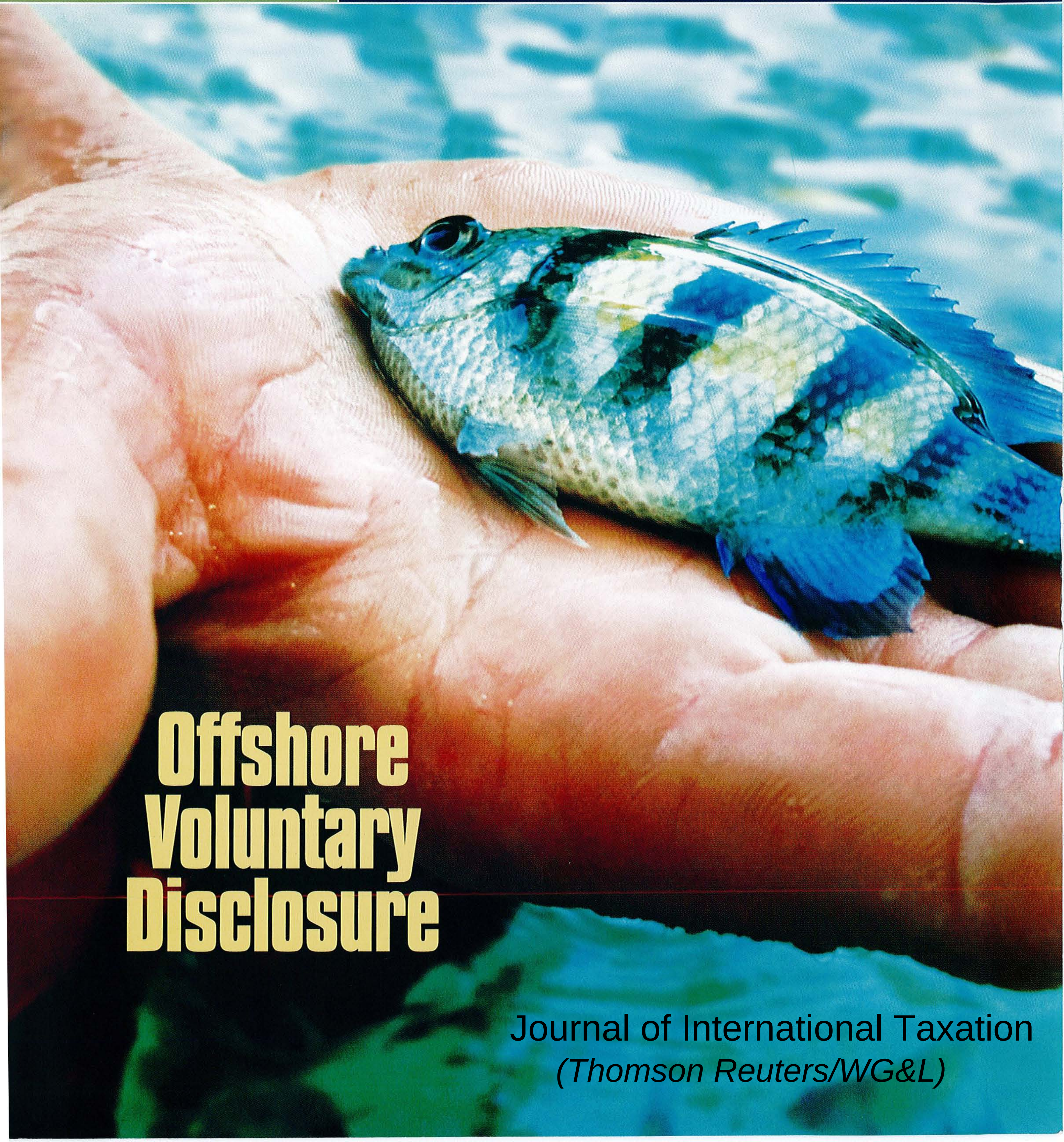
Foreign Person's U.S. Sales | Banks and Formulary Apportionment | Chile Treaty

JOURNAL OF

international taxation

May 2011



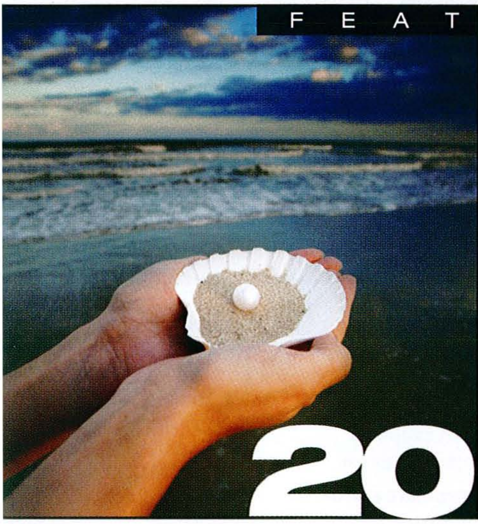
Offshore Voluntary Disclosure

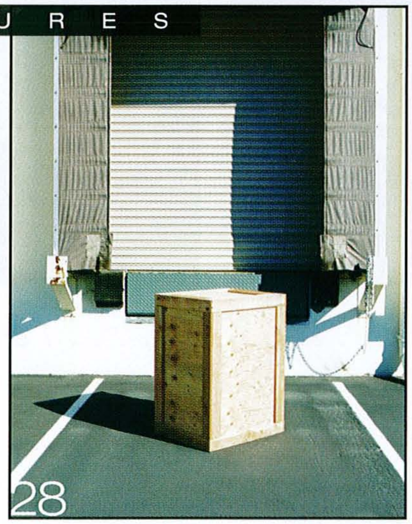
Journal of International Taxation
(Thomson Reuters/WG&L)

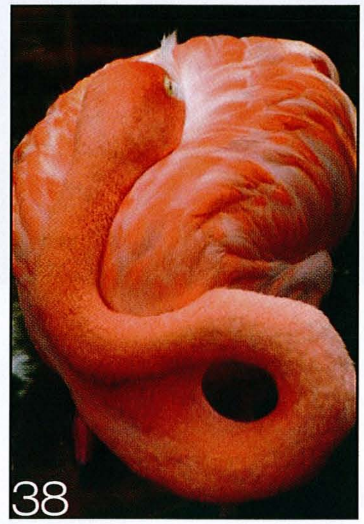
international taxation

MAY 2011 VOLUME 22 NUMBER 5

FEATURES







WG&L

(Part 1)

FOREIGN BUSINESSES, U.S. CUSTOMERS

Mark Merric
Professor Lu Zhian
Wang Jia Di

Mark Merric is special counsel working with Holme, Roberts & Owen LLP, one of Denver's largest law firms, in the areas of estate planning, international taxation and business transactions, and asset protection planning.

