DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR WILLIAM S. TRESS
OFFICE OF ASSISTANT COMMISSIONER
INTERNATIONAL

FROM: Elizabeth U. Karzon
Chief, Branch 1

SUBJECT: Letter from R.E. Haigh, Deputy Director Revenue London, England

This is in response to your memorandum dated August 25, 1999, requesting assistance in connection with a questionnaire sent by Ron Haigh, Deputy Director Revenue London, England.

ISSUE:

Whether the United States taxing right depends upon the existence in the United States of a Permanent Establishment, a mere presence, or evidence of economic activity, or a combination of all three.

LAW AND ANALYSIS:

Engaged in a Trade or Business Within the United States

In the absence of a treaty, under the Internal Revenue Code (the "Code"), the United States has the right to tax income of a foreign corporation which is effectively connected with the conduct of a trade or business within the United States. I.R.C. §§ 864, 882. Section 864(c) provides guidance on when income, gain or loss is effectively connected with a trade or business, assuming a trade or business exists. Special rules apply to periodic income (section 864(c)(2)), income from sources without the United States (section 864(c)(4)), and other income from

sources within the United States that is treated as effectively connected with a trade or business within the United States (section 864(c)(3)). The latter is referred to as the "limited force of attraction" rule. No specific statutory rules exist regarding when income (other than periodic income) is in fact effectively connected with a trade or business or whether it should simply be treated as effectively connected with the trade or business under the limited force of attraction rule.

Section 864(b) provides a non-exhaustive definition of "trade or business within the United States." Section 864(b) provides that, as a general rule, the term "trade or business within the United States" includes the performance of personal services within the United States and does not include trading in stocks or securities or commodities through a resident broker, commission agent, custodian, or other independent agent, or otherwise trading for one's own account. This exception generally does not apply in the case of a dealer in stocks or securities or commodities, and shall apply only if, at no time during the taxable year, the taxpayer has an office or other fixed place of business in the United States through which or by the direction of which the transactions in stock or securities, or in commodities, as the case may be, are effected.

If an activity is not expressly listed in section 864(b), whether a foreign corporation is engaged in a trade or business within the United States is a facts and circumstances determination. Treas. Reg. § 1.864-2(e); Rev. Rul. 99-7, 1999-1 I.R.B. 227 (the determination of whether a taxpayer is engaged in a trade or business within the United States is highly factual and such a determination is not ordinarily made in an advance ruling). Section 875 treats the partners of a partnership as engaged in a U.S. trade or business if the partnership is engaged in a U.S. trade or business.

Generally, whether a foreign corporation is engaged in a trade or business within the United States depends upon whether the foreign corporation is regularly and continuously engaged in profit-seeking activities in the United States. European Naval Stores Co., S.A. v. Commissioner, 11 T.C. 127 (1948); See also Spermacet Whaling & Shipping Co. S/A v. Commissioner, 30 T.C. 618, 634 (1958) (holding that before a taxpayer can be found to be "engaged in a trade or business within the United States" it must, during some substantial portion of the taxable year, be regularly and continuously transacting a substantial portion of its ordinary business in the United States). A foreign corporation may be found to be engaged in a trade or business either through its direct activities in the United States or through the activities in the United States of an agent on behalf of the foreign corporation.

Engaged in a Trade or Business Through an Agent:

In Handfield v. Commissioner, 23 T.C. 633 (1955), a nonresident alien individual residing in Canada and engaged in the manufacture of picture postal cards in Canada was found to be engaged in a trade or business within the United States through the activities of an agent. The taxpayer in Handfield managed the business and carried on his activities from his office in Canada. The taxpayer had a contract with the American News Company by which the latter distributed the cards to newsstands in the United States, where they were sold to the public. The taxpayer had one employee, a resident of the Untied States, to check the vendors of the cards to insure that the cards were being properly displayed.

The taxpayer in Handfield argued that the American News Company purchased the cards from him for resale and that the sale occurred in Canada when the cards were placed in transportation and that, at that time, he surrendered all his rights, title, and interest in the cards to the American News Company. The Service, on the other hand, argued that the arrangement was an agency relationship and that the American News Company was the taxpayer's exclusive distributor in the United States. The Handfield court found that the arrangement between the taxpayer and the American News Company was one in which the American News Company was the taxpayer's agent in the United States and that the cards were shipped on consignment for sale to the public.

