

# Planning Problem on Taxing Income from U.S. Activities

## TOP-TIP ACTIVITIES IN THE UNITED STATES

Attached are two letters, one from Gabrielle Marx, an attorney specializing in patent law and the other from Adam Sea, the Managing Director of an Israeli company, Top-Tip, Inc. Top-Tip wants to export computerized textile machinery to the United States. Ms. Marx has requested expert tax advice from M. McSlim, Esq., for whom you are to act as law clerk. In addition to the information contained in the letters, you should know that Top-Tip has over \$8 million per year in income from world wide sources apart from the U.S. venture. It owns a small investment portfolio of stock. Contained in the portfolio are shares of U.S. companies traded on the New York Stock Exchange valued at \$100,000. Apart from the dividends on those shares and potential income from the proposed venture, it has no income derived from the U.S. In preparing a response for Ms. Marx, consider the following questions:

- (1) What are the U.S. tax consequences if Top-Tip establishes a U.S. subsidiary (TTUS), which makes the sales to unrelated customers in the U.S.?
- (2) What are the U.S. tax consequences of the operation of an unincorporated service office in the United States? Can the service office be separated from the sale activity? What are the U.S. tax consequences of the sale of spare parts by Top-Tip?
- (3) What are the U.S. tax consequences of direct sales by Top-Tip to U.S. customers, assuming Top-Tip does not have a sales office in the U.S.? What is the effect, if any, of making title to the goods pass outside the U.S.?
- (4) What are the U.S. tax consequences of the purchase of components in the U.S.? Does it matter, for U.S. tax purposes, whether the components are shipped to Israel for assembly or are shipped directly to the U.S. purchaser?
- (5) Assume that Top-Tip establishes a U.S. subsidiary, and the subsidiary agrees to pay a royalty to Top-Tip and/or Plato for the use of the textile technology. How would Top-Tip and Plato be taxed on royalties paid?
- (6) What are the tax consequences to Top-Tip in Israel? What is the current Israeli corporate rate? Does Israel provide any applicable tax incentives? Does it have any anti-tax haven legislation?<sup>1</sup>

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<sup>1</sup>Check the relevant BNA Portfolio, Doing Business in Israel.

For each of the following questions (7-10), assume that Israel and the United States have entered into a tax treaty similar to the U.S./Canada treaty.

(7) Will a U.S. subsidiary organized by Top-Tip (TTUS) that engages in sales of the textile machinery be the permanent establishment (PE) of Top-Tip?

(8) Can Top-Tip make purchases of equipment for shipment to Israel and reshipment to the U.S. without having a U.S. PE?

(9) Assume that Top-Tip wants to keep on its own payroll some of the engineers it will send to the United States for installing the equipment at the customers' locations. Will those engineers cause Top-Tip to have a PE in the United States. What if TTUS pays to Top-Tip the fair market value of the services provided by the engineers?

(10) What are the U.S. tax consequences on a royalty from TTUS to Plato, followed by a royalty to Top-Tip Antilles, a tax haven corporation owned by Top-Tip?



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November 29, Year 1

Mr. M. McSlim  
100 Cass St.  
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Dear Mac:

Enclosed is the letter from Adam Sea. Would it be possible for you to work up a draft memo for me to use in my discussions with Crow and Sea on Friday?

I was not able to get you the information on the Israeli tax picture which you requested. Adam thinks that Top-Tip will get a tax holiday in Israel anyway, so there will be no tax problem there for at least three years. I'm almost certain that the regular tax rate in Israel is higher than the U.S. rate. You will undoubtedly know whether the U.S./Israel tax treaty has been ratified.

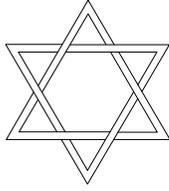
Adam's memo asked about the participation of Plato, Inc. which is a Greek company owning 25 percent of the common stock of Top-Tip. Plato, Inc. owns the textile patents in the U.S. and gets a 10 percent royalty. We can worry about that aspect, however, at a later date.

Very truly yours,

Gabrielle Marx

GM:bak

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**Top-Tip International, Ltd**  
100 Benjamin Drive  
10002 Hefa, Israel

20 November year 1

Ms. G. Marx  
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Detroit, MI 48202  
USA

Re: Top-Tip's Permanent Establishment in the USA — Tax Consequences

Dear Gabby:

I wish to outline to you the following business plan which we may adopt for Top-Tip for our U.S. operations, and ask you to conclude for us a study of tax consequences through your international tax man.

1. Top-Tip expects to be selling a number of computerized systems in the United States at a FOB retail price of \$150,000 - \$200,000 per unit. Our hope is for a volume of 150 per year.
2. We are purchasing \$35,000 of discrete elements per unit for the systems in the U.S., and wish to deliver these to customer's site for assembly and debugging on his premises. An additional \$6,000 of components is being purchased in the U.S. for assembly in Israel into additional system elements which will then be sent to the customer's plant site for incorporation and installation.
3. The Israeli manufactured elements will include the scanner, direct labor on assembly, and other direct charges, amounting in total to about \$35,000. The balance of the purchase price will comprise overhead charges, development write-off, and profit.
4. On discrete elements purchased in the U.S. for forwarding directly to the customer, we would pay the supplier from here and bill the customer for the entire system package in total.
5. Our engineers and technicians would be sent to install the system, debug it, run it in, and train the customer's personnel.
6. We would provide the servicing for the system both within warranty and thereafter. It is our intention to set up a headquarters in the U.S. consisting of a marketing specialist and one or two technicians. The marketing man will supervise our programmes throughout North America for promoting the sales of systems, scanners, and other products, and he will be

entitled to take FOB Israel orders. He will maintain no stock other than whatever is required for display purposes, except for the necessary minimum spare parts stock to ensure adequate servicing. The U.S. office might include a full-time software specialist, should this become a necessary addition to our marketing services, although we may get away with sending one from here periodically.

The marketing organization will have several sources of income:

- a) A commission would be paid on orders booked for shipment from Israel.
- b) Income from service contracts.
- c) Sale of spare parts and components.

We wish you to give us your opinion on the following points, as well as any others which occur to you, which should be covered as a result of such a modus operandi:

1. Should such an operation be incorporated in the U.S.?
2. Assuming that we will set a commission level at a point sufficient to cover operating costs plus a small profit, would this be the only income-tax liability on our operation, vis a vis the U.S. Tax Authorities, or would this be considered doing business in the U.S. by Top-Tip, with or without a U.S. subsidiary corporation? Is there any other corporate structure that would serve us better to avoid having to file a Top-Tip return in the U.S.?
3. Do you feel it would be safer for us to assemble all elements of the system in Israel, or, say, substantially all of them?
4. Is the fact that Plato, Inc. is participating in the equity of Top-Tip of any importance in assessing our tax situation?

You might have your tax man think about our Plato, Inc. deal to see if he has any ideas on how to structure it, so that when we pay out the royalty on sales in exchange for marketing rights this will not attract tax in the U.S. Plato, Inc. is also examining this point, and he could discuss it with Telly Crow if he has any ideas.

We would appreciate your reaction to the above as soon as possible.

Regards.

Yours sincerely,