Professor Lu Zhian is an associate professor at Fudan University Law School in Shanghai and an attorney with the Pu Dong Law Office.

Wang Jia Di (Catherine Wang), from the People's Republic of China, received her Masters of Taxation from the University of Denver Graduate Tax Program in December of 2010.

REDUCING UNITED STATES INCOME TAX

A foreign person (i.e., nonresident alien) often begins doing business in the United States by selling goods directly, or through an importer, to a U.S. firm.[1] After a profitable relationship has been created, the foreign person (i.e., business) may then seek to expand sales to U.S. customers through an independent agent or distributor. Next, the foreign business may use a dependent agent, usually an employee, to sell goods in the United States. Finally, a foreign person may eventually open a U.S. sales office. For these sales methods, other than a U.S. sales office, a foreign business may be able to avoid U.S. income tax on the sale of goods. This and the next installment of this series of articles discuss how to design these transactions as a foreign business's U.S. sales activities evolve. (See Exhibit 1.)

Types of Foreign Persons Doing Business in the U.S.

A foreign entity may conduct business abroad as a sole proprietorship, foreign partnership (or other foreign flow-through entity), or foreign corporation. In mainland China, a partnership is a *he huo qi ye*; a closely held Chinese foreign corporation is a *fei shang shi gong si*; and a publicly traded Chinese corporation is referred to as a *shang shi gong si*. However, the form of a Chinese business is not relevant to the analysis of when it will be subject to U.S. income tax. Therefore, regardless of the form, for purposes of this article "foreign business" or "Chinese business" is used.

A foreign business may reside in a country that does or does not have an income tax treaty with the United States. For purposes of this article, the Chinese business is either resident in Shanghai or Hong Kong, because the People's Republic of China has a treaty with the United States while Hong Kong does not.[2] The U.S. income tax rules are more favorable for a business residing in a treaty country, so the distinction between a Shanghai business and a Hong Kong business is very important. (See Exhibit 2.)

Structures That Will Not Eliminate U.S. Income Taxation

If a Chinese business forms a U.S. partnership or U.S. corporation for its U.S. sales, these structures may be designed to minimize U.S. income tax but they will not eliminate it. Also, if a Chinese business directly opens[3] a U.S. sales office (i.e., a branch), the Chinese person will be subject to U.S. tax.

A U.S. corporation is taxed on its worldwide income. Often a foreign corporation creates a U.S. subsidiary to conduct its U.S. sales. The activities of the U.S. subsidiary are typically limited to U.S. sales, so that foreign income is not inadvertently taxed by the United States. This article does not discuss planning issues that arise when a foreign business creates a U.S. corporation, such as transfer pricing of goods, interest expense paid by a U.S. subsidiary to the foreign parent, or management fees charged by the foreign parent to the U.S. subsidiary. These planning tools reduce U.S. income tax but do not eliminate it.

Similarly, the creation of a U.S. partnership by a Chinese business will not eliminate U.S. tax. The partners of a U.S. partnership are taxed on worldwide income. Section 1446 requires that the U.S. partnership withhold quarterly on the foreign person's share of partnership ECI. The income tax must be withheld at the highest U.S. marginal tax rate unless the IRS agrees to a lower rate. The income tax is remitted quarterly to Treasury regardless of when the income is distributed. After year-end, the Chinese business files Form 1040-NR (U.S. Nonresident Alien Tax Return) or Form 1120-F (U.S. Income Tax Return of a Foreign Corporation), reporting its U.S. ECI, and the Chinese business is taxed on a net basis. To the extent that the amount withheld under Section 1446 exceeds the amount due on these forms, the Chinese business receives a refund.

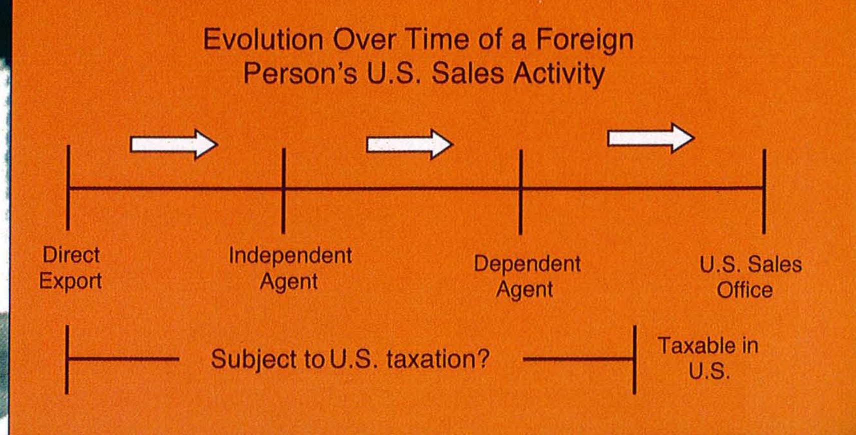


EXHIBIT 1
Sales Time Line

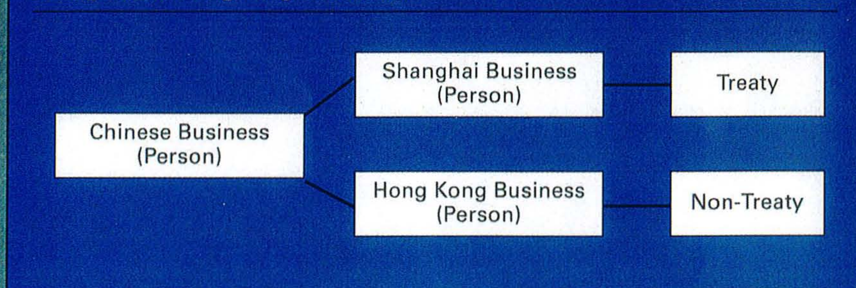


EXHIBIT 2
Shanghai and Hong Kong Businesses

Rather than forming a U.S. corporation or U.S. partnership to consummate sales in the United States, a Chinese business may open a U.S. branch.[4] In a treaty country, such as the People's Republic of China, the "permanent establishment" concept is used to determine the taxation of a U.S. branch. In a non-treaty country, such as Hong Kong, "fixed place of business" is used. Under the U.S.-China treaty (Article 5(2)), a permanent establishment is defined as a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.[5] The concept of a "fixed place of business" is very similar to a permanent establishment. In this discussion, the Chinese business pays U.S. income tax on a net basis on the U.S. branch operations. The Chinese business files Form 1040-NR if it is a Chinese sole proprietorship or Chinese partnership, or Form 1120-F if it is a Chinese corporation.

