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Common Misconceptions: The Function and Framework of "Trade or Business Within the United States"

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Common Misconceptions: The Function and Framework of "Trade or Business Within the United States"

*Nancy H. Kaufman**

Abstract

In this Article, Professor Kaufman examines the administrative and jurisdictional functions of the Internal Revenue Code's term "trade or business within the United States" in the taxation of foreign persons' income and the existing framework established for the term's interpretation. The author contends that the courts, by relying on two common misconceptions of the term, have made the term's application unpredictable. The author further believes that defining the term according to its functions would serve United States tax policy and economic interests. This definition would focus primarily on facts indicating an ongoing commitment to participation the United States economy. The author concludes that a trade or business within the United States should exist only if the foreign person engages in economic activities in the United States and such activities are considerable, continuous, and regular.

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I. INTRODUCTION

The latter half of the twentieth century has seen a startling increase in the volume of international trade. National tax authorities naturally seek to collect income tax from nonresident aliens and foreign corporations ("foreign persons") engaging in transactions within their jurisdictions. Businesses engaging in these transactions understandably seek to determine in advance the extent to which their economic contacts with a given jurisdiction will expose them to tax liability. In the United States, the term "trade or business within the United States" plays a critical role in determining the United States federal income tax liability of foreign persons.[1]

The term "trade or business within the United States" currently per-

1. I.R.C. § 864(b).

forms three related tasks in the taxation of the income of foreign persons. First, it plays a decisive part in determining whether federal income tax will be imposed at regular graduated rates on net income (gross income less deductions) or at a flat rate on gross income. The Internal Revenue Code (Code) imposes tax at regular graduated rates on a foreign person's income which is "effectively connected" with the conduct of a trade or business within the United States.[2] A flat rate of tax applies to gross income consisting of dividends, rents, royalties, and other similar "fixed or determinable annual or periodical gains, profits and income" ("periodical income") from United States sources ("United States source income") which is not effectively connected with the conduct of a trade or business within the United States.[3] Second, the term "trade or business within the United States" serves as the threshold for the imposition of tax on income that does not come within the class of periodical income subject to tax on a gross basis. This category of income primarily consists of income from the purchase and sale of inventory and the production and sale of personal property ("sales income").[4] Before 1987, it also included gains on the sale or exchange of property other than inventory.[5] Whether a foreign person engages in trade or business within the United States determines whether the taxpayer's sales income is subject to tax on a net basis at regular rates or not subject to tax at all.[6] Finally, in the

2. I.R.C. §§ 871(b), 882.

3. I.R.C. §§ 871(a), 881. The general definition of periodical income in the Code includes interest. I.R.C. §§ 871(a), 881(a), 1441(a), 1442(a). However, the Code exempts several different categories of interest from gross-basis tax. I.R.C. §§ 871(h), (i); 881(c), (d).

4. I.R.C. §§ 871, 881(a), 882(a). The Code subjects certain other income items that are exempt from gross-basis taxation to net-basis taxation in the hands of a foreign person engaged in trade or business within the United States only if a close connection exists between the income and the trade or business within the United States. I.R.C. §§ 864(c)(2); 871(h), (i); 882(c), (d). Special rules also apply to transportation income. I.R.C. § 887.

5. *See infra* note 194 and accompanying text (1986 change in the source of income rule for capital gains). The Code subjects to gross-basis tax the net gains from capital assets of a nonresident alien (but not a foreign corporation) present in the United States for 183 days or more during the taxable year unless such gains have a close relationship to the alien's trade or business within the United States. I.R.C. § 871(a)(2).

6. Instances exist in which a foreign taxpayer not engaged in trade or business within the United States is deemed to have income effectively connected with the conduct of a trade or business within the United States. Nonresident aliens and foreign corporations may elect to treat income from real property held for the production of income and located in the United States, as well as rents and royalties from mines, wells, and other natural deposits and timber or iron ore interests, as income effectively connected with the conduct of a trade or business within the United States. I.R.C. §§ 871(d), 882(d). Addi-

case of a foreign corporation, the term "trade or business within the United States" forms the threshold for the imposition of the branch-level tax provisions.[7] In sum, the term serves an administrative function in determining the method for imposing tax on income within United States fiscal jurisdiction and a jurisdictional function in determining whether income is subject to federal income tax.

Under current law, the standard for being engaged in trade or business within the United States is inscrutable. The Code provides that the term includes any performance of personal services in the United States, subject to a narrow exception for services performed by an individual for a foreign employer.[8] The term does not include trading in stocks, securities, and exchange-traded commodities by most nondealers in such assets.[9] Otherwise, neither the Code nor the regulations provide any significant guidance. Judicial decisions construing the term have developed a framework that sometimes yields unpredictable results inconsistent with the term's function and with the policies most relevant to its application.[10] The uncertain scope of the term seriously erodes the efficiency of

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tionally, the Code treats gain derived by a nonresident alien or foreign corporation from the sale or exchange of a United States real property interest as income effectively connected with the conduct of a trade or business within the United States. *See generally* I.R.C. § 897. *See infra* note 43 (discussing additional examples of instances in which a foreign person may have effectively connected income without being engaged in trade or business within the United States).

7. *See generally* I.R.C. § 884. The term "trade or business within the United States" has other significance as well. In some instances, the existence of income effectively connected with the conduct of a trade or business within the United States determines the foreign taxpayer's obligation to file a federal income tax return. *See generally* Treas. Regs. §§ 1.6012-1, 1.6012-2. Further, the Code requires a foreign taxpayer who would be subject to federal income tax on income effectively connected with the conduct of a trade or business within the United States but for the fact that the taxpayer is a resident of a treaty country and does not have a permanent establishment in the United States to disclose the treaty-based exemption from tax to the Internal Revenue Service. I.R.C. § 6114. Finally, countries negotiating income tax treaties with the United States might find it useful to know the parameters of the term "trade or business in the United States" so as to be able to estimate the benefit to be derived by its residents from a particular definition of a permanent establishment in the treaty.

8. I.R.C. § 864(b)(1).

9. I.R.C. § 864(b)(2). The application of these "safe harbors" hinges on the type of trading activity being conducted, the character of the assets that are the subject of the activity, and the structure through which the activities are effected. *See* Leslie B. Samuels & Patricia A. Brown, *Observations on the Taxation of Global Securities Trading*, 45 TAX L. REV. 527, 545 (1990).

10. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 92 (1987) [hereinafter ALI].

compliance and administration. At the same time, it deprives foreign investors of the ability to determine in advance the extent to which their activities in the United States expose them to United States tax liability. This confusion discourages the free flow of investment to the United States and internationally.

This Article examines the functions of the term "trade or business within the United States" along with the framework derived from its legislative history and judicial interpretation with a view to developing a consistent standard for its application. This study reveals that a combination of two early misconceptions of the term served to distract the Congress, the courts, and the Internal Revenue Service from the task of interpreting the term in a manner compatible with its administrative and jurisdictional functions. This mismatch of function and framework has led to the inscrutability of the term under present law.

In 1987, the American Law Institute's Federal Income Tax Project recommended the abandonment of the term "trade or business within the United States."[11] It recommended abandonment because of the current uncertain scope of the term "trade or business within the United States" and the degree to which the apparent scope of the term departs from the standard for net-basis taxation utilized by a number of United States trading partners.[12] The ALI's recommendation endorsed the definition of an "office or other fixed place of business" that is already the subject of specific regulations under the Code.[13] Although perhaps idle speculation, the term "trade or business within the United States" may have developed along these lines had it been interpreted in a manner more consistent with its functions.

Part II examines the administrative functions of the term "trade or business within the United States." In its administrative function, the term brings to light an inevitable conflict between equity and administrative feasibility. Equity considerations favor the imposition of tax on foreign persons on a net basis, the same basis the Code utilizes to impose tax upon the income of United States citizens and residents and domestic corporations. Indeed, if it were administratively feasible to tax foreign persons on a net basis in every instance, the term "trade or business within the United States" may never have found its place in the Code, at least not to serve an administrative function. Net-basis taxation is not administratively feasible, however, in the case of a foreign person with relatively few economic contacts with the United States. Net-basis taxa-

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11. *See id.* at 90.
12. *Id.* at 92.
13. *See id.* at 91. *See also* Treas. Reg. § 1.864-7.

tion then gives way to gross-basis tax withheld at the source for periodical income and the exemption from tax for sales income. The substance of the term "trade or business within the United States" must provide that line of demarcation beyond which net-basis taxation is not administratively feasible.

Part III provides an analysis of the jurisdictional functions of the term and illustrates the interplay between fiscal jurisdiction and administrative considerations in this context. The question arises whether jurisdictional considerations have anything to add to the scope of the term apart from its administrative function. Customary international law imposes few constraints on United States jurisdiction to tax the income of foreign persons. The jurisdictional principles reflected in the Code itself are largely embodied in the source of income rules. The source of income rules provide the jurisdictional basis for the United States to exert source jurisdiction to tax the income of foreign persons derived from United States sources. The "office or other fixed place of business" standard provides the jurisdictional basis for the United States to tax the foreign source income of foreign persons. Under current law, this standard is actually significantly higher than that for being engaged in trade or business within the United States. The source rules in the case of United States source income and the "office or other fixed place of business" standard for foreign source income supply the jurisdictional nexus needed to tax the income of foreign persons. The jurisdictional functions performed by the term "trade or business within the United States," therefore, derive not from jurisdictional principles but from the administrative considerations inherent in taxing the income of foreign persons.

Part IV provides an analysis of the legislative history and judicial framework developed for the application of the term "trade or business within the United States." Two early misconceptions of the term that severed it from its roots emerge. The first misconception of the term results from a failure to recognize that the phrase "trade or business," which appears in more than two hundred sections of the Code, need not be interpreted in the same way in each place it appears. Thus, some of the case law interpreting the term "trade or business within the United States" borrows heavily from case law dealing with the term "trade or business" in other contexts. The policies relevant to other uses of the term "trade or business" differ significantly, however, from the policies that underlie the functions of the term "trade or business within the United States."[14] The first misconception grew out of the discontinuities

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14. MICHAEL J. MCINTYRE, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 2-25 (1992). *See also* David M. Garelik, *What Constitutes Doing Busi-*

between the taxation of foreign persons engaged in trade or business within the United States and those not so engaged. As early as 1942, the United States laid the groundwork to ensure that foreign persons could not devise to engage in trade or business within the United States simply to pay tax on net basis, rather than gross basis.[15]

Part V provides an analysis of the term "trade or business within the United States," which eliminates the misconceptions and places the term within the functions it is required to perform. This section suggests that the United States begin moving in the direction of adopting a framework for the application of the term that focuses on criteria indicating whether the foreign person's economic activities within the United States are considerable, continuous, and regular. Some of the existing case law supports the use of such a standard for the application of the term "trade or business within the United States." Such a standard would permit the term to perform its appropriate administrative and jurisdictional functions.

II. Administrative Functions

A. *The Method of Determining Tax*

The Code taxes United States citizens, resident aliens, and domestic corporations on their worldwide income. In contrast, the United States historically has only taxed nonresident aliens and foreign corporations on income from sources within the United States.[16] Largely statutory source rules govern the determination of the geographical source of income as from sources within or without the United States.[17]

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ness Within the United States by a Non-Resident Alien or a Foreign Corporation, 18 Tax L. Rev. 423, 457 (1963); Elisabeth A. Owens, *International Aspects of Income Taxation, in* Taxation in the United States 1106, 1107 n.303 (World Tax Series ed., 1963).

15. *See infra* notes 172-73 and accompanying text.

16. *See infra* notes 129-34 and accompanying text. Since 1966, the Code has subjected a foreign person to tax on certain foreign source income that is effectively connected with the conduct of a trade or business within the United States. *See infra* notes 181-83 and accompanying text.

17. *See* I.R.C. §§ 861, 862, 863, 865. In addition to their function in the taxation of foreign persons, the source rules serve another important function. They stake out the United States claim to tax the income of United States persons and foreign persons engaged in trade or business within the United States who are subject to income tax in other countries. The source of income rules perform this function by determining the income that can be included in the numerator of the foreign tax credit limitation. *See* I.R.C. § 904(a). The source rules also operate in several other, more circumscribed areas of the Code. *See* I.R.C. §§ 877 (taxation of United States expatriates), 931(a) (exemption

The source rules delineate the principal jurisdictional boundaries claimed by the United States to tax the income of foreign persons.[18] Generally speaking, the United States asserts primary jurisdiction ahead of other nations to tax income derived from sources within the United States. But the source rules do not, in and of themselves, require the inclusion in, or the exclusion from, gross income of any particular item of income.[19] The source rules simply classify income.

Once a particular item is classified as income from sources within the United States, and thus is at least theoretically within United States fiscal jurisdiction, a structural issue arises as to the method of taxation, e.g., net-basis taxation. Horizontal equity involves treating similarly situated taxpayers the same.[20] Taxpayers with the same income should be subject to the same tax. To yield the same tax, the Code should apply the same method to all taxpayers. That is, the Code should tax net income (gross income less deductions).[21] However, at this juncture, admin-

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for income from Guam, American Samoa, or the Northern Mariana Islands by bona fide residents of such possessions), 932 (coordination of United States and Virgin Islands income taxes), 933 (exemption for residents of Puerto Rico), 936(a) (qualification for and the extent of the credit allowed to a possessions corporation), 911 (exemption allowed to U.S. citizens living abroad), 245 (the extent of the dividends received deduction allowed to a corporate shareholder for dividends paid by foreign corporations), 971 (definition of an export trade corporation), 952(b) (amount of earnings and profits currently included in the income of a United States shareholder of a controlled foreign corporation).

18. *See* ALI, *supra* note 10, at 17-18. Under the anti-deferral rules, the Code taxes all or a part of the income of certain foreign corporations currently to such corporations' United States shareholders. I.R.C. §§ 551, 951, 1293. These rules are often viewed as an extension of United States fiscal jurisdiction to tax United States persons. The Code treats the foreign corporate income affected as income of United States persons earned indirectly through such foreign corporations. The anti-deferral rules generally do not result in tax being imposed directly on the foreign corporation. *See, e.g., id.*

19. *See generally* I.R.C. §§ 861, 862, 863, 865. I.R.C. §§ 871, 881 and 882 provide the general definitions of gross income and taxable income applicable to foreign persons.

20. HENRY SIMONS, PERSONAL INCOME TAXATION 206 (1938).

21. *See* ALI, *supra* note 10, at 10. *See also* Robert L. Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 HARV. INT'L L.J. 1, 13 (1989). Even when horizontal equity can be served by imposing tax on foreign persons on a net basis, the demands of vertical equity are difficult to meet. As a general rule, foreign persons do not include in income for purposes of net basis taxation income that is not effectively connected with the conduct of trade or business within the United States. *See infra* notes 33-36 and accompanying text. Thus, the progressivity of the rate structure does not apply in the same way to United States and foreign persons. Administrative limitations militate against any attempt to take a foreign person's entire worldwide taxable income into account in applying the rate structure. *See* ALI, *supra* note 10, at 12.

istrative considerations may dictate a different result.[22]

Foreign persons who derive income from sources within the United States, but who do not engage in activities here, present two different types of problems for audit and collection. First, a foreign person without significant economic contacts with the United States has very little incentive to pay tax after receiving the income. The courts of one jurisdiction will not generally enforce the tax claims of a second jurisdiction.[23] More importantly, it would be exceedingly difficult for the United States to substantiate the deductions allowable to such an investor, since many or perhaps all deductible expenses would have been paid or incurred in a foreign country. Significant limitations exist on the extent to which one jurisdiction will provide tax information about one of its taxpayers to a second jurisdiction.[24] Although there is an increasing amount of international cooperation in tax matters, international cooperation in enforcement and exchange of information remains predominately a matter for bilateral,[25] and in a few cases multilateral,[26] treaty negotiation.

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22. Horizontal equity is but one of several policies used to evaluate the income tax. Thus, the fact that horizontal equity would indicate one result does not preclude the imposition of a rule leading to a different result so long as some reasonable justification exists for the departure from principles of equity. Richard L. Kaplan, *Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate*, 71 GEO. L.J. 1091, 1122 (1983).

23. Harvey P. Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX L. REV. 49, 50-51 (1980); *see also* RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 483 (1986) [hereinafter RESTATEMENT (THIRD)] ("Courts in the United States are not required to recognize or to enforce judgments for the collection of taxes, fines, or penalties rendered by the courts of other states.").

24. *See* ALI, *supra* note 10, at 11. This is less true in cases in which the United States has an income tax treaty with the residence country that provides for exchange of information. *See, e.g.*, Convention Between the Government of the U.S. and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 26, I TAX TREATIES (PH) ¶¶ 20,102, 20,126 (signed Dec. 31, 1984) [hereinafter Barbados Treaty]; Convention Between the U.S. and Trinidad and Tobago for the Avoidance of Double Taxation, the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Encouragement of International Trade and Investment, art. 24, III TAX TREATIES (PH) ¶ 85,031, 85,054 (signed Dec. 22, 1966) [hereinafter Trinidad and Toabago Treaty]. However, even then, limitations restrict the amount of information about specific taxpayers that is easily available to the source country. *See generally* U.N. DEP'T OF INT'L ECONOMICS & SOCIAL AFFAIRS, AD HOC GROUP OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS ON THE WORK OF ITS FIFTH MEETING (1990).

25. *See, e.g.*, Barbados Treaty and Trinidad and Tobago Treaty, *supra* note 24.

26. *See, e.g.*, Agreement Concerning Reciprocal Administrative Assistance in Matters of Taxation, January 1, 1973, Swed., Den., Fin., Ice., and Nor., 956 U.N.T.S. I-13696, *reprinted in* EUROPEAN TAXATION (SUPPLEMENT) SECTION C (trans. 1974); Conven-

Thus, under current circumstances, the United States cannot feasibly tax on a net-income basis foreign persons who do not engage in activities in the United States.[27] To ensure compliance in such cases, tax withheld at the source should apply to the gross amount of the income.[28]

In response to the foregoing administrative considerations, the Code provides two alternative methods for imposing tax on the United States source income of foreign persons. The Code imposes tax at regular rates on a foreign person's net income that is effectively connected with the conduct of a trade or business within the United States.[29] In general, the income treated as effectively connected with a trade or business within the United States includes all United States source income other than periodical income and capital gain.[30] The Code, however, treats United States source periodical income and capital gain having a close economic connection with the taxpayer's trade or business within the United States as effectively connected income.[31] In addition, the Code treats certain income from sources without the United States as effectively connected, but only if the foreign person has an office or other fixed place of business within the United States to which such income is attributable.[32] The

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tion on Mutual Administrative Assistance in Tax Matters, Europ. T.S.—No. 127, *reprinted in* COUNCIL OF EUROPE, EUROPEAN CONVENTIONS AND AGREEMENTS 181 (1990).

27. The United States is not totally powerless to collect tax in these cases. See cases and statutes cited in Dale, *supra* note 23, at 51.

28. *See* ALI, *supra* note 10, at 10; *see also* REPORT OF THE COMMITTEE ON FINANCE OF THIS UNITED STATES SENATE TO ACCOMPANY H.R. 3838, S. REP. NO. 313, 99th Cong., 2d Sess. 400 (1986) [hereinafter 1986 SENATE REPORT].

29. I.R.C. §§ 871(b), 882.

30. I.R.C. § 864(c)(1)-(3).

31. *See generally* I.R.C. § 864(c)(2). *See also* I.R.C. § 887(b)(4) (standard for transportation income).

