Foreign Business, U.S. Customers (Part 2) | Corporate Tax Reform and Firm Valuation

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FOREIGN BUSINESSES, U.S. CUSTOMERS

REDUCING UNITED STATES INCOME TAX

Using a Hong Kong person as an example, Part 1 of this series discussed how a foreign business might avoid U.S. federal income tax when selling goods in the United States, as long as it did not open a U.S. sales office or other fixed place of business. Since neither Hong Kong nor Taiwan has an income tax treaty with the United States, a Hong Kong business made a good example of an Internal Revenue Code-based analysis.[1] Conversely, mainland China (the People's Republic of China) does have a treaty with the United States. Therefore, a Shanghai business is used as an example in this installment of the series (see Exhibit 1).

Permanent Establishment

The effectively connected income analysis for a treaty country is much less complicated than the Internal Revenue Code (Code) analysis for a non-treaty country. The threshold question is whether the foreign person has a permanent establishment (PE). If so, the foreign person is taxed on business profits only to the extent that the income is attributable to the PE.[2]

Under modern treaties (defined below), there are two methods to establish that a foreign person has a PE in a foreign country (see Exhibit 2):

1. The foreign person has a fixed place of business in the foreign country under the principles of Articles 5(1) through 5(4).
2. The foreign business is *deemed* to have a PE if it has a dependent agent who habitually concludes contracts on behalf of the business.

For purposes of this article, "modern treaties" refer to both the OECD model treaties promulgated in 1963[3] and thereafter, and U.S. model treaties promulgated in 1981 and thereafter.[4] The standard design for most conventions prior to the modern treaties was based on the 1945 U.S-U.K. income tax treaty ("1945 U.S.-U.K. Treaty"). Treaties derived from the 1945 U.S.-U.K. Treaty generally apply

substantively different treatment regarding whether a warehouse created a PE, as discussed below.

Fixed Place of Business

A "PE" is defined in modern treaties as a "fixed place of business" where enterprise business is carried on, which is substantially the same definition as case law has interperted the Code. Article 5(2) of modern treaties gives further guidance by providing a non-exclusive list of PEs. While the list may vary slightly from one treaty country to another, the U.S.-China income tax treaty ("1984 U.S.-P.R.C. Treaty") provides the following non-exclusive list:

1. Place of management.
2. Branch.
3. Office.
4. Factory.
5. Workshop.
6. Mine, oil or gas well, quarry, or any other place of extraction of natural resources.

Similar to the Hong Kong example in Part 1 of this series, if the activities of a Shanghai business that sells goods in the United States rise to the level of opening a U.S. sales office,[5] it will constitute an office under Article 5(2)(b) or (c), and establish a PE. The sales office would not meet any of the following exceptions to a PE listed in Article 5(4).

1. Use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise.
2. Maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery.
3. Maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise.

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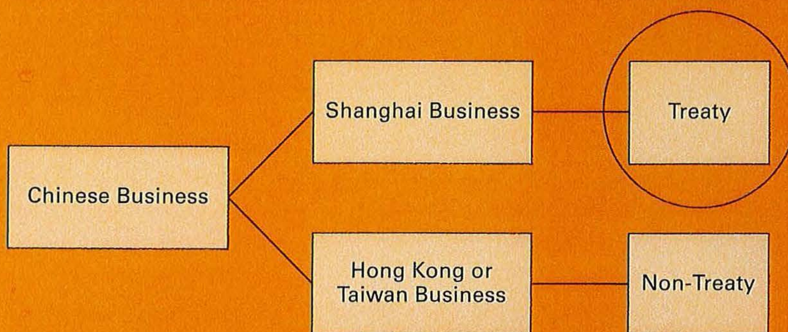
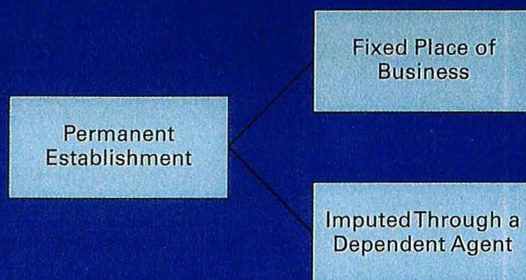
4. Maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise.
5. Maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other preparatory or auxiliary activity.
6. Maintenance of a fixed place of business solely for any combination of the activities in (1)-(5) above.

The exceptions in (1) and (2) above make it clear that goods may be stored in the United States and held for delivery without creating a PE. Exception (3) relates more to the manufacturing of a foreign person's goods and is not within the scope of this article. Exception (4) has two parts. First, it allows a branch to purchase goods without creating a fixed place of business. Second, it allows a foreign person to set up a fixed place of business to collect marketing information. Exception (5), among other things, provides that studies and research to determine an optimal location do not create a PE until one is actually opened. Exception (6) and a possible key difference of interpretation among modern treaties will be discussed in Part 3 of this series in a future issue of the *Journal*, along with Article 5(7), which does not attribute the activities of a subsidiary to a parent, and Article 7, which does not attribute activities of an unrelated branch.

No title passage rule. In a non-treaty analysis, the sourcing of income for goods generally depends on the title passage rule. If title passed from a Hong Kong company to a U.S. purchaser FOB shipping point (i.e., when the goods left Hong Kong), the income would be foreign-source. If title passed when the goods reached the U.S. company, FOB destination, the income would be U.S.-source. In





a non-treaty country, if the income is classified as U.S.-source income, it generally results in U.S. taxation.

In a treaty country, there is no title passage rule. Rather, as noted above, the threshold question is whether a foreign business has a PE. If so, it is taxed on the income attributable to the PE. This leads to the second prong of whether a foreign person has a PE—imputation through an agent.

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

Similar to Part 1 of this series, this part 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, a foreign business that has not risen to this level will not be subject to any U.S. tax:

1. Direct export transaction.
2. Independent agent transaction.
3. Dependent agent transaction.

Direct export transaction. For purposes of this article, a direct export transaction occurs when a Chinese business sells goods by telephone, e-mail, or fax directly to a U.S. buyer.