The Handfield court based its decision on that fact that, under the contract between the taxpayer and the American New Company, the American News Company did not obligate itself to buy any definite amount of merchandise from the taxpayer and was only obligated to account for the merchandise that had been sold. Further, under the contract, all unsold merchandise could be returned, the taxpayer paid all transportation costs for shipping the cards, and gave full credit for unsold cards regardless of their condition. The Handfield court found that the taxpayer was engaged in a trade or business within the United States through the activities of its agent.

The Handfield court, citing In re Taylor, (E.D., Mich., 1931) 46 F.2d 326, 328, stated:

> A contract of consignment * * * imposes no obligation upon the consignor to sell or upon the consignee to buy any property, and it effects no sale or transfer of title, conditional or absolute, from consignor to consignee. It merely creates a bailment between the consignor as bailor and the consignee as bailee, of property of the bailor, with authority in the bailee as his agent to sell such property to third persons and with the duty to account

> to him for the proceeds of any such sale. On such a sale the title passes, not from the consignor to the consignee as in a contract of conditional sale, but from the consignor as owner, through the consignee as his agent, to the purchaser. In the absence of such a sale the consignee may return the property to the consignor without liability for the purchase price thereof.

Lewenhaupt v. Commissioner, 20 T.C. 151, 163 (1953), also involved whether a nonresident alien individual was engaged in a trade or business within the United States due to the activities of an agent. The U.S. agent had broad powers to act on behalf of the nonresident, which included the power to buy, sell, lease and mortgage real estate for and, in the name of the taxpayer. The agent also managed the taxpayer's real properties and other financial affairs in the United States. The Lewenhaupt court found the activities of the agent to be "considerable, continuous, and regular" and, accordingly, found the nonresident to be engaged in a trade or business within the United States through the activities of its agent. Id.

In Amodio v. Commissioner, 34 T.C. 894 (1960), the court also found that a nonresident alien individual was engaged in a trade or business within the United States through his agents where he appointed agents to purchase and manage real property within the United States. The properties were managed by local real estate agents in the United States who negotiated or renewed leases, arranged for repairs, collected rent, paid taxes and assessments, and remitted net proceeds to another agent after deducting commissions. The other agent paid principal and interest on the mortgages, insurance premiums and taxes related to the properties. The Amodio court found that the acts of the agents were attributable to the nonresident alien and that the activities were "considerable, continuous, and regular". Id. at 906. The Amodio court further found that "such activities of a nonresident alien through his agents in the United States constitute engaging in business in the United States." Id.

In Amalgamated Dental Co. v. Commissioner, 6 T.C. 1009 (1946), however, the Tax Court found that a nonresident taxpayer was not engaged in a trade or business. In Amalgamated Dental, the taxpayer, a United Kingdom corporation, was engaged in a vendor-vendee relationship wherein the taxpayer purchased dental supplies from a U.S. dental supply company. Prior to the taxable years in issue in the case, the dental supply company shipped the dental supplies purchased by the taxpayer directly to the taxpayer and the taxpayer would then ship the supplies to its customers. Due to war conditions, it became infeasible for the dental supply company to ship to the taxpayer and for the taxpayer to ship to its customers. As a result, the taxpayer and the U.S. dental supply company agreed that the latter would ship the merchandise directly to the taxpayer's customers.

The taxpayer in Amalgamated Dental argued that the U.S. dental supply company became the taxpayer's agent because, instead of shipping the dental supplies directly to the taxpayer for resale by the taxpayer to its customers, the dental supply company shipped the dental supplies directly to the taxpayer's customers, under directions (both general and special) from the taxpayer, billed the customer at a retail rate set by the taxpayer, billed the taxpayer for the wholesale rate, received payment from the customers, and remitted to the taxpayer the difference between the two rates. No charge was made by the taxpayer for the additional services performed by the U.S. dental supply company.

The Amalgamated Dental court found that gratuitous services provided by the U.S. dental supply company to the taxpayer did not create an agency relationship. The court found that the change in operating methods was directly caused by the war and that, considering the long continued relations on a basis of vendor-vendee between the two companies, it appeared more reasonable to think that the change entailed a mere enforced modification of the previous operation of vendor-vendee relation than to think that, without a definite contract, that relation was changed to one of principal and agent. Id. at 1015. The Amalgamated Dental court also found that "the lack of a formal expression of a contract of agency is to us significant, and what was done appears not as agency, but as detail in carrying on the previous arrangement in a not greatly different way." Id. Accordingly, the court found that the taxpayer was not engage in a trade or business within the United States.