32. I.R.C. § 864(c)(4). Thus, the phrase "effectively connected" should not be interpreted too literally. In the case of most United States source sales income no connection between the income and the business being conducted is necessary. *See* Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689 n.2 (1987). The Code requires a connection only in the case of periodical income, capital gain, and foreign source income. More specifically, the Code treats United States source periodical income and capital gains as effectively connected income if the foreign person derives the income from assets used, or held for use, in the trade or business within the United States or if the activities of the trade or business within the United States were a material factor in the realization of the income. I.R.C. § 864(c)(2). As a practical matter, the United States source capital gains of a foreign person engaged in trade or business within the United States should constitute effectively connected income almost by definition. As a general rule, a foreign person's gains from the sale of noninventory personal property constitute United States source income if the foreign person maintains an office or other fixed place of business in

taxation of foreign source income as effectively connected income effects a secondary source rule in the sense that the income, being attributable to a fixed place of business in the United States, arises from activities occurring in the United States.[33] The regulations defining the requisite United States office require a sufficiently high level of activity that it is doubtful whether the foreign person's being engaged in trade or business within the United States adds anything at all to the statutory scheme in this context.[34]

The Code taxes United States source income of foreign persons not effectively connected with a trade or business within the United States, if at all,[35] at a flat rate on gross income.[36] The Code requires the gross-basis tax to be withheld at the source, generally by the payor of the income.[37] Under current law, the same foreign person may both pay tax

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the United States and the income is attributable to that office or other fixed place of business. I.R.C. § 865(a), (e)(2).

33. H.R. REP. No. 1450, 89th Cong., 2d Sess. 14 (1966); *see also* ALI, *supra* note 10, at 76-77. In general, the affected income consists of rents, royalties, dividends, and interest, and gains on the sale of inventory, the source rules for which are formulated according to the location in which the property producing the income is utilized. The taxation of this nominally foreign source income reflects a judgment that, although the location of the property producing the income is outside the United States, the economic connection between the foreign person's presence in the United States through a United States office and the income is sufficiently strong to justify taxation. Congress believed that a failure to tax such income would create a gap in the worldwide international tax system that would encourage foreign persons to utilize the United States as a tax haven for the affected income.

34. *See generally* Treas. Reg. § 1.864-7.

35. *See infra* note 43 and accompanying text.

36. I.R.C. §§ 871(a), 881, 887(a).

37. I.R.C. §§ 1441, 1442. In general, the statute imposes the obligation to withhold on "all persons, in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States) having the control, receipt, custody, disposal, or payment of any of the items of income . . . ." I.R.C. § 1441(a). For a discussion of withholding agents, see Dale, *supra* note 23, at 49 (1980). *See also* Max Holmes, *Comment, The Scope of Withholding Tax on Payments to Aliens: A Survey*, 22 COLUM. J. TRANSNAT'L L. 359 (1984). The Code subjects certain income effectively connected with a trade or business within the United States or treated as such to withholding nonetheless. *See* I.R.C. §§ 1445 (gain on the disposition of a United States real property interest), 1446 (income derived through partnerships); Treasury Regulation § 1.1441-4(a)(1) (income from services performed by an individual). The withholding mechanism here differs markedly from that which applies to periodical income. The gross-basis tax withheld from periodical income generally equals the amount of tax imposed on such income. *See* I.R.C. §§ 1441, 1442, 871(a), 881(a). The tax withheld from effectively connected income or income treated as such resembles a deposit. The taxpayer must file a federal income tax return in which the

on a net basis on income effectively connected with a trade or business within the United States, and have the gross-basis tax withheld from other United States source income which is not effectively connected.[38] As a general rule, however, the United States does not impose tax on a net basis unless the foreign person engages in trade or business within the United States.[39] Thus, the term "engaged in trade or business within the United States" serves the function of determining whether a foreign person can be subject to federal income tax on a net basis at all.

The imposition of a flat rate of tax on gross income does not necessarily vitiate horizontal equity considerations. At least in theory, the United States should set the rate of tax imposed on a gross basis so as to approximate the amount of tax imposed on net income if deductions were allowed.[40] Where the amount of tax imposed on a gross basis

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correct amount of tax is determined on a net basis. I.R.C. §§ 897(a)(1), 871(b)(1)-(2), 882(a)(1)-(2); Treas. Reg. § 1.6012-2. The taxpayer must pay any additional amount of tax owing or, if the amount withheld exceeds the amount due on a net basis, may obtain a refund of the excess. *Id.*

38. For example, consider a foreign corporation that operates a manufacturing operation in the United States. The manufacturing operation places the foreign person in trade or business within the United States. The corporation's United States source income from its manufacturing operation would be income effectively connected with its trade or business within the United States. United States source dividend income paid to the foreign corporation's home office and not connected with the trade or business within the United States, however, would be subject to the gross withholding tax.

In some circumstances, the taxation of a foreign person engaged in trade or business within the United States on a gross basis on non-effectively connected income is inconsistent with the premise that foreign persons should be subject to tax on a net basis whenever possible. *See supra* notes 20-28 and accompanying text. If, for example, the books and records of the foreign corporation's trade or business within the United States reflect the foreign corporation's stockholdings in domestic corporations, the administrative problems that permit taxation on a gross basis do not exist. *See id.* The legislative history of the Foreign Investors Tax Act of 1966, which introduced the concept of effectively connected income, indicates that gross-basis taxation was imposed on non-effectively connected income in order to provide equity between two foreign persons deriving the same type of income and eliminate any disincentive to other economic activities in the United States. *See* H.R. REP. No. 1450, 89th Cong., 2d Sess. 24 (1966); S. REP. No. 1707, 89th Cong., 2d Sess. 29 (1966).

39. I.R.C. § 864(c)(1)(B). *But see infra* note 43.

40. *See* U.N. DEP'T OF INT'L ECONOMICS & SOCIAL AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES at 140-41, U.N. Doc. St/ESA/102, Sales No. E.80.XVI.3 (1980). In fact, the withholding rates applied in domestic law may exceed the rate that is theoretically justified. For example, the statutory withholding tax rate in the United States remained 30%, even when the maximum rate of tax imposed on individuals was 28%. Whether by accident or design, such apparent inequity served to strengthen the United States position in

would significantly exceed the amount of tax on a net basis, the system encourages foreign persons engaged in activities producing significant amounts of periodical income, e.g., royalties, to structure their operations so as to be engaged in trade or business within the United States and benefit from net-basis taxation.[41] From one point of view, any structuring of operations to come within the term "trade or business within the United States" is tax avoidance. From another perspective, it merely avoids an inequity. If Congress set the rate of gross withholding tax to approximate the amount of tax imposed on a net basis, it would alleviate the equitable concern that foreign persons pay the same tax on United States source income as United States persons and other foreign persons. As discussed below, however, this concern might still exist. There would also be less incentive to structure United States operations to yield a particular tax result. The fact remains that equity prefers net-basis taxation.

Economic considerations also may predominate over equity and administrative feasibility concerns. For example, the United States exempts interest on certain portfolio debt obligations and on bank deposits from gross-basis taxation. This exemption renders much of the United States source interest paid to foreign persons exempt from United States tax. While the exemption from gross-basis tax for interest on bank deposits is of relative antiquity, the United States has only recently exempted portfolio interest. The portfolio interest exemption allows United States borrowers direct access to the Eurobond market. It has also proven useful in funding the federal deficit. Thus, notwithstanding the central position of equity and administrative feasibility concerns in the general scheme for the taxation of foreign persons, economic considerations sometimes predominate.

B. *Income Not Subject to Withholding*

The United States limits gross-basis taxation to interest, dividends, and other periodical income.[42] It exempts other types of income, specifically sales income, from gross-basis taxation, although such income may be nominally United States source income and thus within the United States stated jurisdictional boundaries. If the foreign person does not engage in trade or business within the United States, it also exempts sales

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negotiating income tax treaties with other countries. Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1157 (1981).

41. This incentive does not generally exist for taxpayers investing in portfolio debt obligations and bank deposits since the Code generally exempts interest on such investments from gross-basis taxation. I.R.C. §§ 871(h), (i); 881(c), (d).

42. I.R.C. §§ 871(a), 882, 1441, 1442.

income from net-basis taxation. Thus, the Code usually exempts from all federal income tax sales income of a foreign person not engaged in trade or business within the United States.[43]

On one level, the justifications for the exemption from federal income tax for sales income not effectively connected with the conduct of a trade or business within the United States derive from the same kind of equitable and administrative considerations underlying the imposition of tax on a gross basis by way of withholding.[44] In order for the tax on gross income to approximate the tax ordinarily imposed on net income, it is necessary to have some rough estimate of the relative amount of expenses generally paid or incurred to earn a specified amount of gross income.[45] Interest, dividends, and other periodical income subject to gross tax often have a relatively high proportion of gross income.[46] The activities that generate sales income, on the other hand, almost always involve substantial costs too varied to predict. Gross-basis taxation of sales income

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43. Since 1981, a foreign person's gain or loss on the disposition of a United States real property interest has been treated as income effectively connected with the conduct of a trade or business within the United States, even if the taxpayer is not so engaged. *See generally* I.R.C. § 897. A withholding mechanism facilitates the collection of the tax on such gain. *See generally* I.R.C. § 1445 and regulations thereunder. The Code also treats income or gain that arises before the commencement or after the termination of a trade or business within the United States as effectively connected income if attributable to a sale or exchange of property or the performance of services occurring while the trade or business within the United States exists and the income would have been treated as effectively connected income at that time. I.R.C. § 864(c)(6). Likewise, the Code treats income or gain attributable to a disposition within ten years of the cessation of a trade or business within the United States of property once used or held for use in connection with the trade or business within the United States as effectively connected income if such income would have been effectively connected income if the disposition had occurred immediately prior to the cessation of the trade or business within the United States. I.R.C. § 864(c)(7).

44. *See supra* notes 23-28 and accompanying text. *See also* Owens, *supra* note 14, at 1120.

45. *See supra* note 43.

46. Exceptions exist. For example, the income of a bank on a loan transaction generally consists of the spread between the bank's cost of borrowing and the rate of interest the bank charges the customer. A gross tax imposed on the interest income of a bank can thus exceed the bank's profit on the loan. Alfred C. Groff & James F. Hoch, *Selected Issues in U.S. Taxation of U.S. Branches of Foreign Banks*, 1988 U. ILL. L. REV. 343, 346. For this reason, a bank that is not resident in a country with a favorable income tax treaty might prefer to be engaged in trade or business within the United States and treat its United States source interest income as effectively connected income. *Id.* The same observations would also apply to any foreign person engaged in a business producing periodical income (e.g., services, leasing) that also involved significant deductible expenditures.

would be more than a little arbitrary. Further, the withholding mechanism itself would be unwieldy. It would burden tax administration by expecting every purchaser of goods to ask if the seller is a foreign person and to withhold and remit tax to the government if the answer were affirmative.[47]

At the same time, subjecting sales income to tax on net income is, for the most part, not administratively feasible when the taxpayer does not engage in activities in the United States.[48] Thus, the practical constraints on audit and collection serve to justify the exemption of sales income from net tax when the foreign person does not engage in trade or business within the United States.[49]

The administrative underpinnings of the exemption from tax for sales income relate to certain economic considerations. The exemption encourages the free flow of international trade by freeing importers with only tangential economic contacts with the United States from the necessity of complying with the United States income tax. The impracticality of imposing gross-basis tax on sales income and the compliance burden associated with net-basis taxation results in the exemption for sales income derived by foreign persons without substantial economic contacts with the United States.

Notwithstanding such persuasive justification, the exemption from federal income tax for sales income presents equity problems. The Code

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47. *See* ALI, *supra* note 10, at 88. This problem also inheres to some extent in the current gross-basis taxation and withholding system. For example, the rent paid by a consumer to rent an automobile from a Mexican lessor in Mexico consists of some source income if the consumer drives the car in the United States. I.R.C. §§ 861(a)(4), 862(a)(4), 863(b). *Cf.* Rev. Rul. 75-483, 1975 C.B. 286 (income received by a lessor leasing a vessel under a bareboat charter to a domestic ship operator who used it for voyages between the United States and Alaska is income from sources within the United States to the extent allocable to periods the vessel is in a United States port, is engaged in a voyage that begins and ends in a United States port, and is traveling in United States territorial waters). In many circumstances, the consumer will not know of a withholding obligation and the lessor will not know that it has derived United States source income subject to tax.

48. I.R.C. §§ 897 and 1445 and the regulations thereunder, which govern the taxation of, and withholding mechanism for gains derived by foreign persons on the disposition of United States real property interests, provide a good example of the type of complexity that arises in subjecting to United States tax the gains of foreign persons who do not themselves carry on activities in the United States. The imposition of tax on such gains has been stoutly criticized, in part, because of the administrative nightmare that results. *See generally* Kaplan, *supra* note 22. Enforcement of the tax on effectively connected income that arises before the commencement or cessation of the trade or business within the United States also proves problematic. *See supra* note 43.

49. *See* ALI, *supra* note 10, at 88.

subjects all United States citizens, resident aliens, and domestic corporations to tax on all their sales income. It subjects foreign persons engaged in trade or business within the United States to tax on sales income that is effectively connected income. The Code does not require foreign persons not engaged in trade or business within the United States to pay any federal income tax on business income. This discontinuity between the taxation of foreign persons engaged in trade or business within the United States and those who are not provides a disincentive for foreign persons who derive substantial amounts of sales income to engage in significant United States operations that would result in their being engaged in trade or business within the United States. Attempts to avoid being engaged in trade or business within the United States may be viewed as tax avoidance or as avoiding the inequity inherent in the distinction. While this distinction is justifiably borne of administrative considerations, it is nonetheless offensive to equity.

C. *Branch-Level Tax Provisions*

The term "trade or business within the United States" also provides the threshold for the application of the branch-level tax provisions,[50] which apply only to foreign corporations.[51] The branch-level tax consists of two distinct provisions: the branch profits tax[52] and the branch-level interest tax.[53] The principal purpose of the branch-level tax provisions is to maintain some degree of symmetry between the taxation of investment made in the United States through a domestic subsidiary of a foreign parent corporation and that made by a foreign corporation through a trade or business within the United States.[54] In general, the branch-level

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50. *See generally* I.R.C. § 884. For a detailed discussion of the operation of the branch-level tax provisions, see Fred Feingold & Mark E. Berg, *Whither the Branches?*, 44 TAX L. REV. 205 (1989); Peter J. Genz, *The Branch Tax Regulations: Part I*, 18 TAX MGMT. INT'L J. 44 (1989); Peter J. Genz, *The Branch Tax Regulations: Part II*, 18 TAX MGMT. INT'L J. 99 (1989); Peter J. Genz, *The Branch Regulations: Part III*, 18 TAX MGMT. INT'L J. 191 (1989).

51. I.R.C. § 884(b). Although generally applicable only to foreign corporations engaged in trade or business within the United States, the branch-profits tax also applies to income treated as effectively connected with a trade or business within the United States. I.R.C. § 884(d)(1). *See also* Peter H. Blessing, *The Branch Tax*, 40 TAX LAW. 587 (1987).

52. I.R.C. § 884(a)-(d).

53. I.R.C. § 884(f).

54. *See* TAX REFORM ACT OF 1986 CONFERENCE REPORT TO ACCOMPANY H.R. 3838, H.R. REP. NO. 841, 99th Cong., 2d Sess., II-647 (1986) [hereinafter 1986 CONFERENCE REPORT].

tax provisions achieve the desired correspondence by treating a foreign corporation's trade or business within the United States as a hypothetical wholly owned subsidiary of the foreign corporation.[55]

1. Branch Profits Tax

The branch profits tax applies, in addition to the regular corporate tax,[56] to a foreign corporation engaged in trade or business within the United States.[57] The Code imposes the branch profits tax at a statutory rate of 30 percent on a foreign corporation's "dividend equivalent amount." In general, the dividend equivalent amount consists of the foreign corporation's after-tax earnings attributable to income effectively connected with the conduct of a trade or business within the United States, to the extent the foreign corporation does not reinvest such earnings in United States business assets.[58] In effect, the branch profits tax treats a foreign corporation's trade or business within the United States as a domestic subsidiary that pays a hypothetical dividend of its dividend equivalent amount to the foreign corporation each year. Enacted in 1986,[59] Congress designed the branch profits tax to apply in lieu of the gross-basis taxation of dividends paid to foreign shareholders by a foreign corporation.

The gross-basis tax on dividends paid by a foreign corporation to a foreign shareholder results from the source of income rules. The Code usually classifies dividends paid by a foreign corporation as foreign source income.[60] However, the Code treats a proportionate amount of

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55. *See* Feingold & Berg, *supra* note 50, at 209. *See also* I.R.S. Notice 86-17, 1986-2 C.B. 379; Blessing, *supra* note 51, at 609-10.

56. I.R.C. §§ 11, 882.

57. I.R.C. § 884(a).

58. I.R.C. 884(a), (b). More specifically, the Code defines the dividend equivalent amount as "the foreign corporation's effectively connected earnings and profits" increased by decreases in United States net equity and decreased by increases in United States net equity. I.R.C. § 884(b). In general, effectively connected earnings and profits consist of the earnings and profits of the foreign corporation "attributable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States." I.R.C. § 884(d). United States net equity consists of the net assets of the foreign corporation connected with the conduct of a trade or business within the United States. I.R.C. § 884(c).

59. *See infra* note 189.

60. *See generally* I.R.C. §§ 861(a)(2), 862(a)(2). The treatment of most dividends paid by a foreign corporation as foreign-source income corresponds with the view that a corporation derives its existence from the jurisdiction that grants the corporation's corporate charter and, in addition, that the country of its incorporation is commonly the location of important business functions, such as management activities. *See* ALI, *supra* note

the dividends paid by a foreign corporation as income from sources within the United States if a significant portion of the foreign corporation's gross income is effectively connected with a trade or business within the United States.[61] Such United States source dividends are periodical income. Gross-basis tax generally applies to United States source periodical income paid to a foreign person not engaged in trade or business within the United States.[62] This gross-basis tax on dividends paid by a foreign corporation constitutes a "second-level tax" on dividends.

Practical considerations underlie the second-level tax on dividends. The Code generally treats dividends paid by domestic corporations as United States source income.[63] If dividends paid by foreign corporations engaged in trade or business within the United States were classified entirely as foreign source income, it would encourage foreign investors to conduct their United States activities in foreign, as opposed to domestic, corporate form.[64] Such foreign corporations would potentially obtain a competitive advantage over domestic corporations, whose dividends are generally subject to United States tax.[65]

The second-level tax on dividends has several flaws. First, it applies to foreign persons who may have little or no direct economic contact with the United States, and it imposes a withholding obligation on foreign corporations that pay dividends through their home office outside the United States. From an administrative perspective, it is difficult to know when the tax is due and to enforce its collection.[66] More importantly, a

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10, at 63.

61. I.R.C. § 861(a)(2)(B). Specifically, the Code treats the dividends paid by a foreign corporation as foreign source income unless at least 25% of the foreign corporation's gross income is effectively connected with the conduct of a trade or business within the United States. *Id.* The Code applies the income test to a three-year testing period ending with the close of the taxable year of the foreign corporation preceding the payment of the dividend. *Id.* If a foreign corporation meets the test, then the portion of the dividends paid by it that is treated as United States source is generally the amount that bears the same ratio to the dividends as the foreign corporation's gross income for the testing period bears to its total gross income. *Id.*

62. I.R.C. §§ 871(a), 881(a).

63. I.R.C. § 861(a)(2).

64. *See* 1986 SENATE REPORT, *supra* note 28, at 400; REPORT OF THE COMMITTEE ON WAYS AND MEANS OF THE HOUSE OF REPRESENTATIVES ON H.R. 3838, H.R. REP. No. 426, 99th Cong., 1st Sess., 432 (1985) [hereinafter 1985 HOUSE REPORT]. *See also* Sidney I. Roberts, *From the Thoughtful Tax Man*, 40 TAXES 355 (1962).

65. *See* 1986 SENATE REPORT, *supra* note 28, at 401; 1985 HOUSE REPORT, *supra* note 64, at 432.

