NONRESIDENT TRADE OR BUSINESS

PRIMER

Introduction

Federal income taxation of foreign corporations and nonresident alien individuals (collectively, "foreign persons") is governed by a comprehensive statutory and regulatory framework.[1] The manner of taxation is often dependent upon whether the income at issue is effectively connected with the conduct of a trade or business within the U.S. Therefore, practitioners are often tasked with answering the threshold question of whether their foreign clients have carried on "a trade or business within the U.S." in order to advise them on their tax liability. This primer will provide an overview of the legislative and judicial guidance on what constitutes a U.S. trade or business in this context.

Statutory and Regulatory Framework

Statutory Provisions

Paragraphs 871(b)(1) and 882(a)(1) of the Internal Revenue Code (IRC) prescribe how nonresident alien individuals and foreign corporations, respectively, are generally taxed on income that is effectively connected with a U.S. trade or business.

> § 871(b)(1) - "…[a] nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 or 55 on his taxable income which is effectively connected with the conduct of a trade or business within the United States" (emphasis added).

> § 882(a)(1) – "…[a] foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11 or 59A on its taxable income which is effectively connected with the conduct of a trade or business within the United States" (emphasis added).

The IRC does not define the phrase "engaged in trade or business within the United States" per se, however § 864(b) does provide specific examples of what does and does not meet the standard. In particular, foreign persons providing personal services within the U.S. are generally considered to be engaging in trade or business within the U.S., whereas those trading in stocks through independent agents in the U.S. or those trading in stocks for themselves are generally not so engaged. Each of these examples are discussed in greater detail below.

Personal Services

IRC § 864(b)(1) states that being engaged in a trade or business within the U.S. includes the performance of personal services within the U.S. at any time within the taxable year. However, there is an exception to the general rule; engaging in a trade or business within the U.S. does *not* include the performance of personal services when the following conditions apply:

> (a) the personal services are performed by a nonresident alien individual temporarily present in the United States;
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> (b) for a period or periods not exceeding a total of 90 days during the taxable year;
>
> (c) whose compensation for such services does not exceed $3,000 in the aggregate; and
>
> (d) the services are performed for a nonresident alien individual, foreign partnership or foreign corporation not engaged in trade or business within the United States, or for an office or place of business maintained in a foreign country or possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or corporation.[2]

Trading in Stocks, Securities or Commodities

The IRC also provides two trading safe harbors. Firstly, a foreign person is not engaged in a trade or business within the U.S. if it is merely trading in stocks, securities or commodities through a resident broker, commission agent, custodian, or other independent agent and does not have an office or other fixed place of business in the U.S. through which or by the direction of which the transactions in stocks, securities, or commodities, are effected.[3]

Secondly, a foreign person is *not* engaged in a trade or business within the U.S. by trading in stocks, securities or commodities for its own account, as long as it is not a dealer in stocks, securities or commodities.[4]

Regulatory Provisions

The Code of Federal Regulations, Title 26 (Treasury Regulations) also provides additional information, definitions, examples, and special exclusions relating to the relevant statutory provisions and the ultimate question of whether a foreign person is engaged in a trade or business within the U.S.

Although they provide helpful examples, the IRC and Treasury Regulations do not specify how to determine whether a foreign person is engaging in trade or business in the U.S. under more general circumstances. In fact, Treasury Regulation § 1.864-2(e) clarifies that whether a person is engaged in a trade or business within the U.S. shall be determined on the basis of the facts and circumstances in each case.[5] Therefore, practitioners must look to jurisprudence to fill the gap.

Case Law

While there are no leading cases per se, there is a small body of case law that directly addresses whether a foreign person is engaged in a trade or business within the U.S. The key guiding principles have been borrowed from decisions relating to the definition of the phrase "trade or business" as it has been used in the IRC more generally. For example, the Supreme Court decision of *Higgins v. Commissioner of Internal Revenue* is often cited by courts tasked with determining if a foreign person is engaged in a trade or business within the U.S., although the analysis in that case was focused on whether an activity constituted a "trade or business" in the context of allowable deductions of business expenses.[6]

Courts that have dealt specifically with whether an activity constitutes engaging in a trade or business within the U.S. have held that profit-oriented activities in the U.S. that are regular, substantial, and continuous, and that are not merely clerical, routine or incidental to the ordinary trade or business of the foreign person will meet the threshold.[7] Each of these key components is discussed in greater detail below, but the underlying principle is that each case must be decided on its own facts and circumstances.