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

In a non-treaty transaction, passing title FOB Hong Kong was critical to not creating U.S.-source income and most likely U.S. income tax. However, as discussed above, there is no title passage rule in a treaty analysis. Since the Shanghai business has been defined as not using any independent or dependent agents and it has no fixed place of business in the United States, it does not have a PE and should not be subject to tax in the United States. It does not matter whether the goods are shipped FOB Shanghai (shipping point) or FOB U.S. (destination).

Independent/dependent agent. Many U.S. purchasers may be reluctant to purchase goods by phone directly from a foreign business, so they will often buy Chinese goods through a U.S. agent. If the Shanghai business has a dependent agent that habitually concludes contracts, it will be deemed to have a PE. Conversely, the activities of an independent agent will not create a PE for the Shanghai business. Article 5 of the 1984 P.R.C.-U.S. Treaty states:

> An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other Contracting State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph if it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions.[6]

This second sentence is directed toward a foreign principal that economically controls a U.S. agent. To be classified as an "independent agent," an agent must be:

1. Acting in the ordinary course of business.
2. Economically independent.
3. Legally independent.

The IRS generally finds summarily that an agent is acting in the ordinary course of his business.[7] Sometimes, however, an agent acts partially in the course

of his business and partially in the course of the principal's business. The OECD Commentary on Article 5 Concerning the Definition of Permanent Establishment, para. 38.7, provides that when a commission agent not only sells goods or merchandise of the enterprise in his own name but also "habitually" acts, in relation to the enterprise, as a permanent agent having authority to conclude contracts, he is deemed in respect to that particular activity to be a PE. Since an agent almost always acts in the ordinary course of business, whether he is independent will hinge on whether he is both economically and legally independent.

Neither the 1984 U.S.-P.R.C. Treaty nor its Technical Explanation use the words "economically" or "legally" independent. These terms were also not in the 1981 U.S. model treaty, on which the 1984 U.S.-P.R.C. Treaty was based. However, this language is in the Commentary to the OECD model treaty and the Treasury Technical Explanations of the 1996 and 2006 U.S. model treaties. So at first one might conclude that a Shanghai business would not be required to meet these definitions of being economically and legally independent.

However, an analysis of *Taisei Fire and Marine Insurance Co., Ltd.*, 104 TC 535 (1995), leads to the opposite conclusion—the courts most likely will read into the 1984 U.S.-P.R.C. Treaty the requirement that an independent agent be both legally and economically independent.[8] *Taisei* involved five Japanese insurance companies and the years under audit were 1986 through 1988. Therefore, the 1971 U.S.-Japan income tax treaty controlled. Similar to the Technical Explanation of the 1984 U.S.-P.R.C. Treaty, the 1971 U.S.-Japan treaty did not refer to "legal independence" or "economic independence." However, like most U.S. treaties, the letter of submittal from the President to the Senate for ratification of the treaty stated that the treaty followed policy and technical considerations of the 1963 OECD draft model. Therefore, the Tax Court imported the OECD Commentary on Article 5, para. 15, which stated:

> Persons who may be deemed to be permanent establishments must be strictly limited to those who are dependent, both from the *legal and economic points of view*....[9] [Emphasis added.]

As applied to a Shanghai business or almost any country with a U.S. treaty (except possibly Greece and Pakistan[10]), it can be expected that the Tax Court would look at the OECD Commentary for interpretation. This is helpful because many of the Revenue Rulings and private letter rulings, and some of the cases, in this area are less than a model of clarity.

Another source that is particularly helpful in defining an independent agent is FSA 973A (January 17, 1992), which lists 11 factors that the Service looks at in determining whether an agent is independent.[11] Some authors have condensed this list to four major categories, noting that some of these categories occasionally overlap the economic and legal prongs.[12] We agree that the factors of legal and economic independence sometimes overlap, but prefer to use a more detailed list similar to the one in the FSA, along with OECD comments and other authority, in a table (see Exhibit 3) that we developed and discuss below.

As in Part 1 of this series, independent agents are divided into three categories for discussion purposes.

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

Importer or distributor. As noted in Part 1, when an importer or distributor buys goods for its own account and then sells them at a profit, this is analogous to a direct export transaction. Unless the foreign business unduly restricts the importer's activities by contract,[13] the agreement does not create a dependent agent, and the sales transactions should not be subject to U.S. tax. For the importer or distributor, often all of the factors in the table (see Exhibit 3) will be checked "yes."

General commission agent. Importers and distributors frequently 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 commission agent, who does not take title to the foreign person's goods but rather solicits orders for the foreign person. The agent receives a commission from the sales price of the foreign person's goods and will often have flexibility in setting the price of the goods. However, there are minimum

EXHIBIT 3
Agent Independence Test—Manufacturer's Representative

	Yes	No
Economic Independence: OECD ¶ 38		
Profits: Control over the agent's revenue stream—FSA #5		
Services not provided wholly to one principal over time—FSA #6; OECD ¶ 38.6; 1996 & 2006 Model Tech. Expl.	■	
Does not prevent agent from acquiring new clients without approval—Rev. Rul. 70-424		■
Agent offers its services to the general public—FSA #7	■	
Agent may sell product at greater than standard sales price—PLR 8147001; PLR 7702043120D; *Handfield* Agent could not	■	
Agent is compensated at market rates—FSA #8	■	
Losses:		
Foreign enterprise does not reimburse agent for its ordinary and necessary expenses—FSA #9; Rev. Rul. 70-424	■	
Capital:		
Agent contributes a significant part of the materials and equipment to conduct its activities on behalf of the foreign business—FSA #10	■	
Agent makes long-term investments in the facilities and other resources used in its activities on behalf of the foreign enterprise—FSA #11	■	
Legal Independence:		
Agent not subject to detailed instructions—FSA # 1; OECD ¶38;	■	
Agent responsible for the results of work, not being controlled in how to do the work—OECD ¶38.3;	■	
When services of a third person are required, the principal does not reimburses the agent—FSA # 2	■	
Agent's operations are generally separate from principal—FSA #3	■	
Agent not required to submit regular reports to principal—FSA #4, but see OECD ¶38.5*	■	

* OECD Commentary, 2011, Art 5, ¶ 38.5 states that detailed reports are not a relevant factor unless the detail of the report is seeking approval from the principal for the manner in which the business is conducted.

prices that the agent cannot go below. For purposes of this discussion, the treaty definition of general commission agent may be analogous to the layperson definition of "manufacturer's representative."