With regard to agency relationships between related parties, Bollinger v. Commissioner, 485 U.S. 340 (1988), and National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949), outline the instances in which an agency relationship may be found to exist between related parties. Bollinger involved the relations between a corporate agent and its owner-principal. National Carbide involved the relations between a parent corporation and its wholly owned subsidiaries, which were nominally designated as corporate agents for the parent corporation. In Bollinger, the Supreme Court addressed the issue of whether a corporation holding title to property was an agent with respect to its shareholders who performed all the functions associated with the development and operation of the property, or whether the shareholders were the agents performing functions on behalf of the corporation who was the legal owner of the property. In making its determination as to who was the agent, and who was the principal, the Court applied the four indicia and two requirements of agency status outlined in National Carbide (the last two factors below are the requirements):

1. Whether the corporation operates in the name and for the account of the principal;

2. Whether the corporation binds the principal by its actions;

3. Whether the corporation transmits money received to the principal;

4. Whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal;

5. The agency relationship must not be dependent on the fact that the agent is owned by the principal -- meaning that the separate entity doctrine of Moline Properties v. Commissioner, 319 U.S. 436 (1943), is not subverted; and

6. The agent has a business purpose of carrying on its normal duties as agent. Bollinger, at 346-7.

The Bollinger court also outlined three additional criteria to adequately assure the presence of a valid agent - principal relationship: (1) the agency relationship was set forth in a written agreement at the time the asset was acquired; (2) the corporation functions as agent and not as principal with respect to the asset for all purposes; and (3) the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset. Id. at 349-350.

Impact of Source of Income on Taxing Rights:

Even if a foreign corporation is found to be engaged in a trade or business within the Untied States, either due to its direct activities or those of its agent, the United States may only exercise its taxing rights with regard to income which is "effectively connected with" the conduct of the trade or business within the United States. Section 864(c)(4)(A) generally provides that income from sources without the United States shall not be treated as effectively connected with the conduct of a trade or business within the United States. Accordingly, the United States generally only has the right to tax U.S. sourced income related to the U.S. trade or business. Section 864(c)(4)(B) and (C) provides limited exceptions to this general rule.[1]

Generally, section 864(c)(4)(B) provides an exception with respect to certain types of income where the foreign corporation has an office or other fixed place of business within the United States to which such income is attributable. Under such

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[1] Section 864(c)(4)(C) provides, with respect to insurance companies, that income from sources without the United States that is attributable to its United States business shall be treated as effectively connected with the conduct of a trade or business within the United States.

circumstances, the United States may tax foreign sourced income as income effectively connected with the conduct of a trade or business within the United States. Accordingly, for example, foreign sourced income from the sale of inventory may be taxed by the United States if the foreign corporation has an office or other fixed place of business within the United States to which such income is attributable. Although section 864(c)(4)(B) generally applies to the sale of inventory through an office or other fixed place of business in the United States, it does not apply if the inventory is sold for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign corporation in a foreign country participates materially in such sale. I.R.C. § 864(c)(4)(B)(iii).

The Code generally ignores an office or other fixed place of business of an agent in determining whether a foreign corporation has an office or other fixed place of business. In determining whether a foreign corporation has an office or other fixed place of business, the office or other fixed place of business of a dependent agent will be disregarded unless such agent (1) has the authority to negotiate and conclude contracts in the name of the foreign corporation and regularly exercises that authority, or (2) has a stock of merchandise belonging to the foreign corporation from which orders are regularly filled on behalf of such foreign corporation. I.R.C. § 864(c)(5)(A);Treas. Reg. § 1.864-7(d)(1)(i). Moreover, pursuant to section 864(c)(5)(A), the office or other fixed place of business of an independent agent will not be attributed to a foreign corporation even if the agent has the authority to negotiate and conclude contracts on behalf of the foreign corporation or maintains as stock of goods from which to fill orders on the foreign corporation's behalf.

Treasury Regulation section 1.864-7(c) provides:

> A foreign corporation shall not be considered to have an office or other fixed place of business merely because a person controlling that corporation has an office or other fixed place of business from which general supervision and control over the policies of the foreign corporation are exercised.