Activities Must be Profit-Oriented

A necessary, though not sufficient, requirement for a foreign person to be engaged in trade or business within the U.S. is that the activities at issue be carried out primarily for profit.[8] In most instances, there is no dispute or discussion of profit motive in the cases, likely because it is clear that the activities in the U.S. are contributing to a profit-generating enterprise. However, it has been an issue in at least one recent case; *Free-Pacheco v. United States*.[9] In *Free-Pacheco,* a nonresident alien individual was gambling in the U.S. at various times throughout the year, and the Court ultimately determined that his activities did not constitute a trade or business partly on the basis that he had not demonstrated a sufficient intent to generate a profit through his gambling.[10]

Activities Must Be Regular, Substantial and Continuous

In order to be engaged in a trade or business, a foreign person must also be regularly and continuously transacting a substantial portion of its ordinary business in the U.S. during a substantial portion of the taxable year.[11] Therefore, it is important to understand the foreign person's ordinary or core business before delving into the analysis. For example, in *Spermacet Whaling & Shipping Co. S/A v. Commissioner* the Court found that the foreign taxpayer was formed to facilitate the sale of sperm whale oil between two U.S. companies.[12] The Court established that the taxpayer's ordinary business was managing the whaling expedition, and that the majority of the activities giving rise to the income in question took place in Norway or the high seas, rather than the U.S. Therefore, the Court held that the taxpayer was not regularly and continuously transacting a substantial portion of its ordinary business within the U.S. and was not carrying on a U.S. trade or business.

Although the continuity and regularity of the activity within the U.S. is a critical factor in the analysis, the character of the activity is also important.

Activities Must Not be Clerical, Routine or Incidental

Activities which are merely clerical, routine, or incidental to the ordinary business of a foreign person are not sufficient to render them engaged in a trade or business within the U.S.[13] In *Spermacet* the Court found that the activities which were carried on within the U.S. on behalf of the taxpayer were simply ministerial and clerical in nature, and did not encompass the real business purpose of the

taxpayer (i.e., managing a whaling expedition).[14] In particular, the taxpayer engaged a broker to arrange for the discharge of oil when it was delivered in the U.S., engaged a lawyer to perform certain legal services on its behalf, and hired another individual to receive monthly statements and correspondence, and pay a limited number of obligations requiring payment in American dollars out of the taxpayer's bank account. Therefore, the taxpayer was not found to be engaged in a trade or business within the U.S.

Similarly, in *Linen Thread Co. v. Commissioner*, the Court held that the character of the activities of the U.S. office of the Scottish taxpayer company and the purpose for which that office was established were determinative of whether the Scottish company was engaged in trade or business within the U.S.[15] The Scottish company's real business was the sale in Scotland of manufactured goods and the collection of income from investments. The U.S. office was set up for collecting interest and dividends from American investments. Although two small sales transactions came through the U.S. office, the resident agent for the Scottish company in the U.S. office had no instructions to make sales and simply delivered parcels and collected payment on behalf of the Scottish company. Therefore, the Court held that the Scottish company was not engaged in trade or business through its U.S. office/agent.

Tax Foresight

Although the IRC, Treasury Regulations, and case law provide some guidance on determining whether a foreign person is engaging in a trade or business within the U.S. for federal income tax purposes, the guidance is vague, and uncertainty remains. Blue J Legal's "Nonresident Trade or Business" Classifier is specifically designed to predict how a court would characterize a foreign person's activities in the U.S. (i.e., engaged or not engaged in a U.S. trade or business) based on a particular fact scenario. Tax Foresight's Case Finder also allows users to browse cases dealing with this question and filter by facts, outcomes and factors.

Endnotes

1 Internal Revenue Code, 26 U.S.C. §§ 871-898.
2 Internal Revenue Code, 26 U.S.C. § 864(b)(1).
3 Internal Revenue Code, 26 U.S.C. §§ 864(b)(2)(A)(i), 864(b)(2)(B)(i), 864(b)(2)(C).
4 Internal Revenue Code, 26 U.S.C. §§ 864(b)(2)(A)(ii), §864(b)(2)(B)(ii).
5 26 C.F.R. § 1.864-2(e).
6 61 S. Ct. 475 (1941).
7 *Free-Pacheco v. United States*, No. 12-121T, (Fed. Cl., 2014); *Scottish Am. Inv. Co., Ltd v. Commissioner*, 12 T.C. 49 (T.C., 1949).
8 *Free-Pacheco v. United States*, No. 12-121T, (Fed. Cl., 2014).
9 *Free-Pacheco v. United States*, No. 12-121T, (Fed. Cl., 2014).
10 *Free-Pacheco v. United States*, No. 12-121T, 91 (Fed. Cl., 2014).
11 *Spermacet Whaling & Shipping Co. S/A v. Commissioner*, 30 T.C. 618, 634 (T.C., 1958), aff'd 281 F.2d 646 (6th Cir., 1960).
12 *Spermacet Whaling & Shipping Co. S/A v. Commissioner*, 30 T.C. 618, 634 (T.C., 1958), aff'd 281 F.2d 646 (6th Cir., 1960).
13 *Scottish Am. Inv. Co., Ltd v. Commissioner*, 12 T.C. 49 (T.C., 1949).
14 *Spermacet Whaling & Shipping Co. S/A v. Commissioner*, 30 T.C. 618, 633-634 (T.C., 1958), aff'd 281 F.2d 646 (6th Cir., 1960).
15 *Linen Thread Co. v Commissioner*, 14 T.C. 725 (T.C., 1950).