66. *See* 1986 SENATE REPORT, *supra* note 28, at 401; 1985 HOUSE REPORT, *supra* note 64, at 432. That the second-level tax on dividends is administratively awkward does not automatically indicate that a branch-profits tax should be adopted. *See* Michael J.

foreign corporation operating in more than one country may be able to structure around the second-level tax on dividends by ensuring that the foreign corporation derives a sufficient portion of its gross income from non-United States business activities.[67] In that event, the Code would treat none of its dividends as United States source income, and the second-level tax would not apply.[68]

The second-level tax on dividends does not apply to a foreign corporation's distribution of earnings that have been subject to the branch profits tax.[69] As a substitute for the second-level tax on dividends, the branch

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Cooper, *The Treasury Proposals - Modified Second Dividend Tax Better Than the Branch Profits Tax?*, 14 TAX MGMT. INT'L J. 53, 53-54 (1985).

67. An early case involving the second-level withholding tax on dividends demonstrates a classic example of this possibility. Frank Ross, a nonresident alien residing in Canada, owned all of the stock of an Canadian investment company, Ross Corporation, most of the assets of which consisted of the securities of United States corporations. Ross v. Commissioner, 44 B.T.A. 1, 4 (1941). Under United States tax law at the time, the second-level withholding tax applied to dividends paid by a foreign corporation that derived more than 50% of its gross income from United States sources, and more than 50% of the gross income of Ross Corporation consisted of dividends and interest from United States sources. *Id.* at 10-11. The court found as a fact that Frank Ross also owned in his individual capacity large amounts of Canadian securities yielding foreign source income. *Id.* at 10. In its opinion, the court noted that Ross could have avoided the second-level withholding tax on dividends "simply by transferring a sufficient amount of Canadian securities to the Ross Corporation so that the latter's gross income derived from sources within the United States would have been less than 50 percent of its gross income from all sources." *Id.* at 10, 14-15. In other words, the fact that Ross was subject to the second-level withholding tax on dividends at all was a matter of poor tax planning.

68. *See* 1986 SENATE REPORT, *supra* note 28, at 401; 1985 HOUSE REPORT, *supra* note 64, at 432. Prior to the introduction of the branch profits tax, many of the foreign corporations that exceeded the threshold of effectively connected income were formed in countries with an income tax treaty with the United States that provided an exemption from the second-level tax. *See* Blessing, *supra* note 51, at 589. Other factors indicate the abandonment of a second-tier tax. In particular, some countries claim that dividends paid by foreign corporations are beyond United States fiscal jurisdiction. *See* ALI, *supra* note 10, at 141 (citing ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL, art. 10, para. 33 (1977)). *See also infra* section III(c)(1).

69. I.R.C. § 871(e)(3). The branch profits tax has not completely replaced the second-level withholding tax on dividends. The second-level tax on dividends may still apply where the foreign corporation benefits from an income tax treaty that bars the imposition of the branch profits tax, but permits the imposition of the second-level tax on dividends. I.R.C. §§ 861(a)(2)(B), 871(a), 881(a), 884(e)(3)(B). A foreign corporation may not claim exemption from the branch profits tax under an income tax treaty unless the foreign corporation is a qualified resident of the treaty country. *See* I.R.C. § 884(e). The Code treats a foreign corporation as a qualified resident of a treaty country unless 50% or more (by value) of its stock is owned, directly or indirectly, by individuals who are not

profits tax more efficiently imposes a second level of tax on the effectively connected income of a foreign corporation engaged in trade or business within the United States.[70] The collection of the branch profits tax from the foreign corporation itself in conjunction with the regular corporate tax reduces enforcement problems. The dividend equivalent amount measures the amount of earnings attributable to a foreign corporation's trade or business within the United States available for distribution to its shareholders, no matter how large or small a portion such earnings may be of the foreign corporation's total worldwide earnings. A foreign corporation engaged in trade or business within the United States cannot plan around the branch profits tax. The only way a foreign corporation can avoid the branch profits tax is to conduct its operations without be-

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residents of the treaty country or citizens or residents of the United States, or it uses 50% or more of its income to pay liabilities to persons who are not residents of the treaty country or citizens or residents of the United States. I.R.C. § 884(e)(4)(A). The Code, however, treats a foreign corporation which is the resident of a treaty country as a qualified resident of that country if its stock or the stock of its direct or indirect parent corporation is publicly traded on an established securities market in such country or it is a subsidiary of a United States corporation the stock of which is traded on an established securities market in the United States. I.R.C. § 884(e)(4)(B), (C). Thus, for example, the Code exempts the business profits of a foreign corporation that is a resident of a treaty country and does not have a permanent establishment in the United States from the regular corporate tax on income effectively connected with the conduct of a trade or business within the United States. If the foreign corporation, however, were not a qualified resident of the treaty country and were engaged in trade or business within the United States, the Code would subject it to the branch profits tax on its dividend equivalent amount. I.R.C. § 884(e)(1). Congress designed the limitation on treaty benefits under the branch profits tax to prevent a foreign person from one country from taking advantage of a favorable treaty between the United States and another country to obtain an exemption from the branch profits tax, i.e., treaty shopping.

70. Notwithstanding its purpose, significant structural flaws exist in the branch-profits tax. The branch profits tax applies to a foreign corporation's dividend equivalent amount even if the foreign corporation's dividends are paid to a United States person or a foreign person in whose hands such income is effectively connected with the conduct of a trade or business within the United States. *See* Statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy) Department of the Treasury Before the Subcommittee on Taxation and Debt Management Committee on Finance United States Senate (July 22, 1987). To this extent, foreign corporations may now be said to be at a disadvantage vis-à-vis domestic corporations. The Ways and Means Committee's version of the branch-profits tax provided a credit for the branch profits tax to ten-percent corporate shareholders of the foreign corporation. H.R. 3838, 99th Cong. 1st Sess. § 651 (1985) (proposed I.R.C. § 883(f)). This provision, dropped in the Senate version of the bill, would have provided only a partial solution to the problem. The complexity of the branch profits tax, which has engendered numerous pages of regulations and requires considerable attention to accounting and compliance matters, presents a second problem.

ing engaged in trade or business within the United States.

Viewed in terms of the second-level tax on dividends, the branch profits tax operates as a source of income rule combined with a substantive rule imposing tax.[71] As the threshold for the imposition of the branch profits tax, the term "trade or business within the United States" serves equitable and administrative functions similar to those it performs in the context of the regular corporate-level taxation of sales income.[72] The I.R.S. may administer a second level of tax on the income of a foreign corporation more accurately and more easily when the tax applies to the corporation itself. But the I.R.S. could not efficiently administer the branch profits tax if the foreign corporation's activities in the United States were so insubstantial as to make it impractical to assess and collect even the regular corporate-level tax.

2. Branch-Level Interest Tax Provision

Like the branch profits tax, the branch-level interest provision, in part, replaces a source of income rule. The Code usually classifies interest paid by a foreign corporation as foreign source income.[73] However, prior law treated interest paid by a foreign corporation as income from sources within the United States on a proportionate basis if at least half of the foreign corporation's total gross income consisted of income effectively connected with the conduct of a trade or business within the United States.[74] Unless subject to a specific statutory exemption,[75] the Code subjected such United States source interest to gross-basis taxation when the foreign corporation paid the interest to a foreign creditor and the interest was not effectively connected with the foreign creditor's trade

71. *See* 1986 SENATE REPORT, *supra* note 28, at 401-02.

72. *See supra* subpart II(B).

73. I.R.C. §§ 861(a), 862(a).

74. I.R.C. § 861(a)(1)(D) prior to amendment by the Tax Reform Act of 1986. Specifically, the Code treated the interest paid by a foreign corporation as foreign source income unless at least 50% of the foreign corporation's gross income was effectively connected with the conduct of a trade or business within the United States. *Id.* The Code applied the income test to a three-year testing period ending with the close of the taxable year of the foreign corporation preceding the payment of the interest. *Id.* If a foreign corporation met the test, then the portion of the interest paid by it that was treated as United States source consisted of the amount which bore the same ratio to the interest paid as the foreign corporation's gross income for the testing period bore to its total gross income. *Id.*

75. *See, e.g.*, I.R.C. §§ 871(h), 881(c) (portfolio interest not subject to gross-basis tax). For additional exemptions, see Blessing, *supra* note 51, at 629.

or business within the United States.[76]

This method of imposing the second-level tax on interest resembled the second-level tax on dividends in that it was difficult to enforce and was easily circumvented. Foreign persons could avoid the second-level tax on interest by ensuring that less than half the foreign corporation's gross income was effectively connected with the conduct of a trade or business within the United States. The second-level tax on interest also suffered from the same competitive problems that plague the second-level tax on dividends.[77] Most interest paid by domestic corporations is United States source income,[78] while many foreign corporations engaged in trade or business within the United States could avoid paying United States source interest.[79]

In response, the branch-level interest tax provision classifies the interest paid by a foreign corporation's trade or business within the United States as income from sources within the United States.[80] This classification is nothing more mysterious than a straightforward source of income rule. The second-level tax on interest still applies to the creditor, but is less easily avoided by traditional means. The source of interest paid by a foreign corporation no longer relates to the relative amount of the foreign corporation's income effectively connected with its trade or business within the United States.

However, if the source rule in the branch-level interest provision affected only interest actually paid by a foreign corporation's trade or business within the United States, a foreign corporation might still avoid it and the second-level tax on interest by failing to book interest-bearing obligations as obligations of its trade or business within the United States.[81] The Code avoids this possibility by treating the excess of the amount of interest deducted by a foreign corporation's trade or business within the United States[82] over the amount of interest actually paid by the United States business as if it were interest paid by a domestic corpo-

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76. I.R.C. §§ 871(a), 881(a).

77. *See supra* notes 63-65 and accompanying text (discussing second-level tax on dividends).

78. I.R.C. §§ 861(a)(1), 862(a)(2).

79. *See* 1986 SENATE REPORT, *supra* note 28, at 901; 1985 HOUSE REPORT, *supra* note 64, at 431.

80. I.R.C. § 884(f)(1)(A).

81. *Cf.* ALI, *supra* note 10, at 71.

82. A foreign corporation generally determines the allocation of its interest expense to effectively connected gross income by means of a formula. *See generally* Treas. Reg. § 1.882-5 (as amended in 1984); Prop. Treas. Reg. § 1.882-5, 57 Fed. Reg. 15038 (April 24, 1992). *See also* Blessing, *supra* note 51, at 632.

ration to its foreign parent.[83] This rule subjects the foreign corporation itself to tax on the deemed payment of such excess interest deductions.[84]

III. Jurisdictional Functions

A. *Basic Principles*

The discussion in the preceding section establishes the essential pattern of United States income taxation of foreign persons and the administrative functions of the term "engaged in trade or business within the United States." The term also has the effect of limiting United States jurisdiction to tax foreign persons. It limits the taxation of sales income derived by foreign persons and the imposition of the branch-level tax provisions on a foreign corporation. The jurisdictional and administrative functions of the term "engaged in trade or business within the United States" are not wholly unrelated. The effective exercise of fiscal jurisdiction cannot, as a practical matter, extend beyond the reach of tax administration; that is, the ability of the United States to administer the tax law in a way that is susceptible to taxpayer compliance and accountability. This section questions whether the jurisdictional function of the term "trade or business within the United States" derives from jurisdic-

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83. The United States could avoid excess interest deductions by allowing a foreign corporation to deduct interest from its effectively connected gross income to the extent and only to the extent that such interest is paid by its United States business. *See* Blessing, *supra* note 51, at 632. Although apparently expedient, neither theoretical or administrative considerations justify such an approach. Administratively, a rule that determined both the source and deductibility of interest on the basis of whether the interest is paid by the foreign corporation's trade or business within the United States would be potentially subject to manipulation to the detriment of the fisc. If the creditor, specifically a related creditor, were eligible for a treaty exemption from the second-level tax on interest, an incentive would exist to have as much interest as possible paid, and therefore deducted, by the trade or business within the United States.

84. I.R.C. § 884(f)(1)(B). For example, assume the trade or business within the United States of foreign corporation, *X*, deducts $100 of interest expense in computing its effectively connected taxable income. *See* Treas. Reg. § 1.882-5 (rules governing the deductibility of interest in determining effectively connected taxable income); Prop. Treas. Reg. § 1.882-5 (same). Assume further that *X*'s trade or business within the United States actually pays only $75 in interest during the taxable year. The $25 of excess interest deductions (the excess of the $100 of interest deducted in computing *X*'s effectively connected taxable income, over the amount of interest actually paid by *X*'s trade or business within the United States) would be treated as having been paid to *X* as interest by a wholly owned domestic corporation. The deemed payment of interest would be treated as income from sources within the United States. *See* I.R.C. §§ 861(a)(1), 862(a)(1). *X* would then be subject to tax on the gross amount of such interest. I.R.C. § 882(a).

tional principles that are separate and apart from the administrative feasibility considerations that underlie its administrative functions.

The United States derives its jurisdiction to impose the income tax from its sovereignty. International law is a part of United States law, provided there is no domestic law to the contrary.[85] A considerable amount of conventional international law exists affecting United States jurisdiction to tax the income of foreign persons by virtue of the relatively well-developed network of bilateral income tax treaties to which the United States is a party.[86] However, the term "engaged in trade or business within the United States" is for the most part irrelevant where an income tax treaty applies. The concept of a "permanent establishment" largely supplants the term "trade or business within the United States" in the treaty context.[87]

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85. The Paquete Habana, 175 U.S. 677, 700 (1900). In this case, which concerned the legality of seizing Cuban fishing boats during the Spanish-American War, the Court stated:

> International law is part of our law, and must be ascertained and administered by the courts of justice of appropriate jurisdiction, as often as questions of right depending upon it are duly presented for their determination. For this purpose, where there is no treaty, and no controlling executive or legislative act or judicial decision, resort must be had to the customs and usages of civilized nations . . . .

See also Skiriotes v. Florida, 313 U.S. 69, 73 (1941) (holding that international law is a part of our law "for the application of its own principles, and these are concerned with international rights and duties and not with domestic rights and duties."). Whenever possible, courts will endeavor to construe a statute in a manner that is consistent with international law. *See* Burnet v. Brooks, 288 U.S. 378 (1933) (discussing British, Italian, and French law in finding that stocks and bonds of domestic and foreign corporations and bonds of foreign governments held by the United States agent of a nonresident alien decedent were property situated in the United States under the estate tax statutes).

86. As of August 31, 1992, the United States was a party to 42 income tax treaties currently in force, with several others awaiting the exchange of instruments of ratification or Senate approval. *See generally* Andre Fogarasi et al., *Current Status of U.S. Tax Treaties*, 21 TAX MGMT. INT'L J. 570 (1992).

87. *See generally* I.R.C. §§ 894, 7852(d). *See, e.g.*, Convention Between the U.S. and Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, arts. 5, 7, 14, 15, II TAX TREATIES (PH) 39,031 (signed Aug. 29, 1989) [hereinafter U.S.-German Tax Treaty]; Convention Between the U.S. and Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, arts. III, III TAX TREATIES (PH) 82,106 (signed May 24, 1951). The threshold for what constitutes a permanent establishment and the threshold for what constitutes being engaged in trade or business within the United States differ. *See* De Amodio v. Commissioner, 34 T.C. 894, *aff'd on other grounds*, 299 F.2d 623 (3d Cir. 1962) (taxpayer found to be engaged in trade or business within the United States but not to have a permanent establishment in the United States). Thus, a detailed discussion of the scope of the authorities devel-

Other than income tax treaties, international law imposes few limitations on United States jurisdiction to impose tax on the income of foreign persons. A body of general international tax principles exists that enjoys a substantial degree of international acceptance, especially among industrialized countries.[88] Whether these general principles of international taxation constitute customary international law at this time is doubtful.[89] These general international tax principles have a bearing on United States fiscal jurisdiction, but the United States does not necessarily follow such principles out of a sense of legal obligation.[90]

In fact, the United States rules governing the taxation of the income of foreign persons follow general international tax principles to a large extent. General international tax principles contemplate the taxation of the income of foreign persons on the basis of source.[91] The substantive con-

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oped under income tax treaties is beyond the scope of this article. The success of the United States treaty program has limited the relevance of the term "trade or business within the United States." However, many foreign taxpayers do not reside in treaty countries. Further, as a result of limitations on benefits articles in the treaties themselves and in the Code, the term "trade or business within the United States" continues to be relevant to some treaty-country residents. *See, e.g.*, U.S.-German Tax Treaty, *supra*, art. 28, II TAX TREATIES (PH) 39,031, 39,046-39, 047; I.R.C. §§ 884(e), 883(c). *See also supra* notes 7 & 69.

88. *See* ALI, *supra* note 10, at 1.

89. *See, e.g.*, Rudolf Weber-Fas, *Corporate Residence Rules for International Tax Jurisdiction: A Study of American and German Law*, 5 HARV. J. ON LEGIS. 175 (1968) (Editorial Introduction); Martin Norr, *Jurisdiction to Tax and International Income*, 17 TAX L. REV. 431 (1962); Harold Wurzel, *Foreign Investment and Extraterritorial Taxation*, 38 COLUM. L. REV. 809, 814 (1937).

90. Customary international law "results from a general and consistent practice of states followed by them from a sense of legal obligation." *See* RESTATEMENT (THIRD), *supra* note 23, § 102(2). General international tax principles would be prevented from constituting customary international law unless they were adhered to "from a sense of legal obligation." The *Restatement (Third)*, however, sets forth fairly well-defined rules covering the jurisdiction to prescribe tax law. *See id.* §§ 411-15. *See also* KEES VAN RAAD, NONDISCRIMINATION IN INTERNATIONAL TAX LAW 20-21 (1986).

91. *See* RESTATEMENT (THIRD), *supra* note 23, § 412(1). International tax principles contemplate the overlap between one nation's source jurisdiction and another's residence jurisdiction that results in double taxation. *See* RESTATEMENT (THIRD), *supra* note 23, § 411, reporters' note 2. The obligation to relieve double taxation generally falls on the residence country. *Id.* § 413, reporters' note 1. *See also* ALI, *supra* note 10, at 6. In practice, most countries base their jurisdiction to tax on the basis of source or on the basis of residence or on a combination of the two. CHARLES R. IRISH, TAX REFORM ISSUES IN DEVELOPING AND RECENTLY INDUSTRIALIZED COUNTRIES 6 (1986). Most countries also place the responsibility for the relief of double taxation on the residence country. *See* RESTATEMENT (THIRD), *supra* note 23, § 413, cmt. a. *See also* ALI, *supra* note 10, at 126. Notwithstanding the apparent international agreement on these points, it

tent of source-basis taxation under general international tax principles includes jurisdiction to tax the income of foreign persons associated with, or having an economic connection to,[92] the foreign person's presence within that country.[93] Source-basis taxation also extends to income derived by a foreign person from property located within a country.[94]

The United States source of income rules lie at the core of the United States claim to tax the income of foreign persons. These rules may be analyzed in terms of one of two related principles: the location where the income-producing activity occurs or the place where the property or capital giving rise to the income is used.[95] For example, the Code's source rules generally classify income from the performance of services by reference to the place where the services producing the income occur.[96] On

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has been suggested that residence-based taxation should take precedence over source-based taxation as the only basis for jurisdiction to tax. *See* DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 90 (2d ed. 1984).

92. *See* VAN RAAD, *supra* note 90, at 21-22; J.J.TH. SCHIPPER, THE LIABILITY TO TAX OF NON-RESIDENT COMPANIES 208 (1958).

