(c)(4)(B)(iii)</li> </ul>

# 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	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Determine if sales to U.S. OEM's 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.</li> <li>▪ Confirm that the FC has a US bank account used to deposit revenue.</li> <li>▪ Determine how much interest income is received from US banks.</li> <li>▪ Confirm that FC has technical personnel in the U.S. performing services at US OEM customer locations</li> </ul>	<ul style="list-style-type: none"> <li>▪ Review the invoices for address of seller.</li> <li>▪ Review Bill of Lading and other documents for shipping terms and other terms of sale including risk of loss.</li> <li>▪ Obtain copies of all bank statements.</li> <li>▪ Review bank and brokerage statements to determine if the securities are generating interest income.</li> <li>▪ Obtain the project logs or work orders of the technical personnel.</li> </ul>	

# 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	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ The sale of inventory produces US source income if it is sold in the US. It is sold in the US if the rights, title, and interest of the seller in the property are transferred to the buyer in the US.</li> <li>▪ The sale of inventory that would otherwise generate foreign source income because the seller is a nonresident may still be treated as US 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.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 861(a)(6)</li> <li>▪ Treas. Reg. 1.861-7(c)</li>   <li>▪ IRC 865(e)(2) and (e)(3)</li> <li>▪ IRC 864 (c )(5)</li> <li>▪ IRC 863(a) and 863(b)(2)</li> </ul>	
 <p><b>CONSULTATION:</b> Counsel should be consulted as necessary for a determination of the amount of gross sales income that is US source as it applies to the facts of your case</p>		

# 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	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ 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.</li> <li>▪ Allocate gross income accordingly between US and Foreign source income for the performance of services.</li> <li>▪ Income from services performed in the U.S. is U.S. source income.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 861(a)(3)</li> <li>▪ IRC 862(a)(3)</li> <li>▪ IRC 863(b)(1)</li>   <li>▪ Treas. Reg. 1.861-4(b)(1)</li> </ul>	

# 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"><li>▪ 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 US office, but not FDAP income.</li><li>▪ 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 US taxation at graduated rates.</li><li>▪ The determination of whether US source FDAP income is ECI requires a separate analysis, considering both the “asset use” and “business activities test”.</li></ul>	<ul style="list-style-type: none"><li>▪ IRC 864(c)(3)</li><li>▪ IRC 882(a)</li><li>▪ IRC 864(c)(2)(A)</li><li>▪ IRC 864(c)(2)(B)</li> <li>▪ IRC 882(c)(2)</li> <li>▪ Treas. Reg. 1.864-4(c)(2)</li><li>▪ Treas. Reg. 1.864-4(c)(3)</li></ul>

# 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	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ With regards to technical services income, such income is sourced in the US based on where the services are performed.</li> <li>▪ With regards 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.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 861(a)(3)</li> <li>▪ IRC 864(c)(3)</li> <li>▪ Treas. Reg. 1.861-4(a) and (b)</li> <li>▪ Review the cash receipts and cash disbursements journals and other periodic cash flow reports</li> </ul>	



# 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	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ If the sale takes place in the US because FC transfers all rights, title and interest in the property to the OEMs in the US, the income is US source, whether or not attributable to a US office.</li> <li>▪ If there is no transfer of rights in the US, but the 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 US resident.</li> <li>▪ Assuming the bank account is held for use for the present needs of the business and not the future needs, the US 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 US tax.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 864(c)(3)</li> <li>▪ Treas. Reg. 1.864-4(b)</li> <li>▪ Treas. Reg. 1.861-7(c)</li>   <li>▪ IRC 865(e)(2)</li> <li>▪ IRC 864(c)(2)(A)</li>   <li>▪ Treas. Reg. 1.864-4(c)(2)(i)</li> <li>▪ IRC 871(i)(2)(A)</li> </ul>	

# 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	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ 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</li> <li>▪ 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 1120-F for that year or if FC filed a return late, adjustments to taxable income should be documented on Form 886-A.</li> <li>▪ In addition, the disallowance of expenses may be appropriate if the return is filed 18 months after the due date.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.864-4(c)(3)(i)</li> <li>▪ Treas. Reg. 1.864-4(c)(6)(i)</li> <li>▪ IRC 864(c)(2)(B)</li>   <li>▪ IRC 882(c)(2)</li> <li>▪ Treas. Reg. 1.882-4(a)(3)</li>   <li>▪ Form 1120-F</li> <li>▪ Form 886-A</li> </ul>	

# Training and Additional Resources

## Chapter 6.1.1 Determination of Proper Income Allocation

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"><li>10/11/12- IBC Jurisdiction to Tax Network call - Recognizing a Potential U.S. Trade or Business issue</li></ul>	
CENTRA sessions	<ul style="list-style-type: none"><li>11/8/2012 - IBC Jurisdiction to Tax Network Call - Outer Continental Shelf U.S. TB and PE Issues</li></ul>	
CENTRA sessions	<ul style="list-style-type: none"><li>10/24/12 – IBC 10/24/12 Jurisdiction to Tax IPN</li></ul>	
Podcasts / Videos	<ul style="list-style-type: none"><li>IBC 2011 CPE : Jurisdiction to Tax</li></ul>	

# 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 Issues

Issue	Associated UIL(s)	References
Determine the amount of general deductions that are allocated and apportioned to gross income	<ul style="list-style-type: none"> <li>▪ 9422.01-02</li> </ul>	<ul style="list-style-type: none"> <li>▪ U.S. Branch Allocations (Non-Treaty ECI Determinations) IPS Unit</li> </ul>
Determine the amount of interest deductions allocated to gross income under Treas. Reg. 1.882-5	<ul style="list-style-type: none"> <li>▪ 9422.01-02</li> </ul>	<ul style="list-style-type: none"> <li>▪ Interest Expense of U.S. Branch of a Foreign Bank (Non-Treaty) IPS Unit</li> <li>▪ Interest Expense of a Foreign Corporation Engaged in a U.S. Trade/Business (Non-Bank, Non-Treaty) IPS Unit</li> </ul>
Determine the amount of home office deductions allocated and apportioned to gross income under Treas. Reg. 1.861-8	<ul style="list-style-type: none"> <li>▪ 9422.01-02</li> </ul>	<ul style="list-style-type: none"> <li>▪ Section 861 – Home Office and Stewardship Expenses IPS Unit</li> </ul>
Determining whether income earned by a FC is ECI or FDAP income	<ul style="list-style-type: none"> <li>▪ 9424.01</li> </ul>	<ul style="list-style-type: none"> <li>▪ Non-Services FDAP Income IPS Unit</li> </ul>