



LB&I International Practice Service Concept Unit

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Unit Name	Effectively Connected Income (ECI)
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General Overview

Effectively Connected Income (ECI)

IRC §871(b) provides that a nonresident alien (NRA) individual is generally subject to U.S. income taxes at graduated rates on taxable income which is effectively connected (ECI) with the conduct of a U.S. trade or business (USTB).

The determination of “taxable income” starts with gross income which is effectively connected with the conduct of the USTB. A USTB is only partially defined in the code, therefore case law is relevant and courts have opined on what activities constitute a USTB. Relevant court cases and rulings state that some kind of continuous business contacts with the U.S. are usually required in order for an NRA or foreign corporation to be engaged in a USTB. Generally, the activities by the taxpayer directly or through agents, have to be regular, substantial and continuous in order to be engaged in a trade or business.

IRC §873 provides that an NRA can generally deduct all deductible items connected with ECI, plus casualty and theft losses attributable to property located in the U.S, losses to U.S. property incurred in transactions entered into for profit, charitable contributions, and personal exemptions. Under IRC §874(a), deductions can only be claimed if the NRA individual files a timely and accurate return.

Thus, the two questions that arise when considering whether an NRA has ECI are:

1. Whether or not the NRA is engaged in a USTB, and
2. What income is effectively connected with that USTB.

This Practice Unit will focus only on what income is effectively connected with a USTB. More information about whether an NRA is engaged in a USTB can be found in the “Overview of a United States Trade or Business of a Nonresident Alien” IPS Unit, DCN: USB/CU/P_14.1_XX(2014) in process as of 9/2014.

T TREATY IMPLICATION: This unit assumes the NRA is a resident of a non-treaty jurisdiction. Other IPS units will address situations where the NRA is a resident of a jurisdiction having an income tax treaty with the U.S. and may be eligible to use the Permanent Establishment and Business Profits Articles of the treaty to override domestic tax provisions discussed in this unit.

Relevant Key Factors

Effectively Connected Income (ECI)

Key Factors

What income is effectively connected with that USTB?

There are a number of considerations to evaluate when determining whether or not income is effectively connected with a USTB. The first key factor is determining the tax status of the income recipient and verifying that the individual is an NRA. Once it is determined that the individual is an NRA, the next factor to consider is whether or not the NRA is engaged in a USTB.

In addition, the rules in determining whether or not income is effectively connected with a USTB apply differently depending on whether the income is from **U.S. or foreign sources**. See IRC §864(c) and the related Treasury Regulations.

There are two categories of **U.S. source income** that may be effectively connected with the conduct of a USTB under IRC §864(c)(2) and §864(c)(3):

- Periodical, etc., income (includes FDAP income, portfolio interest income, and gain/loss from the sale or exchange of capital assets)
- All other U.S. source income, gains, and losses

Foreign source income is generally **not** treated as ECI, but there are a few exceptions for certain items of income that are attributable to a U.S. office or fixed place of business. IRC §864(c)(4) and §864(c)(5).

Detailed Explanation of the Concept

Effectively Connected Income (ECI)

U.S. Source FDAP Income

Analysis	Resources
<p>NRAs are generally subject to U.S. income taxes on fixed or determinable annual or periodic gains, profits and income (FDAP) received from sources within the U.S. Examples of FDAP income include U.S. source interest, dividends, rents, and royalties.</p> <p> CAUTION: Although salaries and wages are listed in IRC §871(a)(1) as an example of FDAP income, compensation for personal services performed in the U.S. is usually treated as ECI with a USTB, unless a de minimis exception applies. If the de minimis exception applies, then such compensation is treated as foreign source income. See IRC §861(a)(3).</p> <p>FDAP income may or may not be effectively connected with a USTB. Under IRC §871(a), FDAP income that is not effectively connected with a USTB is generally taxed at a flat rate of 30%, but tax treaties may provide for a lower tax rate or exemption on specified income items. Otherwise, FDAP income that is ECI is taxable at graduated rates.</p>	<ul style="list-style-type: none"> ▪ IRC 871(a)(1) ▪ IRC 861(a)(3)

Detailed Explanation of the Concept (cont'd)

Effectively Connected Income (ECI)