Treasury Regulation section 1.864-7(d)(3)(ii) provides:

> The determination of whether an agent is an independent agent for purposes of this paragraph shall be made without regard to facts indicating that either the agent or the principal owns or controls directly or indirectly the other or that a third person or persons own or control directly or indirectly both. For example, a wholly owned domestic subsidiary corporation of a foreign corporation which acts as an agent for the foreign parent corporation may be

> treated as acting in the capacity of independent agent for the foreign parent corporation.

However, if the agent acts exclusively, or almost exclusively, in such capacity, pursuant to Treasury Regulation section 1.864-7(d)(3)(iii), even if the agent is otherwise an independent agent, the facts and circumstances of the particular case must be taken into account in determining whether the agent, while acting in that capacity, may be classified as an independent agent.

Because section 864(c)(4)(A) generally provides that income from sources without the United States shall not be treated as effectively connected with the conduct of a trade or business within the United States and, therefore, even where a foreign corporation is engaged in a trade or business within the United States, the United States may not be able tax foreign source income related to that trade or business, the source of income becomes important in determining the United States' right to tax such income.

In the United States, income from the sale of inventory property is generally sourced based on the place of sale. I.R.C. §§ 861(a)(6), 862(a)(6) and 863(b). Treasury Regulation section 1.861-7(c) provides:

> For purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. <u>However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred</u>. [Emphasis added.]

Accordingly, the place of title passage determines the source of inventory income for U.S. tax purposes.

The general title passage source rule for inventory in U.S. law may provide taxpayers with an avenue to manipulate the source of inventory income, and accordingly the United States' right to tax such income, by designating where title passage occurs. Section 865(e)(2) provides an exception to the general title

passage source rule for inventory. Section 865(e)(2)(A) provides that where a foreign corporation maintains an office or other fixed place of business in the Untied States, income from any sale of property (including inventory property) attributable to such office or other fixed place of business shall be source in the United States. Section 865(e)(2)(B), however, provides that section 865(e)(2)(A) "shall not apply to any sale of inventory property which is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the taxpayer in a foreign country materially participates in the sale." Section 865(e)(3) provides that the principles of 864(c)(5) apply in determining whether a taxpayer has an office or other fixed place of business and whether a sale is attributable to such an office or other fixed place of business.

In determining whether property is sold for use, disposition or consumption outside the United States, Treasury Regulation section 1.864-6(b)(3)(ii)(a) provides:

> As a general rule, personal property which is sold to an unrelated person shall be presumed for purposes of this subparagraph to have been sold for use, consumption, or disposition in the country of destination of the property sold; for such purpose, the occurrence in a country of a temporary interruption in shipment of property shall not cause that country to be considered the country of destination. However, if at the time of a sale of personal property to an unrelated person the taxpayer knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the taxpayer must determine the country of ultimate use, consumption, or disposition of the property or the property shall be presumed to have been sold for use, consumption, or disposition in the United States. A taxpayer who sells personal property to a related person shall be presumed to have sold the property for use, consumption, or disposition in the United States unless the taxpayer establishes the use made of the property by the related person; once he has established that the related person has disposed of the property, the rules in the two immediately preceding sentences relating to sales to an unrelated person shall apply at the first stage in the chain of distribution at which a sale is made by a related to an unrelated person. For purposes of this (a), a person is related to another person if either person owns or controls directly or indirectly both. For this purpose, the term "control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable. Treas. Reg. § 1.864-6(b)(3)(ii)(a).

Under U.S. law, the source of interest income is generally the resident of the debtor. I.R.C. §§ 861(a)(1), 862(a)(1). Income from rentals or royalties from

property, including intangibles, is source where the property is located or used or where the licensee has the privilege to use such property. I.R.C. §§ 861(a)(4), 862(a)(4). Income from personal services is source based on where the services are performed. I.R.C. §§ 861(a)(3), 862(a)(3).

Even if a foreign corporation is found to be engaged in a trade or business within the United States and income if found to be effectively connected with that trade or business, if an income tax treaty of the United States applies, the United States may still not have the right to tax such income.

Treaty Permanent Establishment Requirement

Code section 894(a)(1) provides:

> The provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.

The provisions of the United States Model Income Tax Convention (1996) (the "U.S. Model Treaty") are fairly indicative of the provisions of U.S. bilateral Income Tax Treaties. Accordingly, we will use the provisions thereof for purposes of this discussion.

Article 7 paragraph 1 of the U.S. Model Treaty provides:

> The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment.

