

shall not be treated as income, gain, or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States, unless there is a direct economic relationship between his holding of the asset from which the income, gain, or loss results and his trade or business of performing the personal services.

(ii) *Wages, salaries, and pensions.* Wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses, received by a non-resident alien individual for performing personal services in the United States which, under paragraph (a) of §1.864-2, constitute engaging in a trade or business in the United States, and pensions and retirement pay attributable to such personal services, constitute income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if he is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

(7) *Effective date.* Paragraphs (c)(2) and (c)(6)(i) of this section are effective for taxable years beginning on or after June 6, 1996.

[T.D. 7216, 37 FR 23425, Nov. 3, 1972, as amended by T.D. 7332, 39 FR 44232, Dec. 23, 1974; T.D. 79-58, 49 FR 21052, May 18, 1984; T.D. 8657, 61 FR 9337, Mar. 8, 1996; T.D. 9226, 70 FR 57510, Oct. 3, 2005]

**§ 1.864-5 Foreign source income effectively connected with U.S. business.**

(a) *In general.* This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person from sources without the United States. The income, gain, or loss of such person for the taxable year from sources without the United States which is specified in paragraph (b) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, only if he also has in the United States at some time during the taxable year, but not necessarily at the time the income, gain,

or loss is realized, an office or other fixed place of business, as defined in §1.864-7, to which such income, gain, or loss is attributable in accordance with §1.864-6. The income of such person for the taxable year from sources without the United States which is specified in paragraph (c) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States when derived by a foreign corporation carrying on a life insurance business in the United States. Except as provided in paragraphs (b) and (c) of this section, no income, gain, or loss of a non-resident alien individual or a foreign corporation for the taxable year from sources without the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. Any income, gain, or loss described in paragraph (b) or (c) of this section which, if it were derived by the taxpayer from sources within the United States for the taxable year, would not be treated under §1.864-4 as effectively connected for the taxable year with the conduct of a trade or business in the United States shall not be treated under this section as effectively connected for the taxable year with the conduct of a trade or business in the United States.

(b) *Income other than income attributable to U.S. life insurance business.* Income, gain, or loss from sources without the United States other than income described in paragraph (c) of this section shall be taken into account pursuant to paragraph (a) of this section in applying §§1.864-6 and 1.864-7 only if it consists of—

(1) *Rents, royalties, or gains on sales of intangible property.* (i) Rents or royalties for the use of, or for the privilege of using, intangible personal property located outside the United States or from any interest in such property, including rents or royalties for the use, or for the privilege of using, outside the United States, patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like properties, if such rents or royalties are derived in the active conduct of the trade or business in the United States.

(ii) Gains or losses on the sale or exchange of intangible personal property located outside the United States or from any interest in such property, including gains or losses on the sale or exchange of the privilege of using, outside the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties, if such gains or losses are derived in the active conduct of the trade or business in the United States.

(iii) Whether or not such an item of income, gain, or loss is derived in the active conduct of a trade or business in the United States shall be determined from the facts and circumstances of each case. The frequency with which a nonresident alien individual or a foreign corporation enters into transactions of the type from which the income, gain, or loss is derived shall not of itself determine that the income, gain, or loss is derived in the active conduct of a trade or business.

(iv) This subparagraph shall not apply to rents or royalties for the use of, or for the privilege of using, real property or tangible personal property, or to gain or loss from the sale or exchange of such property.

(2) *Dividends or interest, or gains or loss from sales of stocks or securities*—(i) *In general.* Dividends or interests from any transaction, or gains or losses on the sale or exchange of stocks or securities, realized by (a) a nonresident alien individual or a foreign corporation in the active conduct of a banking, financing, or similar business in the United States or (b) a foreign corporation engaged in business in the United States whose principal business is trading in stocks or securities for its own account. Whether the taxpayer is engaged in the active conduct of a banking, financing, or similar business in the United States for purposes of this subparagraph shall be determined in accordance with the principles of paragraph (c)(5)(i) of § 1.864-4.

(ii) *Substitute payments.* For purposes of this paragraph (b)(2), a substitute interest payment (as defined in § 1.861-2(a)(7)) received by a foreign person subject to tax under this paragraph (b) pursuant to a securities lending transaction or a sale-repurchase transaction

(as defined in § 1.861-2(a)(7)) with respect to a security (as defined in § 1.864-6(b)(2)(ii)(c)) shall have the same character as interest income paid or accrued with respect to the terms of the transferred security. Similarly, for purposes of this paragraph (b)(2), a substitute dividend payment (as defined in § 1.861-3(a)(6)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in § 1.861-3(a)(6)) with respect to a stock shall have the same character as a distribution with respect to the transferred security. This paragraph (b)(2)(i) is applicable to payments made after November 13, 1997.

