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Memorandum

Re: Tax Consequences for the Foreign Corporation: A Focus on Taisei Fire & Marine Insurance Co. et al. v. Comm'r and the rules of permanent establishment

In today's globalized society, there is an ever increasing trend promoting multinational, transnational and cross-border businesses as a result of both economies of scale and the benefits associated with outsourcing. For the corporate executive or the wealthy international family, individuals may be overseeing operations of a foreign corporation while they are present in the United States. This may result in U.S. tax liability.

In general, in the United States, foreign corporations[1] and nonresident alien individuals[2] are subject to U.S. federal income tax on (1) fixed or determinable annual or periodic income derived from U.S. sources which are not effectively connected with a U.S. trade, on which a 30% withholding tax is imposed, or (2) business or income from sources which are in fact *effectively connected* with a U.S. trade or business, for which the generally understood graduated rate system is applied.[3]

There are, however, ways of being exempt from these taxing regimes. Foreign corporations which are residents in a country that has a tax treaty with the United States can avoid federal income tax on effectively connected income if they do not have a U.S. permanent establishment as statutorily defined.[4] Tax treaties typically define permanent establishment as an office or other fixed place of business. Also, activities

[1] Foreign corporations are corporations which are non-domestic. They are corporations which are not created or organized in the United States or under the law of the United States or of any State. I.R.C. § 7701 (4),(5).

[2] An individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States. I.R.C. § 7701(b)(1)(B). A nonresident alien is an individual who has satisfied neither the green card nor the substantial presence test.

[3] I.R.C. § 882(a)(1). Foreign corporations are subject to federal corporate income tax on taxable income effectively connected with the conduct of a U.S. trade or business. *See id.* Foreign corporations are considered to be engaged in the conduct of a U.S. trade or business when they are engaged in activities which are "considerable, continuous and regular." Foreign source income can also be considered as effectively connected to a U.S. trade or business to the extent attributable to a foreign corporation's U.S. office. *See* I.R.C § 864(c)(4)(B)(iii).

[4] *See* Internal Revenue Service, *United States Income Tax Treaties – A-Z*, http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z.

of agents can constitute permanent establishment in some instances. Even if there is a permanent establishment in the United States, business profits are exempt if they are not attributable to such an establishment.[5]

Example:

Sample Motor Co. is a Brazil based business. It has offices throughout Brazil and South America. It is currently in negotiations with a U.S. advertising corporation which does promotions and marketing for individuals in their industry within the U.S. Sample Motor Co. has hired Joe American as an agent to represent Sample Motor Co. for the next three months to set up the terms of the agreement for this arrangement, the contractual relationship of which is expected to last more than one year.

The primary issue here is whether or not Sample Motor Co.'s hiring of Joe American will result in Sample Motor Co. being subject to U.S. income tax. The *Taisei Fire & Marine Insurance Co. et al. v. Comm'r*[6] clarifies more of how the Internal Revenue Service ("IRS") intends for I.R.C. § 864(c), the issue of what constitutes an office or another fixed place of business means to be interpreted under the code. The I.R.C. § 864 regulations provide that general management activity in the United States will not constitute an office of a foreign corporation. For example, officers in the United States who are generally responsible for overseeing and supervising the activities of a foreign corporation does not create a U.S office. The action of agents on behalf of a foreign corporation does not create a U.S. office unless such agents (1) have the authority to negotiate and conclude contracts in the name of the foreign corporation and regularly exercise that authority or (2) have a stock of merchandise belonging to the foreign corporation from which orders are regularly filled. Additionally, officers of related

[5] Foreign corporations can avoid U.S. federal income tax on profits when the foreign corporation is a resident in a country with which the U.S. has an income tax treaty, the foreign corporation satisfies the limitation on benefit provision found in the treaty, the foreign corporation's presence in the U.S. is not considered to be a permanent establishment and the foreign corporation elects to be taxable under the income tax treaty rather than the I.R.C.

[6] 104 TC 27 (1995). *See also* Pollack, Lawrence A., *Tax Court's Taisei Case Sheds Light on the Definition of "Permanent Establishment*," 27 THE TAX ADVISER 28 (1996).

parties, such as subsidiaries or parent corporations, do not automatically result in attribution. Here, Joe American, while acting as an agent for Sample Motor Co., he is engaging in contracts having the authority to negotiate on behalf of Sample Motor Co. Despite Joe American's acting as an agent and having the aforementioned authority, he was only able to act for a limited duration and not with regular authority, accordingly Joe American's engagement in this business with Sample Motor Co. would not result in Sample Motor Co. being considered a permanent establishment of the United States, and consequently Sample Motor Co. would remain exempt from U.S. income taxes.

Where activities of an agent are involved it is generally necessary to determine whether the agent is "dependent" or "independent" of the taxpayer. When the agent's activities are "independent" regardless of the degree of discretionary authority the independent agents action will not be treated as a principal's permanent establishment. On the contrary, the activities of "dependent" agents, will be considered the action of the principal's permanent establishment. In the *Taisei* case, the court noted 20 factors which are commonly used by the IRS to distinguish employees from independent contractors. In determining whether or not an agent is dependent or independent the court applied the legal and economic independence tests. Under the legal independence test, the court looks to the obligations of the agent in reference to the total enterprise. For example, when the agent's activities for the enterprise are highly regulated and regimented by the hiring enterprise, including detailed instructions or comprehensive control, then the agent would have failed the legal independence test and would be considered a dependent and not an independent agent. Under the economic independence test, also referred to as the entrepreneurial risk test, you look to the risk of loss and option for gain the agent has from the engagement with the enterprise. If the agent had guaranteed payment and controlled risk of loss, then he would be considered a dependent agent. *Taisei* illustrates this principal in holding that an agent who had no guarantee of revenues and incurred its own operating expenses would be considered economically independent.

It is imperative to note that while *Taisei* illustrates some of the interpretation of the tests for permanent establishment as interpreted under international income tax treaties, it is not fail safe. Additionally, the bulk of U.S. income tax treaties do not have state income tax provisions, therefore while foreign corporations under the U.S. federal income tax treaty may be considered to be exempt from tax, the foreign corporations business profits may be subject to state income or franchise tax.