

Reproduced with permission from Tax Management International Journal, 45 TMIJ 625, 10/14/2016. Copyright © 2016 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

The Interplay Between Subpart F and the Effectively Connected Income Rules

By Lowell D. Yoder, Esq.
McDermott Will & Emery LLP
Chicago, Illinois

Subpart F income earned by a controlled foreign corporation (CFC) is included currently in the gross income of its U.S. shareholders.¹ Subpart F income includes certain insurance income, passive income, certain sales income, certain services income, and oil-related income.²

This commentary discusses an exclusion from Subpart F income that applies to U.S.-source income effectively connected with the conduct of a trade or business in the United States. It also describes an exception to the effectively connected income rules for foreign-source Subpart F income.

U.S.-Source ECI Exclusion from Subpart F

Section 952(b) provides that the definition of Subpart F income does not include any item of income from sources within the United States that is effectively connected with the conduct of a trade or busi-

¹ §951(a)(1)(A). In addition, the amount of certain investments in U.S. property held by a CFC is currently included in the gross income of its U.S. shareholders. §951(a)(1)(B), §956.

² §952, §953, §954. Only the net amount is included in the income of the U.S. shareholders. §954(b)(5).

ness within the United States.³ A CFC that derives such income generally would be subject to direct U.S. taxation on its net amount of effectively connected income.⁴

The existence of a U.S. trade or business generally requires “considerable, continuous and regular” profit-seeking activities (carried out directly or through agents).⁵ If a CFC is engaged in a trade or business in the United States, all of its U.S.-source business income generally is treated as effectively connected with its U.S. trade or business.⁶ This rule applies whether or not the income has any connection with the trade or business conducted in the United States, and thus is referred to as the “limited force of attraction” rule.⁷

U.S.-source passive income (e.g., dividends, interest, capital gains) is treated as effectively connected with a U.S. trade or business only if it arises from business assets located in the United States or is asso-

³ Reg. §1.952-1(b). See also §956(c)(2)(H) (exception to definition of U.S. property to the extent of earnings and profits excluded from Subpart F income under §952(b)).

⁴ §882(a). A 30% branch profits tax also applies to the dividend equivalent amount (analogous to a dividend withholding tax). §884(a).

⁵ See, e.g., *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940); *de Amodio v. Commissioner*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618, 634 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960); Rev. Rul. 88-3, 1988-1 C.B. 268. See also §864(b); Reg. §1.864-2.

⁶ §864(c)(3); Reg. §1.864-4(b).

⁷ The rule does not apply in situations in which a typical U.S. income tax treaty applies (as treaties require a fact-based attribution of business profits to a permanent establishment).

ciated with activities occurring in the United States.⁸ If not effectively connected with a U.S. trade or business, U.S.-source passive income generally is subject to a 30% withholding tax on the gross amount.⁹

As an illustration, income derived by a CFC from the performance of services within the United States generally is considered as U.S.-source income¹⁰ that is effectively connected with a U.S. trade or business,¹¹ and the net amount is subject to direct U.S. taxation.¹² Accordingly, even if such income fell within the definition of foreign base company services income, it would be excluded from the CFC's Subpart F income.

As another illustration, income from the sale of inventory to U.S. customers where title passes in the United States generally is U.S.-source income,¹³ and therefore would be effectively connected with any U.S. trade or business of the CFC. If title passes outside the United States, income from sales of inventory to U.S. customers nevertheless will be U.S.-source if the sale is attributable to an office or fixed place of business maintained by the CFC in the United States,¹⁴ and therefore such income will be effectively connected with the CFC's U.S. trade or business. U.S.-source effectively connected sales income would not be Subpart F income, even if it fell within the definition of foreign base company sales income.

⁸ §864(c)(2); Reg. §1.864-4(c). While gains from the sale of personal property derived by a CFC would ordinarily be foreign-source based on the CFC's residence, such gain generally is treated as U.S.-source if the CFC maintains an office or other fixed place of business in the United States and the income is attributable to such office or other fixed place of business. §865(a), §865(e). See also §897 (gain on the disposition of a United States real property interest is treated as effectively connected with the conduct of a trade or business in the United States).

⁹ §881(a). In situations in which treaty benefits are available, withholding tax may be reduced or eliminated.

¹⁰ §861(a)(3); Reg. §1.861-4.

¹¹ §864(b), §864(c)(3); Reg. §1.864-2(a), §1.864-4(b).

¹² A foreign corporation that derives services income only from foreign operations is not subject to U.S. taxation on that income, even if the services are performed for U.S. customers. §862(a)(3), §864(c)(4). See *Barclay & Co. v. Edwards*, 267 U.S. 442, 448 (1925); *Nat'l Paper & Type Co. v. Bowers*, 266 U.S. 373 (1924); *British Timken Ltd. v. Commissioner*, 12 T.C. 880 (1949); *Piedras Negras Broadcasting Co. v. Commissioner*, 43 B.T.A. 297 (1941), *nonacq.*, 1941-1 C.B. 18, *aff'd*, 127 F.2d 260 (5th Cir. 1942); Rev. Rul. 60-55, 1960-1 C.B. 270.