Example. A manufacturer's representative sells office furniture products. Typically, the representative works with seven to ten different furniture manufacturers. However, one manufacturer may account for 25% to as high as 40% of an agent's revenue in any give year. All agency agreements provide that the agent has the exclusive territory of Colorado. Before becoming an agent, all manufacturers review any existing competitor products sold by the agent. If the manufacturer deems that a specific line competes directly with it, the agent will have to decide which manufacturer to represent. Any future competing lines that the agent acquires are subject to the manufacture's approval. The agency agreements are silent on whether an agent may take a financial interest in a competitor. The agent can sell the goods plus or minus about 10% of the suggested price, and is paid a commission of 7% on all sales. The manufacturer does not provide detailed instructions regarding the selling process.

To analyze whether an agent is independent, see Exhibit 3. "Yes" indicates a factor of independence and "No" a factor of dependence. If an item is indented, it is a sub-factor of the factor above it. For example, if services are provided wholly to only one principal, this would be a strong indication, but not an irrefutable presumption,[14] that the principal had a large degree of economic control over the agent. As a sub-factor, one principal may not control all of the agent's revenue, but a substantial percentage, as this factor with others may lead to the conclusion that the agent is a dependent agent. Also, as a sub-factor, when an agent offers its services to the general public, this indicates intent to be economically independent, even though currently the agent may have one or a few principals.

Economic independence. The degree of entrepreneurial risk that the agent assumes determines whether the agent is independent or dependent.[15] For simplicity, entrepreneurial risk might be grouped into three sub-categories: profits, losses, and investment capital. With respect to the profit sub-category, does the foreign principal control so much of an agent's revenue that the agent may be considered more like an employee? From the loss standpoint, does the foreign principal insure the agent from business losses? As related to the agent's business, did the agent provide the investment capital?

From the profit side of the equation, the OECD Commentary states: "Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time."[16] As noted above, Article 5 of the 1984 P.R.C.-U.S. Treaty phrases the issue slightly differently:

> However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph if it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions.[17]

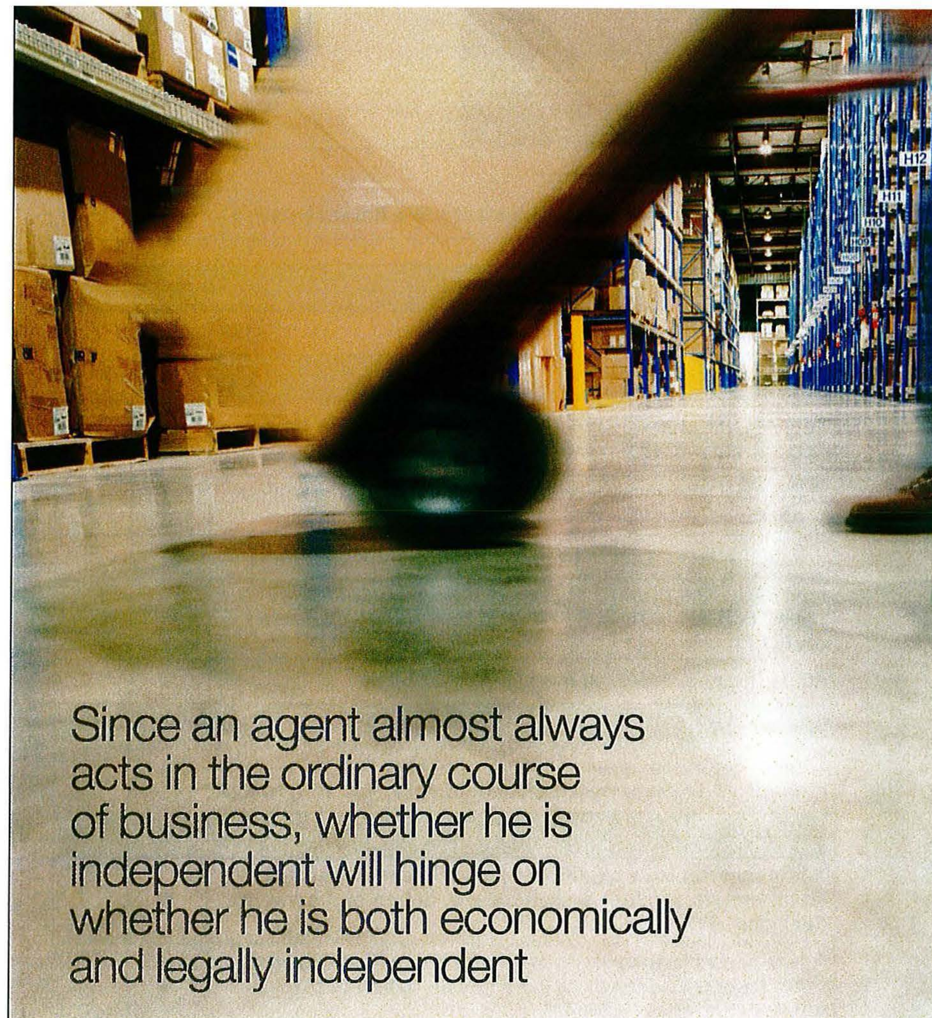
While an agent working only for one principal does not automatically fail the independent agent test, the terms of the agency agreement would need to be the

same that were offered to other independent agents in the industry. For example, manufacturer representatives in the furniture industry typically represent five to ten different manufacturers. If a representative chose to represent only one manufacturer, but the terms of the agreement were identical to those of others who represented five to ten manufacturers, the agent's activities should not automatically result in a finding of economic dependence.