93. *See* RESTATEMENT (THIRD), *supra* note 23, § 412(1). *See also id.* § 412, cmt. a; EDWIN R.A. SELIGMAN, ESSAYS IN TAXATION, 121 (1919); SCHIPPER, *supra* note 92, at 208. Income may be associated with or have an economic connection to the taxpayer's presence if the taxpayer's presence involves an activity in which labor is a constituent element. *See* VAN RAAD, *supra* note 90, at 22. In theory, a nation's jurisdiction to tax the income of a foreign person based on such person's presence in its territory is without limitation. *See* RUSTEL SILVESTRE J. MARTHA, THE JURISDICTION TO TAX IN INTERNATIONAL LAW 94. Under this view, any presence, either in person or through agents, would be sufficient. *Id.* However, the international community generally accepts that the jurisdiction to tax the income of a foreign person is more limited. *Id.* at 95.

94. *See* RESTATEMENT (THIRD), *supra* note 23, § 412(1). The jurisdiction to tax nonresidents on the basis of the location of the activity or property producing the income corresponds to common-law in rem jurisdiction. *See* Louis L. Ceruzzi, *United States International Taxation: Jurisdiction to Tax and Accommodation Among Competing Tax Systems*, 1 N.Y.L. SCH. J. INT'L & COMP. L. 36, 38 (1979).

95. *See* ALI, *supra* note 10, at 18-19. A similar, but somewhat narrower, formulation of the principles underlying the source of income rules would assign geographical source to the place where the property or the activity giving rise to the income is located. RESTATEMENT (THIRD), *supra* note 23, § 412, reporters' note 6; *see also id.* § 412, cmt. f.

96. I.R.C. §§ 861(a)(3), 862(a)(3). This rule is subject to a very limited exception that classifies income from the performance of services in the United States as foreign source income if the income does not exceed $3,000 and a nonresident alien temporarily present (not exceeding 90 days) in the United States performs the services for a foreign employer. *Id.* Special rules govern the source of income from certain transportation services, space and ocean activities, and international communications income. I.R.C. § 863(c)-(e).

the other hand, the source rules classify royalties for the use of intangible property according to the place where the property is used.[97] Both rules require an economic connection between the United States and the income it classifies as derived from United States sources. The United States formulation of its jurisdictional principles generally follows, but occasionally expands, the general international tax principles set forth above.

Although no definitive principles underlying the United States source of income rules exist, the economic nature of the requisite connection between the United States and income classified as United States source is at least, in theory, based on the conceptual underpinnings justifying the imposition of the income tax in the first instance. Specifically with respect to foreign persons, the United States may justify taxation on the basis of the foreign person having derived some type of economic advantage from the United States. One line of thought to this effect develops this advantage in terms of more or less direct benefits derived by the taxpayer from the government. The United States has the power to tax those persons upon whom it confers benefits.[98] Therefore, a person pays taxes in exchange for the benefits the United States confers.[99]

A different line of thought defines the economic advantage giving rise to source jurisdiction in terms of a more general economic allegiance owed by a person who benefits from the United States economy.[100] This line views the income tax as a tax on economic performance within the United States. The location of the taxpayer's economic interest in the United States provides the United States with jurisdiction to tax income arising from such economic interest.[101] Under an economic allegiance theory, the United States may assert source jurisdiction based upon the

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97. I.R.C. §§ 861(a)(4), 862(a)(4).

98. *See* MARTHA, *supra* note 93, 19-20 (1989); Yoseph Edrey & Shmuel Shant, *The U.S. Taxation of Aliens*, 21 CAP. U. L. REV. 121, 127 (1992).

99. The benefits theory enjoys some apparent acceptance in United States case law. *See* Cook v. Tait, 265 U.S. 47, 56 (1924) (utilizing a benefits analysis in confirming the validity of the federal income tax when applied to the worldwide income of United States citizens residing abroad); Commissioner v. Nubar, 185 F.2d 584 (4th Cir. 1950), *cert. denied*, 341 U.S. 925 (1951) (utilizing a benefits analysis to question the power of the United States to tax the income of a nonresident alien); Lord Forres v. Commissioner, 25 B.T.A. 154, 161 (1932) (relying on the benefits theory to find that the second-level tax on dividends paid to a nonresident alien did not violate the Fifth Amendment of the Constitution; "It was the distribution of such earnings that Congress intended to tax for they were acquired within this country by the corporation under the protection which our laws afforded to its properties and operations."). *See also* ALI, *supra* note 10, at 18.

100. SELIGMAN, *supra* note 93, 112-13. *See* MARTHA, *supra* note 93, at 22.

101. *See* Edrey & Shant, *supra* note 98, at 127-28.

creation of the income in the United States economy, the recognition of the taxpayer's economic interest under United States law, or the realization or disposition of the taxpayer's wealth in the United States.[102]

Against the backdrop of the general source of income rules, the term "trade or business within the United States" provides an additional layer of connectedness between the income derived by a foreign person and the United States. As discussed below, however, the source of income rules themselves generally provide a sufficient degree of economic connection to the United States to justify the imposition of the income tax on the United States source income of foreign persons. Although having a jurisdictional effect, the term "trade or business within the United States" does not appear to add anything to the source of income rules that is necessary for the United States to establish source jurisdiction to tax the income of a foreign person. As a result, administrative considerations should largely define the term.

B. *Sales Income from United States Sources*

Sales income consists primarily of gain from the purchase and sale of inventory property[103] and the production and sale of personal property. The Code treats income derived from the purchase and sale of inventory property not attributable to a United States office as income from the country in which the property is sold.[104] It treats income from the production and sale of personal property in the United States as income from sources within the United States. The Code treats income from personal property produced by the taxpayer within the United States and sold without, or produced without and sold within, as partly from United States sources and partly from foreign sources.[105] In this last instance, the split source of the income reflects at least an attempt to source the income attributable to producing the property at the place of production and the income attributable to sales activities at the place of sale.[106]

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102. *Id.*

103. For this purpose, inventory property consists of personal property that is "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." I.R.C. §§ 865(i)(1), 1221(1).

104. I.R.C. § 861(a)(6), 862(a)(6). *See also* Treas. Reg. § 1.861-7(a).

105. I.R.C. § 863(b)(2).

106. *Cf.* Treas. Reg. § 1.863-3(b)(2) (example (1))(division of income from manufacture and sale between United States and foreign sources based on an independent factory or production price); I.R.S. Notice 89-10, 1989-1 C.B. 631 (noting instances in which an independent factory or production price may be utilized).

In general, a sale occurs at the place where title passes from the seller to the purchaser or, if the seller retains bare legal title to the property, the place where beneficial ownership and risk of loss pass to the purchaser.[107] Recent case law and commentary suggest that the place where the risk of loss passes from the seller to the purchaser should prevail.[108] This general rule for sourcing sales income reflects an effort to source such income according to the location of the economic activities giving rise to it.[109] The place where title passes or, more significantly, the place where risk of loss passes, is pivotal economically and commercially. It is the point at which the buyer relieves the seller of responsibility for hazards that might befall the property arising thereafter.[110]

The general rule sourcing sales income in the United States, if the United States is the place where title and risk of loss pass to the purchaser, provides the economic nexus necessary for the United States to assert source jurisdiction under either a benefits theory or an economic allegiance theory. In terms of a benefits theory, where title and risk of loss pass in the United States, the seller has likely taken advantage of general government services in the United States. In terms of an economic allegiance theory, the recognition of private property under United States law provides the basis upon which the seller may benefit from a sale of the property. The passage of title and risk of loss in the United States also may constitute a realization of the taxpayer's gain.

An exception to the title passage and risk of loss rule applies to sales attributable to an office or fixed place of business in the United States. The Code classifies income from the sale of personal property attributable to a foreign person's United States office as United States source income regardless of where the sale occurs, unless the property is sold for use, disposition, or consumption outside the United States and the taxpayer's foreign office materially participates in the sale.[111] This exception to the general source rule for inventory property also reflects an

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107. Treas. Reg. § 1.861-7(c). The regulations provide an anti-avoidance rule under which all facts related to the sale will be examined to source the income in the country in which the substance of the transaction occurred. *Id.* However, the courts have resisted applying the substance test in the overwhelming majority of cases. Linda Galler, *An Historical and Policy Analysis of the Title Passage Rule in International Sales of Personal Property*, 52 U. PITT. L. REV. 521 (1991); Patricia B. Brennan, Note, *Revising the Source of Income Rule for the Purchase and Sale of Personal Property: The Tax Reform Act of 1986*, 41 TAX LAW. 169, 176-177 (1987).

108. *See* Galler, *supra* note 107, at 524.

109. *Id.*

110. *Id.* at 559-60.

111. I.R.C. § 864(e)(2).

effort to source such income according to the location of the economic activities giving rise to it[112] and similarly provides the economic nexus needed to support source jurisdiction.

Since the economic links establishing source jurisdiction form the basis of the source of income rules for inventory property, the term "trade or business within the United States" adds little or nothing to the source of income rules for sales of property that is based on jurisdictional principles. In the case of sales income from sources within the United States under the title passage and risk of loss rule, the United States has jurisdiction to tax the income without the foreign person meeting the additional standard of being engaged in trade or business within the United States. The use of the term "trade or business within the United States" to limit the United States taxation of sales income derived from United States sources under the title passage and risk of loss rule reflects a judgment that, although the United States may be the source country, the United States should not tax sales income unless the foreign person meets a higher threshold of economic contacts with the United States.[113] However, the considerations inherent in that judgment do not derive from principles of jurisdiction.

The term "trade or business within the United States" adds even less of a jurisdictional nature to the office rule for sourcing sales income. An office is a fixed site through which the foreign person conducts business over a period of time, although not necessarily on a continuous basis.[114] The I.R.S. may attribute to the foreign person the office of a dependent agent who regularly exercises the authority to conclude contracts in the name of the foreign person or has a stock of goods belonging to the foreign person from which orders are regularly filled on behalf of the foreign person.[115] The office standard requires a considerable degree of economic connection with the United States that is higher than that customarily required to find that a foreign person engages in trade or business within the United States. The office standard is particularly relevant to sales occurring outside the United States. It provides the jurisdictional nexus otherwise lacking in sales occurring outside the United States.[116]

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112. DEPARTMENT OF TREASURY, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 399-400 (May 1985).

113. *See* ALI, *supra* note 10, at 88.

114. Treas. Reg. § 1.864-7(b)(1).

115. Treas. Reg. § 1.864-7(d).

116. Consideration has been given to changing the source rule for sales of inventory to conform to the new source of income rules for sales of other personal property. In that event, sales income would generally be sourced by reference to the residence of the seller.

C. *Branch-Level Tax Provisions*

1. Second-Level Tax on Dividends and the Branch Profits Tax

As discussed previously, the Code generally determines the source of dividend income by reference to the residence of the distributing corporation. Commentators often explain this general rule by reference to the location of the stock giving rise to the income. Under general situs rules, the location of corporate stock for income tax purposes is the corporation's country of residence.[117] The primary justification for this situs rule is that a corporation often derives its very existence from a corporate charter granted under the laws of its country of residence. Even where the place of incorporation and place of residence differ, important corporate functions, e.g., management, contributing to the generation of dividends generally occur in the country of residence.[118]

Determining the source of dividend income by reference to the location of the corporate stock finds conceptual support in both benefits theory and economic allegiance theory. In terms of benefits theory, the residence country confers benefits, e.g., a corporate charter, police, and diplomatic protection, on the corporation giving rise to an obligation to pay for such services. In terms of an economic allegiance theory, the recognition of a corporation's existence and ownership of property contributes to its economic performance.

Apart from situs rules, the economic activities of a foreign corporation and the utilization of its capital in its country of residence also provide the jurisdictional basis to source dividends in the country of the corporation's residence without resort to situs rules. In a sense, the situs rules for corporate stock are perhaps an unnecessary intermediate step in determining whether a corporation has derived benefits from, or has eco-

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The office rule, assuming it would applied in that context, would still perform the function of providing the jurisdictional nexus for United States source jurisdiction where the general jurisdictional nexus, i.e., residence, is lacking.

117. *See* RESTATEMENT (THIRD), *supra* note 23, § 412, cmt. f; MARTHA, *supra* note 93, at 105.

118. *See* ALI, *supra* note 10, at 63. The situs rules for intangible property for income tax purposes differ from the situs rules for such property for purposes of other types of taxes. For example, the situs of corporate stock is generally the country in which the corporation is resident. However, the presence of the stock certificates themselves in the taxing jurisdiction provides jurisdiction to tax the property itself. *See* MARTHA, *supra* note 93, at 112. *See also* Burnet v. Brooks, 288 U.S. 378 (1933) (holding that bonds of foreign governments and stocks and bonds of domestic and foreign corporations held by a United States agent of a nonresident alien decedent were situated in the United States and includible in the decedent's gross estate).

nomic interests that are recognized in, a particular country.

An important exception to the Code's general source rule for dividends applies if a substantial amount of the foreign corporation's income is effectively connected with the conduct of a trade or business within the United States. In that event, the Code classifies a proportionate part of the foreign corporation's dividends as income from sources within the United States. This exception gives rise to the second-level tax on dividends in the very limited circumstances in which the branch profits tax does not apply.

At least two ways exist to conceptualize the classification of dividends paid by a foreign corporation as United States source. First, with reference to situs rules, one may view a foreign corporation as a quasi-resident of the United States. A foreign corporation's presence in the United States through agents operating a trade or business within the United States becomes, at least to that extent, a resident in the sense that the economic interests and activities giving rise to effectively connected income are located in the United States.[119] The treatment of a foreign corporation as a quasi-resident implies a bifurcation of the corporate entity.[120] One part of the entity (everything but its trade or business within the United States) resides outside the United States, while the trade or business within the United States resides in the United States. This concept of quasi-residence does not entirely represent the overall pattern of taxation established under the Code.[121]

One may also conceptualize the United States source of dividends paid by a foreign corporation by reference to the location of the economic processes giving rise to the income.[122] The jurisdictional link becomes a matter of economic attachment between the United States and the income itself.[123] On the basis of economic source, a nation may tax income having its economic genesis in its territory.[124] As envisioned by Seligman

119. *See* SELIGMAN, *supra* note 93, at 121.

120. *Cf.* ALI, *supra* note 10, at 70.

121. The United States does not give effect to this fiction of a bifurcated foreign corporation for purposes of determining the regular corporate tax. For example, a foreign corporation's trade or business within the United States may not deduct interest paid to the home office on intracompany debt or for other expenses paid to the home office on intracompany transactions. Rather, the corporation must allocate and apportion the expenses of the entire corporation between effectively connected income and other income. *See generally* I.R.C. § 882(c); Treas. Reg. § 1.882-5; Prop. Treas. Reg. § 1.882-5 (interest). *See also* Treas. Reg. § 1.861-8 (other deductions).

122. *See* ALI, *supra* note 10, at 63.

123. *See* MARTHA, *supra* note 93, at 108.

124. *Cf.* ALI, *supra* note 10, at 76-77.

in 1919: "The ideal solution is that the individual's whole faculty should be taxed; but that it should be taxed only once, and that it should be divided among the districts according to his relative interests in each."[125] As attractive as this jurisdictional basis may be, some nations consider it inconsistent with general international tax principles.[126]

However controversial economic source may be as a jurisdictional basis for the second-level taxes, it serves to clarify the role of "trade or business within the United States" in establishing that basis. The United States source of dividends paid by a foreign corporation has its basis in the economic connection between the income and the foreign corporation's activities in the United States. The foreign corporation pays the dividend from earnings arising within the United States.[127] The requisite economic connection then derives not so much from the fact that the foreign corporation engages in trade or business within the United States, but from the source of income rules applicable to the income derived by the foreign corporation. Thus, the term "trade or business within the

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125. *See* SELIGMAN, *supra* note 93, at 113. *See also* MARTHA, *supra* note 93, at 107. Other more pragmatic grounds exist for imposing a second-level tax on dividends and interest paid by foreign corporations. *See supra* notes 63-68 & 77-79 and accompanying text.

126. *See* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, art. 10, para. 33 (1992) [hereinafter OECD Model Treaty]. On the other hand, the American Law Institute appears to have adopted economic source as a basis of its recommendations regarding the United States source of income rules. *See, e.g.*, ALI, *supra* note 10, at 19 ("There are generally two ways to establish source: an 'activities' test based on the location of the income-producing activities and a 'utilization' test based on where the property or capital giving rise to the income is used.") *See also* Palmer, *supra* note 21, at 31-42. The controversy over the jurisdiction to tax such dividends and interest only exists when the person to whom the income is paid is a foreign person who is either not present in the United States or with respect to whose United States presence the income is not economically connected. In all other circumstances, the United States has jurisdiction to tax the income. *See* OECD Model Treaty, *supra*, art. 10, paras. 33-35.

127. The second-level withholding tax on dividends also applies in certain circumstances where the foreign corporation does not actually engage in trade or business within the United States, but derives income treated as income effectively connected with the conduct of a trade or business within the United States. This occurs, for example, when a foreign corporation disposes of a United States real property interest at a gain. *See* I.R.C. § 897(a). *See also supra* note 43. The application of the second-level taxes where the foreign corporation is not actually present in the United States does not undercut the explanation proposed in the text. It simply reflects the view that dividends paid by a foreign corporation can have their economic source in the United States, absent the presence of the foreign corporation, where the income arises from real property located in the United States.

United States" provides an additional economic connection between the United States and the income from which the foreign corporation pays the dividend. But it does not appear to be one that is conceptually required for the United States to exert jurisdiction to tax such income on the basis of economic source.

Viewed as a substitute for the second-level tax on dividends paid to foreign shareholders, the branch profits tax derives from the same jurisdictional basis as the second-level tax, economic source. From a different perspective, since the branch profits tax is in essence a tax on deemed remittances of earnings from the foreign corporation's trade or business within the United States to the home office,[128] one may view the branch profits tax as giving effect to the fiction of a bifurcated foreign corporation consisting of a notional foreign parent and a notional domestic subsidiary.[129] In that event, traditional situs rules justify the branch profits tax. The location of the property producing the income, the stock of the notional domestic subsidiary, is in the United States. Under each of these first two approaches, the jurisdictional inquiry focuses on the power to tax the income of the recipient shareholder. Under the first approach, the relevant shareholder is the person who owns the foreign corporation's stock. Under the second, the shareholder is the notional foreign parent of the notional domestic subsidiary. Yet a third approach focuses the jurisdictional inquiry on the power to impose a second level of tax on the foreign corporation that earns the income. The foreign corporation is present or has property in the United States by virtue of its trade or business within the United States, and the income relates to such presence or property under the effectively connected income provisions. Thus, the income exists within United States fiscal jurisdiction under traditional jurisdictional principles without resort to economic source.[130] Regardless of the way in which one conceptualizes the branch profits tax, the term "trade or business within the United States" in this context does not appear to have a jurisdictional function apart from the jurisdictional effect of its administrative functions.

2. Branch-Level Interest Provisions

The Code generally determines the source of interest income by reference to the residence of the obligor. The fact that, under general situs rules, the location of a debt obligation for income tax purposes is the

128. *See* ALI, *supra* note 10, at 142.
129. *See* ALI, *supra* note 10, at 155-156.
130. *See supra* notes 92-94 and accompanying text.

residence of the obligor may explain this general rule.[131] The justification for fixing the situs of a debt obligation in the country of the obligor's residence derives from the fact that an obligation often derives its value from its enforceability under the laws of that country. The utilization of the capital forming the principal amount of the loan in the country of the obligor's residence provides a basis for sourcing interest in the obligor's residence country on the basis of economic source, without resort to situs rules.

An important exception to the Code's general source rule for interest applies if the foreign corporation's trade or business within the United States pays the interest.[132] This exception gives rise to the second-level tax on interest paid by a foreign corporation.