This discussion is limited to the level of U.S. tax when a Chinese business forms a U.S. corporation, U.S. partnership, or U.S. branch. The scope of this article does not include or discuss the second level of U.S. tax when a U.S. corporation repatriates a dividend to its foreign parent or the branch profits tax imposed when a foreign corporation conducts its activities through a foreign parent.

MARK MERRIC is special counsel working with Holme, Roberts & Owen, one of Denver's largest law firms in the areas of estate planning, international tax and business transactions, and asset protection planning. PROFESSOR LU ZHIAN is an associate professor at Fudan University Law School in Shanghai and an attorney in Pu Dong Law Office. WANG JIA DI (Catherine Wang), from the People's Republic of China, received her Masters in Taxation from the University of Denver in December 2010. *The authors thank John R. Wilson for his continuing help throughout the years in the area of international taxation, and his highly acclaimed international tax outline, without which this series of articles would not be possible.*

may want to have its own employees come to the United States and solicit sales directly from U.S. companies rather than relying on an independent agent. An employee is considered a dependent agent, and the most common type, but not the only type. If a Chinese business has control over the detailed operations of an agent or economically controls the agent's profit, the agent may be classified as a dependent agent for U.S. tax purposes.

This article discusses how U.S. income tax may be eliminated by using a direct export transaction, an independent agent, and, in certain circumstances, a dependent agent. This works so long as the Chinese business does not open a U.S. branch (e.g., a sales office).

Methods of Doing Business in the U.S. That May Not Result in U.S. Tax

This article focuses on situations where a foreign person's U.S. business has not yet evolved to the point that it is doing business through a U.S. corporation, U.S. partnership, or U.S. branch. In many of the following situations, where a foreign person's business activity has not risen to this level, the foreign person will not be subject to any U.S. tax:

1. A direct export transaction.
2. An independent agent transaction.
3. A dependent agent transaction.

A direct export transaction is when a Chinese business (i.e., person) sells goods by telephone, e-mail, or fax directly to a U.S. buyer.

Example. A Chinese manufacturer of refrigerators ("Chinese MFG") calls a U.S. national retailer ("U.S. Retailer") and solicits its business. Chinese MFG then ships sample refrigerators to U.S. Retailer. U.S. Retailer sends employees to Chinese MFG in China to review specifications. The entire sales transaction is consummated without Chinese MFG setting foot in the United States and without using the services of an independent or a dependent agent. For purposes of this article, this is a "direct export transaction."

As discussed below, this transaction may be designed to completely avoid any U.S. income tax. However, many U.S. purchasers may be reluctant to purchase goods over the phone directly from a foreign business so they will often buy the Chinese goods through a U.S. independent agent.

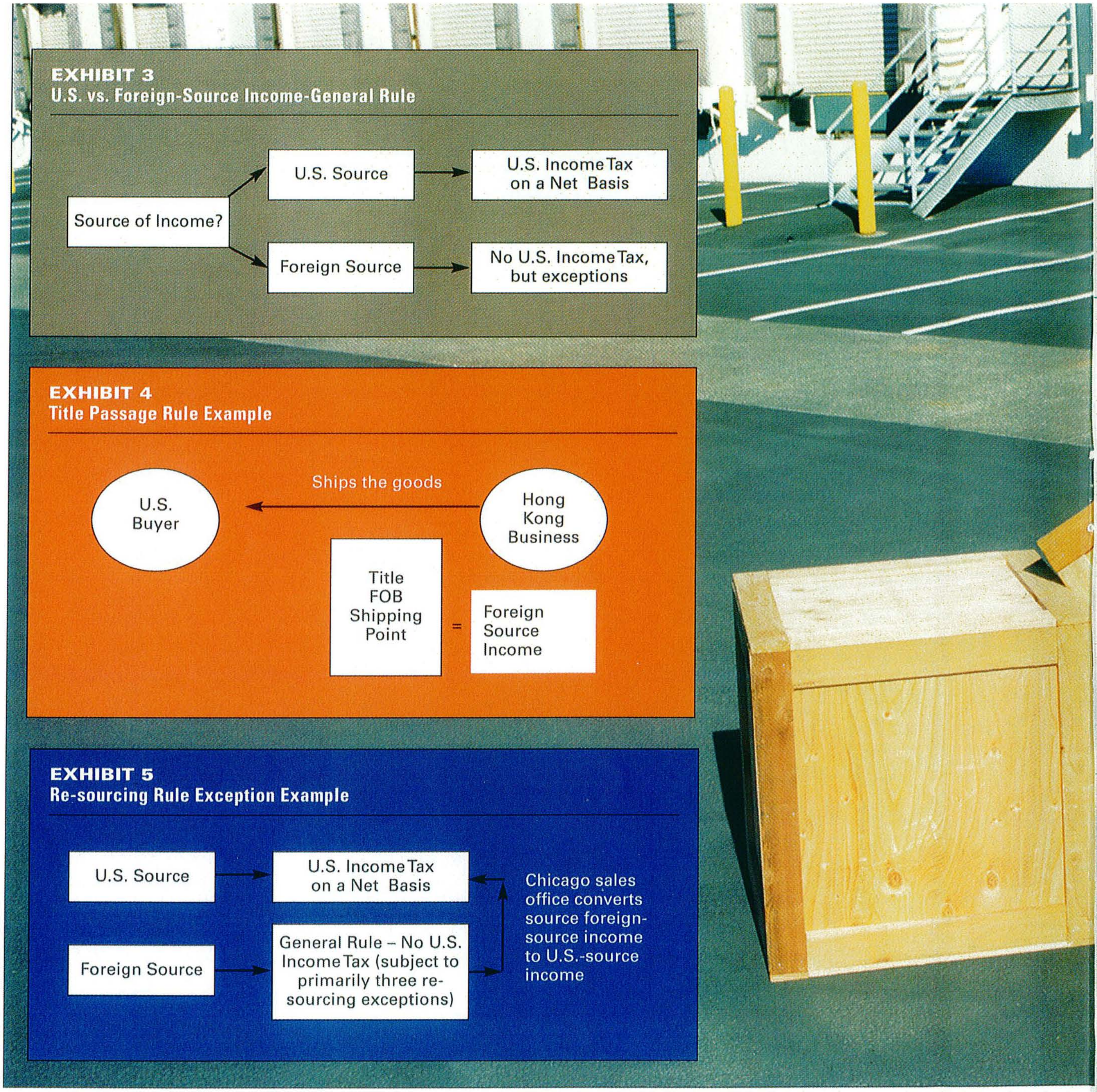
As the sales activity of the Chinese business increases in the United States, it