U.S. Source FDAP Income

Analysis	Resources
<p>An item of FDAP from sources within the United States is treated as ECI with a USTB under IRC §864(c)(2) only if it meets either an “asset use” test or a “business activities” test.</p> <p>The asset use test is met if the income is derived from assets used or held for use in the conduct of a USTB. The business activities test is met if the activities of the USTB were a material factor in the realization of the income. These two tests are often applied together. In applying the asset use and business activities test, “due regard shall be given to whether or not the asset ,or the income, gain, or loss, is carried on books of account separately kept for the trade or business”.</p> <p>More information about FDAP is covered in the “Overview of FDAP” IPS Unit, DCN: WIT/CU/P_15.1_01(2014).</p>	<ul style="list-style-type: none"> ▪ IRC 864(c)(2)

Detailed Explanation of the Concept (cont'd)

Effectively Connected Income (ECI)

U.S. Source FDAP Income / Asset Use Test

Analysis	Resources
<p>Under the asset use test per Treas. Reg. §1.864-4(c)(2), an asset shall be treated as used in, or held for use in, the conduct of a USTB if the asset is either:</p> <ul style="list-style-type: none"> a) Held for the principal purpose of promoting the present conduct of the USTB (e.g., plant & equipment), b) Acquired and held in the ordinary course of the USTB (e.g., accounts & notes receivable), or c) Held in a direct relationship to the USTB (e.g., bank accounts or securities held to meet present needs) <p>In determining whether an asset is held in a direct relationship to the USTB, principal consideration shall be given to whether the asset is needed in that trade or business presently, and not for anticipated future needs. Treas. Reg. §1.864-4(c)(2)(iv).</p> <p>There is a rebuttable presumption that this test is met if the asset was acquired with funds generated by the USTB, income from the asset is retained by that business, and employees or other personnel present in the U.S. and actively involved in the business “exercise significant management and control over the asset.”</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.864-4(c)(2) ▪ Treas. Reg. 1.864-4(c)(2)(iv)

Detailed Explanation of the Concept (cont'd)

Effectively Connected Income (ECI)

U.S. Source FDAP Income / Business Activities Test

Analysis	Resources
<p>Salaries and wages earned by NRA employees while working in the U.S., as well as U.S. source pensions and retirement pay attributable to such personal services, constitute ECI. If an NRA's only business activity in the U.S. is the performance of personal services, income from property (including capital gains) realized by the NRA is ECI only if there is a "direct economic relationship" between the property and the performance of services. Treas. Reg. §1.864-4(c)(6).</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.864-4(c)(6)

Detailed Explanation of the Concept (cont'd)

Effectively Connected Income (ECI)

U.S. Source "Other" Income

Analysis	Resources
<p>Under IRC §864(c)(3), if a foreign person is engaged in the conduct of a USTB, <i>all of the foreign person's U.S. source income</i>, other than FDAP income, is treated as ECI, whether or not it is directly related to the NRA's USTB (e.g., income and gain on sales of inventory and other property held for sale to customers in the ordinary course of business). This is frequently referred to as the limited "force of attraction principle", reflecting the idea that once a USTB is found to exist, it attracts to it virtually all U.S. source income, whether or not the income was actually generated by the operations of the USTB.</p>	<ul style="list-style-type: none"> ▪ IRC 864(c)(3)
<p>T TREATY IMPLICATION: Some U.S. tax treaties override this provision. For example, the Technical Explanation for the U.S. tax treaty with Australia on Article 7 (Business Profits) states that "the limited 'force of attraction' rule in IRC section 864(c)(3) does not apply for U.S. tax purposes under the Convention".</p>	<ul style="list-style-type: none"> ▪ TE to U.S.- Australia Income Tax Treaty, Art. 7(2)

Detailed Explanation of the Concept (cont'd)

Effectively Connected Income (ECI)

