

U.S. Tax Treatment of Income Earned through a Permanent Establishment

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For residents of a treaty country, U.S. effectively connected income is generally exempt from U.S. tax unless the taxpayer has a permanent establishment (p.e.) within the United States. In general, a permanent establishment is a fixed place of business, such as an office or a factory. The treaty rules limiting U.S. taxation of income that is effectively connected with a U.S. business are discussed in § 1.1, below. The rules for allocating deductions to effectively connected gross income are addressed in § 1.2.

§ 1.1. General

Under the typical U.S. tax treaty, the business profits of a foreign person entitled to treaty benefits cannot be taxed by the United States unless that person has a permanent establishment (PE) located within the United States and the profits are attributable to that permanent establishment.¹ According to the U.S. Model Treaty (2006), the profits attributable to a permanent establishment are the profits that the permanent establishment “might be expected to make” if it were an independent juridical entity acting on its own behalf.²

A permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on.³ It would include an office, a branch, a place of management, a factory, a workshop, or a mine.⁴ A construction site or drilling rig located within the United States for an extended period—typically 12 months—also would be a PE.⁵ The activities of an agent could cause a foreign person to have a PE

¹ See, e.g., U.S. Model Treaty (2006), Art. 7(1).

² U.S. Model Treaty (2006), Art. 7(2).

³ See, e.g., U.S. Model Treaty (2006), Art. 5(1).

⁴ See, e.g., U.S. Model Treaty (2006), Art. 5(2); U.S./India treaty, Art. 5(2)(f) (plantation constitutes a PE), 5(2)(l) (furnishing of services for 90 days or for a related person constitutes a PE).

⁵ See, e.g., U.S. Model Treaty (2006), Art. 5(3) (12 months). See also U.S./Australia treaty, Art. 5(5)(f) (9 months); U.S./Barbados treaty, Art. 5(2)(j) (183 days generally but 120 days for dredging site); U.S./Belgium treaty, Art. 5(2)(h) (12 months); U.S./Canada treaty, Art. 5(3) (12 months); U.S./China treaty, Art. 5(3) (6 months generally but 3 months for natural resources site); U.S./Egypt treaty, Art. 5(2)(g) (6 months); U.S./France treaty, Art. 5(3) (12 months); U.S./Hungary treaty, Art. 5(3) (24 months); U.S./India treaty, Art. 5(2)(k) (120 days); U.S./Japan treaty, Art. 9(2)(g) (24 months); U.S./Mexico treaty, Art. 5(3) (6 months); U.S./Philippines treaty, Art. 5(2)(i) (183 days); U.S./Thailand treaty, Art. 5(3)(a) (120 days); U.S./U.K. treaty, Art. 7(2)(c) (12 months).

within the United States if the agent had certain powers to act on behalf of its principal⁶ and was not an independent agent acting in the ordinary course of its business.⁷ A foreign taxpayer would not be deemed to have a PE within the United States simply because it engaged in purchasing activities or certain activities of a preparatory or auxiliary character through a fixed place of business or through an agent.⁸ The PE rule in U.S. tax treaties is generally in accord with the PE rule recommended in Article 5 of the OECD Model Treaty.

Under the standard treaty rule, a foreign taxpayer may engage in very substantial activities in the United States without becoming subject to U.S. tax. Some commentators contend that the exemption provided by the current PE rule should be narrowed. In their view, a dependent representative of a foreign taxpayer, including an affiliated company, should be treated as the PE of that taxpayer if the representative carries on substantial business on behalf of the taxpayer, such as, for example, generating \$100,000 of sales. The current rule would not treat a dependent agent as a PE if it does not have the authority to conclude contracts on behalf of the taxpayer. Using the power to conclude contracts as the test is criticized on the ground that it has little commercial significance in a world where communication between an agent and its foreign principal can be nearly instantaneous.

Activities carried on by a foreign taxpayer within the United States that would cause that taxpayer to have a PE generally would also cause that taxpayer to be engaged in a trade or business within the United States. It is possible, however, for a foreign taxpayer to be engaged in business within the United States without having a PE. For example, purchasing activities, however extensive, generally would not cause a taxpayer to have a PE, although they could cause it to be engaged in business. Similarly, a construction site present in the United States for a short period would not be a PE but would cause a taxpayer to be engaged in business.

The Code imposes U.S. tax on a foreign person engaged in business within the United States with respect to all of its U.S. source income, other than periodical income not effectively connected with the conduct of a U.S. business. Thus the Code would tax a foreigner with respect to U.S. source income that is unrelated to the activities that

⁶ See, e.g., U.S. Model Treaty (2006), Art. 5(5).