Treaty vs. Non-Treaty Analysis

The analysis of how to design a sale-of-goods transaction to avoid a U.S. branch depends on whether the Chinese business is from a treaty or non-treaty country. If a Hong Kong business sells goods to a U.S. person, there is no income tax treaty, and the Internal Revenue Code ("Code") and Treasury Regulations determine which activities rise to the level of creating a U.S. branch, and consequently U.S. taxation.[6] Conversely, if a Shanghai business sells goods to a U.S. person, the question whether there is U.S. tax depends primarily on treaty analysis.

Non-Treaty Analysis

If a Hong Kong business has more than isolated U.S. sales, it will be engaged in a U.S. trade or business.[7] However, whether the business will be subject to U.S. income tax depends primarily on whether it has U.S. or foreign-source income. If the Hong Kong business has U.S.-source income, it will be subject to U.S. income tax on its effectively connected income (ECI).[8] Conversely, if the Hong Kong business has foreign-source income, it generally will not be subject to any U.S. income tax unless one of the re-sourcing exceptions applies. (See Exhibit 3.) There are three major re-sourcing exceptions, one of which applies to the sale of goods when a Hong Kong entity opens a fixed place of business in the United States.[9]



Title Passage Rule

For the sale of goods, whether income is U.S.- or foreign-source depends on the title passage rule. If title to the goods passes from the Hong Kong business to the U.S. buyer in Hong Kong (i.e., FOB shipping point), the sales income is foreign-source. If the Hong Kong business does not have a fixed place of business in the United States (see the re-sourcing rule discussed below), the Hong Kong business is not subject to any U.S. income tax.

Conversely, if title to the goods passes to the U.S. buyer in the United States (FOB destination), how much of the income is U.S.-source depends on whether the Hong Kong business is selling inventoried or manufactured goods. For inventoried goods, the entire FOB destination transaction is U.S.-source income.[10] For manufactured goods, part of the sale will be foreign-source and part U.S.-source.[11]

The title passage rule offers an excellent planning opportunity for Hong Kong (i.e., foreign) businesses that export directly to a U.S. buyer without using any U.S. fixed place of business, independent agent, or dependent agent. As noted above, in a direct export transaction, the Hong Kong business contacts U.S. customers directly by phone, fax, or e-mail. The U.S. buyer places the order with either a Hong Kong distributor (inventoried sales) or a Hong Kong manufacturer. If the goods are sent FOB shipping point, title passes at the Hong Kong dock. All of the income is foreign-source income, not subject to any U.S. income tax. (See Exhibit 4.)

Re-sourcing Rule Exceptions

There are basically three re-sourcing rules that change foreign-source income to U.S.-source income.[12] One deals primarily with intellectual property-type sales, another relates mostly to banks or financial institutions, and the third encompasses the sale of goods and a U.S. fixed place of business.[13] Under the third exception, even if the transaction is a direct export transaction, if the Hong Kong business directly opens a U.S. fixed place of business, regardless of the title passage rule under FOB shipping point, the foreign-source income is resourced as U.S.-source income. This results in income tax on the Hong Kong business's U.S. ECI. A fixed place of business includes, but is not limited to, a factory; a store or other sales out-

let; a workshop; or a mine, quarry, or other place of extraction of natural resources.[14]

Example. The Hong Kong business arranged most of its sales to U.S. customers under the direct export method discussed above, but rented a Chicago office and staffed it with sales people who contacted customers and potential customers in the United States. Sales orders from these salespersons were e-mailed to the Hong Kong office and accepted in Hong Kong. Title to the goods also passed FOB Hong Kong. In this situation, not only the sales by the Chicago sales office but all of the U.S. sales would be reclassified as U.S.-source income. The Chicago sales office taints all sales transactions with the United States.[15] (See Exhibit 5.)

Independent Agent

While a direct export transaction is the safest way to avoid U.S. taxation, in most situations it is not a practical alternative for a Chinese business. Most Chinese businesses do not have a name brand in the United States. Further, many U.S. companies are reluctant to do business with a foreign company when they have never met a representative face to face. In this respect, many international sales transactions begin through the use of an independent agent. The Code defines an "independent agent" as "a broker, a general commission agent, or other agent acting in independent status in the ordinary course of his or her business."[16] While this provides some help in defining an independent agent, in this article, the following classification is used to differentiate the types of independent agents:

1. Importer or distributor.
2. General commission agent.
3. Consignment through an independent agent in the ordinary course of his business.

Importer or distributor. For purposes of this article, "importer" means a U.S. business that buys goods abroad taking title to the goods. The importer makes its profit when it resells them in the United States. In this respect, an "importer" is analogous to a "distributor," as commonly used in U.S. business transactions. Generally, a distributor buys goods on its own account from manufacturers and then resells them to a retail store or, possibly, an end-user.

The Code classifies an importer or distributor as an independent contractor. However, as long as the importer or distributor is buying on its own account and not unduly restricted by any agreement with a foreign principal (e.g., Hong Kong business), the transactions should be nothing more than direct export transactions, resulting in foreign-source income and no U.S.-source income. For example in Ltr. Rul. 7702043120D, the importer was not unduly restricted (i.e., controlled by the foreign business) when:

1. The importer could import other brands of beer from any but two prohibited countries.
2. The importer could sell the beer for any price, although it had to inform the foreign company of the sales price.
3. The foreign business granted a discount to the importer for advertising its product in the United States, but the importer was not required to advertise on behalf of the foreign person.
4. The foreign business supplied advertising materials to the importer.