At least one non-treaty Revenue Ruling, one private letter ruling, and possibly one case refer to an exclusive agreement as a negative factor.[18] Unfortunately, "exclusive contract" can have vastly different meanings. As noted above, almost all manufacture furniture representative contracts give an agent an exclusive sales territory to sell certain lines of their furniture. This type of an exclusive agreement has nothing to do with controlling the agent economically. Rather, such a contractual provision is a benefit to the agent that controls (i.e., prevents) the principal from using another agent to sell its goods.

In Rev. Rul. 70-424, 1970-2 CB 150, the Service found 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 and that the foreign corporation was engaged in trade or business in the United States. The agent's exclusive agreement was coupled with a provision that the agent could not sell the same kind of products *or any other products of any company* except with express permission from the foreign business. In this respect, "exclusive" meant that the foreign business controlled whether the agent could have any income other than from the foreign business.

Fortunately, the OECD Commentary, the Treasury Technical Explanations of the 1996 and 2006 U.S. models,[19] and FSA 973A all point to how much of the agent's revenue is controlled by the principal as the determinative factor, particularly when the principal controls almost all of the agent's revenue and shares in the agent's losses up to a specified level.[20] The concept of an independent agent is that the agent is in business for himself and bears the entrepreneurial risk of that business. An agency agreement that guarantees against loss and provides almost all income from one principal is more analogous to an employee arrangement, because employees generally share very little in the profits and rarely share in a loss of the employer.



If one manufacturer provides one-third of an agent's revenue, how significant a negative factor is this in finding economic dependence? Unfortunately, this has not been addressed by any authority of which the authors are aware. In the above furniture industry fact pattern, the agreement is an arms-length arrangement, so this should not be determinative in finding a dependent agency.

Another minor factor in determining whether an agent is independent economically is whether the agent can make a profit on the sale of the principal's goods or services. In the non-treaty context, Ltr. Rul. 8147001 noted that the agent's ability to sell the principal's goods above the standard price and retain the profit was a positive factor for showing independence. A furniture manufacturer representative typically has the ability to sell the goods for a higher price and retain a substantial part of the profits, while an employee seldom has the ability to mark up the goods.

1 Merric, Zhian, and Di, "Foreign Businesses, U.S. Customers—Reducing U.S. Income Tax (Part 1)," 22 JOIT 28 (May 2011). See Notice 97-40, 1997-2 CB 287.

2 Article 7(1) of the 2006, 1996, and 1981 U.S. model income tax treaties; 2010 OECD model income tax treaty; 1984 U.S.-China income tax treaty.

3 The first OECD model treaty draft was in 1963 and the first published model in 1977.

4 For many years, Treasury has issued Technical Explanations to various U.S. income tax treaties. However, it was not until 1996 that Treasury issued a "Model Convention and Technical Explanation." See Dorenberg and van Raad, *The 1996 U.S. Model Income Tax Convention: Analysis, Commentary and Comparison* (Kluwer Law, 1997).

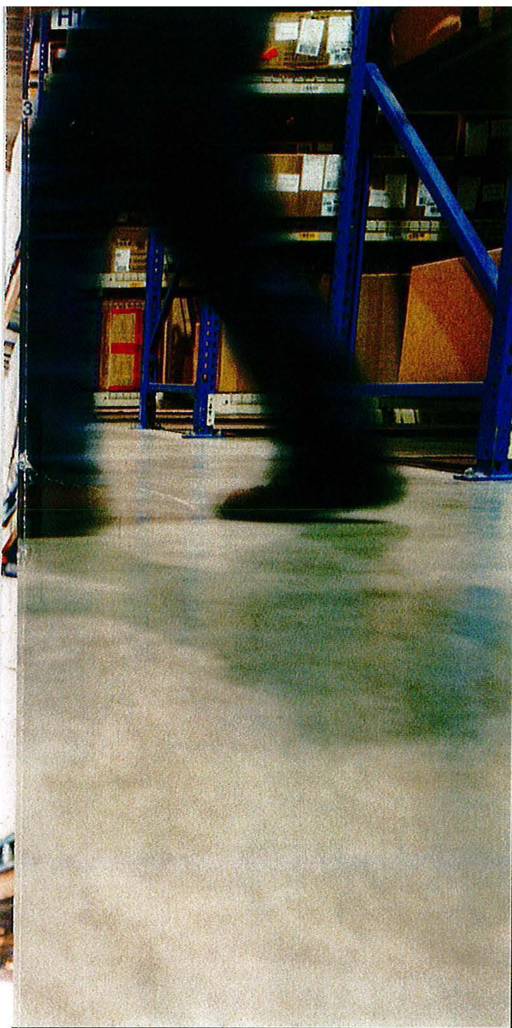
5 Rev. Rul. 62-31, 1962-1 CB 367; Rev. Rul. 65-262, 1965-2 CB 391.

6 The 1984 P.R.C.-U.S. Treaty Treasury Technical Explanation includes language that is substantially similar to the last sentence in Article 5 of the Treaty.

7 Tittle, "A Unified Approach to Permanent Establishment by Agent in the U.S.," in *Permanent Establishment in the United States: A View Through Article V of the U.S-Canada Tax Treaty* (Vandeplas Publishing, 2007), pages 22-24.

8 See Schwartz, "*TAISEI*: U.S. Agent Did Not Create Permanent Establishment," 6 JOIT 292 (July 1995).

9 The literal language of the 1963 Commentary seemed to require that the Service prove that an agent was both legally and economically



Further, if an employee has this ability, the percentage going to the employee is usually nominal.

Regarding the furniture manufacturer representative, agency contracts with at least seven different manufactures and the ability to sell at greater than the standard price are factors that favor classifying the agent as independent. Conversely, that one manufacturer controls one-third to 40% of the agent's revenue does not guarantee that the Service will not challenge the transaction.

Legal dependence. The OECD Commentary provides that "[w]here the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise."[21] Later, the Commentary states that "[a]n independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out."[22]

In summary, as applied to the furniture manufacturer representative in the example, there appears to be little support for the position that the representative is legally dependent. Even though in some years one principal controls up to 40% of the furniture manufacturer representative's income, the agreement is based on market rates. Therefore, without other significant economic dependence factors, this example indicates that the furniture manufacturer representative is economically independent.

