Taxing Foreign Corporations on U.S. Business Income

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This proposal recommends that engaging in business in the United States should be determined on the basis of the regularity of transactions both inside and outside the United States; that the source and doing business rules take into account a U.S. audience or customers; and that financial investments involving credit be treated as interest. Gain from derivative contracts would continue to be exempt (with exceptions): gain from portfolio stock by foreigners would also be exempt without regard to technicalities, but gain from takeovers of U.S. businesses would become taxable. This regime is intended to affect tax-haven investors rather than those who obtain treaty protection.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. This is the third in a series of Shelf Project international tax proposals by the author.


Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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The code taxes foreign corporations “engaged in trade or business within the United States” on their income from such business (U.S. business income) in much the same way as it taxes domestic corporations.1 Income considered derived from sources within the United States but not from a U.S. business (U.S. nonbusiness income) incurs U.S. tax of 30 percent on the gross amount or, in the case of some interest and gain from the sale of personal property, no tax at all.2

In three areas the law has become outdated, inconsistent, and confusing. Those areas are: what constitutes engaging in business in the United States, especially as signals replace the need for physical presence; the extent to which income from signals sent from outside the United States should be considered income derived from sources within the United States; and how to treat financial transactions with or involving U.S. companies. The discussion and recommendations primarily concern foreign entities incorporated in tax haven countries. In general, if they do not pay U.S. tax on their profits, they will pay little or none.3

Engaged in a U.S. Trade or Business: Current Law

1. Regularity and Continuity

Under the Supreme Court case of Groetzinger,4 whether a U.S. person is engaged in business at all depends on the facts and circumstances. In that decision, Groetzinger, a full-time gambler, was considered engaged in business because he pursued his activity “with continuity and regularity.” The decision rejected Justice Frankfurter’s formulation that carrying on business “involves holding one’s self out to others as engaged in the selling of goods or services.”5 A previous lower court decision (also involving a full-time gambler) had adopted Frankfurter’s test, noting that to say engaging in a trade

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1Section 882(b) incorporates section 11, which taxes the net income of corporations at rates of up to 35 percent. Sections 871(b) and 1 enact a similar regime for individuals, but the discussion focuses on foreign corporations incorporated in low-tax countries.

2See section 881(a) and (c); reg. section 1.1441-2(b)(2).

3Income tax conventions with other countries modify the code provisions — for example, by allowing taxation of a foreign corporation’s U.S. business income only if it is attributable to a fixed place of business, termed a “permanent establishment.” See article 7, U.S. model income tax convention. But those treaties are generally concluded with countries that have a substantial corporate tax, so that the provision is reciprocal. U.S. companies doing business in the foreign country without a fixed place of business there will pay U.S. rather than foreign tax, and foreign companies doing business here without a fixed place of business will pay foreign rather than U.S. tax.


5Deputy v. du Pont, 308 U.S. 488 (1940) (concurring opinion).
or business was a factual question nonetheless required determining what legal standard to apply to those facts.\textsuperscript{6} The test has been used to determine whether a foreign corporation otherwise engaged in business is engaged in business in the United States, taking into account only its U.S. activities:

   The meaning of the phrases ‘engaged is business’ ‘carrying on business’ and ‘doing business’ . . . convey the idea of progression, continuity, or sustained activity. . . . ‘Carrying on business’ does not mean the performance of a single disconnected business act.\textsuperscript{7}

   But the tests of whether someone is engaging in business at all and whether a corporation is engaged in business in the United States may not mesh. An obvious example involves athletic and artistic performance. If a foreign rock group gives a U.S. concert or an Argentine golfer wins the U.S. Open, the code will tax their profits as U.S. business income.\textsuperscript{8} The IRS has ruled (pre-Groetzinger) that entering a horse in one race here constitutes engaging in business in the United States.\textsuperscript{9}

   This is consistent both with implicit assumptions of internal law and with recent OECD treaty developments. For internal law, if members of an American law firm go up to Canada overnight to act on behalf of a client, their expenses in Canada would be deductible here as incurred in carrying on a trade or business.\textsuperscript{10} Under the recently revised OECD treaty, if a foreign law firm similarly came to the U.S. overnight, its income would be exempt from United States tax under the article relating to business profits.\textsuperscript{11}

   Under that standard, insurance or reinsurance of U.S. risks by an insurance company that insure elsewhere should likewise be considered engaging in business in the United States without regard to regularity or continuity. Moreover insurance requires a physical presence in the United States to evaluate claims. The fact that those evaluations may be done by independent agents that do not constitute a fixed place of business is relevant to whether a treaty precludes taxation under the code. It does not affect the issue of whether the code taxes source premiums and investment income as U.S. business income. Thus, companies insuring or reinsuring U.S. risks should be taxed on the premiums and related investment income as U.S. business income if they are engaged in significant insurance activities anywhere.