⁷ See, e.g., U.S. Model Treaty (2006), Art. 5 (6). See *Taisei Fire and Marine Insurance Co. v. Comm'r*, 104 T.C. 535 (1995) (holding that a U.S. agent acting as a reinsurance underwriting manager on behalf of several Japanese insurance companies was an “agent of an independent status” within the meaning of Article 5 of the U.S./Japan treaty and thus not a PE of its Japanese principals). It appears from the facts of that case that the U.S. agent also avoided U.S. tax on at least a portion of its profits by shifting those profits to a captive tax-haven reinsurance company organized in Bermuda.

⁸ See, e.g., U.S. Model Treaty (2006), Art. 5(4).

cause the foreigner to be engaged in business within the United States. The typical treaty rule, however, would prohibit the United States from taxing under the so-called force-of-attraction rule.⁹ A few tax treaties with developing countries retain some small element of the force-of-attraction rule by providing that income derived from sources within a Contracting State that is similar in nature to income earned through a permanent establishment in that state can be taxed by that state.¹⁰

Whether an activity constitutes a PE typically depends on the facts and circumstances of the particular case. Depending on the nature of the taxpayer's business, even a temporary business location may constitute a PE. For example, a taxpayer that regularly occupies space at a fair or market may have a PE despite the fair or market running for only a few weeks each year. Similarly, a temporary field office used to supervise construction of a pipeline or highway may constitute a PE, even if the office is shifted periodically as the construction activities progress.¹¹

Under Code section 864(c)(6) and (7), income earned through a PE but received after the PE ceases to exist is taxable as income effectively connected with a U.S. business. For example, if PCo earns consulting fees in year one, when it has a U.S. office, and gets paid those fees in year two, after it has closed that office, the fees are taxable as business income effectively connected to the office. The United States takes the position that the statutory rule is consistent with the permanent establishment clause of its tax treaties. That is, in the above example, the fees would be treated as earned through a PE. Article 7(8) of the U.S. Model Treaty provides as follows:

[A]ny income or gain attributable to a permanent establishment or fixed base during its existence is taxable in the Contracting State where such permanent establishment or fixed base is situated even if the payments are deferred until such permanent establishment or fixed base has ceased to exist.

The position taken in the U.S. Model Treaty is also taken in the Technical Explanation to that model¹² and in a U.S. reservation to the OECD Commentary.¹³ Some recent

⁹ IRC § 894(b) provides that a foreign person will be deemed not to have a permanent establishment within the United States for the purpose of determining whether that person is entitled to an exemption or a special tax rate with respect to periodical, etc., income that is not effectively connected with a U.S. business. That section was adopted in order to remove the force-of-attraction rule contained in some older U.S. tax treaties.

¹⁰ See, e.g., U.S./India treaty, Art. 7(1)(b); U.S./Philippines treaty, Art. 8(3); U.S./Thailand treaty, Art. 7(1)(b). See also UN Model Treaty (2001), Art. 7(b).

¹¹ See OECD Commentary on Article 5, para. 4.

¹² See Art. 7, Para. 8 of the *Technical Explanation of U.S. Model Treaty* (2006).

¹³ OECD Commentary on Article 7, para. 45. Article 7, para. 9 of the Commentary sanctions general anti-avoidance rules in domestic legislation to prevent the use of a PE for fiscal evasion.

U.S. tax treaties make the point explicitly.¹⁴ Commentators have also supported the U.S. position.¹⁵ Any other position would simply invite tax avoidance and make a mockery of the PE rule.

§ 1.2. Income and Deductions Attributable to a PE

The rules for attributing gross income and deductions to a PE are underdeveloped. The language of Article 7(2) of the U.S. Model Treaty (2006), repeated exactly or with minor variations in most actual U.S. treaties,¹⁶ provides as follows:

Subject to the provisions of paragraph 3 [dealing with deductions attributable to a PE], where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. For this purpose, the profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment.

The apparent purpose of this rule is to carry over to branches the arm's length principle contained in Article 9 (Associated Enterprises) of the OECD Model Treaty. As a general guideline for determining profits attributable to a PE, the treaty language quoted above is reasonable and uncontroversial. For example, if a foreign corporation engaged in business in the United States through a PE is buying goods from unrelated persons and selling them to U.S. customers, the U.S. tax authorities obviously should look at the real prices paid for the goods in determining the profits attributable to the PE

It is no doubt true that evasion of tax could be practised by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched.... It is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion.