Foreign Source Income / U.S. Office Required

Analysis	Resources
<p>Under IRC §864(c)(4)(B), certain items of foreign source income are treated as ECI if such income is attributable to an office or other fixed place of business in the U.S. The income is attributable to an office if the office is a material factor in the production of such income and it regularly carries on activities of the type from which the income is derived. IRC §864(c)(5)(B) and Treas. Reg. §1.864-6(b).</p> <p>Whether an NRA has a U.S. office depends on the facts and circumstances, “particularly to the nature of the taxpayer’s trade or business and the physical facilities actually required by the taxpayer in the ordinary course of the conduct of his trade or business.” Treas. Reg. §1.864-7(a)(2). A fixed facility, including a sales outlet, factory, workshop, or mine, may be an office, even if the NRA does not use it continuously. Treas. Reg. §1.864-7(b)(1).</p> <p>An NRA will not be deemed to have a U.S. office merely because a related person has such an office. In addition, occasional use of a related person’s U.S. office will generally not be considered an office attributable to an NRA. Treas. Reg. §1.864-7(b)(2) and Treas. Reg. §1.864-7(f).</p>	<ul style="list-style-type: none"> ▪ IRC 864(c)(4)(B) ▪ IRC 864(c)(5)(B) ▪ Treas. Reg. 1.864-6(b) ▪ Treas. Reg. 1.864-7(a)(2) ▪ Treas. Reg. 1.864-7(b)(1) ▪ Treas. Reg. 1.864-7(b)(2) ▪ Treas. Reg. 1.864-7(f)

Detailed Explanation of the Concept (cont'd)

Effectively Connected Income (ECI)

Foreign Source Income / U.S. Office Required

Analysis	Resources
<p>A U.S. office of a dependent agent (e.g., an employee) may be considered an office of an NRA if the NRA maintains the office directly, or if the agent has and regularly exercises authority to make contracts on the NRA's behalf or regularly fills orders from a stock of the NRA's merchandise in the agent's possession. An office of an independent agent will not be treated as an office attributable to an NRA. IRC §864(c)(5)(A) and Treas. Reg. §1.864-7(d).</p>	<ul style="list-style-type: none">▪ IRC 864(c)(5)(A)▪ Treas. Reg. 1.864-7(d)

Detailed Explanation of the Concept (cont'd)

Effectively Connected Income (ECI)

Foreign Source Income / Types of Income

Analysis	Resources
<p>IRC §864(c)(4)(B) treats the following types of foreign source income as ECI.</p> <ul style="list-style-type: none"> ▪ Rents or royalties for the use of, or for the privilege of using, certain intangible property described in IRC §862(a)(4) derived in the active conduct of the USTB. <ul style="list-style-type: none"> – Rents or royalties are from foreign sources if they are received for use outside of the U.S. of intangible personal property, including patents, copyrights, and trademarks. – This rule does not cover foreign source gains on sales of intangibles. ▪ Dividends and interest that are either derived in the active conduct of a banking, financing, or similar business within the U.S., or received by a corporation whose principal business is trading in stocks or securities for its own account. ▪ Income, gain, or loss derived from the sale or exchange of inventory type property, but excluding the sale or exchange of property for use, consumption, or disposition outside the U.S. when the NRA's foreign office or other fixed place of business participated materially in the sale. <p>Exceptions- The following foreign source income is not treated as ECI: (1) foreign source dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the total combined voting power of all classes of stock entitled to vote, and (2) subpart F income within the meaning of IRC §952(a). See IRC §864(c)(4)(D); Treas. Reg. §1.864-5(d).</p>	<ul style="list-style-type: none"> ▪ IRC 864(c)(4)(B) ▪ IRC 862(a)(4) ▪ IRC 864(c)(4)(D) ▪ Treas. Reg. 1.864-5(d)

Training and Additional Resources

Effectively Connected Income (ECI)

Type of Resource	Description(s) and/or Instructions for Accessing	References
Issue Toolkits	▪ Treaty / Visa Tool	

Glossary of Terms and Acronyms

Acronym	Definition
ECI	Effectively Connected Income
FDAP	Fixed Determinable Annual and Periodic Income
NRA	Nonresident Alien
USTB	U.S. Trade or Business

Index of Related Issues

Issue	Associated UIL(s)	References
Determining Tax Residency Status of Lawful Permanent Residents	▪ 9431.01-02	▪ IPS Unit – DCN: JTO/9431.01_02(2013)
Overview of a United States Trade or Business of a Nonresident Alien	▪ 9441.01-01	▪ IPS unit in process as of 09/2014
Allocation and Apportionment of Expenses	▪ 9441.02-02	▪ IPS unit in process as of 09/2014
Overview of FDAP	▪ 9442.01	▪ IPS Unit – DCN: WIT/CU/P_15.1_01(2014)