2. Physical Presence

   Because methods of doing business have changed from a “phalanx of drummers,” the Supreme Court decided that the Constitution gives a state (North Dakota) tax jurisdiction over an out-of-state corporation with no physical presence there. The out-of-state corporation did business in North Dakota by mailing in both its sales solicitations (catalogs) and products (office equipment).\textsuperscript{12} The result depended on the “mail-order house [being] engaged in continuous and widespread solicitation of business within” the state. That reasoning applies to taxing non-U.S. corporations that do business without a physical presence in this country, by sending in and receiving back signals. Those can take the form of sales solicitation, entertainment, gambling, and communications services, as well as furnishing information, content, and even credit.

   A question therefore arises as to whether the sending in of signals must be “continuous and widespread” to be taxed. This can be a matter both of source of income and proof of regularity. If income from an activity is considered to be from U.S. rather than foreign sources, this country’s ability to tax isolated U.S.-source transactions on a gross basis\textsuperscript{13} should allow their taxation on a net basis without proof of which tax haven company or server sent in the signals.

   As a corollary, the source as well as the doing business rules should be modernized. For broadcasting, a 65-year-old decision still apparently establishes that the physical place from which signals are sent determines source.\textsuperscript{14} In that case, a radio station broadcasting from a Mexican transmitter to a United States audience was held not to derive U.S. income, because the transmitter was located in Mexico. The majority considered the source rules to have developed with reference to physical location, and

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\textit{8Gajewski v. Commissioner, 723 F.2d 1062 (2d Cir. 1983).}
\textit{10In fact, article 17 of the U.S. model treaty allows the United States to tax their income despite the requirement of article 7 that business profits cannot be taxed unless attributable to a fixed place of business. See paragraph 10 of the commentary on article 17 of the OECD model convention. The United States does not apply a low gross rate to the income of athletes and other performers.}
\textit{11Rev. Rul. 58-63, 1958-1 C.B. 624. The foreign owner was not taxed because the horse was not considered to be a fixed place of business.}
\textit{12Section 162(a).}
\textit{13Article 14 of the OECD model convention, regarding independent personal services, was deleted as duplicative of article 7 (Business Profits), and the commentary states that profits are to be computed the same under both articles. See paragraph 1.1 of the commentary on article 5 of the OECD model. For performers and athletes not entitled to article 7 by reason of article 17, section 6013(g) was enacted in part to allow them to file joint returns on their U.S. business income.}
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in 1942 that made sense. A dissenting judge was concerned that the audience was in Texas, and that U.S. advertisers paid the station to reach that audience.

The growth of intangibles and electronic commerce has both diminished the importance of physical location and increased the difficulty of determining it. Where physical goods are made and delivered, as well as where physical labor is performed, can be easily identified. This becomes less so to the extent value is transferred electronically. Moreover, value itself has become less physical. It inheres more and more in information, data, entertainment, and the ability to communicate them. Thus, the importance of furnishing intangibles has increased while that of physical location has decreased. As a condition, the distinction between furnishing services and transferring property becomes less pronounced when property consists of cars or steel. Yet, if intangible property is transferred, the income is derived where the audience is; if a service is furnished, where the income is derived may still depend on where physical signals are sent.

Those disparate results should not rest on minute distinctions. Income derived from the sending of signals should be considered in significant part derived from where the audience is (and the audience may well interact by sending signals back). At the same time, where income from signals is derived might well give recognition to where the intangible property transferred or used to perform services was created.

3. Financial Transactions

Compensation for the use of money has been considered interest, although that has been less true of compensation for its forbearance: furnishing credit, in the form of loan commitments or guarantees, has sometimes been treated as performing a service. But like — and in part because of — advances in communication, financial transactions have evolved. Tax law (and business activity) initially contemplated loans, buying and selling stocks and bonds, and guarantees in the form of bank letters of credit. Now there are instruments that derive from, and often mimic, those transactions: credit and debit cards; interest rate, total return, and credit default swaps; and index funds, hedge funds, and private equity funds that acquire public companies.

For balance of payments and other commercial reasons, the United States has permitted tax haven corporate funds that acquire public companies. Tax haven corporations are often owned by foreign individuals resident in a high-tax country. That owner could generally avoid U.S. taxes on the gain by claiming a tax treaty but would have to pay tax to the country of residence.