¹⁴ See, e.g., U.S./France treaty, Art. 7(8); U.S./Denmark treaty, Art. 7(8); U.S./Estonia treaty, Art. 7(9). See also U.S./Ireland treaty, Para. 4 of Protocol to 1997 convention.

¹⁵ See, e.g., Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* 316-17 (3d ed. 1997).

¹⁶ See, e.g., U.S./Canada treaty, Art. VII(2) (identical language except at the end of the clause, but before the period, the following language is added: "and dealing wholly independently with the resident and with any other person related to the resident (within the meaning of paragraph 2 of Article IX (Related Persons)"); U.S./France treaty, Art. 7(2) (identical language); U.S. Lithuania treaty, Art. 7(2) (identical language); U.S./ Mexico treaty, Art. 7(2) (essentially identical language); U.S./Spain treaty, art. 7(2) (identical language); U.S. Thailand treaty, Art. 7(2) (identical language); U.S./U.K. treaty, Art. 7(2) (identical language except at the end of the clause, but before the period, the following language is added: "and dealing wholly independently with the enterprise of which it is a permanent establishment").

According to the OECD Commentary on Article 7, the profits determined under this language normally “would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy.”¹⁷

The extension of the arm’s length principle more generally can present some difficulties. For example, assume that BCo, a corporation resident in Country B, is manufacturing goods in Country B and selling them in Country A through a PE. Applying the arm’s length approach in this situation is easy enough if BCo also makes sales to unrelated distributors or if unrelated manufacturers produce substantially identical goods and sell them to unrelated distributors. In the more typical case, however, goods sold on international markets embody trademarks and other proprietary intangible property rights, making comparably sales difficult or impossible to identify. The arm’s length principle has been adapted, with limited success, to deal with cases of this type in the context of sales between related corporations. The special methods employed give great weight to the respective ownership rights of the related corporations to the intangible property. Those methods cannot be used properly for branch accounting, however, because the various branches of a corporation do not have ownership rights distinct from the rights of the corporation itself.

The United States typically uses a profit-splitting formula in cases like the one illustrated above.¹⁸ The use of that formula is sanctioned by paragraph 4 of Article 7 of the OECD Model Treaty. No comparable language is included in the U.S. Model Treaty (2006). Formulas are sanctioned by the OECD Commentary to Article 7.¹⁹

Some commentators have suggested that the language of Article 7(2) quoted above should be read as requiring a Contracting State to tax a PE as if it were an entity having an independent juridical status. Article 7(2), however, does not state or suggest that a branch should be taxed as an entity. What it does say is that the profits of the branch should be computed by reference to the profits that would be earned by “a distinct and independent enterprise engaged in the same or similar activities.” The clear implication is that profits should be attributed to the branch, using the arm’s length principle, with respect to activities of the branch that actually occurred. To treat a branch as a legal entity, however, the tax authorities would need to construct a series of hypothetical activities between the branch and the rest of the corporation that in fact never occurred.²⁰

¹⁷ OECD Commentary on Article 7 (1997), para. 11.

¹⁸ Reg. § 1.863-3(b) (1996) (generally applying a 50/50 splitting formula to allocated profits between the place of manufacture and the place of sale).

¹⁹ See OECD Commentary (1997) to Article 7, para. 25 (noting a preference for an arm’s length method but authorizing countries that have customarily used profit-splitting formulas to continue doing so).

²⁰ In *North West Life Assurance Company of Canada v. Comm’r*, 107 T.C. 363 (1996), the Tax Court held that the United States could not impose the formula contained in IRC § 842(b) to compute the income

Treating a branch, which has no capacity to own property or to enter into contracts, as if it were a legal entity having those capacities would lead to anomalous results. Assume, for example, that a foreign corporation having a PE in the United States owned a valuable trademark that was being used by all of its branches. Relying on the separate entity analogy, the company might assign ownership of the trademark to a branch located in a tax haven and record on the books of the various branches, including the PE in the United States, an “arm’s length charge” for the use of that trademark. The result would be that profits would be stripped out of the U.S. branch (and branches located in other countries that tax the business profits of foreign corporations) and transferred to the tax-haven branch.

The example above illustrates the possible use of a separate-entity analogy to deplete profits in the source country. An aggressive source country could use the same approach, however, to inflate the income of a PE operating within its borders. The tax authorities of that country might readjust the company books on the assumption that the PE located within its borders was the owner of the company trademark. Under that assumption, the taxable income attributed to the PE would be inflated by hypothetical payments to it from the various other branches of the company.