(iii) *Incidental investment activity.* This subparagraph shall not apply to income, gain, or loss realized by a nonresident alien individual or foreign corporation on stocks or securities held, sold, or exchanged in connection with incidental investment activities carried on by that person. Thus, a foreign corporation which is primarily a holding company owning significant percentages of the stocks or securities issued by other corporations shall not be treated under this subparagraph as a corporation the principal business of which is trading in stocks or securities for its own account, solely because it engages in sporadic purchases or sales of stocks or securities to adjust its portfolio. The application of this subdivision may be illustrated by the following example:

*Example.* F, a foreign corporation, owns voting stock in foreign corporations M, N, and P, its holdings in such corporations constituting 15, 20, and 100 percent, respectively, of all classes of their outstanding voting stock. Each of such stock holdings by F represents approximately 20 percent of its total assets. The remaining 40 percent of F's assets consist of other investments, 20 percent being invested in securities issued by foreign governments and in stocks and bonds issued by other corporations in which F does not own a significant percentage of their outstanding voting stock, and 20 percent being invested in bonds issued by N. None of the assets of F are held primarily for sale; but if the officers of that corporation were to decide that other investments would be preferable to its holding of such assets, F would sell the stocks and securities and reinvest the proceeds therefrom in other holdings. Any income, gain, or loss which F may derive from this investment activity is not

considered to be realized by a foreign corporation described in subdivision (i) of this subparagraph.

(3) *Sale of goods or merchandise through U.S. office.* (i) Income, gain, or loss from the sale of inventory items or of property held primarily for sale to customers in the ordinary course of business, as described in section 1221(1), where the sale is outside the United States but through the office or other fixed place of business which the non-resident alien or foreign corporation has in the United States, irrespective of the destination to which such property is sent for use, consumption, or disposition.

(ii) This subparagraph shall not apply to income, gain, or loss resulting from a sales contract entered into on or before February 24, 1966. See section 102(e)(1) of the Foreign Investors Tax Act of 1966 (80 Stat. 1547). Thus, for example, the sales office in the United States of a foreign corporation enters into negotiations for the sale of 500,000 industrial bearings which the corporation produces in a foreign country for consumption in the Western Hemisphere. These negotiations culminate in a binding agreement entered into on January 1, 1966. By its terms delivery under the contract is to be made over a period of 3 years beginning in March of 1966. Payment is due upon delivery. The income from sources without the United States resulting from this sale negotiated by the U.S. sales office of the foreign corporation shall not be taken into account under this subparagraph for any taxable year.

(iii) This subparagraph shall not apply to gains or losses on the sale or exchange of intangible personal property to which subparagraph (1) of this paragraph applies or of stocks or securities to which subparagraph (2) of this paragraph applies.

(c) *Income attributable to U.S. life insurance business.* (1) All of the income for the taxable year of a foreign corporation described in subparagraph (2) of this paragraph from sources without the United States, which is attributable to its U.S. life insurance business, shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation.

Thus, in determining its life insurance company taxable income from its U.S. business for purposes of section 802, the foreign corporation shall include all of its items of income from sources without the United States which would appropriately be taken into account in determining the life insurance company taxable income of a domestic corporation. The income to which this subparagraph applies shall be taken into account for purposes of paragraph (a) of this section without reference to §§ 1.864-6 and 1.864-7.

(2) A foreign corporation to which subparagraph (1) of this paragraph applies is a foreign corporation carrying on an insurance business in the United States during the taxable year which—

(i) Without taking into account its income not effectively connected for that year with the conduct of any trade or business in the United States, would qualify as a life insurance company under part I (section 801 and following) of subchapter L, chapter 1 of the Code, if it were a domestic corporation, and

(ii) By reason of section 842 is taxable under that part on its income which is effectively connected for that year with its conduct of any trade or business in the United States.

(d) *Excluded foreign source income.* Notwithstanding paragraphs (b) and (c) of this section, no income from sources without the United States shall be treated as effectively connected for any taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or a foreign corporation if the income consists of—

(1) *Dividends, interest, or royalties paid by a related foreign corporation.* Dividends, interest, or royalties paid by a foreign corporation in which the non-resident alien individual or the foreign corporation described in paragraph (a) of this section owns, within the meaning of section 958(a), or is considered as owning, by applying the ownership rules of section 958(b), at the time such items are paid more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(2) *Subpart F income of a controlled foreign corporation.* Any income of the foreign corporation described in paragraph (a) of this section which is subpart F income for the taxable year, as determined under section 952(a), even though part of the income is attributable to amounts which, if distributed by the foreign corporation, would be distributed with respect to its stock which is owned by shareholders who are not U.S. shareholders within the meaning of section 951(b). This subparagraph shall not apply to any income of the foreign corporation which is excluded in determining its subpart F income for the taxable year for purposes of section 952(a). Thus, for example, this subparagraph shall not apply to—

(i) Foreign base company shipping income which is excluded under section 954(b)(2),

(ii) Foreign base company income amounting to less than 10 percent (30 percent in the case of taxable years of foreign corporations ending before January 1, 1976) of gross income which by reason of section 954(b)(3)(A) does not become subpart F income for the taxable year,

(iii) Any income excluded from foreign base company income under section 954(b)(4), relating to exception for foreign corporations not availed of to reduce taxes,

(iv) Any income derived in the active conduct of a trade or business which is excluded under section 954(c)(3), or

(v) Any income received from related persons which is excluded under section 954(c)(4).