¹³ §861(a)(6), §862(a)(6), §865(b); Reg. §1.861-7(c) (income from the sale of inventory generally sourced based on where title and risk of loss pass); *Liggett Group, Inc. v. Commissioner*, 79 T.C.M. 1167 (1990). See also §863(b); Reg. §1.863-3(b) (generally 50% of the income from the sale of inventory manufactured by the taxpayer is sourced based on the place of manufacture).

¹⁴ §865(e)(2)(A). If the sale of inventory is instead to foreign customers, the resourcing rule will not apply if the foreign corporation has a foreign office that materially participated in the sale. §865(e)(2)(B).

The Subpart F exclusion does not apply to any U.S.-source effectively connected income that is exempt from taxation (or is subject to a reduced rate of taxation) pursuant to a treaty obligation of the United States.¹⁵ For example, if a CFC qualifies for the benefits of an income tax treaty, any U.S.-source income that is effectively connected with a U.S. trade or business solely by reason of the limited force of attraction rule would not be subject to U.S. taxation because the income would not be attributed to a U.S. permanent establishment. Therefore, such income would not qualify for the Subpart F exclusion for effectively connected income.

In addition, the IRS has ruled that this exclusion does not apply to income that would be treated as effectively connected income but for a statutory exemption. The IRS held that shipping income that was not effectively connected income by reason of the reciprocal shipping exemption under §883(a)(1) was includible in Subpart F income.¹⁶

U.S.-source passive income that is not effectively connected with the conduct of a trade or business within the United States does not qualify for this exclusion from Subpart F income, even if the income is subject to U.S. withholding tax.¹⁷ For example, U.S.-source interest income received by a CFC that is subject to a 30% withholding tax would also generally be Subpart F income.¹⁸

Foreign-Source Subpart F Income Exception to ECI

As a general rule, income earned by a foreign corporation from sources without the United States under general sourcing principles is not treated as effectively connected with the conduct of a trade or business within the United States.¹⁹ However, certain income that is foreign-source under general principles and is derived by a foreign corporation in the active conduct of a trade or business in the United States can be treated as effectively connected with a U.S. trade or business. This rule can apply to rents or royalties for the use of intangible property, for example, if such income is attributable to an office or other fixed place of business of the foreign corporation in the United States.²⁰

Section 864(c)(4)(D)(ii) provides that no income from sources without the United States shall be

¹⁵ Reg. §1.952-1(b)(2). For this purpose, a reduction under a treaty of the §884 branch profits tax is not taken into account.

¹⁶ Rev. Rul. 87-15, 1987-1 C.B. 248.

¹⁷ Reg. §1.952-1(b)(2).

¹⁸ §881(a), §1441(a).

¹⁹ §864(c)(4)(A); Reg. §1.864-5(a). Also, foreign-source passive income is not subject to U.S. withholding tax. §881(a).

²⁰ §864(c)(4)(B), §864(c)(5); Reg. §1.864-5(b).

treated as effectively connected with a trade or business within the United States if it is Subpart F income within the meaning of §952(a). This exception, however, does not apply to the extent an item falling within the general definition of Subpart F income qualifies for an exception.²¹

For example, a CFC may derive royalty income that is foreign-source income effectively connected with the conduct of a U.S. trade or business. If the royalty income is Subpart F income includible in the income of the U.S. shareholders, it will not be treated as effectively connected with the conduct of a U.S. trade or business, and therefore the CFC will not be subject to direct U.S. taxation on the royalty income. On the other hand, if such income qualifies for the active trade or business exception to Subpart F income, it would not qualify for the Subpart F exception to effectively connected income.²²

²¹ Reg. §1.864-5(d)(2).

²² Another exception provides that no income from sources

Summary

Subpart F income generally does not include U.S.-source income that is effectively connected with the conduct of a trade or business in the United States. This exception does not apply to other U.S.-source income nor does it apply to foreign-source income, even if such income is subject to U.S. taxation. Nevertheless, foreign-source Subpart F income generally is not subject to direct U.S. taxation as effectively connected with the conduct of a U.S. trade or business.

without the United States shall be treated as effectively connected with a U.S. trade or business within the United States if it consists of “dividends, interest, or royalties” paid by a foreign corporation in which the taxpayer owns (directly or constructively) more than 50% of the total combined voting power entitled to vote. §864(c)(4)(D)(i); Reg. §1.864-5(d)(1). For example, foreign-source royalties received by a CFC from a related CFC generally would not be considered as effectively connected with the conduct of a U.S. trade or business under this exception (and also generally would not be Subpart F income under the look-through rule of §954(c)(6)).