U.S. Taxation of Foreign Corporations in the Digital Age

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I. INTRODUCTION

The United States taxes foreign corporations only on that portion of their income derived from economic activities that have some nexus with the United States. The highly technical rules that the United States has developed for determining whether the necessary nexus has been established are addressed in this article. The operation of those rules depends, in substantial part, on the U.S. rules that determine the source of income. The U.S. source rules, however, are addressed only briefly here. The U.S. rules established by the Internal Revenue Code of 1986, as amended (I.R.C.) for taxing foreign corporations are modified in important ways by U.S. tax treaties. Although the focus of this article is on the U.S. rules, tax treaty rules are addressed when necessary to explain how the U.S. rules actually operate or are likely to be interpreted.

Part II of this article presents an overview of the U.S. rules for taxing foreign corporations on business income derived from the United States.[1] In general, these rules provide that foreign corporations engaged in business in the United States are taxable on their U.S.-source taxable income, unless that income is investment income (fixed or determinable annual or periodical income) that is unrelated to their U.S. business. Such investment income is taxable on a gross basis through the imposition of a withholding tax or is exempt from tax by statute or treaty. Special emphasis is given in Part II to the rules governing the taxation of income derived by a foreign corporation from the sale of tangible personal property in the United States.

Foreign corporations that are directly engaged in business in the United States are concentrated in the finance, insurance and real estate industries. Most foreign-based multinational companies that engage in manufacturing or marketing goods in the United States operate through a U.S. affiliate. In 1997, foreign corporations engaged in business in the United States had U.S. gross receipts of USD 109 billion,[2] whereas the U.S. gross receipts of foreign-controlled domestic corporations were USD 1.8 trillion.[3] In general, a U.S. affiliate of a foreign corporation is subject to the U.S. rules applicable to domestic corporations owned by U.S. interests.

Part III deals with the U.S. income taxation of foreign corporations engaged in electronic commerce in the United States. Various types of businesses can be conducted through

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[1] For a more detailed discussion of the U.S. tax rules, see McIntyre, Michael J., *The International Income Tax Rules of the United States*, two volumes (Lexis Publishing, 2000; loose-leaf), Chapter 2. Some portions of this article are adapted from that treatise.

[2] Internal Revenue Publication (IRS) Publication 16, revised September 2000, Table 10 (97COALCR.EXE available at www.irs.gov/tax_stats/soi/int_fc.html (for 1997).

[3] Hobbs, James R., "Foreign-Controlled Domestic Corporations, 1997", 20/1 *SOI Bulletin* 122 (Summer 2000), at 123.

electronic means. The focus in this part is on sales of tangible and intangible personal property over the Internet. Most of the relevant U.S. tax rules governing the sale of tangible and intangible property by foreign corporations were developed decades ago, before the Internet age. The application of these old rules to this new form of business activity is unclear in many respects. The article contends, nevertheless, that the current U.S. tax rules, properly interpreted, give the U.S. tax authorities the power to impose tax on foreign corporations engaged in many forms of electronic commerce in the United States.

The article also looks briefly (in III.C.) at the protection from U.S. taxation that a foreign corporation engaged in electronic commerce in the United States might obtain through a tax treaty. The basic issue, under the I.R.C. and under U.S. tax treaties, is whether a foreign corporation operating a business in the United States through a virtual office has a fixed place of business within the United States. A virtual office, for purposes of this discussion, is a web site employed by a taxpayer to transact its business. This part of the article argues that a virtual office is functionally equivalent to a "bricks and mortar" office and should be treated as a fixed place of business under the I.R.C. and existing U.S. tax treaties. This view obviously rejects the contrary position recently taken by the OECD in its new Commentary on Art. 5 (Permanent establishment) of the its Model Tax Convention on Income and on Capital (OECD Model).[4]

II. U.S. TAXATION OF THE BUSINESS PROFITS OF FOREIGN CORPORATIONS

A. Overview

In general, the United States taxes foreign persons under the I.R.C. only on their U.S.-source income (I.R.C. §§ 872(a) and 882(b)). An exception to this rule applies to certain foreign-source income earned through a U.S. office (I.R.C. §§ 864(c)(4), 872(a)(2) and 882(b)). Not all U.S.-source income, however, is subject to U.S. taxation. In general, a

[4] See OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, Paris, 22 December 2000 (hereafter "new OECD Commentary").

taxpayer is not taxable on U.S.-source income from business operations unless the taxpayer is engaged in a trade or business within the United States. More specifically, foreign corporations are subject to tax on taxable income that is effectively connected with a U.S. trade or business and on certain periodical investment income having a U.S. source.[5] Effectively connected income is computed by determining the gross income that is effectively connected with a U.S. trade or business and subtracting therefrom the properly allocable deductions. Information on the business activities of foreign corporations in the United States is provided in Table 1.