Article 5 paragraph 1 of the U.S. Model Treaty provides:

> For purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Article 5 paragraph 5 of the U.S. Model Treaty provides:

> 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 that are binding on the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities that the person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 that, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

Article 5 paragraph 6 of the U.S. Model Treaty provides:

> An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that 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 as independent agents.

Based on the foregoing provisions, if there is an applicable U.S. bilateral treaty with similar language, the United States may tax the foreign corporation on its business profits only if (1) the foreign corporation maintains a permanent establishment ("PE") within the United States and (2) the profits are attributable to the PE. The limited force of attraction rule in section 864(c)(3) of the Code is, therefore, not applicable if the foreign corporation itself maintains no fixed place of business in the United States. If the foreign corporation itself maintains no fixed place of business in the United States, it is necessary to determine whether the foreign corporation nonetheless has a PE within the United States, pursuant to Article 5 paragraph 5 of the U.S. Model Treaty, through the acts of an agent on its behalf. Even if an agent, as a matter of course, executes contracts within the United States in the name of a foreign corporation, pursuant to Article 5 paragraph 6 of the U.S. Model Treaty, if the agent is of an independent status, and is acting in the ordinary course of its business as an independent agent, the foreign corporation will not be deemed to have a PE within the United States by virtue of such agent's activities.

In order to meet the requirements of Article 5 paragraph 6 of the U.S. Model Treaty, the agent must be (1) independent and (2) be acting in the ordinary course of its business. The Technical Explanation to Article 5 paragraph 6 of the U.S. Model Treaty provides that if an agent concludes contracts in the name of a foreign corporation, it must satisfy the following conditions in order to avoid dependent agent status: it must be (1) legally independent; (2) economically independent; and (3) acting in the ordinary course of its business in carrying out activities on behalf of the principal. See also Taisei Fire and Marine Ins. Co., Ltd. v. Commissioner, 104

T.C. 535 (1995) (In order to meet the agent of independent status requirement, both legal and economic independence are required).

SPECIFIC QUESTIONS:

(A) Do you have, within your statutory code, any means of taxing a nonresident company that sells products in your country via a commission agent?

[Suppose a retailer is selling stock on commission for a nonresident affiliated company: (a typical commissionaire arrangement) under what circumstances could you impose a tax charge on the nonresident company.]

If there is no applicable treaty:

The United States can tax the income of the affiliated foreign corporation if it is viewed as engaged in a trade or business within the United States through the activities of a related retailer/commission agent, and the income is effectively connected with the U.S. trade or business. The United States may only deem the affiliated foreign corporation to be engaged in a trade or business through the activities of the retailer if it views the retailer as a dependent agent of the affiliated foreign corporation. See e.g., Handfield v. Commissioner, *supra*. Whether the retailer is a dependent agent of the affiliate foreign corporation depends upon the facts and circumstances of the case and the degree of control the affiliated foreign corporation has or exercises over the activities of the retailer.

Even if the affiliated foreign corporation is viewed as engaged in a trade or business within the United States, because of the activities of the related retailer as a dependent agent, the United States may only tax the income from the sale of goods if it is effectively connected with the trade or business within the United States. If the income is attributable to the trade or business and it is U.S. sourced income, the Untied States will generally be able to tax such income. If, however, title to the goods passes outside the United States, because section 864(c)(4)(A) generally provides that income from sources without the United States shall not be treated as effectively connected with the conduct of a trade or business within the United States, unless the office or other fixed place of business of the retailer is attributed to the affiliated foreign corporation and, pursuant to section 865(e)(2)(A), the income is deemed to be U.S. source, the United States would not be able to tax such income even if the affiliated foreign corporation is found to be engaged in a trade or business within the United States.

Section 865(e)(3) provides that the principles of 864(c)(5) apply in determining whether a taxpayer has an office or other fixed place of business and whether a sale is attributable to such an office or other fixed place of business. Treasury Regulation section 1.864-7(c) provides:

> A foreign corporation shall not be considered to have an office or other fixed place of business merely because a person controlling that corporation has an office or other fixed place of business from which general supervision and control over the policies of the foreign corporation are exercised.

Further, in determining whether a foreign corporation has an office or other fixed place of business, the office or other fixed place of business of a dependent agent will be disregarded unless such agent (1) has the authority to negotiate and conclude contracts in the name of the foreign corporation and regularly exercises that authority, or (2) has a stock of merchandise belonging to the foreign corporation from which orders are regularly filled on behalf of such foreign corporation. I.R.C. § 864(c)(5)(A);Treas. Reg. § 1.864-7(d)(1)(i). Moreover, pursuant to section 864(c)(5)(A), the office or other fixed place of business of an independent agent will not be attributed to the foreign corporation even if the agent has the authority to negotiate and conclude contracts on behalf of the foreign corporation or maintains as stock of goods from which to fill orders on the foreign corporation's behalf.