The Service concluded that the importer was an independent agent for the following reasons:

1. The importer had total discretion in setting the selling price.
2. It imported and distributed other brands of beer.
3. Title passed to the importer on the purchase of the beer.
4. The importer could not execute contracts on behalf of the foreign person.

In most instances, the sale of goods by a Hong Kong business to a U.S. importer or distributor is analogous to a direct export transaction. If the title to the goods passes FOB shipping point, there will be no U.S.-source income.[17] In this respect, the use of a U.S. importer or distributor to buy and sell foreign goods is a viable option for a Chinese business beginning to sell goods in the United States.

General commission agent. Importers and distributors often do not want to purchase and inventory a foreign business's products and then resell them. In this situation, the foreign business may want to use a general commissioned agent. Such an agent does not take title to the foreign person's goods, but rather obtains contracts for the foreign person. The general commission agent receives a commission from the sales price of the foreign person's goods and will often have some flexibility in setting the price of the goods. However, there are minimum prices that the general agent cannot go below. In simple terminology, the Code definition of general commission agent is basically analogous to the layperson term of "manufacturer's representative."

An excellent example of a case detailing a general commission agent is *Estate of Cadwallader*, 13 TC 214 (1949), where the agent purchased lumber from a Philippines lumber company and was paid on a commission basis. The Tax

Court held that the following factors did not create U.S.-source income:

1. The corporation had no sales offices in the United States and did not solicit business in the United States.
2. Orders were procured by a New York general commission agent (i.e., an import-export brokerage firm).[18]
3. The orders were forwarded to the Philippine lumber company for acceptance or rejection.
4. It appeared that the terms of sale were FOB Philippines.[19]
5. Lumber was not shipped for future sale or consignment[20] or sold directly to the New York general commission agent.
6. Payment for the lumber was received by the New York general commission agent, who then deducted his expenses and commission.

In general, a Hong Kong business's use of a general commission agent does not result in U.S. tax so long as the agency agreement does not significantly control the agent's activities or restrict the agent's economic profit.

Another example regarding an independent general commission agent is Ltr. Rul. 8147001. While this ruling is not directly on point in that it deals with radio advertising time sold in the United States rather than the sale of goods, it does provide some insight into when a general commission agent is not considered a dependent agent. In the ruling, Y (U.S. agent) sold radio time from a foreign person. The foreign person was broadcasting into the United States from outside the country. Y received a commission and did not have an exclusive contract. Y had the discretion to sell the radio time for higher than the standard price and keep the difference. U.S. companies could buy the advertising time directly from the foreign person rather than through Y. The ruling concluded that these facts were distinguishable from Rev. Rul. 70-424, 1970-2 CB 150 (discussed below), since Y did not have an exclusive contract with the foreign person. The ruling stated that broadcasting income is sourced where the facilities are and, therefore, not subject to U.S. tax.

As long as the U.S. independent agent's contract with the principal (i.e.,

1 This series of articles is being published in both the U.S. and in mainland China. Therefore, while the U.S. income tax principles apply to any foreign business doing business in the United States, the article will frequently refer to the foreign business as a "Chinese business."

2 A Chinese person from Taiwan would work for purposes of this article as well because Taiwan also has a treaty with the United States. However, using the People's Republic of China provides a unique analysis between treaty and non-treaty nations because even though the PRC acquired Hong Kong in 1997, Hong Kong is treated as a non-treaty nation. Notice 97-40, 1997-2 CB 287.

3 "Directly opens" is distinguished from a dependent agent paying for a sales office, which is discussed later in this article.

4 A wholly owned U.S. LLC that is classified as a disregarded entity would also be classified as a branch.

5 See 2006 U.S. model income tax treaty, Art. 5(2).

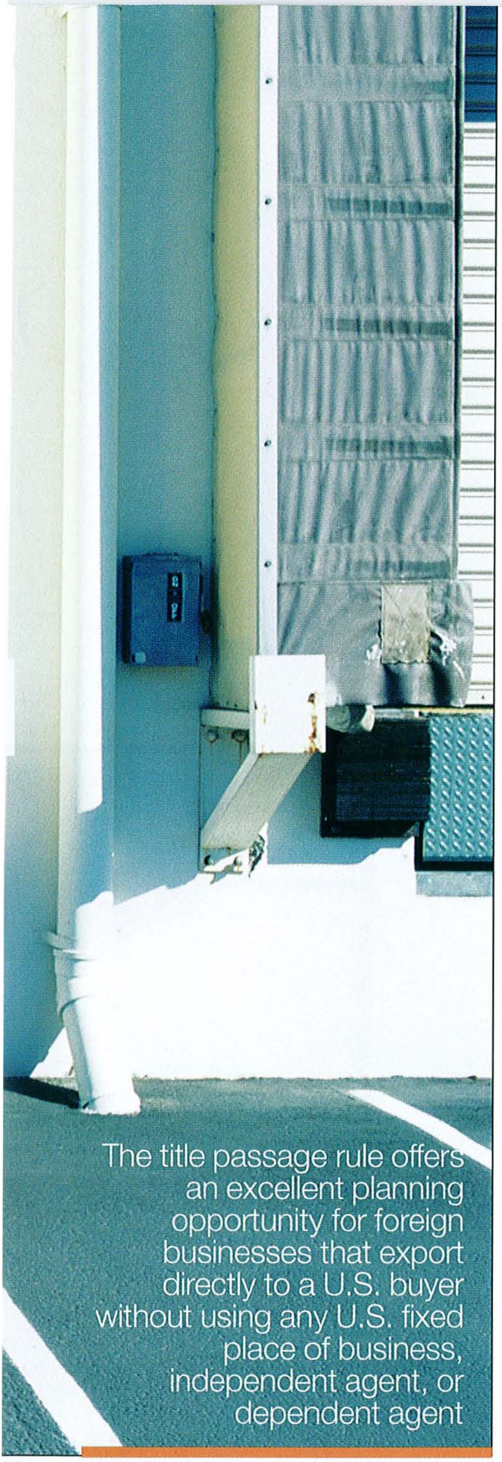
6 In general, Sections 861-865.