This subparagraph shall apply to the foreign corporation's entire subpart F income for the taxable year determined under section 952(a), even though no amount is included in the gross income of a U.S. shareholder under section 951(a) with respect to that subpart F income because of the minimum distribution provisions of section 963(a) or because of the reduction under section 970(a) with respect to an export trade corporation. This subparagraph shall apply only to a foreign corporation which is a controlled foreign corporation within the meaning of section 957 and the regulations thereunder. The application of this subparagraph may

be illustrated by the following examples:

*Example 1.* Controlled foreign corporation M, incorporated under the laws of foreign country X, is engaged in the business of purchasing and selling merchandise manufactured in foreign country Y by an unrelated person. M negotiates sales, through its sales office in the United States, of its merchandise for use outside of country X. These sales are made outside the United States, and the merchandise is sold for use outside the United States. No office maintained by M outside the United States participates materially in the sales made through its U.S. sales office. These activities constitute the only activities of M. During the taxable year M derives \$100,000 income from these sales made through its U.S. sales office, and all of such income is foreign base company sales income by reason of section 954(d)(2) and paragraph (b) of § 1.954-3. The entire \$100,000 is also subpart F income, determined under section 952(a). In addition, all of this income would, without reference to section 864(c)(4)(D)(ii) and this subparagraph, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by M. Through its entire taxable year 60 percent of the one class of stock of M is owned within the meaning of section 958(a) by U.S. shareholders, as defined in section 951(b), and 40 percent of its one class of stock is owned within the meaning of section 958(a) by persons who are not U.S. shareholders, as defined in section 951(b). Although only \$60,000 of the subpart F income of M for the taxable year is includible in the income of the U.S. shareholders under section 951(a), the entire subpart F income of \$100,000 constitutes income which, by reason of section 864(c)(4)(D)(ii) and this subparagraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by M.

*Example 2.* The facts are the same as in example 1 except that the foreign base company sales income amounts to \$150,000 determined in accordance with paragraph (d)(3)(i) of § 1.954-1, and that M also has gross income from sources without the United States of \$50,000 from sales, through its sales office in the United States, of merchandise for use in country X. These sales are made outside the United States. All of this income would, without reference to section 864(c)(4)(D)(ii) and this subparagraph, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by M. Since the foreign base company income of \$150,000 amounts to 75 percent of the entire gross income of \$200,000, determined as provided in paragraph (d)(3)(ii) of § 1.954-1, the entire \$200,000 constitutes foreign base company income under section

954(b)(3)(B). Assuming that M has no amounts to be taken into account under paragraphs (1), (2), (4), and (5) of section 954(b), the \$200,000 is also subpart F income, determined under section 952(a). This subpart F income of \$200,000 constitutes income which, by reason of section 864(c)(4)(D)(ii) and this subparagraph, is not effectively connected for the taxable year with the conduct of a trade or business in the United States by M.

(3) *Interest on certain deposits.* Interest which, by reason of section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before January 1, 1976) and paragraph (c) of § 1.864-4, is determined to be income from sources without the United States because it is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation.

[T.D. 7216, 37 FR 23429, Nov. 3, 1972, as amended by T.D. 7893, 48 FR 22507, May 19, 1983; T.D. 8735, 62 FR 53501, Oct. 14, 1997]

**§ 1.864-6 Income, gain, or loss attributable to an office or other fixed place of business in the United States.**

(a) *In general.* Income, gain, or loss from sources without the United States which is specified in paragraph (b) of § 1.864-5 and received by a nonresident alien individual or a foreign corporation engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States only if the income, gain, or loss is attributable under paragraphs (b) and (c) of this section to an office or other fixed place of business, as defined in § 1.864-7, which the taxpayer has in the United States at some time during the taxable year.

(b) *Material factor test*—(1) *In general.* For purposes of paragraph (a) of this section, income, gain, or loss is attributable to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States only if such office or other fixed place of business is a material factor in the realization of the

income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. For this purpose, the activities of the office or other fixed place of business shall not be considered to be a material factor in the realization of the income, gain, or loss unless they provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss. Thus, for example, meetings in the United States of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income, gain, or loss. It is not necessary that the activities of the office or other fixed place of business in the United States be a major factor in the realization of the income, gain, or loss. An office or other fixed place of business located in the United States at some time during a taxable year may be a material factor in the realization of an item of income, gain, or loss for that year even though the office or other fixed place of business is not present in the United States when the income, gain, or loss is realized.

(2) *Application of material factor test to specific classes of income.* For purposes of paragraph (a) of this section, an office or other fixed place of business which a nonresident alien individual or a foreign corporation, engaged in a trade or business in the United States at some time during the taxable year, had in the United States, shall be considered a material factor in the realization of income, gain, or loss consisting of—

(i) *Rents, royalties, or gains on sales of intangible property.* Rents, royalties, or gains or losses, from intangible personal property specified in paragraph (b)(1) of § 1.864-5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease, license, sale, or exchange from which such income, gain, or loss is derived or performs significant services incident to such lease, license, sale, or exchange. An office or other fixed place of business in the United States shall not be considered