Treasury Regulation section 1.864-7(d)(3)(ii) provides:

> The determination of whether an agent is an independent agent for purposes of this paragraph shall be made without regard to facts indicating that either the agent or the principal owns or controls directly or indirectly the other or that a third person or persons own or control directly or indirectly both. For example, a wholly owned domestic subsidiary corporation of a foreign corporation which acts as an agent for the foreign parent corporation may be treated as acting in the capacity of independent agent for the foreign parent corporation.

However, if the agent acts exclusively, or almost exclusively, in such capacity, pursuant to Treasury Regulation section 1.864-7(d)(3)(iii), even if the agent is otherwise an independent agent, the facts and circumstances of the particular case must be taken into account in determining whether the agent, while acting in that capacity, may be classified as an independent agent.

If there is an applicable treaty:

If there is an applicable U.S. bilateral treaty, the United States may only tax the business profits of the affiliated foreign corporation if it is found to have a PE within the United States. Assuming the affiliated foreign corporation does not directly maintain a fixed place of business within the United States, the issue becomes whether it is deemed to have a PE within the United States by virtue of the activities of the retailer.

If the retailer is an agent of an independent status acting in the ordinary course of its business as an independent agent, the affiliated foreign corporation will not be deemed to have a PE within the United States and, despite the fact that the affiliate foreign corporation may be engaged in a trade or business within the United States and that the income is effectively connected with that trade or business, the United States would not be entitled to tax that income. In order to be independent, the agent must be both legally and economically independent. (See above for detailed discussion of legal and economic independence and an analysis of what "acting in the ordinary course of its business as an independent agent" means).

(B) Do you have any means of taxing a non-resident company that undertakes economic activity in your territory by way of subcontracting to another?

[Suppose a nonresident company undertakes the warranty risk of a product sold in your territory by a resident affiliate company. The repair work under the warranty is carried out by the selling affiliate, on behalf of the non-resident affiliate, who pays the selling affiliate for the work done on its behalf. Are there any circumstances under which you could assess the non-resident affiliate's profits?]

The United States' right to tax income of the foreign corporation will also be dependent upon whether the foreign corporation can be deemed to be engaged in a trade or business within the United States or to have a PE within the United States, as appropriate. As discussed above, the mere fact that the entities are related should not impact this analysis. The determining factor is the facts and circumstances of the relationship between the parties, and whether the selling affiliate is viewed as an independent rather than a dependent agent as to the repair work it undertakes. In addition, depending on the facts, there may be transfer pricing issues with regard to the prices charged between the affiliates for the services performed, and, if the warranty was sold as a part of the price of the product, the portion of that total price allocated to the warranty.

(C) Are you able to counter a situation in which commercial decisions over assets or business functions are taken in you territory, yet legal ownership of assets or legal responsibility for those functions belongs to or rests with a company in a different jurisdiction?

[Suppose goods are manufactured in your country, and are sold to an affiliate in a second county, who then sells them to a third party customer resident in your country. The sale is facilitated by an affiliate company resident in your country- it 'services' the customer in that it demonstrates products and discusses customer needs, but plays no apparent part in the sale contract.]

The analysis set forth above with regard to question A is equally applicable to this question.

In addition, another possible avenue of taxing this income is through the U.S. subpart F regime. The U.S. subpart F regime may allow the United States to reach income where related parties attempt to manipulate the structure of their operations for tax avoidance purposes. Depending on the facts and circumstances, this may be foreign base company sales income and, thus, subpart F income on which United States shareholders are taxable on their pro rata share.

The transfer pricing rules may be implicated with regard to the allocation of profits on the initial transfer of the manufactured goods from the manufacturing affiliate to the affiliate in the second country, who sells them to the third party customer in the United States. Further, the United States may also apply its substance over form principles to recharacterize the substance of the transaction if, for example, there is no economic substance to the transaction or no business purpose of the entity in the second country. See, e.g., UPS of Am. v. Commissioner, T.C. Memo. 1999-268.

If you have any questions, please contact Shawn R. Pringle at (202) 622-3880.

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