7 The amount of sales activity that constitutes a U.S. trade or business is a bit elusive. For example, in Lewenhaupt, 20 TC 151 (1953), the foreign person rented three commercial pieces of real estate through an agent, which was sufficient to constitute a trade or business. In Amodio, 34 TC 894 (1960) , the foreign person rented four U.S. residential properties in different states through different U.S. agents and this, among other facts, was sufficient to constitute a trade or business. Conversely, in Neill, 46 BTA 197 (1942), the foreign person inherited property that was leased for a long term to a tenant who was required to pay the taxes, insurance, and maintenance on the property. The single tenant, long lease, and responsibilities assumed by the tenant resulted in the Tax Court concluding that the foreign person's activities did not rise to the level of a trade or business. See also Spermacet Whaling & Shipping Co., 281 F.2d 646 (CA-6, 1960).

8 Sections 871(b), 882(a).

9 Sections 864(c)(4)(B), 865(e)(2).

10 For inventoried goods, Reg. 1.861-7 sources all income as U.S. or foreign based on the title



Hong Kong business) is not so controlling as to convert the U.S. independent agent into a dependent agent, the title passage rule will control. Again, if the sale is FOB shipping point (Hong Kong), there will be no U.S. tax. If it is FOB destination point (United States) and the sale is of inventoried goods, all will be U.S.-source. If the sale is of manufactured goods and is FOB destination point (United States), it will generally be partially U.S.-source and partially foreign-source.[21]

Conversely, if the principal (the Hong Kong business) strongly controls the independent agent's activities, as well as profit, the agent may be much more appropriately classified as a dependent agent. In Rev. Rul. 70-424, Treasury concluded without discussion that the following factors in combination resulted in a foreign person carrying on a trade or business in the United States subject to U.S. tax:

1. The U.S. agent was the sole agent for the sale of the foreign person's products.
2. The U.S. agent could not sell a competitor's product.
3. The U.S. agent could obtain contracts only subject to the foreign person's approval.
4. The U.S. agent guaranteed certain levels of sales.
5. If there was a loss, the foreign person agreed to share in the loss up to a certain amount.

Similar to Ltr. Rul. 8147001, the holding in Rev. Rul. 70-424 appears to be correct but the analysis weak. The Revenue Ruling does not give any weight to the above factors. Conversely, the Ruling implies that it is the "exclusivity" issue that carries the most weight. Further, as discussed in the next installment of this series, whether an exclusive contract is a fatal factor is highly questionable and probably not determinative.[22]

Consignment sale or storage of product in the U.S. In a consignment sale, the Hong Kong business delivers the goods to the independent agent or possibly a retail store, and retains title until the goods are purchased in the United States. When a U.S. agent sells a Hong Kong business's goods on consignment, it is uncertain whether the transaction results in U.S.-source income and, consequently, U.S. tax. There are at least three views on this subject:

1. Consignment is nothing more than application of the title passage rule.
2. The holding in *Handfield*, 23 TC 633 (1955), a treaty case discussed below.
3. The rule in Reg. 1.864-7(d)(3)(i).

The IRS might merely apply the title passage rule to the consignment sale, so that title passes when the U.S. independent agent sells the goods to the U.S. buyer in the United States. The result would be U.S.-source income, regardless of independent agent status. This view may be inferentially supported by *Handfield*. However, we are not aware of any case that discusses the title passage rule as applied to the sale of consigned goods by an independent agent in a *non-treaty* analysis. Further, as discussed below, Reg. 1.864-7(d)(3)(i) takes the opposite position.

Handfield (1955) can be distinguished from Reg. 1.864-7(d)(3)(i), issued in 1972. First, the Tax Court did not discuss the difference between an independent agent and a dependent agent. Rather, the court seemed to conclude that the income was U.S. source based on the three factors:

1. The goods were sold on consignment.
2. The principal, Handfield, controlled the selling price.
3. There was an exclusive contract.

Second, *Handfield* was decided under the U.S.-Canada tax treaty in 1955, and the distinction between independent and dependent agency was not relevant. This is because the treaty specifically stated that either "an employee or agent" that had a stock of merchandise from which to fill orders created a permanent establishment:

> When an enterprise of one of the contracting States carries on a business in the other contracting State through *an employee or agent* established there, who has general authority to contract for the principal or has a stock of merchandise from which he regularly fills orders which he receives, such enterprise shall be deemed to have a permanent establishment in the later State. [Emphasis added.]

In *Handfield*, once the Tax Court found that News Company was Handfield's agent, the treaty automatically resulted in taxation because News Company regularly filled orders on

passage rule. See also Ligget Group, Inc., TCM 1990-18.

11 Section 863(b)(2). Generally, there are two methods to source manufactured goods when the sale is part U.S.- and part foreign-source: (1) independent factory price (Reg. 1.863-3A); and (2) the 50/50 method (Reg. 1.863-3).

12 For an excellent flowchart of many of the nuances of ECI, see Rothman, "Gain From Sales as Effectively Connected Income—A Roadmap," 20 JOIT 30 (July 2009). This article is limited to a discussion of the sale of goods and so primarily uses a simplified three-step approach. For a more elaborate review of this approach see Wilson's flowchart, U. of Denver graduate tax outline (Winter 2010), International Taxation, App. A5.

13 Section 864(c)(4)(B)(i)-(iii). As discussed in Rothman, *id.*, in almost all situations, Section 865(e)(2) is broader and trumps Section 864(c)(4)(B)(iii) for the sale of goods. However, as related to the attribution of a fixed place of business, the Section 864(c)(5) rules are incorporated by reference in Section 865(e)(3).

14 Reg. 1.864-7(b).

behalf of Handfield. Conversely, modern treaties do not create a permanent establishment when an independent agent sells on consignment.[23] Further, in the non-treaty context, Reg. 1.864-7(d)(3)(i) specifically states:

> [A]n agent who, in pursuance of his usual trade or business, and for compensation, sells goods or merchandise *consigned or entrusted to his possession*, management, and control for that purpose by or for the owner of such goods or merchandise is an *independent agent.* [Emphasis added.]

In this respect, the reliance on consignment of goods as a determinative factor resulting in U.S. taxation in the non-treaty context appears to be misplaced. Rather, the additional factors in *Handfield*, such as the principal controlling the selling price and the exclusive nature of the contract, are more critical in determining whether an agent will be classified as an independent or dependent agent.

