



INTERNATIONAL TIDBIT:

Being Active When it Counts

When crossing national boundaries, there are numerous instances in which the term “active trade or business” is found, whether in the law (the Internal Revenue Code or IRC) or in double taxation treaties between the U.S. and other countries. This is quite apart from what distinguishes an active from a passive investment in the purely domestic context.

The main areas in which the term “active trade or business” is encountered within the realm of international tax revolve around the following operations or transactions. Each instance is covered by different sections of the law or treaties, often interpreted by case law and requiring careful consideration before concluding that commercial operations seeming to comprise an active business will be treated as such.

1. EXCEPTION FROM SUBPART F INCOME FOR RENTS AND ROYALTIES

Generally, U.S. shareholders of a controlled foreign corporation (“CFC”) are not taxed on the CFC’s earnings until distributed by the CFC as a dividend. However, if that CFC earns income such as rents and royalties, the resultant earnings may be taxable currently as foreign personal holding company income under IRC section 954(c)(1)(A) unless the CFC qualifies for an exception. One such exception is for rents and royalties earned in the active conduct of a trade or business and received from unrelated parties.

In the case of leasing, an exception is available in Treas. Reg. section 1.954-2(c) for leases with unrelated parties, offering several alternatives. One requires that the CFC must have manufactured (or acquired and added substantial value to) the property and be regularly engaged in those activities. A second applies to the leasing of real property and requires that the CFC regularly perform active and substantial management and operational functions through its own officers or staff of employees. A third alternative includes leasing of property in general. The property is considered leased as a result of the performance of marketing functions by the CFC lessor if, through its own officers or staff of employees located in a foreign country, it maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived. For purposes of qualifying for this last alternative, the Regulations covering the substantiality of the CFC’s activities provide safe harbors based on the amount of active leasing expenses as

a percentage of adjusted leasing profit. Certain amounts, such as payments to related parties, agents, or independent contractors, are excluded from the definition of active leasing expenses, making it difficult to meet the safe harbor if a CFC relies heavily on persons who are not its own employees to run its business. Similar concepts apply in the case of royalties earned by a CFC from unrelated parties, as found in Treas. Reg. section 1.954-2(d).

2. CLASSIFYING A FOREIGN CORPORATION AS A PASSIVE FOREIGN INVESTMENT COMPANY

A foreign corporation is a passive foreign investment company or PFIC within the meaning of IRC section 1297 if 75% or more of its gross income is passive or the average percentage of its assets held for the production of passive income is at least 50% in a taxable year. Passive income is defined as foreign personal holding company income within the meaning of IRC section 954(c), making the exceptions for rents and royalties earned in the active conduct of a trade or business (discussed in (1), above) equally important in the PFIC context. The shareholder of a PFIC (unless the foreign corporation is also a CFC and the shareholder owns at least 10% of voting power) is subject to rules whose impact is to eliminate the U.S. tax benefits of deferring income outside the U.S. in a foreign corporation.

3. EXCEPTION FROM OUTBOUND TOLL CHARGE FOR TRANSFERS OF PROPERTY

When U.S. persons transfer property to a foreign corporation in exchange for shares, such as in a section 351 transaction, IRC section 367(a) applies a general rule denying the transferor the nonrecognition treatment available in a purely domestic transaction. However, if the property will be used in the active conduct of a trade or business outside the U.S. by the transferee foreign corporation, nonrecognition treatment may still be available for transfers of property other than inventory, accounts receivable, foreign currency, intangible property, and property subject to a lease at the time of transfer.

Treas. Reg. section 1.367(a)-2T(b) provides that whether activities of a foreign corporation constitute a trade or business must be determined under all the facts and circumstances. A corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operations activities. Incidental activities are permitted to be carried out on the corporation's behalf by independent contractors without jeopardizing the characterization of the trade or business as active. The Regulations go on to provide that in the case of a trade or business producing rents or royalties, the active nature of the business is determined under principles of Treas. Reg. section 1.954-2(d)(1) but without having to satisfy the requirement that the rents or royalties are received from unrelated parties.

4. QUALIFYING UNDER THE LIMITATION ON BENEFITS CLAUSE OF A DOUBLE TAXATION TREATY

Since the 1980s, the U.S. Treasury has insisted on the inclusion of limitation on benefits ("LOB") provisions in double taxation treaties in order to prevent residents of nontreaty countries from obtaining benefits of a treaty by, for example, setting up a corporation in the treaty country and claiming reductions in withholding taxes on payments from the U.S. LOB articles are some of the lengthiest and most complex in U.S. double taxation treaties.

One of the ways for a foreign corporation to satisfy the conditions of an LOB article is for it to be engaged in an active trade or business in the treaty country where it is resident. Paragraph 3 of Article 22 of the U.S. Model Income Tax Convention of 2006 provides benefits to a corporation resident in a treaty country if the

resident is engaged in the active conduct of a trade or business in that country and the U.S. source income it earns is derived in connection with, or is incidental to, that trade or business. Specifically excepted from the concept of an active trade or business is the making or managing of investments for the resident's own account unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer. Therefore a foreign holding company, even if it owns subsidiaries in other countries and they are engaged in activities such as manufacturing and selling products, would not qualify for treaty benefits designed for companies engaged in an active trade or business in the treaty country. The Technical Explanation to the Model Convention indicates that reference should be made to the Treasury Regulations under IRC section 367(a) for defining "trade or business." Presumably this also applies for determining whether the trade or business is "active."

For a discussion of an active trade or business in the context of a "permanent establishment" created by a U.S. person in a foreign country with which the U.S. has a double taxation treaty, see [Could You Be an Accidental Taxpayer?](#)

5. INCOME EFFECTIVELY CONNECTED WITH A U.S. TRADE OR BUSINESS

Apart from the treaty context, a nonresident individual or foreign business enterprise will be subject to U.S. tax on income effectively connected with a U.S. trade or business within the meaning of IRC sections 872 and 882. While the Code does not define a trade or business, Treasury Regulations and case law require someone to be "engaged" in a trade or business in order for income effectively connected with it to be taxable. Being engaged in a trade or business appears to entail commercial functions analogous to conducting an "active" trade or business in other contexts. For example, cases have concluded that a foreign corporation or nonresident individual is engaged in a U.S. trade or business if carrying on activities in this country for the production of income and they are considerable, continuous, and regular. Ownership of real estate and merely collecting rents from it will not constitute engaging in a U.S. trade or business.

From the foregoing, it is evident that concepts seemingly as straightforward as what constitutes a trade or business, and whether it is active, involve different criteria depending on the context in which the terms appear and having significant ramifications for the tax position a person adopts.

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