Consignment sale or storage of product in the United States. For many, the first impression of a consignment arrangement is a manufacturer or distributor selling a small quantity of goods from a retail outlet. However, the analysis actually goes much deeper. Will a foreign business be subject to U.S. tax if a U.S. independent agent sells goods that are delivered from a warehouse? In Part 1 of this series, the analysis of this situation was not certain and leaned toward U.S. taxation.[23]

As for a treaty analysis, some Revenue Rulings provide guidance on how to structure a consignment sale transaction without incurring U.S. tax. However, on the direct question of whether an independent agent may sell goods for delivery from a warehouse, the analysis in the Revenue Rulings, private letter rulings, and some cases is less than adequate. In this respect, part of the confusion may well be a structural change in the definition of a PE in modern treaties when compared with the 1945 U.S.-U.K. Treaty. For this reason, the topic is discussed chronologically, first analyzing the Rulings and then *Handfield*, 23 TC 633(1955).

Rev. Rul. 56-594, 1956-2 CB 1126, dealt with the following facts:

1. A British manufacturer exported goods to the United States.
2. A U.S. commissioned agent solicited orders for the corporation, subject to the corporation's approval and acceptance in England; the agent had no authority to make contracts on behalf the British manufacturer.
3. A small stock of merchandise was consigned to a New York warehouse, to be used if customers were out of stock and wanted small orders, in which case the British manufacturer would instruct the warehouse to deliver the merchandise so sold and bill the American purchaser.
4. The U.S. commissioned agent had no authority to make contracts or withdraw merchandise from the N.Y. warehouse.

Article 2(l) of the 1945 U.S.-U.K. Treaty defined a "PE" as follow:

> The term "permanent establishment" means a branch office, factory, warehouse or other fixed place of business, but does not include the casual and temporary use of merely storage facilities, nor does it include an agency unless the agent has and exercises a general authority to negotiate and conclude contracts on behalf of an enterprise *or has a stock of merchandise from which he regularly fills on its behalf.* An enterprise of one of the contracting States shall not be deemed to have a permanent establishment in the other State merely because it carries on business dealings in such other State through a bona fide commission agent, broker, or custodian acting in the ordinary course of his business as such.

Based on the above facts and with little analysis, the Service determined that the U.S. commissioned agent did not create a PE. Since the U.S. agent could not withdraw goods from the warehouse, it can be assumed that he could not sell from it. In this respect, Rev. Rul. 56-594 is not directly on point with an agent selling goods from a warehouse or on consignment.

Rev. Rul. 63-113, 1963-1 CB 410, provides a better consignment fact pattern:

1. A Canadian manufacturer sent products to a U.S. company (agent) on consignment.
2. The Canadian manufacturer retained title to the goods until the moment before the sale to a U.S. customer by the U.S. company. At this time, title

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dependent to be classified as a dependent agent. However, the 1977 and subsequent OECD Commentaries clarified that if an agent was either legally or economically dependent, the agent would be classified as a dependent agent. The Tax Court agreed with the Service that "or" should be used in determining whether an agent should be classified as a dependent agent.

10 The current treaties with Greece and Pakistan were entered in 1950 and 1957, respectively. All other U.S. income tax treaties currently in effect were entered after 1970.

11 The 11 factors have not yet been published and are presently for internal IRS use only.

12 See Katz, Plambeck, and Ring, 908-2nd T.M. (BNA), *U.S. Income Taxation of Foreign Corporations*," pages A-110-112.

would pass from the Canadian manufacturer directly to the U.S. agent and then to the U.S. customer.

3. Even though title was in the name of the Canadian manufacturer until the time of sale, the U.S. company bore the risk of loss to the goods until sale in the event of fire, damage, destruction, theft, or loss. The U.S. company paid for the insurance on the goods with the loss-payable clause in favor of the Canadian manufacturer.
4. On request, the U.S. company furnished the Canadian manufacturer with an inventory of products held on consignment, but was not liable to account for the proceeds for the sale by the U.S. company.
5. The Canadian manufacturer had the right to recall any consigned products prior to their purchase by the U.S. company and immediate sale to a U.S. customer.
6. The 1942 U.S.-Canadian tax treaty was substantially similar to the 1945 U.S.-U.K. Treaty.

The Service ruled that it was doubtful that a limited agency was created and certain that no general agency was created. In fact, the Service commented that "the relationship between the corporation [Canadian manufacturer] and the [U.S.] Company is more in the nature of seller and purchaser." The Ruling pointed out that this type of arrangement may not even be classified as an agency-type transaction at all. In other words, except that title had not passed to the U.S. company, the Service implied that this type of an arrangement was more analogous to a distributor or importer arrangement. The Service also concluded:

> Further, while the corporation [Canadian manufacturer] has a "stock of merchandise" in the United States, it has no employee or agent in the United States from which stock of merchandise it "regularly fills orders" which it receives.

Rev. Rul. 76-322, 1976-2 CB 487, which was based on the 1956 U.S.-Australia income tax treaty, involved substantially similar facts except that the Australian parent was selling to its U.S. subsidiary on a consignment basis. The Service held that the U.S. subsidiary would not be deemed a PE of the Australian parent. Therefore, the Australian parent was not subject to U.S. tax on its sales to its U.S. subsidiary. The same was true in Ltr. Rul. 7816031, where a Canadian parent sold goods on consignment to one of its U.S. subsidiaries.

With three Revenue Rulings and a private letter ruling directly on point, the planning technique developed of a "consignment sales arrangement," sometimes referred to as a "limited risk buy-sell arrangement."[24] With this structure, the parent company creates a distributor in a low-tax foreign jurisdiction. The distributor purchases goods from third parties and then sells them to a U.S. subsidiary using a consignment arrangement, as described above. The result is that profit is moved from the higher-tax jurisdiction, the United States, to the distributor's lower-tax jurisdiction.

Consignment arrangements that did not work. The consignment sales arrangement requires that title pass to the agent immediately prior to the sale and that the U.S. agent bears the economic risk of loss while the goods were held on consignment.

