

Effectively Connected Income

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I. INTRODUCTION

A score of years ago, the Congress brought forth in the Internal Revenue Code a new concept, conceived in international tax treaty precedent, and dedicated to the solution of two quite different problems. It is altogether fitting and proper to reexamine that concept now, even though its twenty years of existence has produced a paucity of precedent.

The Foreign Investors Tax Act of 1966¹ introduced the new concept: income "effectively connected with the conduct of a trade or business within the United States."² The single notion has two almost opposite purposes and effects. To understand them, it is helpful to discuss briefly the status of the pre-existing law—the backdrop against which the new ECI concept was drafted. After analyzing the 1966 definition, this article considers a few of the relevant amendments made by the Tax Reform Act of 1986,³ and suggests some further changes which seem desirable.

A. Historical Background

Prior to the FITA, the United States taxed foreign persons in two alternative patterns, depending upon whether they were "engaged in trade or business within the United States."⁴ A foreign person *not* so engaged was taxed only upon U.S.-source income of a limited class, referred to

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¹ Title I of Pub. L. No. 89-809, 80 Stat. 1539 (1966) [hereinafter FITA].

² I.R.C. § 864(c), added by FITA § 102(d)(2), 80 Stat. 1545-47 (1966) (amended 1986). This phrase—income which is "effectively connected with the conduct of a trade or business within the United States"—is abbreviated as "ECI" in this article both for the sake of brevity and to avoid the erroneous implication that the relevant income must have some relationship to the business being conducted.

³ Pub. L. No. 99-514, 100 Stat. 2085 (1986) [hereinafter the 1986 Act]. The 1986 Act not only amended § 864(c) itself—the principal residence of the ECI concept— but also made many other collateral changes which bear on the operation of the ECI taxing pattern. Some, but by no means all, of the latter amendments are touched on. In particular, the new branch-profits-tax provisions of § 884 and the new withholding rules of § 1446, although quite important in understanding how the U.S. taxes foreign persons doing business here, are outside the scope of this article. The new source rules for sales of personal property, in § 865, are mentioned briefly where relevant, but none should mistake the discussion for a careful analysis of that section.

⁴ It is outside the scope of this article to discuss the concept of engaging in trade