The classification of interest paid by a foreign corporation as United States source may be conceptualized in at least two ways. First, with reference to situs rules, one may view a foreign corporation as a quasi-resident of the United States by virtue of the presence of agents operating a trade or business within the United States[133] or the ownership of property giving rise to effectively connected income. One may also conceive the United States source of interest paid by a foreign corporation by reference to economic source. Economic source principles might apply when a foreign corporation present in the United States uses the borrowed funds to produce income from activities in the United States. Nonetheless, as with the exercise of United States source jurisdiction to tax dividends paid by a foreign corporation, those adhering to source rules based on the situs of the income producing property may consider the exercise of United States source jurisdiction to tax interest paid by a foreign corporation an exercise of extra-territorial jurisdiction.

The branch-level tax on excess interest deductions, if conceived as a tax on the foreign corporation's creditors, also constitutes a second-level tax on interest with the foreign corporation acting as a withholding agent required to withhold the tax, not at the time of the interest payment, but at the time of the interest deduction. In that event, the tax has the same jurisdictional basis as the second-level tax generally. On the other hand, like the branch profits tax, one can conceptualize the branch-level tax on excess interest deductions by reference to the bifurcation of the foreign corporation into a notional foreign parent with a notional domestic subsidiary. In this context, the branch-level tax on excess interest deductions

131. *See* RESTATEMENT (THIRD), *supra* note 23, at § 412, cmt. f; MARTHA, *supra* note 93, at 105.

132. I.R.C. § 884(f)(1)(A).

133. *See supra* notes 119-21 and accompanying text.

taxes a notional interest payment made by the domestic subsidiary to the foreign parent on a notional intercompany loan. In fact, the statutory language of the branch-level tax on excess interest deductions defines the base for the tax by reference to this fiction.[134]

Conceiving the jurisdictional basis of the second-level tax on interest in terms of economic source reveals the role of the term "trade or business within the United States" in establishing that basis. The economic connection between the interest and the foreign corporation's activities in the United States forms the basis for the source rule. The interest arises from income having its source in the United States. The fact that the foreign corporation engages in trade or business within the United States is incidental except insofar as it allows the taxpayer the benefit of the deduction for the interest. Thus, it does not appear that engaging in a trade or business within the United States provides the economic connection between the United States and the interest. Thus, the term "trade or business within the Unites" does not appear to have a jurisdictional function in this context beyond the jurisdictional limitations grounded in its administrative function.

D. *Administrative and Jurisdictional Functions*

The above discussion suggests that the administrative and jurisdictional functions of the term "trade or business within the United States" are inextricably intertwined. Absent a jurisdictional function of its own, separate and apart from administrative considerations, the jurisdictional function of the term becomes dependent upon administrative considerations.

Were it possible to devise a system for taxing the income of foreign persons based only on equity considerations, the clear preference would be to tax the United States source income of all foreign persons on a net basis. Such United States source income includes dividends and interest paid from a foreign person's own United States source income. The United States makes these fundamental jurisdictional decisions in its formulation of the source of income rules. The United States abandons net-basis taxation of United States source income in favor of gross-basis taxation of periodical income and an exemption for sales income when ad-

134. I.R.C. § 884(f)(1)(B). Unlike the branch profits tax, the branch-level interest tax on excess interest deductions cannot easily be conceptualized as an income tax on the foreign corporation itself. If it were a tax on the foreign corporation itself, it would not be an income tax. The Code does not measure the branch-level interest tax by the foreign corporation's income, but rather by the amount of the foreign corporation's interest deductions in excess of the amount of United States source interest it paid.

ministering a net-basis tax becomes unfeasible. Thus, although the term "trade or business within the United States" performs a jurisdictional function, it is a jurisdictional function based on administrative considerations.

IV. The Existing Framework

A. *Legislative Development*

Consistent with principles of equity, the Act of October 3, 1913 (the 1913 Act), which established the modern income tax, made all resident and nonresident individuals, and all foreign and domestic corporations subject to a federal income tax on a net basis.[135] Income, in the case of a nonresident alien or foreign corporation, was limited to that income derived from sources within the United States.[136]

The net-basis income tax imposed on individuals under the 1913 Act, both residents and nonresidents alike, was to be collected by withholding income at its source.[137] However, withholding did not apply to the income of foreign corporations until 1916, when a limited withholding obligation became applicable to payers of United States source interest and dividends to foreign corporations "not engaged in business or trade within the United States or having any office or place of business therein."[138] The Revenue Act of 1917 took United States citizens and resident aliens out of the withholding scheme, but retained the net-basis withholding regime for income paid to nonresident aliens and interest and dividends paid to foreign corporations.[139]

The Revenue Act of 1918 (the 1918 Act) overhauled the withholding system in two important ways. First, the 1918 Act introduced the term "trade or business within the United States." Foreign corporations "not engaged in trade or business within the United States and not having any office or place of business therein" became subject to withholding on all United States source income other than dividends.[140] Nonresident

135. Act of October 3, 1913, § II.E, 38 Stat. 166 (1913-15) [hereinafter the 1913 Act].

136. *Id.* §§ II.B (nonresident aliens were subject to tax on income from "property owned and business carried on in the United States"); II.G(a) (foreign corporations were subject to tax on income from "business transacted and capital invested within the United States").

137. *Id.* § II.E.

138. Revenue Act of 1916, § 13(e)-(f). Unfortunately, no legislative history accompanying the enactment of this provision exists.

139. Revenue Act of 1917, § 1204(2), 40 Stat. 2 (1919).

140. Revenue Act of 1918, §§ 221, 237, 40 Stat. 1057 (1919).

aliens remained subject to withholding as well.[141] Second, the withholding agent under the 1918 Act withheld tax based on the gross amount of the income paid.[142] The foreign taxpayer could, however, take advantage of any deductions and credits upon filing a return.[143] The rate of withholding matched of the normal tax rate.[144] This withholding rate was thus significantly lower than the highest overall marginal rate applicable to those taxpayers taking advantage of deductions and credits, because the income tax at the time consisted of the normal tax, an additional surtax for individuals, and a war-profits tax on corporations.[145]

The 1918 introduction of the term "trade or business within the United States" was effected without comment. Given the evolution of the withholding system during the first five years of the income tax, it seems reasonable to conclude that the term, when combined with the phrase "any office or place of business therein," was intended to identify those foreign corporations maintaining sufficient economic contacts with the United States to ensure compliance with, and collection of, the income tax. In 1924, the whole phrase was added to the provision governing the withholding of tax from United States source income, other than dividends, paid to nonresident aliens.[146]

The net-basis taxation of foreign persons, reinforced by withholding on a gross basis, remained largely unchanged until 1936.[147] In the Reve-

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141. *Id.* § 221(a).

142. Revenue Act of 1918, § 221(a), 237, 40 Stat. 1057 (1918).

143. *Id.* §§ 221(d), 237.

144. *Id.* §§ 210, 221, 230, 237.

145. *Id.* §§ 211, 301.

146. Revenue Act of 1924, § 221, 43 Stat. 253 (1923-25). In 1921, the term applied to exclude from withholding bank interest payments to nonresident individuals not engaged in a trade or business within the United States and not having an office or place of business in the United States. Revenue Act of 1921, § 221, 42 Stat. 227 (1921-23).

147. Minor changes were made to the rate of withholding to match changes in the normal tax rate. Revenue Act of 1921, § 230 (corporate normal tax rate of 12½%), § 210 (individual normal tax rate of 8%), § 237 (foreign corporate gross withholding rate of 12%), § 221 (nonresident alien gross withholding rate of 8%) 42 Stat. 227; Revenue Act of 1924, § 230 (corporate normal tax rate of 12½%), § 210 (individual normal tax rate of 6%), § 237 (foreign corporate gross withholding rate of 12½%), § 221 (nonresident alien gross withholding rate of 6%) 43 Stat. 253; Revenue Act of 1926, § 230 (corporate normal tax rate of 13½%), § 210 (individual normal tax rate of 5%), § 237 (foreign corporate gross withholding rate of 13½%), § 221 (nonresident alien gross withholding rate of 5%) 44 Stat. 9; Revenue Act of 1928, § 13 (corporate normal tax rate of 12%), § 11 (individual normal tax rate of 5%), § 145 (foreign corporate gross withholding rate of 12%), § 144 (nonresident alien gross withholding rate of 5%) 45 Stat. 791; Revenue Act of 1932, § 13 (corporate normal tax rate of 13¾%), § 11 (individual normal tax rate of 8%), § 144 (foreign corporate gross withholding rate of 12%), § 143 (nonresident alien

nue Act of 1936 (the 1936 Act),[148] most nonresident aliens and all foreign corporations[149] not engaged in trade or business within the United States or maintaining an office or other place of business in the United States lost the opportunity to avail themselves of deductions by filing a return.[150] These taxpayers became subject to federal income tax on a gross basis collected primarily by withholding the tax at the source.[151] Simultaneously, these taxpayers obtained an exemption from tax for sales income and capital gains.[152] Foreign persons engaging in a trade or business within the United States or having an office or place of business in the United States became subject to a net-basis tax at the same rates applicable to United States persons.[153] This latter group of taxpayers also became completely exempt from withholding.[154]

The legislative history of the 1936 Act focuses on the capital gains exemption afforded nonresident aliens and foreign corporations not engaging in trade or business within the United States or having an office or fixed place of business therein. Addressing the administrative considerations, the Senate Finance Committee Report states: "Such a nonresident will not be subject to tax on capital gains, including gains from hedging transactions, as at present, it having been found administratively impossible effectually to collect this latter tax."[155] The tax-writing com-

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gross withholding rate of 5%) 47 Stat. 169; Revenue Act of 1934, § 13 (corporate normal tax rate of 13¾%), § 11 (individual normal tax rate of 4%), § 144 (foreign corporate gross withholding rate of 12%), § 143 (nonresident alien gross withholding rate of 4%) 48 Stat. 680; Revenue Act of 1936, § 13 (corporate normal tax rate of 13%), § 11 (individual normal tax rate of 4%), § 144 (foreign corporate gross withholding rate of 15%, 10% on dividends), § 143 (nonresident alien gross withholding rate of 10%) 49 Stat. 1014. After World War I, the war-profits tax on corporations was replaced by an excess-profits tax. Revenue Act of 1921, tit. III, 42 Stat. 227. The Revenue Act of 1921 also amended the source of income rules to provide that interest and dividends paid by a foreign corporation would be income from sources within the United States if more than 50% of the gross income of the foreign corporation consisted of United States source income. *Id.* § 232.

148. 50 Stat. 813 (1937).

149. Nonresident aliens in this category could avail themselves of deductions if they had gross income from United States sources subject to withholding of at least $20,600. *See* Revenue Act of 1936, § 211(c).

150. *Id.* § 231(a).

151. *Id.* §§ 211(a), 231(a).

152. *See id.* § 211(a), 231(a).

153. *Id.* §§ 211(b), 231(b).

154. *Id.*

155. S. REP. 2156, 74th Cong., 2d Sess. 21-23 (1936) [hereinafter 1936 SENATE REPORT]. *See also* H.R. REP. 2475, 74th Cong., 2d Sess. 9-10 (1936) [hereinafter 1936 HOUSE REPORT].

mittees also apparently believed that the exemption for capital gains would provide an incentive for foreigners to invest in United States markets through United States brokers, thereby increasing the market activity of such investors.[156] To clarify the status of foreign investors in United States securities and commodities markets, the Senate Finance Committee added language to the statute to exclude from the term "trade or business within the United States" those transactions effected "in the United States in stock, securities, or commodities through a resident broker, commission agent, or custodian."[157]

The structure of the system for taxing foreign persons devised in 1936 placed the emphasis in tax planning for foreign investors on the terms "trade or business within the United States" and "an office or fixed place of business therein." A foreign investor engaging in transactions that yielded a relatively large amount of capital gain found it advantageous to avoid trade or business within the United States and not have an office or fixed place of business in the United States. Alternatively, a foreign investor who earned relatively large amounts of interest, dividends, or other periodical income, and who also incurred substantial expenses, might have preferred to engage in trade or business within the United States or have an office or fixed place of business therein.[158] The preference for net-basis taxation was especially pronounced for foreign corporations earning relatively large amounts of dividend income. Dividends were subject to gross-basis taxation at a somewhat reduced rate (ten rather than fifteen percent).[159] However, an eighty-five percent dividends received deduction applied to dividends paid to foreign corporations subject to a net-basis tax.[160] Much of the early litigation concerned the office requirement and foreign investors whose income consisted largely, if not entirely, of periodical income.[161] The early office require-

156. *Id.*

157. Revenue Act of 1936, § 211. *See also* 1936 SENATE REPORT, *supra* note 155, at 21-22. The same amendment also added the performance of personal services, subject to the same exception still existing in the Code today, to the definition of "trade or business within the United States." *Id.*

158. However, apparently a number of cases in which the imposition of gross-basis tax significantly reduced the United States tax liability of foreign investors existed. *See Hearings Before the Senate Comm. on Finance on H.R. 8245, Confidential Committee Print* (1921) (testimony of T.S. Adams).

159. *Id.* § 231(a).

160. *Id.* §§ 26(b), 232(a), 119(b).

161. *See* Aktiebolaget Separator v. Commissioner, 45 B.T.A. 243 (1941); Recherches Industrielles, S.A. v. Commissioner, 45 B.T.A. 253 (1941); Linen Thread Co. v. Commissioner, 128 F.2d 166 (1942); Scottish Am. Inv. Co., Ltd. v. Commissioner, 47 B.T.A. 474, *aff'd as to 1936 and 1937*, 139 F.2d 419 (4th Cir. 1943), *rev'd as to 1938 and*

ment cases laid the groundwork for the first misconception of the term "trade or business within the United States;" that is, construing the phrase "trade or business" by reference to a general standard for engaging in business applicable elsewhere in the Code.

The first such reported case was *Aktiebolaget Separator*,[162] in which the taxpayer was a Swedish corporation engaged in the manufacture of centrifugal machines outside the United States. The taxpayer's entire United States source income consisted of dividends on the stock of two domestic corporations, De Laval Separator and De Laval Turbine. In 1936, De Laval Separator leased the office occupied by its president's secretary to the taxpayer for two years with rent payable annually. In the lease, De Laval Separator reserved the right to continue to use the office so long as such use did not interfere with the taxpayer's use and occupation of the premises. The taxpayer also employed the president's secretary to receive and deposit dividends from both companies in a New York bank, notify Sweden of their receipt, and then remit ninety percent of such dividends to Sweden; maintain records of receipts and disbursements and make monthly reports to Sweden regarding them; receive and forward all mail to Sweden; prepare tax returns, forward them to Sweden for verification and signature, and file them upon their return; and pay the expenses of the office, including her own salary.[163]

The taxpayer took the position that, by virtue of having an office or place of business in the United States, it was subject to federal income tax on a net basis.[164] The Board of Tax Appeals (the predecessor of the Tax Court) construed the phrase "office or place of business" to mean "office for the transaction of business or other place of business"[165] and found that the evidence failed "to establish that the space which [the taxpayer] leased was designed for the transaction of any part of its business."[166] In reaching its decision the Board relied on *McCoach v. Minehill & Schuylkill Haven Railroad Co.*[167]

The Board's reliance on *Minehill*, which had been decided under the 1909 corporation tax,[168] seems misplaced. Minehill was a corporation originally formed to do business as a railroad but had since leased all of

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1939, 142 F.2d 401 (3d Cir. 1944), *aff'd* (4th Cir.) *&* *rev'd* (3d Cir.) 323 U.S. 119 (1944).

162. 45 B.T.A. 243 (1941).

163. *Id.* at 243-45.

164. *Id.* at 248.

165. *Id.* at 249.

166. *Id.*

167. 228 U.S. 295 (1913).

168. Tariff Act of 1909 (The Corporation Tax), § 38, 36 Stat. 11, 112 (1909-10).

its assets for operation by another railroad. Minehill's activities were limited to receiving rents under the lease and collecting any interest from investments of the lease payments. Although measured by net income, the 1909 tax had been upheld earlier against a constitutional challenge in *Flint v. Stone Tracy Co.*[169] In *Stone Tracy*, the Supreme Court upheld the 1909 tax based on its characterization as an excise tax on the privilege of doing business in corporate form. The Court in *Minehill* rested its decision on the *Stone Tracy* characterization of the 1909 tax as a tax on a privilege not being exercised by Minehill.[170] In contrast, the tax at issue in *Aktiebolaget Separator* was an income tax; a tax levied without regard to the type of activity involved.

The *Aktiebolaget Separator* decision, which was reviewed by the full Board of Tax Appeals, generated a dissenting opinion joined by two other members of the Board. Relying on the 1936 legislative history's concern for administrative problems, the dissent found that the "test of residence is a practical one of the collector finding a properly authorized agent of the corporation at a fixed office or place where adequate records of the corporation's American income may be found."[171]

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169. 220 U.S. 107 (1911) (holding that 1909 corporation tax was not a direct tax levied without apportionment according to population in violation of Article I of the Constitution).

170. *Minehill*, 228 U.S. at 303-04.

171. 45 B.T.A. at 252. *See also* Recherches Industrielles, S.A. v. Commissioner, 45 B.T.A. 253 (1941). *Recherches Industrielles* was decided on the same day as *Aktiebolaget Separator*, and its majority opinion was written by the same member of the Board who wrote the dissent in the latter case. *Recherches Industrielles* concerned a Swiss corporation owning stock in a single United States company that set up an office in New Jersey also used by some fifty other companies. Neither the taxpayer nor its agent used the office and no books were kept there. The taxpayer did not maintain a bank account in the United States, with all receipts of income from United States sources being sent directly to the taxpayer's Geneva office. The Board held that the New Jersey office did not constitute an office or other place of business in the United States. Referring to the dissent in *Aktiebolaget Separator*, the opinion noted:

> However, it might be well to point out that, even under the reasoning of the dissenting opinion filed in [*Aktiebolaget Separator*], we should reach the same result. Here the "office" was not a fixed place in which the collector could find a properly authorized agent of petitioner; it was not a place where adequate records of the petitioner's American income could be found; and it was not a place from which control over that income was retained. In reality, this "office" performed no real function.

Id. at 255.

The Board was able to find that a foreign person had an office in the United States in B.W. Jones Trust v. Commissioner, 46 B.T.A. 531, *aff'd*, 132 F.2d 914 (4th Cir. 1943). B.W. Jones Trust invested extensively in United States securities, which comprised 90%

The dissent in *Aktiebolaget Separator* was the first and last reported judicial opinion to refer to the initial administrative function of the phrase "engaged in trade or business within the United States or having an office or place of business therein" or its successor "trade or business within the United States." In the Revenue Act of 1942 (the 1942 Act), Congress deleted the office language,[172] thereby making the distinction between net-basis and gross-basis taxation entirely dependent upon whether the foreign person was engaged in trade or business within the United States. The legislative history of the 1942 Act was subsequently interpreted to provide support for the second misconception of the term "trade or business within the United States"; that is, that the term should be used to prevent taxpayers from taking advantage of net-basis taxation. The House Ways and Means Committee Report states:

> A tendency has arisen, principally on the part of foreign corporations which are substantial holders of the stock of domestic corporations and, occasionally on the part of nonresident alien individuals, to attempt to establish that they have an 'office or place of business' within the United States and hence secure the very different tax treatment accorded taxpayers [engaged in trade or business within the United States or having an office or place of business therein]. Since such corporations and individuals engage in no other economic activities in the United States, they cannot be said to be engaged in trade or business within the United States. . . . Such amendment narrows sharply the field of uncertainty arising in such cases and removes a possible avenue of tax avoidance to large foreign, corporate and other holders of domestic securities.[173]

The Committee Reports support the notion that foreign corporations that owned stock in domestic corporations and sought to bring themselves

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of the trust assets. The bulk of the trust's United States source income consisted of capital gain from the sale of its securities. The trust had four trustees, one of whom effected the trust's United States securities transactions through an office located in the United States. All four trustees met at the United States office twice a year to make investment decisions.