Change the facts so that the agent does not bear the risk of loss on the goods while they are in the United States. Instead, the foreign business holds title and the risk of loss while the goods are stored in a warehouse and title transfers directly from the foreign business to the U.S. customer. Along these lines, the facts in Ltr. Rul. 6510289940A were as follows:

1. A foreign business had a U.S. subsidiary.
2. The foreign business shipped goods to the United States and stored them in a U.S. public warehouse.
3. Title to the goods remained in the name of the foreign business, which paid the warehouse and insurance costs.
4. The U.S. subsidiary sold goods to U.S. customers and the orders were filled from the warehouse.

While the letter ruling did not state the treaty country, from the language quoted it appears that it could have been the 1951 U.S.-Switzerland or 1948 U.S.-Denmark income tax treaty. Article II(1)(c) of both treaties stated:

> The term "permanent establishment" means a branch, office, factory, workshop, warehouse or other fixed place of business, but does not include the casual and temporary use of merely storage facilities, nor does it include an agency unless the agent has and habitually exercises a general authority to negotiate and conclude contracts on behalf of an enterprise or has a stock of merchandise from which he regularly fills orders on its behalf. An

[13] In a non-treaty analysis, Ltr. Rul. 7702043120D provides an importer analysis that did not overly restrict an importer's activities and change the importer's status to that of a dependent agent.

[14] The 2006 and 1996 U.S. model Treasury Technical Explanations note as an example that an agent's ability to diversify and acquire other clients without substantial modification to its current business could mitigate this factor.

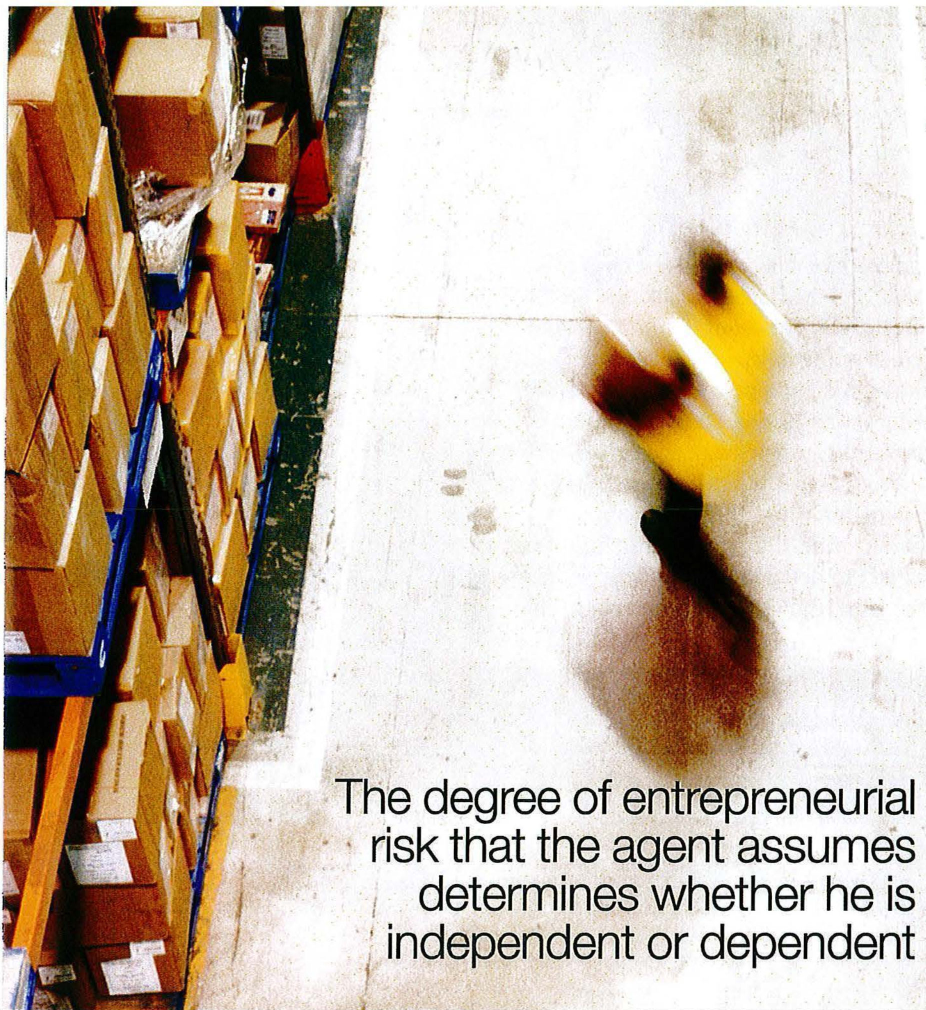
[15] OECD Commentary on Article 5 Concerning the Definition of Permanent Establishment, para. 38.

[16] *Id.* para. 38.6.

[17] See note 6, *supra.*

[18] Rev. Rul. 70-424, 1970-2 CB 150; Ltr. Rul. 8147001; Handfield, 23 TC 633 (1955).

[19] When discussing an "exclusive relationship with a principal," the 2006 and 1996 U.S. model Treasury Technical Explanations both note that "[t]he limited scope of an agent's activities and the agent's dependence on a single



> enterprise of one of the contracting States shall not be deemed to have a permanent establishment in the other State merely because it carries on business dealings in such other State through a commission agent, broker or custodian or other independent agent acting in the ordinary course of his business as such.

Similar to the 1945 U.S.-U.K. Treaty and its derivatives, the language above is not a model of clarity. If an enterprise carries on business dealings through an independent agent, does the second sentence trump the first? If so, it would not matter if an independent agent was selling goods from the foreign business's U.S. warehouse. The clause "or has a stock of merchandise from which he regularly fills orders on its behalf" would be interpreted to apply only to a dependent agent. Conversely, if the first sentence is to apply to all agents, any agent (dependent or independent) selling goods from the foreign business's U.S. warehouse would result in a PE.[25]

Finding in the letter ruling that the U.S. subsidiary resulted in a PE, the Service distinguished the facts of Rev. Rul. 63-113 from those in the letter ruling:

1. The foreign business was an unrelated party, not a U.S. subsidiary.
2. In Rev. Rul. 63-113, the U.S. agent's purchase of the goods from the foreign business took place immediately prior to the sale to the U.S. customers.
3. While there was a stock of merchandise in the United States, no employee or agent in the U.S. regularly filled orders from it.