Third, as noted above, Reg. 1.864-7(d)(3)(i) specifically states that in a non-treaty analysis, an independent agent may sell goods on consignment without creating U.S.-source income (i.e., U.S. taxation). Further, an independent agent's office is not attributed to a foreign person. Reg. 1.864-7(d)(2) states:

> The office or other fixed place of business of an independent agent ... shall not be treated as the office or other fixed place of business of his principal who is a nonresident alien individual or a foreign corporation, *irrespective of whether such agent has authority to negotiate and conclude contracts in the name of his principal*, and regularly exercises that authority, or *maintains a stock of goods from which he regularly fills orders on behalf of his principal.* [Emphasis added.]

Therefore, the lynchpin question with an agent who sells consigned goods appears to be whether he is a dependent or an independent agent. If the agent is independent, the sale of consigned goods does not create U.S.-source income and the agent's office is not attributed to the foreign person. Further, a U.S. independent agent may conclude contracts on behalf of the principal.

Dependent Agent

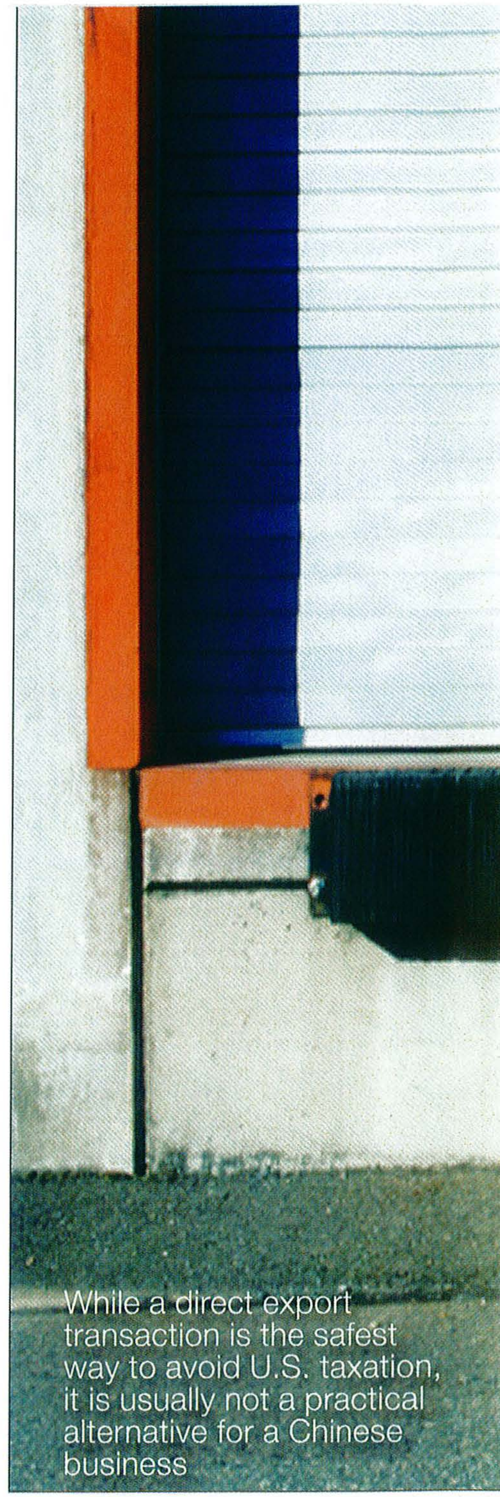
The most common example of a dependent agent is an employee. However, as noted above, if the foreign business exercises detailed control over an independent agent or significantly controls the agent's profits, the agent may also be classified as a dependent agent.[24] Determining when the use of a dependent agent results in U.S. taxation is even more confusing than when an independent agent sells goods on consignment. Part of the confusion is attributable to inconsistencies between Rev. Rul. 70-424 and both Section 864(c)(5)(A) and Reg. 1.864-7.

Rev. Rul. 70-424. Rev. Rul. 70-424 held that a foreign corporation's arrangement with a domestic corporation for the exclusive sales of its products within the United States was one of "ordinary principal and agent through which M carrie[d] on its activities in the United States and thus [was] engaged in a trade or business within the United States [and, therefore,] subject to the provision of section 882 [i.e., taxed as ECI]." The Ruling did not discuss either a dependent or an independent agent and was issued two years prior to Reg. 1.864-7(d)(1), but not prior to Section 864(c)(5)(A). As noted, the Ruling's conclusion that the arrangement was one of ordinary principal and agent was based on the following negative facts:

1. The foreign principal's products could only be sold exclusively by the U.S. agent.
2. The U.S. agent could not sell any competitor's products.
3. The U.S. agent could not take a financial interest in a competitor.
4. The foreign principal agreed to share equally with the U.S. agent in any loss up to a specified amount.

Conversely, in favor of not attributing the fixed place of business, the U.S. agent obtained contracts for the foreign principal but the principal was required to approve the contracts. Section 864(c)(5)(A) regarding the sale of goods states:

> [I]n determining whether a nonresident alien individual or foreign corporation has an office or other fixed place of business, an office or other fixed place of business of an agent shall be disregarded unless such agent (i) has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation and regularly exercises that authority or has a stock of merchandise from which he regularly fills orders on behalf of such individual or foreign corporation....



The foreign business in Rev. Rul. 70-424 specifically did not have the authority to conclude contracts. Therefore, even though the Ruling implied that the U.S. agent should have been reclassified as a dependent agent (i.e., was an "ordinary principal and agent"), this should not have required taxation under Sec-

tion 882. This is also the position of Reg. 1.864-7(d)(1). In this respect, it appears that whether a dependent agent would be attributed a fixed place of business depends on whether the agent had a stock of merchandise from which it regularly filled orders. Nothing in the fact pattern of Rev. Rul. 70-424 suggests that this was true. The Service's classification of the general commission agent as a dependent agent may well be correct, but the determination that sales were taxable as ECI under Section 882 appears to be incorrect. No fixed place of business would be attributed to a dependent agent unless the agent either (1) consummated contracts on behalf of the foreign business (which it did not); or (2) had a stock of merchandise from which it regularly filled orders.