172. Revenue Act of 1942, ch. 619, 56 Stat. 798 (1942 Act). The 1942 Act amended the exception to a trade or business within the United States for trading in commodities through agents. *Id.* § 167. This provision was apparently intended to overrule Vahram Chimchirian v. Commissioner, 42 B.T.A. 1437 (1940), in which the Board of Tax Appeals held that a Turkish exporter of rugs and furs was not engaged in trade of business within the United States through a United States commission agent because he did nothing more than trade in commodities through a commission agent.

173. H.R. REP. NO. 2333, 77th Cong., 2d Sess. 103 (1942), *reprinted in* J.S. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAW 1953-1939, at 1877 (1954). *See also* S. REP. NO. 1631, 77th Cong., 2d Sess. 135-36 (1942) (report of the Senate Finance Committee).

within net-basis taxation were somehow engaging in impliedly illicit tax avoidance. Certainly some abusive situations arose, such as the foreign corporation that leased an "office" which was also leased to fifty other corporations, in which the foreign person did not maintain books, receive mail, or receive income.[174] Yet, if one accepts the general premise that a foreign person should be subject, as much as possible, to the same tax as United States persons and other foreign persons,[175] then the fault in the above decisions was to some extent with the tax law itself. The allowance of the dividends received deduction resulted in the effective rate of the shareholder-level tax on dividends being lower for net-basis tax purposes than for purposes of the tax imposed on a gross basis. This apparent inequity[176] at least makes for a more sympathetic case for those seeking to avoid the withholding tax in favor of net-basis taxation.

The legislative history of the 1942 Act suggests congressional assent to the type of reasoning implied in the majority opinion of *Aktiebolaget Separator*. The language from the Committee Report quoted above has been cited to support the misconception that the term "trade or business within the United States" should be construed, not by reference to the extent of the foreign person's presence within the United States for purposes of compliance and administration, but by reference to the line of cases distinguishing deductible trade or business expenses from nondeductible personal expenses.[177]

Another reading of the 1942 legislative history, however, underscores

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174. *See, e.g.*, Recherches Industrielles, S.A. v. Commissoner, 45 B.T.A. 253 (1941).

175. *See supra* notes 20-22 and accompanying text.

176. When, as under current law, the second-level tax on dividends paid by foreign corporations (or as more commonly known, the branch profits tax) is tied to net-basis taxation of such corporations, it is not objectionable to impose a gross-basis United States tax on dividends derived by foreign corporations that are not subject to net-basis tax. The theory underlying the dividends received deduction for corporate shareholders is the prevention of multiple levels of taxation. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 15.23 (5th ed. 1987). Individuals are not allowed this deduction because they are the appropriate subjects of the shareholder-level tax on corporate earnings. The imposition of the withholding tax on dividends leaving the taxing jurisdiction of the United States ensures collection of the shareholder level of tax. In 1942, and indeed from 1921 until 1966, dividends paid by a foreign corporation that derived more than 50% of its gross income from United States sources were treated as United States source income and were therefore subject to tax under the Code when paid to foreign persons. Revenue Act of 1921, § 217(a)(2)(B); Foreign Investors Tax Act of 1966, § 102, 80 Stat. 1539 (1966). Complete parity would then have required an extremely low withholding rate on dividends paid to foreign corporations whose dividends were treated as United States source income.

177. *See* Continental Trading, Inc. v. Commissioner, 265 F.2d 40, 44 (9th Cir.), *cert. denied*, 361 U.S. 827 (1959).

the importance of the words "within the United States" found in the term "trade or business within the United States." The Committee Reports state that "[s]ince such corporations and individuals engaged in no other economic activities or business within the United States [other than holding stock of domestic corporations], they cannot be said to be engaged in trade or business within the United States."[178] Undoubtedly foreign investment and holding companies engage in trade or business. The important question then is whether these companies engage in their trade or business *within the United States*.[179] Read from this perspective, the 1942 legislative history addresses the relationship between the foreign person's United States income and such person's United States activities, implying that back-room functions performed in the United States such as accounting, are insufficient to give rise to a trade or business *within the United States.*

The system in place for taxing the United States source income of foreign persons in 1942 largely survived enactment of the 1954 Code until 1966 when Congress enacted the present pattern for the taxation of foreign persons in the Foreign Investors Tax Act of 1966 (the 1966 Act). In the 1966 Act, Congress acted on a series of proposals that originated out of a concern for problems with the United States balance of payments during the early 1960s.[180] The 1966 Act retained the dichotomy between those foreign persons subject to gross-basis tax and those subject to net-basis tax, but it also introduced the concept of "effectively connected" income.[181] As under current law, foreign persons became subject to federal income tax on a net basis on income effectively connected with the conduct of a trade or business within the United States.[182] However, United States source periodical income (defined to exclude capital gains and sales income) not effectively connected with the conduct of a trade or business within the United States remained subject to gross-basis tax.[183] The 1966 Act also narrowed the source of income rules governing interest and dividends paid by foreign corporations, thereby limiting the scope of the second-level tax on dividends and interest.[184] The express purpose

178. *See supra* note 173.

179. *See* Garelik, *supra* note 14, at 453-54.

180. Report to the President of the Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad (April 27, 1964).

181. Foreign Investors Tax Act of 1966, § 102.

182. *Id.* § 103(b).

183. *Id.* § 103(a).

184. *Id.* § 102(b). This narrowing makes the imposition of a gross-basis tax on dividends paid to a foreign corporation not engaged in trade or business within the United

of these changes was to rationalize the taxation of foreign persons, making investments in the United States, especially investments in United States securities markets, more attractive.[185]

The 1966 Act also amended the exception to "trade or business within the United States" for trading in securities and commodities expressly to include trading for the taxpayer's own account by most nondealers without regard to the volume of trading or the exercise of discretionary authority by a United States agent.[186] The purpose of this change, in part, was to overcome some of the uncertainties faced by portfolio investors in United States markets under the case law discussed below.[187] More importantly, the expansion of safe harbors was prompted by the government's desire to encourage portfolio investment by foreign investors in United States securities and commodities markets.[188] Thus, the function of the safe harbors differs from more general functions of the term "engaged in trade or business within the United States."

The last major structural change in the taxation of foreign persons occurred in the Tax Reform Act of 1986 (the 1986 Act) with the enactment of the branch-level tax provisions discussed previously.[189] Notwithstanding the substantial changes made in 1966 and 1986 in the pattern of taxing foreign persons, discontinuities still remain between the taxation of foreign persons engaged in trade or business within the United States and those not so engaged. In general, foreign persons who are not eligible for lower withholding tax rates under United States income tax treaties and who derive substantial amounts of periodical income still might prefer to be engaged in trade or business within the United States if they incur substantial expenses in earning that income. In the case of periodical income derived from real property and interest, the taxpayer's preference has been somewhat alleviated. In 1960, Congress added a provision whereby foreign persons may elect to treat specified types of income from real property as income effectively connected with the conduct of a trade or business within the United States.[190] The Deficit Re-

States far less objectionable. *See supra* note 176.

185. FOREIGN INVESTORS TAX ACT OF 1966, REPORT OF THE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, H.R. REP. 1450, 89th Cong., 2d Sess. 5-6 (1966) [hereinafter 1966 HOUSE REPORT].

186. Foreign Investors Act of 1966, § 102(d)(2).

187. 1966 HOUSE REPORT, *supra* note 188, at 12-13.

188. 1966 HOUSE REPORT, *supra* note 188, at 15.

189. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1241, 100 Stat. 2216 (codified as amended in scattered sections of 26 U.S.C.).

190. Pub. L. 86-437, § 2(b), 74 Stat. 79 (1960) (codified at I.R.C. §§ 871(d), 882(d)).

duction Act of 1984 added an exemption from gross-basis tax for "portfolio interest," as specifically defined.[191] Alternatively, the preference for net-basis taxation of those deriving United States source dividends, royalties, and other periodical income still subject to gross-basis tax has been more or less aggravated over the years depending upon the relative rates of tax applicable for net-basis and gross-basis tax purposes. For a period following the 1986 Act, the rate of gross-basis tax was actually higher than the maximum rate of tax imposed on individuals subject to tax on a net basis.[192]

Foreign persons deriving sales income still have reason to avoid becoming engaged in trade or business within the United States since such income remains exempt from federal income tax. The term is no longer critical, however, to many investors deriving capital gains. Legislation enacted in 1980 made gains of foreign persons on the disposition of United States real property interests automatically subject to net-basis federal income tax. The legislation effected this change by treating such gain as income effectively connected with the conduct of a trade or business within the United States.[193] The 1986 Act then amended the source of income rules for noninventory property. The gains of foreign persons from noninventory property are classified, in general, as income from sources without the United States, unless the foreign person maintains a United States office to which such gains are attributable.[194] On the other hand, the introduction of the branch-level tax provisions strengthened the tax incentive for foreign corporations earning sales income to avoid being engaged in a trade or business within the United States. Thus, construction of the term "trade or business within the United States" remains of critical importance in determining the United States tax liability of a large number of foreign persons.

191. Deficit Reduction Act of 1984, Pub. L. 98-369, § 127(a)(1), (b)(1), 98 Stat. 494 (codified at I.R.C. §§ 871(h), 882(c)).

192. The rate of the gross-basis tax was 30%. I.R.C. § 871(a), 881(a). For 1988, 1989, and 1990 taxable years, the maximum marginal rate of tax imposed on the individuals subject to tax on net basis was 28%. I.R.C. § 1, prior to amendment by the Revenue Reconciliation Act of 1990, § 11101(a), 104 Stat. 1388.

193. *See supra* note 43.

194. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1211(a), 100 Stat. 2216 (codified at I.R.C. § 865(a), (e)(2)).

B. *Judicial Development*

Not surprisingly, the term "engaged in trade or business within the United States" has spawned its share of litigation.[195] Generally, the framework developed by the courts in settling disputes divides the term into two elements. The foreign person must be engaged in "trade or business," and the trade or business activities must occur "within the United States."[196] The determination of whether a foreign person meets each of these elements is generally a question of fact decided on a case-by-case basis.[197]

In the decided cases, the term "trade or business within the United States" is critical for one of two reasons. In some instances, a foreign person has sought to be classified as engaged in trade or business within the United States to take advantage of substantial deductions. For example, some taxpayers have wanted to take advantage of deductions for mortgage interest or dividends received and therefore have wanted to be engaged in trade or business within the United States.[198] In other cases, however, the foreign person has derived substantial sales income or, before 1987, capital gains and has therefore sought the exemption from tax accorded such income in the hands of those not engaged in a trade or business within the United States.[199]

1. Trade or Business

The question of whether a foreign person is engaged in trade or business has been litigated almost exclusively with respect to noncorporate taxpayers, probably because the Code tends to presume that corporations are engaged in trade or business.[200] The "trade or business" issue arises

195. For more thorough examinations of the term, see generally Garelik, *supra* note 14; Owens, *supra* note 14, at 1106-19; Joseph Isenbergh, *The "Trade or Business" of Foreign Taxpayers in the United States*, 61 TAXES 972 (1983).

196. Owens, *supra* note 14, at 1106-07. *See also* JOSEPH ISENBERGH, INTERNATIONAL TAXATION 297 (1991); Kaplan, *supra* note 22, at 1097; Sidney I. Roberts & Sanford H. Goldberg, *Engaged in Trade or Business in the United States and H.R. 13103*, 24 J. TAX'N 364, 364-65 (1966).

197. *See, e.g.*, Estate of Yerburgh v. Commissioner, 4 T.C.M. (CCH) 1145, 1146 (1945); Amalgamated Dental Ltd. v. Commissioner, 6 T.C. 1009, 1014 (1946).

198. *See, e.g.*, Neill v. Commissioner, 46 B.T.A. 197, 198 (1942) (real estate); Continental Trading, Inc. v. Commissioner, 16 T.C.M. (CCH) 724, *aff'd*, 265 F. 2d 40 (9th Cir.), *cert. denied*, 361 U.S. 827 (1959) (corporate stock).

199. United States v. Balanovski, 131 F. Supp. 898 (S.D.N.Y. 1955), *aff'd in part, rev'd in part*, 236 F.2d 298, *cert. denied*, 352 U.S. 968 (1957).

200. *See* Garelik, *supra* note 14, at 453. But see *Continental Trading*, 16 T.C.M. (CCH) at 725, *aff'd*, 265 F.2d 40, where the appellate court appeared to treat the issue

most commonly with respect to activities in securities and commodities markets,[201] investments in real estate,[202] and, more recently, working interests in oil and gas.[203] Judicial opinions in these cases draw heavily upon cases decided under other areas of the Code that utilize the term "trade or business."[204] The upshot of these opinions is a distinction between activities that are actively conducted and those that are more in the nature of passive investment.[205]

The real estate cases provide a good illustration. Few, if any, of these cases arise under current law. Since 1960 foreign persons have been able to elect net-basis taxation for income from real property.[206] Moreover, since 1980 the Code has treated gains from the disposition of United States real property interests as effectively connected with the conduct of a trade or business within the United States.[207] The real estate cases remain relevant, however, for other types of investment.[208]

An early real estate case illustrating the active/passive dichotomy is *Neill v. Commissioner*.[209] Neill was a nonresident alien whose United States source income consisted of rent paid to her under a long-term ground lease of a single parcel of Philadelphia real property. Neill employed a Philadelphia law firm to receive the rents due from the tenant and pay the interest due on the mortgage and incidental expenses. The tenant had full responsibility for the upkeep of the property.[210] The Board concluded, after very little discussion, that "the rule is settled that the mere ownership of property from which income is drawn does not

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of whether a foreign corporation is engaged in trade or business within the United States as one concerning whether the taxpayer is engaged in trade or business rather than whether the taxpayer's trade or business is within the United States.

201. *See, e.g.*, Adda v. Commissioner, 10 T.C. 273 (1948), *aff'd*, 171 F.2d 457 (4th Cir. 1948), *cert. denied*, 336 U.S. 952 (1949); Chang Hsiao Liang v. Commisioner, 23 T.C. 1040 (1955).

202. *See, e.g.*, Neill v. Commissioner, 46 B.T.A. 197 (1942); Lewenhaupt v. Commissioner, 20 T.C. 151, *aff'd*, 221 F.2d 227 (9th Cir. 1953).

203. *See* Di Portanova v. United States, 690 F.2d 169 (Ct. Cl. 1982).

204. *See, e.g., Chang Hsiao Liang*, 23 T.C. at 1040; Herbert v. Commissioner, 30 T.C. at 26, 27 (1958).

205. *Compare Chang Hsiao Liang*, 23 T.C. at 1045 (taxpayer's investment in United States securities were in the nature of investments for long-term growth, and did not rise to the level of a trade or business) *with Adda*, 10 T.C at 274 (active trading in commodities).

206. *See supra* note 190.

207. *See supra* note 43.

208. *See infra* notes 228-30 and accompanying text.

209. 46 B.T.A. 197 (1942).

210. *Id.* at 197-98.

constitute the carrying on of business within the purview of the cited section."[211] In reaching its conclusion, the Board relied upon *Higgins v. Commissioner*,[212] a well-known Supreme Court decision in the domestic tax context holding that expenses incurred by an individual in managing investments held for capital appreciation and current income could not be deducted as expenses incurred in a trade or business.

In contrast to *Neill's* "mere ownership of property," the courts have had very little difficulty finding that a trade or business exists when a foreign person owns several pieces of real estate managed by an agent who signs leases, collects rents, and supervises maintenance and other activities necessary to operate the properties, even though the degree of discretion actually exercised by the agent is quite limited.[213] For example, in *Lewenhaupt v. Commissioner*,[214] a nonresident alien owned several pieces of United States real estate that were managed by his agent in California. Under the power of attorney establishing the agency, the agent had broad discretionary authority to act for Lewenhaupt, including the authority to negotiate leases and purchase and sell properties. Nonetheless, the parties understood that the agent would not, and did not, take any important action, such as consummating a sale, without first consulting with the taxpayer or the taxpayer's nonresident alien

211. *Id.* at 198. The Board concluded with even less discussion that Ms. Neill also did not have an office or other place of business in the United States. *Id.* at 199 (citing Aktiebolaget Separator v. Commissioner, 45 B.T.A. 243 (1941) and Recherches Industrielles, S.A. v. Commissioner, 45 B.T.A. 253 (1941)). *See supra* notes 62-74 and accompanying text. A case subsequent to *Neill*, but to the same effect, is Herbert v. Commissioner, 30 T.C. 26 (1958). In *Herbert*, the court concluded that the real estate subject to a net lease and managed by United States agents having to pay only occasional attention to the property did not constitute being engaged in trade or business within the meaning of the treaty between the United States and the United Kingdom in effect at that time.

212. 111 F.2d 795 (2d Cir.), *aff'd*, 312 U.S. 212 (1941).

213. De Amodio v. Commissioner, 34 T.C. 894, *aff'd on other grounds*, 299 F.2d 623 (3d Cir. 1962) (nonresident alien owning real estate managed by independent agents is engaged in trade or business within the United States, but such activities did not constitute a permanent establishment under applicable treaty); Lewenhaupt v. Commissioner, 20 T.C. 151, *aff'd*, 221 F.2d 227 (9th Cir. 1953) (nonresident alien owning real estate in California with United States agent who executed leases, found tenants, collected rents, maintained accounts, and supervised repairs and maintenance); Estate of Yerburgh v. Commissioner, 4 T.C.M. (CCH) 1145 (1945) (nonresident alien owning part interests in two apartment buildings managed by management company and law firm). *But see* Barbour v. Commissioner, 3 T.C.M. (CCH) 216 (1944) (holding that rental of real estate "merely incidental" to investments in stock and securities is not a trade or business in the United States).

214. 20 T.C. 151, *aff'd*, 221 F.2d 227 (9th Cir. 1953).

father.[215]

The Tax Court held that the taxpayer was engaged in trade or business within the United States. In reaching this conclusion, the court stated that the activities carried on by the agent were beyond the scope of mere ownership of real property or the receipt of income from real property.[216] The court found that the activities constituted engaging in trade or business within the United States because the activities were "considerable, continuous, and regular."[217]

The application of the active/passive dichotomy to real estate leads to curious results. A foreign person who owns real property in the United States subject to a long-term net lease is not engaged in trade or business within the United States. A long-term net lease, which shifts to the lessee the day-to-day activities and expenses necessary for the upkeep of the property, leaves the foreign person with the "mere ownership of property." The I.R.S. apparently agrees with this position, even where the foreign person engages in significant oversight activities.[218] The sale of the foreign person's holdings does not appear to be relevant.[219]

The active/passive dichotomy also applies to cases involving the activities of foreign persons in United States securities or commodities markets. The 1936 Act added statutory language to clarify that such investments effected through a United States broker, commission agent, or custodian did not constitute a trade or business within the United States.[220] However, the courts found that foreign persons who effected their transactions through United States agents having discretion to act for their foreign principals were not insulated under the 1936 Act.[221] The 1966 Act protected most individuals effecting transactions through discretionary agents.[222] The issue continues to plague foreign dealers of securities and commodities, including foreign financial institutions, who were not covered by the safe harbors enacted in the 1966 legislation.[223]

Nearly all of the cases dealing with taxpayers' activities in securities and commodities markets concern taxable years between 1936 and 1966. Thus, the analysis begins with a determination of whether the foreign

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215. *Id.* at 152-55.
216. *Id.* at 163.
217. *Id.* (citing Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940)).
218. Revenue Ruling 73-522, 1973-2 Cum. Bull. 226.
219. ISENBERGH, *supra* note 196, at ¶ 9.5.3.
220. *See supra* notes 157 & 172 and accompanying text.
221. *See Adda*, 10 T.C. at 278.
222. *See supra* note 186.
223. *See* Samuels & Brown, *supra* note 9, at 550.

person's activities fall within the pre-1966 statutory exception.[224] Once the foreign person's activities exceed that threshold, the courts frame their analysis in terms of the distinction between a trader and an investor that developed after *Higgins*. The courts define a trader as one who engages in frequent transactions leading to a high turnover in investment assets in an effort to take advantage of any short-term market fluctuations.[225] They define an investor, by contrast, as one who engages in relatively fewer transactions, holding assets longer for income and capital appreciation.[226] The trader/investor distinction derives from cases arising in the domestic context that are concerned with the deductibility of expenses or the characterization of assets as capital assets or inventory.[227]

The most recent judicial decision to apply the active/passive distinction is *Di Portanova v. United States*.[228] *Di Portanova* concerned the working interests in oil and gas held by foreign trusts formed for the benefit of a nonresident alien. Unrelated third parties operated the working interests under agreements that generally gave the third-party operators complete control and supervision of the properties. The trusts' activities were limited to paying bills, receiving income, and consulting with the operator of the working interests on matters of general policy.[229] Again citing *Higgins* for the proposition that "mere investing does not constitute a trade or business," the court concluded that the activities of the trusts were those of investors. Thus, neither the trusts nor their nonresident alien beneficiary was engaged in trade or business within the United States.[230]

The amount of income derived from the activity is insignificant in these cases. For example, in *Estate of Yerburgh*,[231] the taxpayer held several pieces of real estate in the United States managed by an agent.