There are three possible interpretations of why the Service held that these facts resulted in a PE. One is that the subsidiary's activities, including its fixed place of business, were imputed to the parent, despite the general treaty rule that this should not happen.[26] This rare situation will be discussed in detail in Part 3 of this series.

The second interpretation is that the Service classified the subsidiary as a dependent agent. The second sentence results in a permanent establishment dependent agent classification because under this interpretation, the dependent agent sold goods from a warehouse. Support for this position may be based on the letter ruling's conclusion that the above three facts "dissipate the independent agency doctrine which to a great extent formed the basis [of Rev. Rul. 63-113]."

The third interpretation is that under the 1945 U.S.-U.K. style of treaties, the second sentence of the definition of PE above applies to all agents, both dependent and independent. If this is true, anytime an agent, dependent or independent, sold goods from a stock of merchandise, it would create a PE.

A very similar analysis was presented in *Handfield*, except that the parent did not create a domestic subsidiary to sell goods. Rather, they were sold through an unrelated retail establishment. The facts were as follows:

1. A Canadian business sold postcards through a U.S. retail company.
2. In the sales contract, the U.S. retail company was granted the exclusive territory of the United States.
3. The contract required that each rack of postcards contain 300 cards, and set the purchase and sales price.

source of income may indicate that the agent lacks economic dependence."

20 Rev. Rul. 70-424, discussed in the text above (sole source of the agent's income was from one principal and the principal would share equally with the agent in any loss up to a certain amount). Conversely, when a foreign business granted a discount to a beer importer for advertising its product in the United States, this and a lack of other factors did not create a dependent agent. Ltr. Rul. 7702043120D.

21 OECD Commentary, *supra* note 15, para. 38.

22 *Id.* para. 38.3.

23 However, the result in *Handfield*, *supra* note 18, as well as the sourcing-of-income argument, seemed to contradict a literal interpretation of Reg. 1.864-7(d)(3)(i).

24 McGill and Yoder, "From Storefronts to Servers to Service Providers: Stretching the Permanent Establishment Definition to Accommodate New Business Models," Taxes (March 2003), page 153.

25 Adding further confusion to the interpretation, "independent agent" is not mentioned in the 1945 U.S.-U.K. Treaty, which uses "bona fide commission agent," and the 1942 U.S.-Canada treaty used "commission agent."

26 Art. 5(7) of most modern treaties; last sentence of 1945 U.S.-U.K. Treaty, Art. 5.

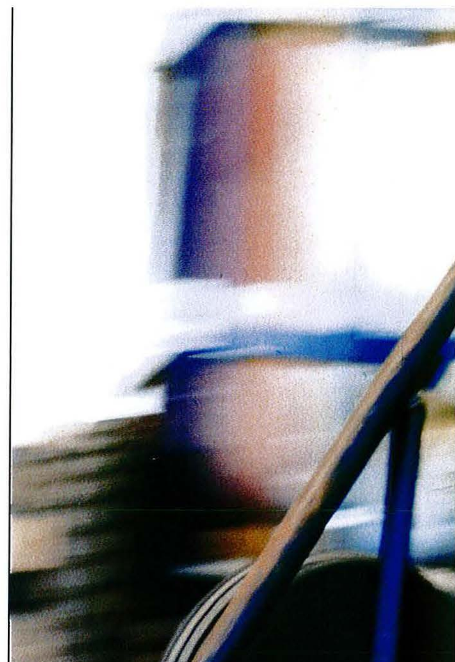
27 As noted above, *Handfield* was decided under the 1942 U.S.-Canada income tax treaty.

28 Katz et al., *supra* note 12, page A-111.

29 McGill and Yoder, *supra* note 24, page 152. "The IRS and U.S. courts have expressly held that where a foreign taxpayer has a sales agent in the U.S., the sales agent creates a PE for the foreign taxpayer."

30 The 2006 and 1996 U.S. model treaties and the 2010 OECD model treaty have substantially similar language.

31 2006 U.S model treaty, Art. 5(5).



4. Any unsold merchandise could be returned to the Canadian business, regardless of condition.
5. The Canadian business was to pay for transportation of cards to and from the Canadian business.
6. The Canadian business paid for an employee in the United States to check the various outlets to ensure that the cards were properly displayed and retailed.

The Service challenged the transaction, contending that it was an "agency relationship." The Tax Court agreed that it was an "agency relationship in the form of a consignment contract" for the following reasons:

1. The U.S. retail company was not obligated to buy a definite amount of merchandise from the petitioner but only to account for merchandise that had been sold, and all unsold merchandise could be returned. This indicated that the transaction was not one resembling the buyers and sellers in Rev. Rul. 63-113, Rev. Rul. 76-322, and Ltr. Rul. 7816031.
2. The agreement controlled the retail price. This could be a factor indicating control between a principal and agent. However, the Tax Court did not discuss this in any detail.
3. The U.S. retail company had the right to discontinue merchandising the cards when they moved slowly or infringed on a copyright or patent.

Without any other analysis, the Tax Court concluded that the U.S. retail company was an agent with "a stock of merchandise" from which it regularly filled orders for the public. Unfortunately, the lack of detail in the opinion leads to two possible reasonable interpretations of the holding.

First, the Tax Court found that the consignment arrangement created a dependent agent. Under modern treaties,[27] the court would need to find that the Canadian business was legally or economically dependent. Some authors take the position that *Handfield* represents an economic dependence case.[28] The following factors might support this conclusion: there was an "exclusive" contract for the sale of all goods in the United States; the Canadian business bore the transportation costs for delivery and return of postcards; and the Canadian business set the sales price. However, from a cursory review of the independent agent table in Exhibit 4, there appear to be few factors in favor of finding that Handfield would be classified as a dependent agent.