Those issues largely go away if the Frankfurter concept of trade or business is adopted or if — even short of that — investing without having customers is not considered a business.20 Basically, gain from the sale of portfolio stock or securities would not be taxable to foreign persons. Income from derivative contracts, as now, would be generally exempt as under the current artificial source rules.21 It would be irrelevant whether U.S. persons were members of an investing partnership. By contrast, gain from the resale of acquired U.S. corporations would be taxable to foreign sellers as U.S. business income. The United States has little reason to encourage that activity.

Finally, the furnishing of money and of credit should be treated alike. There is no reason to treat the furnishing of credit in the form of a guarantee, a letter of credit, or a credit or debit card differently from the furnishing of money. Those activities should be considered business activities and sourced with reference to the residence of the borrower.

This last issue raises a question — recently discussed in a report by the New York City Bar23 — about the difference between purchased investments and loans. For reasons that probably arose out of bank regulatory concerns rather than those of tax, the code does not exempt from tax interest on loans made in the ordinary course of a banking business. The bar report makes significant distinctions between a bank’s purchase of syndicate loans.

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17The U.S. source rules as to use of intangibles do not defer to where the intangible was created, although the royalty source rule of where an intangible is used is generally nullified by treaty exemption from source country tax. See article 12 of the U.S. model and OECD model treaties. This will often give the same result as sourcing the income where the intangible was developed.

18Sections 864(b)(2) and 881(c). Tax haven corporations are often owned by foreign individuals resident in a high-tax country. That owner could generally avoid U.S. tax on the gain by claiming a tax treaty but would have to pay tax to the country of residence.

19One relates to permitted activities in the United States, such as soliciting investors; a second to section 875, since the U.S. investment adviser wanted a partnership profits interest; a third involves whether trading in securities includes activities such as lending, notional principal contracts, and corporate takeovers. The fourth results from the fact that if a corporation is otherwise engaged in business in the United States, section 864(b) becomes irrelevant.

20This would prevent disparities like that between U.S. citizens like the Rollers and a nonresident alien like Nubar. The Rollers were not given favorable expense deductions for trading in securities. By contrast, the profits of Nubar from trading in securities were treated as U.S. business income. But the Rollers traded more frequently than Nubar. Compare Moller v. United States, 721 F.2d 810 (Fed. Cir. 1983), with Commissioner v. Nubar, 185 F.2d 584 (4th Cir. 1950), both cited favorably in footnote 6 of Grootzinger.

21Reg. section 1.863-7.

22They would be exempted from U.S. tax under article 11 of most U.S. tax treaties.
under a prior or subsequent agreement. But U.S. banks themselves, to achieve combined foreign tax credit treatment for business and investment income, got Congress to:

acknowledge the practical difficulty of distinguishing passive income of a bank, insurance company, finance company or similar business — most all of the income of which arises from financial activity — from its active business income.24

To exempt passive income of U.S. banks from U.S. tax (by the foreign tax credit) on the grounds that it cannot be distinguished from active business income, and then to exempt passive income of tax-haven corporations from United States tax by ineffable distinctions within loans, lacks coherence. The exemption for portfolio interest should, in the case of a banking business, be limited to publicly traded securities.25

Recommendations

1. Engaged in Trade or Business

If a foreign corporation is engaged in business outside the United States, its activities there should be taken into account in determining whether a similar transaction constitutes engaging in business within the United States. This should not adversely affect foreign corporations entitled to the benefit of a tax treaty, whose business income is taxable only to the extent attributable to a fixed place of business.

Section 882(c) of the code denies deductions to a foreign corporation that is engaged in a U.S. business but that does not file a timely return. It should be clarified that later returns do not prevent this denial.

2. Source Rules

The location of the audience should be taken into account in determining the source of signals sent into the United States, and that activity should generally (to the extent of U.S. source) be taxable as U.S. business income under section 882.

3. Financial Transactions

Transactions involving the sale of portfolio stocks or securities by investors should be exempt from U.S. tax, regardless of whether U.S. investors — including the investment manager — are in the same or a cloned fund and regardless of where they were solicited.26 In this connection, the Frankfurter formulation of engaging in trade or business might be adopted.

Financial transactions involving the use or forbearance of money or credit would be treated as interest for source and character purposes. Transactions in notional principal contracts would be exempt to the same extent as under the current source rules. Investments that were intended to mimic dividends, however, such as equity index swaps, would be treated as dividends when the obligor was a U.S. person unless both parties to the transaction were foreign and the payer did not hold the stock.

Profits from takeovers of U.S. companies would become taxable to foreign persons as U.S. business income. Persons in the banking business would qualify for the portfolio interest exemption only in respect of publicly traded securities.

26The rules denying the section 864(b) exemption if investors were solicited in the U.S. were intended to prevent unwarranted competition by reason of a tax advantage for investing in foreign corporations. But the concept of passive foreign investment companies has eliminated that advantage.