As the examples above suggest, the separate-entity approach to branch taxation is fundamentally flawed because it requires arbitrary assumptions about the allocation of ownership rights among the branches of a company when the assets are actually owned by the company as a whole. Treating a branch as a separate juridical person is actually inconsistent with the arm’s length principle because, in the real world of commerce, a company does not pay another company for the right to use property when the other company does not own that right. The United States has never interpreted its tax treaties as requiring it to treat branches of a company as if they were separate legal entities.²¹

of the taxpayer attributable to its U.S. PE That section requires a foreign insurance company to treat a minimum portion of its net investment income as income effectively connected with its U.S. business. According to the Court, para. 2 of Article VII of the U.S./Canada precludes “the fictional allocation of business profits to [North West’s] permanent establishment.” In a concurring opinion, Judge Halperin states as follows:

Section 842(b) is inconsistent with paragraph 1. The imputation to a foreign insurance company of a *notional* amount of investment income under section 842(b) . . . contravenes the threshold requirement in paragraph 1 that the business profits attributed to a permanent establishment come from the pool of business profits of the resident carrying on business through the permanent establishment.

²¹ For discussion of the difficulties that would arise in attempting to treat a PE as a separate juridical entity, see H. David Rosenbloom, “The Source of Interest Payments Made by Nonresidents,” 30 *Wayne Law Review* 1023, 1030-1038 (1984). See also Brian J. Arnold & Michael J. McIntyre, *International Tax Primer*, 2d ed. (2002), chapter 4/C.

In general, a foreign taxpayer having a PE within the United States is taxable on its U.S. source income derived through the activities and assets of the PE. This approach is specifically sanctioned in some U.S. tax treaties.²² An arm's length approach would be used in appropriate cases to compute the amount of gross income items attributed to the activities of the PE and to determine the amount of the expenses of the foreign corporation attributed to a PE.

The principles that the United States applies in attributing U.S. source income to the PE of a foreign taxpayer are the principles developed in the regulations for determining whether various items of periodical income are effectively connected with a U.S. trade or business. In accordance with those principles, substantial reliance is placed on the books and records of the PE.²³ The Service would adjust the gross income and deductions shown on the books of the PE, however, if the amounts shown were improper. For example, the Service would adjust the books if U.S. source income derived from activities of the PE within the United States or from assets held by the PE within the United States was not included on those books. Nothing in Article 7 of the OECD model can fairly be read as being inconsistent with the U.S. approach.

U.S. tax treaties require the United States to allow a PE taxable in the United States to take deductions properly allocated to it. Article 7, paragraph 3, of the U.S. Model Treaty (2006) contains the following language:

In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses that are incurred for the purposes of the permanent establishment, *including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.*
(Emphasis added.)

Similar language, with some significant variations and embellishments, is included in most U.S. tax treaties.²⁴

²² See U.S./Canada treaty, Art. 7(7) ("the business profits attributable to a permanent establishment shall include only those profits derived from the assets or activities of the permanent establishment"). See also U.S. France treaty, Art. 7(6) (similar statement); U.S. Mexico treaty, Art. 7(5) (similar statement); U.S./Netherlands treaty, Art. 7(5) (similar statement).

²³ The records must be kept in a consistent manner. See Art. 7(5), U.S./Canada treaty.

²⁴ See, e.g., U.S./France treaty, Art. 7(3) ("In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are reasonably connected with such profits, including executive and general administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere."); U.S. Lithuania treaty, Art. 7(3) (identical language except that the

As required by its tax treaties, the United States permits foreign taxpayers to deduct from the gross income of its U.S. PE the actual expenses incurred by the foreign taxpayer to earn U.S. source gross income. For example, if a foreign corporation makes sales into the United States through a U.S. office, it could deduct the salaries for the local office manager and the sales staff from the gross income generated by the U.S. office in computing its U.S. taxable income. The foreign taxpayer also would be allowed to deduct a reasonable portion of the expenses of its head office that related to the management of the U.S. office.

following sentence is added: "A Contracting State may, consistent with its law, impose limitations on deductions, so long as these limitations are consistent with the concept of net income."); U.S./Mexico treaty, Art. 7(3) ("In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of such amounts, if any, paid (otherwise than toward reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices by way of royalties, fees or other similar payments in return for the use of patents or other rights, by way of commission, for specific services performed or for management, or except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment."); U.S./Spain treaty, art. 7(3) (identical language); U.S./U.K. treaty, Art. 7(3) (identical language).