The ultimate holding in Rev. Rul. 70-424 is even more perplexing when an employee's functions are compared with a dependent general commission agent. Using the above four criteria, only the first factor, that an employee may not have an exclusive territory in which he may sell the employer's product, may be different. On the other hand, it is quite common for companies to assign different sales employees different territories. Further, the following remaining three negative factors in the Revenue Ruling apply equally to employees:

1. Naturally an employee cannot sell any competitor's products.
2. An employee cannot take a financial interest in a competitor.
3. The foreign employer bears all risk of loss. In the Ruling, the facts were more favorable to the dependent general commission agent because the foreign business shared the risk of loss equally only up to a specified amount.

In addition, a foreign employer controls the detailed acts of its employees, as well as their wages. Also, a sales employee has much less profit potential than a dependent agent. In this respect, a foreign employer exercises far more control over an employee as to their operations, as well as economics, than a dependent general commission agent. However, Section 864(c)(5)(A), and Reg. 1.864-7(d), have specifically stated only two situa- *(Continued on page 62)*

15 Even if the sales were from a completely different type of operation, a fixed place of business taints the transaction. Reg. 1.864-4(b), Ex. 3, discusses how a foreign corporation sells two products, electronic equipment and wine. The wine sales are a direct export transaction with title to the goods passing FOB shipping point. The electronic products are sold through a U.S. sales office (fixed place of business). The electronic sales naturally are U.S. ECI but they taint the wine sales, making them also ECI subject to U.S. tax.

16 Section 864(c)(5)(A).

17 Ltr. Rul. 7702043120D. This also assumes that the Hong Kong company does not directly open a fixed place of business.

18 The case uses "import-export brokerage firm" to discuss the U.S. general commission agent. However, in this article, "import-export firm" has been limited to an importer that buys the goods on its own account. Hence, for purposes of this article, "import-export brokerage firm" in this case is more analogous to a general commission agent or manufacturer's representative.

19 While the case does not specifically state that the terms of the sale were FOB shipping point, it does say that the broker paid all freight and insurance expenses during shipment and delivery, as well as billing the customer.

20 As discussed below, it is unclear whether consignment by itself creates U.S.-source income or is a major factor resulting in an independent agent being classified as a dependent agent.

21 See note 11, *supra*.

22 In the treaty context with a permanent establishment, the OECD Committee on Fiscal Affairs notes to the 1977 OECD model treaty state that an exclusive contract is not by itself fatal to the finding of a dependent agent.

23 1996 and 2006 U.S. model income tax treaties, Arts. 5(4)(a) and (b).

24 Rev. Rul. 70-424, 1970-2 CB 150.

25 Reg. 1.864-7(e) and the example therein.

26 See note 23, *supra*.

Foreign Person's Sales in the U.S.

(Continued from page 37) tions where a dependent agent's fixed place of business should be attributed to the Hong Kong business.

Dependent agent's level of activity in the U.S. The language of Section 865(c)(5)(A) and Reg. 1.864-7 clearly implies that a Hong Kong business may have a dependent agent in the United States with some level of activity without creating a fixed place of business. The question is what level of activity?

Could a Hong Kong business send an employee to the United States to solicit sales, who would then rent his own office in his own name from the money that the Hong Kong business paid him? Several points need to be clarified. First, if the Hong Kong business directly leases an office or fixed place of business, it does not matter what the employee does. The re-sourcing rules under Section 864(c)(4)(B) apply due to the foreign person leasing the office, and the foreign person is taxable on the income.[25] However, in the above example, it is not the Hong Kong business directly leasing the office but the employee salesperson leasing it in his own name. Section 864(c)(4)(B) in combination with Reg. 1.864-7(d) seems to indicate that so long as a dependent agent does not have the ability to either conclude contracts or store goods, his activities should not be attributed to the foreign person, and the Hong Kong business would not have any ECI. In this respect, could the dependent agent merely fax or e-mail sales contracts to the foreign person for execution? In many instances, a well-run Hong Kong business may be able to approve a contract overnight and e-mail the approval or disapproval the next morning.

The Code and Regulations seem to support this interpretation. However, the Service might argue that it is a step transaction and that the Hong Kong business is really renting the U.S. office by providing the salesperson an inflated salary. Again, there appears to be no authority regarding the outcome of this proposed structure.

What if the dependent agent is a traveling salesperson with no rented office? Could the Service argue that the dependent agent's hotel room was really a fixed place of business? Some commentators have occasionally mentioned this as a possible concern. Since a hotel room is generally temporary by nature, it is probably not a fixed place of business. Unfortunately, there does not appear to be any authority regarding this issue, and the use of a dependent agent to sell goods in the United States remains unclear.

Orders cannot regularly be filled from a stock of merchandise. While it may be possible for an independent agent to fill orders from a stock of merchandise without creating U.S. taxation, Reg. 1.864-7(d)(1) specifically precludes a dependent agent from doing so. As will be discussed in the next installment of this series, this is a major difference between a treaty country and a non-treaty country. In a treaty country, the "use of facilities solely for the purpose of storage, display or delivery of goods" does not create a permanent establishment.[26] In a treaty analysis, if there is no permanent establishment, there is no taxation of the Hong Kong business.

Conclusion

The formation of a U.S. corporation or a U.S partnership by a foreign person will subject these entities to worldwide U.S. income tax. Also, directly opening a fixed place of business (e.g., a sales office) in the United States will subject a non-treaty country business to U.S. tax. However, there are many sales transactions that are not subject to U.S. income tax, provided that they are structured properly. The plain vanilla of these transactions is the direct export transaction, which should not result in U.S. tax.

Similarly, a Hong Kong business selling goods directly to a U.S. importer or U.S. distributor FOB Hong Kong should not incur any U.S. income tax because the sale is foreign-source income and the reclassification rule should not apply. This type of transaction is very similar to a direct export transaction. Conversely, when a general commission agent is used, the degree of control, as well the extent that the Hong Kong business restricts the general agent's economic profits, must be reviewed in detail.

Unfortunately, contracts vary widely regarding the restrictions and the amount of control that a foreign business will have over an independent agent that is paid a commission. In this respect, many independent agent contracts may be reclassified as dependent agent contracts by the Service. Classification as a dependent agent should not be fatal by itself, but there is little guidance in this area and the Service took an aggressive position in Rev. Rul. 70-424. Further, as discussed in a forthcoming installment of this series, the downside of being incorrect about whether an independent or dependent agent's activities result in U.S. income tax is fairly severe. In this respect, when foreign businesses move out of the plain-vanilla planning areas, it may be wise to seek a private letter ruling regarding the foreign business's specific fact pattern. ●