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224. *See* Adda v. Commissioner, 10 T.C. 273, *aff'd*, 171 F.2d 457 (4th Cir. 1948), *cert. denied*, 336 U.S. 952 (1949); Commissioner v. Nubar, 185 F.2d 584 (4th Cir. 1950), *rev'g* 13 T.C. 566 (1949), *cert. denied*, 341 U.S. 925 (1951).

225. Adda v. Commissioner, 10 T.C 273, *aff'd*, 171 F.2d 457 (4th Cir. 1948), *cert. denied*, 336 U.S. 952 (1949). *See also* deKrause v. Commissioner, 33 T.C.M. 1362 (1974); *Nubar*, 185 F.2d at 588-89.

226. Chang Hsiao Liang v. Commissioner, 23 T.C. 1040 (1955). *See also* De Vegvar v. Commissioner, 28 T.C. 1055, 1060-61 (1957).

227. *See, e.g.*, Fuld v. Commissioner, 44 B.T.A. 1268 (1941), *aff'd*, 139 F.2d 465 (2d Cir. 1943); Snyder v. Commissioner, 73 F.2d 5 (3d Cir. 1934), *aff'd*, 295 U.S. 134, 139 (1935).

228. 690 F.2d 169 (Ct. Cl. 1982).

229. *Id.* at 173.

230. *Id.* at 174. For a more detailed discussion of *Di Portanova*, see generally ISENBERGH, *supra* note 199.

231. 4 T.C.M. (CCH) 1145 (1945).

The taxpayer, Yerburgh, also had significant portfolio investments that, in and of themselves, did not rise to the level of a trade or business within the United States. The income from Yerburgh's investment portfolio, however, was significantly greater than the income derived from his real estate activities.[232] The I.R.S. argued that the taxpayer's real estate activities, conducted through his agent, did not give rise to a trade or business within the United States because the taxpayer's income from real estate was nominal compared to his investment income. The court, in a memorandum decision, rejected the position proffered by the I.R.S. and ruled that the taxpayer was engaged in a trade or business within the United States.[233]

The distinction between active and passive activity may be extended to other endeavors as well. A foreign person's receipt of royalties for the use of intangible property, taken alone, should not rise to the level of a trade or business within the United States. A foreign person's receipt of interest on a loan negotiated outside the United States, particularly a loan arising in a noncommercial context, should not result in a trade or business within the United States.

The results in the cases applying the active/passive dichotomy make a sharp contrast to the Code provisions relating to foreign persons' interests in partnerships, trusts, and estates. The Code imputes the trade or business within the United States of a partnership, trust, or estate to the entity's partners or beneficiaries.[234] For example, a foreign person who is a limited partner in a limited partnership conducting a real estate business in the United States is engaged in trade or business within the United States.[235] Likewise, a foreign person who is the beneficiary of a trust is engaged in trade or business within the United States if the trust is engaged in trade or business within the United States.[236] Under the

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232. *Id.* at 1145-46.

233. *Id.* at 1146-47. *See also* Investors Mortgage Sec. Co. v. Commissioner, 4 T.C.M. (CCH) 45, 47 (1945). *But see* Barbour v. Commissioner, 3 T.C.M. (CCH) 216 (1944) (holding that rental of real estate "merely incidential" to investments in stock and securities is not a trade or business within the United States). The introduction of the "effectively connected" concept vitiated the concern reflected in the position taken by the I.R.S. in Estate of Yerburgh v. Commissioner, 4 T.C.M. (CCH) 1145 (1945). Under current law, net basis taxation would not apply to Yerburgh's interest and dividends unless such income were effectively connected with Yerburgh's trade or business within the United States. *See supra* note 31 and accompanying text (discussing meaning of "effectively connected").

234. I.R.C. § 875.

235. Revenue Ruling 75-23, 1975-1 Cum. Bull. 290.

236. I.R.C. § 875(2).

analysis employed in the cases utilizing the active/passive dichotomy, it is doubtful whether limited partners or the beneficiaries of trusts or estates would be found to be engaged in trade or business within the United States solely on account of the activities of the partnership, trust, or estate. The entity would shield them from the activity necessary to support such a finding.

The passive characterization cannot readily apply to many activities other than those producing interest, dividends, rents, and royalties. For example, sales of goods are inherently active. Where the nature of the foreign person's endeavors is active, the existence of a trade or business depends upon whether the foreign person's activities are considerable, continuous, and regular.[237] On the one hand, a single isolated sale of goods generally does not rise to the level of a trade or business.[238] There are scenarios, however, when an isolated sale might involve a magnitude of activity as to constitute a trade or business.

2. Within the United States

The second element of the term "trade or business within the United States" concerns the location of the trade or business; whether it is located *within the United States.* This issue arises in relatively few cases. This inattention may reflect in part the limitations of tax administration in marginal cases. For example, a foreign person engaged in activities in the United States that produce sales income may conclude that the activities do not constitute a trade or business within the United States. Sales income is not subject to withholding at its source and often is not subject to information reporting by the payer.[239] As a result, the taxpayers' resolutions of this important issue are more likely to escape the scrutiny of the I.R.S. The result is relatively few disputes on this issue.

Under the cases that do exist, the court will consider whether a sufficient portion of the foreign person's business activity occurs in the United States.[240] The court will review both quality and quantity. In terms of the quality of the business activities, some cases draw a distinction between foreign persons engaging in the United States in "what they were principally organized to do in order to realize a profit" and other foreign persons engaged in activities that are "adjunct."[241]

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237. *See supra* note 217 and accompanying text.

238. *See* Pasqual v. Commissioner, 12 T.C.M. (CCH) 1431 (1953).

239. *See generally* I.R.C. §§ 6031-6053.

240. *See, e.g.*, Scottish Am. Inv. Co. v. Commissioner, 12 T.C. 149 (1949); Spermacet Whaling & Shipping Co., 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960).

241. *Scottish American*, 12 T.C. at 159.

In *Scottish American Investment Co. Ltd.*, for example, the Tax Court held that a foreign investment company that maintained a significant portion of its assets in United States securities was not engaged in trade or business within the United States.[242] Scottish American had a United States office that performed extensive clerical activities and even voted proxies, but still consulted with the home office in unusual cases. The United States office did not participate in the investment decisions, which were made at Scottish American's home office. The court found that the activities of the United States office, although extensive, were "adjunct" to Scottish American's "real business" of managing investments in United States securities. Therefore, Scottish American was not engaged in trade or business within the United States.[243] In this instance, the court seemed to imply that a foreign person engages in trade or business within the United States when United States activities involve the exercise of entrepreneurial judgment in the United States. One commentator has hypothesized that at least in the case of a foreign corporation, the management might need to be located in the United States.[244]

The decision in *Scottish American* is difficult to reconcile with the decision in *Lewenhaupt* in which the agent engaged in routine activities related to real estate but did not engage in any significant transactions without first consulting the nonresident alien taxpayer or the taxpayer's nonresident alien father. Lewenhaupt may have been engaged in trade or business, but under the *Scottish American* analysis, whether he was engaged in trade or business *within the United States* is doubtful.

Whether a foreign corporation qualifies to do business under state law has mixed significance in the case law. In one case,[245] the court noted in its findings of fact that the foreign corporation had qualified to do business in Nevada, but did not mention this fact in its opinion, which held that the taxpayer was not engaged in trade or business within the United States. On the other hand, some courts have noted the failure of a for-

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242. Scottish Am. Inv. Co. v. Commissioner, 12 T.C. 149 (1949).

243. *Id.* To the same effect, see Spermacet Whaling & Shipping Co., 30 T.C. 618 (1958) *aff'd*, 281 F.2d 646 (1960); Continental Trading v. Commissioner, 16 T.C.M. (CCH) 724 (1957); Linen Thread Co. v. Commissioner, 14 T.C. 725 (1950). The court in *Scottish American* might have been able to base its holding entirely on the exception from trade or business within the United States for stock and security transactions conducted through resident brokers, commission agents, or other nondiscretionary agents. The existence of a United States office seems to have led the court to base its holding both on the 1942 legislative history and the more general basis that Scottish American's trade or business was not conducted within the United States.

244. *See* Garelik, *supra* note 14, at 457.

245. Continental Trading, Inc. v. Commissioner, 16 T.C.M. (CCH) 724 (1957).

eign corporation to qualify to do business under state law as a factor, albeit not the decisive one, in finding that a foreign corporation is not engaged in trade or business within the United States. [246]

Other cases also appear to make this distinction between adjunct and "real" business activities, although the courts have not generally discussed the issue in those terms. It seems fairly clear that mail-order sales to United States customers should not give rise to a trade or business within the United States. Likewise, advertising in the United States also should not result in a trade or business within the United States.[247] On the other end of the spectrum, the production and sale, or purchase and sale, of property in the United States should not generally be classified as adjunct.[248] The middle ground is far more murky. For example, the purchase or goods in the United States for resale elsewhere does not appear to give rise to a trade or business within the United States.[249] It is not clear whether the maintenance of a showroom or storage facility in the United States results in a trade or business within the United States.[250] Even business activities that cannot be classified as adjunct generally do not give rise to a trade or business within the United States if they do not occur in the United States in sufficient quantity. In most cases, one or two transactions in the United States are not sufficient to qualify as a trade or business within the United States.[251]

In *Pasquel v. Commissioner*,[252] a nonresident alien taxpayer invested one hundred thousand dollars in two ships that were to be refitted and

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246. The court stated that:

> 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 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.

Amalgamated Dental Co. v. Commissioner, 6 T.C. 1009, 1017 (1946). *See also Linen Thread*, 14 T.C. at 737.

247. Commissioner v. Piedras Negras Broadcasting Co., 43 B.T.A. 297, *aff'd*, 27 F.2d 260 (1941).

248. United States v. Balanovski, 236 F.2d 298, *cert. denied*, 352 U.S. 1019 (1957). Some cases may turn upon the location of sale. *See id.*

249. Consolidated Premium Iron Ores Ltd. v. Commissioner, 28 T.C. 127 (1957).

250. *Cf.* Commissioner v. Piedras Negras Broadcasting Co., 43 B.T.A. 297, *aff'd*, 27 F.2d 260 (1941) (discussing Mexican radio station soliciting United States advertisers that maintained an office in Texas in which it received mail).

251. *See* Spermacet Whaling & Shipping Co., 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (1960).

252. 12 T.C.M. 1431 (1953).

sold by a United States corporation. Upon resale Pasquel received his original investment plus a hefty profit paid from the down payment made by the purchaser of the ships. The I.R.S. argued that Pasquel and the United States corporation constituted a joint venture resulting in Pasquel being engaged in trade or business within the United States. Although the court did not find that a joint venture existed, it did state in dicta that even if a joint venture had existed, the single transaction in the United States would have been insufficient to result in Pasquel being engaged in a trade or business within the United States.[253]

On the other hand, the existence of a United States agent through whom sales are made on a regular basis is usually sufficient to classify the foreign principal as engaged in a trade or business within the United States.[254] In *Handfield v. Commissioner*,[255] a Canadian individual engaged in the manufacture of greeting cards sold in the United States under a contract with a United States distributor. The question of whether Handfield's trade or business was conducted within the United States turned upon the characterization of the distribution contract as creating an agency relationship, rather than a seller and purchaser relationship.[256] The court, in finding that the contract created an agency relationship, held that Handfield was engaged in trade or business within the United States.[257]

The question of the quantity of transactions occurring in the United States takes on a new flavor when it appears that a foreign person, who otherwise owns the stock of domestic corporations, engages in sales for the apparent purpose of giving rise to a trade or business within the United States.[258] The extreme version of this situation arose in *Continental Trading, Inc. v. Commissioner*.[259] In *Continental Trading*, a foreign corporation, which was wholly owned by an international financier, owned blocks of stock in two domestic corporations. The foreign corporation, which was largely managed by its sole shareholder from abroad, provided financing for business ventures outside the United States. *Continental Trading* would have benefited from being engaged in trade or business within the United States since, under the law in

253. *See also* European Naval Stores Co. v. Commissioner, 11 T.C. 127 (1948) (analyzing single sale of a large quantity of industrial chemicals).

254. Handfield v. Commissioner, 23 T.C. 633 (1955).

255. *Id.*

256. *Id.*

257. *Id.*

258. *See, e.g.*, Linen Thread Co. v. Commissioner, 14 T.C. 725 (1950) (examining two sales in which the taxpayer's United States office participated only marginally).

259. 16 T.C.M. (CCH) 724.

effect at that time, the taxpayer would have thereby obtained the advantage of the dividends received deduction for dividends it received on its domestic corporate stock. Through its United States agent, Continental Trading purchased tin cans and resold them to a single corporation engaged in the production of milk products. Continental Trading's United States agent owned a block of stock in the purchaser of the cans. After examining the circumstances surrounding the sales of cans and other more sporadic transactions in the United States, the court concluded that Continental Trading's nonsecurities transactions lacked a business purpose. Therefore, the court agreed with the I.R.S. that Continental Trading was not engaged in a trade or business within the United States.

If, however, the court finds that a foreign person's United States activities, which are arguably adjunct to the foreign person's principal business, rise to the level of a trade or business, then the taxpayer may nonetheless be engaged in a trade or business within the United States. In *Investors' Mortgage Security Co. v. Commissioner*,[260] a United Kingdom company engaged in the investment business, including mortgage lending. The company held numerous properties in the western United States as a result of foreclosures. The properties were operated by agents. The I.R.S. argued that the real estate holdings were ancillary to the corporation's investment business. However, the Tax Court, finding that the real estate activities conducted by the United States agents constituted a trade or business, held that Investors' Mortgage was engaged in a trade or business within the United States even though the size of its real estate holdings in relation to its investment assets was rather small.

3. The Significance of Agents

An important issue lurking within any discussion of the scope of the term "trade or business within the United States" relates to the significance of United States agents. In each case in which a court has found a foreign person to be engaged in trade or business within the United States, the foreign person has been present in the United States or acted in the United States through agents. While the reported cases often involve agents,[261] the judicial opinions deal with the significance of the

260. 4 T.C.M. (CCH) 45 (1945).

261. *See, e.g.*, Cantrell & Cochran, Ltd. v. Commissioner, 19 B.T.A. 16, 23-24 (1930); Estate of Yerburgh v. Commissioner, 4 T.C.M. (CCH) 1145, 1146 (1945); Investors' Mortgage Security Co. v. Commissioner, 4 T.C.M. (CCH) 44, 45-47 (1945); Adda v. Commissioner, 10 T.C. 273, 277, *aff'd*, 171 F.2d 457 (4th Cir.), *cert. denied*, 336 U.S. 952 (1948); Lewenhaupt v. Commissioner, 20 T.C. 151, 163, *aff'd*, 221 F.2d 227 (9th Cir. 1953). *See also* Pinchot v. Commissioner, 113 F.2d 718, 719 (2d Cir.

agents' activities in conclusory fashion. The results in the reported cases appear consistent with the view that the control exercised by a foreign principal over an agent in the United States gives rise to an imputation of the agent's activities to the principal.[262] However, the courts' analyses neither support nor refute that observation. The I.R.S. appears to take the view that the United States activities of every agent should be imputed to the agent's foreign principal.[263]

In cases in which an imputation of the United States activities of an agent to a foreign principal clearly exists, the foreign principal will not be engaged in trade or business within the United States unless the United States activities of the agent, in combination with the foreign person's own United States activities, rise to the level of a trade or business within the United States.[264] Further a corporation is not generally treated as the agent of its principal shareholder.[265]

V. Function and Framework

A. *Eliminating the Misconceptions*

If the functions of the term "trade or business within the United States" are principally administrative and jurisdictional, then the framework established in the foregoing cases does not serve these functions well. This conclusion does not suggest that the courts have been remiss in writing their opinions or that the result reached in any given case is necessarily incorrect. To the contrary, precedent to support the existing judicial opinions does exist, not the least of which is the legislative history of the 1942 Act.[266] In many of the reported cases, the result reached is probably the correct one. Rather, the premise of this Article is that, in developing a framework for the application of the term "trade or business within the United States," the courts have failed to take into account the functions of the term. This separation of function and framework has tended to blur analysis and lend an unpredictable quality to

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1940).

262. ISENBERGH, *supra* note 196, ¶ 9.17. *See also* MCINTYRE, *supra* note 14, at 2-25, 2-26.

263. *Cf.* Revenue Ruling 70-424, 1970-2 Cum. Bull. 150.

264. *See* Neill, 46 B.T.A. at 199 (1942); *Chang Hsiao Liang*, 23 T.C. 1044-45.

265. Whipple v. Commissioner, 33 T.C. 1112, *aff'd*, 301 F.2d 108, *vacated & remanded*, 373 U.S. 193, *reh'g denied*, 374 U.S. 858 (1963); *De Vegavar*, 28 T.C. at 1061 (1957). *See also* Estate of Banac v. Commissioner, 17 T.C. 748 (1951) (no evidence to suggest that employees of decedent's wholly owned corporation were his agents); Tarafa v. Commissioner, 37 B.T.A. 19, 23 (1938); Garelik, *supra* note 14, at 447.

266. *See supra* note 173 and accompanying text.

the pattern established in the United States for the taxing the income of foreign persons.

The term "trade or business within the United States" may be viewed as a single term of art or as the sum of its constituent parts, "trade or business" and "within the United States." The language of Code supports the single interpretation. In setting forth the statutory inclusion of services and the securities and commodities safe harbors, the Code sets off the entire term in quotation marks: "For purposes of this part, part II, and chapter 3, the term 'trade or business within the United States' includes . . . ."[267] Still, breaking the term into its constituent parts is not without logic. If courts have made mistakes in dealing with the term in a piecemeal fashion, it is by treating the first of those pieces, "trade or business," as if it must have the same meaning in the taxation of foreign persons as it has in other areas of the Code and by failing to develop a consistent set of criteria for applying the second piece, the point at which a trade or business is conducted *within the United States.*

The term "trade or business" does not necessarily have the same meaning in each place it appears in the Code. To the contrary, the Supreme Court in *Commissioner v. Groetzinger* in 1987[268] implied that the term might have different meanings in different contexts.[269] That the term should have a particular meaning in the international provisions finds support in the statutory language quoted above and in the apparent care with which the Code utilizes the entire term "trade or business within the United States" throughout the international provisions.[270] Commentators have also suggested that the term "trade or business" may have a distinct meaning in its application to the taxation of foreign persons.[271]

Once one accepts that the use of "trade or business" in the term "trade or business within the United States" may be, and should be, interpreted in light of the functions the term performs in the interna-

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267. I.R.C. § 864(b)(2).