From a legal dependence standpoint, one of the most important factors is whether the U.S. retail company was subject to detailed instructions or control from the Canadian business. The

EXHIBIT 4
Agent Independence Test—*Handfield*

	Yes	No
Economic Independence: OECD ¶ 38		
Profits: Control over the agent's revenue stream—FSA #5		
Services not provided wholly to one principal over time—FSA #6; OECD ¶ 38.6; 1996 & 2006 Model Tech. Expl.	■	
Does not prevent agent from acquiring new clients without approval—Rev. Rul. 70-424	■	
Agent offers its services to the general public—FSA #7	■	
Agent may sell product at greater than standard sales price—PLR 8147001; PLR 7702043120D; *Handfield* Agent could not		■
Agent is compensated at market rates—FSA #8	■	
Losses:		
Foreign enterprise does not reimburse agent for its ordinary and necessary expenses—FSA #9; Rev. Rul. 70-424	■	
Capital:		
Agent contributes a significant part of the materials and equipment to conduct its activities on behalf of the foreign business—FSA #10	■	
Agent makes long-term investments in the facilities and other resources used in its activities on behalf of the foreign enterprise—FSA #11	■	
Legal Independence:		
Agent not subject to detailed instructions—FSA # 1; OECD ¶38;	?	
Agent responsible for the results of work, not being controlled in how to do the work—OECD ¶38.3;	■	
When services of a third person are required, the principal does not reimburses the agent—FSA # 2	■	
Agent's operations are generally separate from principal—FSA #3	■	
Agent not required to submit regular reports to principal—FSA #4, but see OECD ¶38.5*	■	

* OECD Commentary, 2011, Art 5, ¶ 38.5 states that detailed reports are not a relevant factor unless the detail of the report is seeking approval from the principal for the manner in which the business is conducted.

the goods are shipped directly from the factory to the U.S. customer. The furniture manufacturer representative does not have a stock of merchandise from which he fills orders.

With respect to the second interpretation of *Handfield*, the Tax Court held that in the Protocol to the relevant (1942) U.S.-Canada income tax treaty (Article 3), the second sentence (para. (f)) applied to both dependent and independent agents:[29]

> When an enterprise of one of the contracting States carries on business in the other contracting State through an employee or agent established there, who has general authority to contract for his employer or 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 latter State.

Since the U.S. treaties prior to the modern treaties provided that an agent who either habitually concluded contracts or filled orders from a stock of goods created a PE, either a consignment or filling orders from a warehouse would result in U.S. taxation.

Modern treaties have eliminated "or has a stock of merchandise from which he regularly fills orders on its behalf" from the definition of a PE. In fact, Article 5(4)(a) and (b) provide a specific exclusion for a stock of goods (e.g., warehouse and most likely a consignment arrangement). Further, modern treaties clarify that only a dependent agent that habitually concludes contracts may create a deemed PE for the foreign business.

For example, the 1984 U.S.-P.R.C. Treaty, Article 5(5) and (6) state:

> 5. Notwithstanding the provisions of paragraphs 1 and 2, where a person, other than an agent of an independent status to whom paragraph 6 applies, is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a PE in that Contracting State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those *(Continued on page 64)*

agency contract required that each rack of postcards contain 300 cards, and the Canadian company had an employee who went to different retail locations to make sure that the postcards were displayed properly. Conversely, this type of arrangement is typical in many agreements when a retailer is given an exclusive contract to market goods, and it is questionable that this degree of control would result in legal dependence. Further, the Tax Court's opinion did not discuss any issues of legal dependence.

Economically, the sale of postcards by a retail store is most likely a very small product line, contributing little to the U.S. retail company's revenue. In this respect, the Tax Court may have been a bit confused over the term "exclusive." As noted above, earlier authority implied that "exclusive" could be a negative factor. However, the issue is not whether there is an exclusive arrangement regarding a territory but rather how much of the agent's revenue the principal controls. Since the U.S. retail company in *Handfield* operated throughout the country, the sale of postcards was very likely a minor part of its revenues. Further, nothing in the facts suggested that Handfield could not sell postcards of a competitor. Also, the U.S. retail company offered its services to the general public and nothing in the facts indicated that the compensation to the agent was anything but market rate. From a capital perspective, the U.S. retail company bore significant costs to open a retail store, both in the short and long run. From an economic dependence perspective, the principal did control the sales price of the goods but this factor alone should not result in a finding that the U.S. retail company was economically dependent.

The Tax Court also seemed to be concerned that the U.S. retail company did not bear any risk of loss as related to the goods on consignment. In the furniture manufacturing example above, the representative bears no risk of loss and never takes title to the goods. The only significant difference between the typical furniture manufacturer representative type of agency and *Handfield* is that

(*Continued from page 39*) mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a PE under the provisions of that paragraph.

6. An enterprise of a Contracting State shall not be deemed to have a PE in the other Contracting State merely because it carries on business in that other Contracting State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph if it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions.[30]

The second clause of paragraph 5 specifically omits "other than an agent of independent status to whom paragraph 6 applies." Therefore, only a dependent agent creates a PE.

Conclusion

Under the treaty analysis, a foreign business is taxed only if it has a PE. A PE may be created by having a fixed place of business in the United States or a dependent agent that habitually concludes contracts on behalf of the employer. An independent agent will not result in U.S. taxation. Under modern treaties, when an agent fills goods orders from a foreign person's warehouse, this should not result in U.S. taxation. However, many planners may prefer to follow the conservative consignment sales type of contract detailed in Rev. Rul. 63-113, Rev. Rul. 76-322, and Ltr. Rul. 7816031. See Exhibit 5 for a flowchart of treaty taxation of a foreign business selling in the U.S.

Even if an independent agent is classified as a dependent agent, it does not necessarily mean that the foreign person has created a PE. To create a deemed PE, the dependent agent must have and habitually conclude contracts on behalf of the foreign business.[31] Naturally, this begs the question: can a dependent agent solicit orders in the United States, e-mail them to foreign business, and still avoid U.S. taxation? This will be the subject of Part 3, the final installment of this series. Part 3 will also include an analysis of *Taisei* from both a treaty and non-treaty perspective that brings in other U.S. activities of a foreign person, such as an unrelated branch or subsidiary. ●