268. 480 U.S. 23 (1987).

269. The Supreme Court wrote:

> But the difficulty rests in the Code's wide utilization in various contexts of the term "trade or business" in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code.

Id. at 988.

270. *See, e.g.*, I.R.C. §§ 864(c); 871(a)-(b); 881(a)-(b). *But see generally* I.R.C. § 884 ("trade or business in the United States").

271. *See supra* note 14 and accompanying text.

tional context, the reliance by the courts on *Higgins* and its progeny in determining whether a foreign taxpayer is engaged in "trade or business" ceases to be appropriate.[272] The active/passive dichotomy derived from *Higgins* does not serve the functions of the term "trade or business within the United States." In *Higgins*, the Supreme Court presumably defined the term "trade or business" narrowly so as to prevent the deduction of personal expenses, which is generally not allowed.[273] As used in the term "trade or business within the United States," "trade or business" functions quite differently.

The distinct functions of the term "trade or business" in the taxation of foreign persons derives from the fact that the tax involved is an income tax. Generally, the tax applies to all income regardless of whether it derives from activities principally undertaken to produce a profit.[274] The function of the entire term "trade or business within the United States" is to ensure that the income subject to net-basis tax arises from economic activities and that the foreign person's economic activities in the United States are sufficiently substantial to ensure that the tax can be administered efficiently. Thus, a trade or business in this context should include economic activity in its simplest, as well as its more complex, manifestations.

The workhorse of the term "trade or business within the United States" is its second component, "within the United States." The 1942 legislative history, although assailable for the misconceptions it engendered,[275] reflects an understanding of the importance of determining whether a trade or business is within the United States.[276] The phrase "within the United States" describes the level of economic activity within the United States that permits the efficient administration of a net-basis tax. Whether the foreign person involved has made a conscious effort to

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272. *Id.*

273. *See* Garelik, *supra* note 14, at 457. *See also* I.R.C. § 262. *But see, e.g.*, I.R.C. §§ 163(h); 165(c)(3), (h), 213 (deductions for home mortgage interest, personal casualty losses, and medical expenses, respectively).

274. This statement is reflected in the Haig-Simons definition of income:

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.

See SIMONS, *supra* note 20, at 50. *See also* Commissioner v. Glenshaw Glass, 348 U.S. 426, 429-30 (1955) ("Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature."). Gross income for federal income tax purposes encompasses, for example, windfalls. *See, e.g.*, Cesarini v. United States, 296 F. Supp. 2 (N.D. Ohio 1969), *aff'd per curiam*, 428 F.2d 812 (6th Cir. 1970).

275. *See supra* notes 173-74.

276. *See supra* notes 178-79.

establish sufficient economic contacts with the United States to become subject to net-basis taxation should matter little. Likewise, evidence that a foreign person has intentionally avoided significant economic contacts with the United States in an effort to take advantage of the exemption for sales income is not especially relevant. The relevant issue is whether the foreign person engages in the requisite level of economic activities within the United States.

B. *More Properly Conceived*

Properly conceived, the term "trade or business within the United States" is that measure of a foreign person's economic activity within the United States that will enable net-basis taxation to be imposed in a way that is susceptible to efficient compliance and administration. Any additional overlay appropriately arises from equity and economic considerations, which in many respects are inseparable from administrative feasibility. Taxation lacking, or perceived as lacking, equity between and among taxpayers, undercuts the voluntary compliance essential to efficient administration. The taxation of foreign persons in a way that imposes an undue compliance burden impedes the free flow of international trade and investment. To satisfy these fundamentals, the substance of the term "trade or business within the United States" must incorporate a threshold of United States economic activity that the I.R.S. and the affected taxpayers can apply with consistency to yield predictable results.

A predictable and consistent standard would minimize compliance and administrative burdens by decreasing the time and attention necessary to determine the amount of tax imposed and the number of disputes arising from differences between the tax paid and the tax assessed. A predictable and consistent standard would also serve equitable considerations to the extent that all similarly situated foreign persons would be taxed in the same way. Predictability and consistency also serve economic considerations since a consistent standard yielding predictable results ultimately decreases the cost of compliance and administration. This type of standard also facilitates international trade by enabling foreign investors to reliably predict the United States tax consequences of their economic contacts with this country.

Not uncommonly, the needs of tax equity on the one hand and administrative feasibility on the other remain somewhat at odds. As discussed, horizontal equity favors the imposition of net-basis tax whenever possible. The imposition of a net-basis taxation in every possible case would require a case-by-case approach that would inevitably lead to a large measure of unpredictability. Marginal cases might escape scrutiny entirely, resulting in inequities. At the same time, a higher standard for

net-basis taxation focusing on only a few specified criteria would serve to limit the imposition of net-basis taxation. By its very nature, the limitation would serve to impose gross-basis taxation in cases in which net-basis taxation is obtainable and provide an exemption from tax for sales income when the taxation of such income is entirely possible. This trade-off between horizontal equity and administrative feasibility is unavoidable. On balance, the considerations weigh in favor of a standard and predictable application of the term "trade or business within the United States."

The existing case law is by no means devoid of precedents that the I.R.S. and the courts could develop into an appropriate standard for the application of the term "engaged in trade or business within the United States." The cases correctly treat the issue as one involving a factual inquiry.[277] Given the highly factual nature of the inquiry, the development of a mechanical rule is neither possible nor desirable. Instead, the goal is to identify a set of relevant criteria that yields relatively predictable and consistent results in the almost infinite variety of factual settings. The key to achieving this objective is to focus primarily on facts indicative of an ongoing commitment by the foreign person to participate in the United States economy.

Foreign persons with a continuing economic commitment toward participation in the United States economy have an incentive to comply with the legal constraints associated with United States operations, including the income tax. The continuing economic presence of such taxpayers in the United States ensures their availability for audit and collection proceedings. Likewise, the limitation of net-basis taxation to foreign persons with an enduring United States economic connection reduces the risk of inconsistently applying net-basis taxation and the exemption for sales income. In the identification of foreign persons with continuing economic commitments to participation in the United States economy, only three aspects of a foreign person's transactions would seem to be relevant: *(i)* the foreign person's economic activities; *(ii)* whether such economic activities occur within the United States; and *(iii)* whether the foreign person's economic activities occurring in the United States are considerable, continuous, and regular.

Within this proposed framework, the I.R.S. and the courts should discard the distinction between active business and passive investment. Economic activities should include any activity producing income or from which income can be produced. Clearly the term should include sales of

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277. *See supra* note 197.

goods, the performance of services, leasing, licensing, and such similar activities. It should also include other activities that are not so clearly undertaken for the production of income. Gambling, for example, is an economic activity. This first aspect of the proposal potentially departs from some of the existing case law. The courts and the I.R.S. should not consider whether the foreign person's activities are active, passive, or otherwise meet some threshold established for purposes of unrelated areas of the Code to determine if a taxpayer is engaged in trade or business.

In focusing on an extremely broad class of economic activities, one must consider activities sometimes referred to in the case law as "adjunct."[278] This is the distinction made between the foreign person's activities contributing most directly to the realization of income (sales, services, leasing, licensing, and manufacturing) and activities that are preparatory or ancillary to the income-producing activity (accounting, purchasing, advertising, storage, and the like). In this respect, the legislative history of the 1942 Act and some of the existing case law weigh in favor of excluding such adjunct activities from economic activity.[279] Pragmatic reasons for doing so also exist.

Adjunct activities do not generally bring the person engaging in such activities into the mainstream of the economy in which those activities occur. Further, such activities probably produce no more than a modicum of profit for the enterprise. As a practical matter, such activities, when taken alone, do not often produce United States source income.[280] Treating such activities as giving rise to a trade or business within the United States would only serve to pull into net-basis taxation other United States source income not related to such activities.

For example, consider a foreign person engaged in the manufacture of a product in her country of residence. She sells the product worldwide to independent distributors, including distributions in the United States, for resale. She travels to the United States on a regular basis to purchase materials used in the manufacturing process. In this case, the purchase of property in the United States does not produce United States source income unless the property manufactured by the foreign person is also sold to the independent distributors in the United States.[281] Since the

278. *See supra* notes 241-43 and accompanying text.

279. Commissioner v. Piedras Negras Broadcasting Co., 43 B.T.A. 297, *aff'd*, 27 F.2d 260 (1941) (advertising); *cf.* Consolidated Premium Iron Ores Ltd. v. Commissioner, 38 T.C. 127 (purchasing).

280. Regarding sales income, see *supra* notes 103-112 and accompanying text.

281. I.R.C. § 863(b)(2); Treas. Reg. § 1.863-3(b).

foreign individual's sales in the United States are made without engaging in significant economic activities here, the only revenue the government can gain by taking the purchasing activities into account as activities giving rise to a trade or business within the United States would be to tax the United States source sales income that is largely unrelated to the purchasing activities. The same conclusion applies to other adjunct activities.

Of course, one person's adjunct activities can be another's principal economic activity. Accounting services to an accounting firm are not ancillary. Advertising services are not ancillary to an advertising agency. The taxpayers, the I.R.S., and ultimately the courts must consider what is adjunct with respect to the nature of the foreign person's activities. The scope of adjunct activities should be quite broad, thus narrowing the field of economic activities to those activities involving at least some exercise of entrepreneurial judgment.

Further, a foreign person may engage in two different types of transactions, neither of which is adjunct.[282] The obvious example is manufacturing and sales. For instance, a foreign corporation that manufactures a product in its country of residence and sells it through sales offices in the United States is engaged in two economic activities: manufacturing and sales. Although the foreign person does not engage in manufacturing in the United States, it may be engaged in a trade or business within the United States if the economic activities giving rise to sales income occur in the United States and are considerable, continuous, and regular.

The second criterion relevant to determining whether a foreign person is engaged in a trade or business within the United States should be the location of the foreign person's economic activities. A trade or business within the United States should not exist unless the foreign person engages in economic activities within the United States. The relevant activities are those actually occurring within the United States. The legislative history and existing case law amply support reliance on this criterion.

Finally, the foreign person's economic activities within the United States must be considerable, continuous, and regular to constitute a trade or business within the United States. This phrase derives from the existing case law.[283] The phrase should address the issue of whether the

282. The courts have recognized the possibility that a foreign person might be engaged in two businesses, only one of which rises to the level of a trade or business within the United States. *See supra* note 260 and accompanying text.

283. The phrase "considerable, continuous, and regular" derives from existing case law. *See, e.g.*, *Lewenhaupt*, 20 T.C. at 163. Some commentators have suggested that

foreign person's economic activities within the United States exhibit an ongoing participation in the United States economy.

Whether a foreign person's economic activities within the United States are considerable depends upon the nature of the taxpayer's overall activities. As the courts have already noted, an appropriate consideration would be the amount of the taxpayer's economic activities within the United States in relation to the taxpayer's economic activities elsewhere. Another appropriate consideration is whether the person's United States economic activities contribute significantly to the income derived from the taxpayer's total activities. A foreign person's economic activities might be continuous if the foreign person engages in a single transaction and, in carrying out this single transaction, engages in economic activities over a considerable period of time within the United States. On the other hand, a foreign person's economic activities might not be continuous, even though a number of separate transactions occur in the United States, if the United States transactions transpire on single day. A foreign person's economic activities within the United States could be regular if such activities occur at regular intervals over a period of time, although not every day or even once a week. For example, a foreign person's economic activities might be regular even though seasonal. In short, the determination of whether a foreign person's economic contacts within the United States are considerable, continuous, and regular requires an examination of the nature of taxpayer's economic activities. The decision should rest upon the overriding principle that the functions of the term "trade or business within the United States" require that the term apply only when the foreign person participates in the United States economy over a period of time.

A major issue in the application of any standard for a trade or business within the United States is the extent to which the United States activities of an agent should be imputed to the agent's foreign principal. The failure of the existing law to address this issue squarely has contributed significantly to the currently amorphous boundaries of the term. The treatment of an agent's United States activities should be guided by the same standard that should underlie the overall analysis of whether a foreign person is engaged in trade or business within the United States. First, it is necessary to determine if an agent's activities within the United States are the activities of the agent's foreign principal. If so, it

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continuity of activity is already a prerequisite to finding that a foreign person is engaged in trade or business within the United States. *See, e.g,* Frederick R. Chilton, Jr., *Income Effectively Connected with a United States Trade or Business or Attributable to a Permanent Establishment*, 5 HASTINGS INT'L & COMP. L. REV. 487, 498 (1982).

becomes necessary to determine if the agent's activities within the United States, taken together with the foreign person's other United States activities, are considerable, continuous, and regular.

The United States activities of independent agents, including general commission agents, brokers, or other agents who act in the ordinary course of their own businesses as agents,[284] are not those of their foreign principals.[285] Consider a corporation engaged in the business of managing a number of apartment buildings owned by several different persons. The management company is an independent agent of the owners of the apartment buildings under its management. When the management company locates tenants, enters into leases, and arranges for repairs and maintenance, it is acting in its business of managing apartment buildings. Its activities cannot be said to be those of the building's owners.

Since the activities of a foreign person's independent agent cannot be said to be the activities of the foreign principal, such activities should not cause the foreign principal to be engaged in trade or business within the Untied States. Without more, the foreign person is not engaged in economic activities within the United States. This approach to independent agents is consistent with the view that the activities of a lessee under a net lease are not those of the lessor.[286]

In contrast to an independent agent, a dependent agent, i.e., an employee or other agent who is not an independent agent,[287] is subject to sufficient control by a foreign principal to support the imputation to the foreign principal of the dependent agent's activities. The inquiry must then shift to an examination of the nature and extent of the dependent agent's United States activities to determine if such activities are considerable, continuous, and regular. Thus, for example, a foreign person whose dependent agent's United States activities consist only of activities properly classified as adjunct is not engaged in trade or business within

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284. Treas. Reg. 1.864-7(d)(3)(i). *See also* OECD Model Treaty, *supra* note 126, art. 5, para. 36-39.

285. *See* McINTYRE, *supra* note 14, at 2-26. *See also* OECD Model Treaty, *supra* note 126, art. 5, para. 36.

286. *See supra* notes 218-19 and accompanying text.

287. OECD Model Treaty, *supra* note 126, art. 5, para. 32. The approach advocated herein makes the distinction between an independent agent and a dependent agent extremely important. There is currently little guidance on this issue available in the law relating to the term "trade or business within the United States." However, resort may be had to the considerable body of law and commentary on the same distinction drawn in income tax treaties for purposes of determining if a treaty-country resident has a permanent establishment in the other treaty country. *See, e.g.*, *id.* art. 5, para. 36-42; ARVID A. SKAAR, PERMANENT ESTABLISHMENT 463-536 (1991).

the United States by reason of the agent's activities.[288] The foreign principal must authorize the agent to exercise some form of entrepreneurial judgment in the United States, and the agent must actually exercise that authority. Absent the exercise of such authority, the agent's activities, although attributable to the foreign principal, do not constitute economic activities within the United States. Further, the agent's exercise of such authority, in conjunction with the foreign principal's other economic activities within the United States must be considerable, continuous, and regular.

VI. CONCLUSION

The term "trade or business within the United States" serves both administrative and jurisdictional functions in the provisions of the Code relating to the taxation of the income of foreign persons. It is the dividing line between net-basis and gross-basis taxation of foreign persons. The term also defines the limits of United States taxation of the sales income of foreign persons. Finally, the term serves as the threshold for the imposition of the branch-level tax provisions on a foreign corporation.

Equity considerations favor the imposition of net-basis tax on foreign persons, the same basis upon which the Code taxes the income of United States persons. However, net-basis taxation is administratively infeasible in the case of a foreign person with relatively few economic contacts with the United States. Net-basis taxation then gives way to a gross-basis tax withheld at source from periodical income and an exemption from tax for sales income, unless the foreign person deriving the income is engaged in a trade or business within the United States. Thus, in its administrative functions, the term should reflect that point at which a foreign person's activities in the United States are such that net-basis taxation is administratively feasible.

As the threshold for the United States taxation of sales income and the imposition of the branch-level tax provisions on a foreign corporation, the term "engaged in trade or business within the United States" also performs a jurisdictional function. However, the primary formulation of United States jurisdiction to impose the income tax is found in the Code's source of income rules.[289] The source of income rules provide the economic nexus between the United States and the income of foreign persons necessary to support source jurisdiction. With the jurisdictional

288. *See supra* notes 278-82 and accompanying text.
289. *See supra* note 18 and accompanying text.

basis for the taxation of the income of foreign persons already provided for in the source of income rules, the jurisdictional boundaries imposed by the term "trade or business within the United States" do not so much derive from jurisdictional principles as from the administrative considerations inherent in taxing the income of foreign persons.

An examination of the case law applying the term "trade or business within the United States" demonstrates that the framework developed to date does not wholly serve the functions the term must perform in the Code. This mismatch between function and framework is due to two early misconceptions of the term. The first misconception arose out of an attempt to define the term "trade or business" identically in each place it appears in the Code. The second arose out of the discontinuities between the taxation of foreign persons engaged in trade or business within the United States and those not so engaged. These common misconceptions of the term "trade or business within the United States" have distracted the courts from the task of developing a cogent framework for the consistent application of the term.

Once the misconceptions of the term "engaged in trade or business within the United States" are stripped away, a framework for the application of the term that comports with its functions begins to emerge. The existing case law provides a foundation for finding a trade or business within the United States only if the foreign person has an ongoing commitment to participate in the United States economy. This standard requires the foreign person to engage in activities that involve the exercise of entrepreneurial judgment within the United States and are considerable, continuous, and substantial.

The adoption of this standard for being engaged in trade or business within the United States would serve equity by treating similarly situated foreign persons similarly and by ensuring that foreign persons whose activities bring them into the mainstream of the United States economy compete on equal footing with United States citizens and residents and domestic corporations. The clearer set of criteria involved in the standard would assist the I.R.S. in the efficient administration of the income tax without imposing unreasonable compliance burdens on foreign persons. The adoption of this standard would serve economic considerations by enabling foreign persons to determine in advance the United States income tax consequence of their activities and ensuring that foreign persons compete in the United States on equal footing with their United States counterparts. Although the standard proposed herein is higher than the activity currently thought to give rise to a trade or business within the United States, it would exclude from net-basis taxation largely marginal cases in which administrative and compliance con-

siderations outweigh equity and economic concerns and in which compliance under current law is questionable.

In 1987, the American Law Institute's Federal Income Tax Project recommended the abandonment of the term "trade or business within the United States" and its replacement with the term "a trade or business through a fixed place of business in the U.S."[290] One of its reasons for doing so was the uncertain scope of the original term under current law.[291] The recommendation endorsed the definition of an "office or other place of business" that is already the subject of specific regulations under the Code.[292] In general, this standard would require a fixed place of business, an office, a factory, a construction site, or other substantial location through which the foreign person engages in a trade or business in this country. The fixed place of business of an agent would be attributed to a foreign principal only if the agent had and exercised the authority to enter into contracts on behalf of the foreign principal or maintained a stock of goods to fill orders regularly.

Although the "office or other fixed place of business" standard is plausible, its adoption would appear to require legislative action. The legislative history of the 1942 Act stands as a rejection of a standard for net-basis taxation tied to the existence of one type of fixed place of business, an office. The term "trade or business within the United States" now embodies decades of judicial and administrative interpretation. However, the state of current law does not preclude a shift in the administrative and judicial interpretation of the term "trade or business within the United States" in order to establish a consistent set of criteria for the development of the term. This Article has attempted to explore the functions of the term and the misconceptions that have confused its development to date, and to suggest a framework for its appropriate application, much of which the existing, albeit insufficiently developed, case law already contains.

290. *See* ALI, *supra* note 10, at 90.
291. *Id.* at 92.
292. *See id.* at 91; Treas. Reg. § 1.864-7.