Table 1: Foreign Corporations with Income Effectively Connected With a U.S. Business, 1983-1997
(money amounts in millions of U.S. dollars)

Item	1983	1987	1991	1993	1997
Number of returns	8,001	10,478	10,135	10,510	12,154
Total receipts	$20,794	$61,004	$109,597	$75,486	$109,072
Total deductions	$21,882	$61,130	$108,702	$76,535	$107,957
Aggregate net income	-$1,118	-$162	$849	-$1,093	$1,034
U.S. income subject to tax	$469	$1,647	$2,318	$2,556	$3,930
Income tax after credits	$152	$614	$810	$895	$1,436
Taxes as percent of receipts	0.7%	1.0%	0.7%	1.2%	1.3%

Sources: Sarah E. Nutter, "Statistics of Income Studies of International Income and Taxes," 18 *SOI Bulletin* 151-177 (Winter 1998-1999), Figure N (for 1983-93) and IRS Publication 16.[6]

The I.R.C. contains many special provisions applicable to foreign taxpayers. One such provision, added by the 1986 Tax Reform Act, is the branch profits tax. Another important provision is the "earnings stripping" rules, which typically limit the allowable deduction for interest payments made by a U.S. corporation to its foreign parent. Although the earning stripping rules formally apply to U.S. affiliates of foreign corporations, their economic effect is to tax foreign corporations on income earned through a U.S. affiliate that otherwise would escape U.S. taxation through what the U.S. government considers to be an excess interest deduction.

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[5] See I.R.C. § 881(a)(1) (imposing a withholding tax of 30% on "fixed or determinable annual or periodical gains, profits, and income"). Regarding effectively connected income, see II.B.

[6] See note 2, supra, for the full citation to IRS Publication 16.

The general statutory pattern described above is modified by numerous tax treaties. All U.S. tax treaties limit U.S. source jurisdiction over the business income of foreign nationals of treaty partners to income attributable to a permanent establishment located in the United States. U.S. tax treaties are "relieving" only -- that is, they may provide relief from the taxes imposed by the I.R.C., but do not impose taxes themselves.

B. Taxation of effectively connected income

Under I.R.C. § 882(a)(1), a foreign corporation engaged in a trade or business within the United States is taxable "on its taxable income which is effectively connected with the conduct of a trade or business within the United States". In general, a foreign corporation must be engaged in a trade or business within the United States during the taxable year to have effectively connected income. This rule allows foreigners with minimal economic contacts with the United States to escape taxation on their U.S.-source business income, regardless of how much they earn from U.S. sources. The "engaged in business" requirement serves a function similar to the permanent establishment article in U.S. tax treaties, although the permanent establishment threshold for taxation is much higher than the "engaged in business" threshold. In some special circumstances, a corporation not engaged in business is deemed to be so engaged.[7]

A foreign corporation is taxable on its effectively connected income under rules that are roughly comparable to the rules that would apply if that income were earned by a U.S. corporation. The tax rate is the rate provided by the rate schedule in I.R.C. § 11. Foreign corporations are also subject to the alternative minimum tax (I.R.C. § 55).[8] Under some

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[7] Gain or loss derived from the sale or other disposition of a U.S. real property interest is classified as effectively connected income under I.R.C. § 897(a)(1) whether or not the taxpayer is engaged in business in the United States. The complex rules applicable to U.S. real property interests are not addressed in this article.

[8] The alternative minimum tax (AMT) is imposed instead of the regular tax when a taxpayer has claimed an above-average amount of tax preferences under the regular tax rate. In general, the AMT has a broader base (after a large exempt amount) and a lower rate than the regular tax.

circumstances, a foreign corporation is subject to the personal holding company tax[9] and the accumulated earnings tax.[10]

1. Allowable deductions

A foreign corporation may claim a deduction for business expenses and depreciation in computing its effectively connected income. In general, business expense deductions are not allowed unless they are linked to gross income that is effectively connected with a U.S. trade or business. The rules for establishing that linkage are complex and, in some cases, indeterminate. Most of these rules are a subset of the rules for determining U.S.-source taxable income.

To claim a deduction, the foreign taxpayer must generally file a "true and accurate" tax return and submit it in a timely fashion (Treas. Reg. § 1.882-4(a)(2)).[11] A foreign corporation must also file a timely and true return to claim most tax credits.[12] In general, the regulations under I.R.C. § 882 provide that foreign corporations will not lose their right to claim deductions if they file a true return within 18 months of the due date

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[9] The personal holding company (PHC) tax is a tax on the undistributed PHC income of a PHC. See I.R.C. § 541 (imposing the tax) and § 545(c)(7) (exempting a foreign corporation from the PHC tax if all of its stock is held, directly or indirectly, by non-resident alien individuals).

[10] The accumulated earnings tax is a tax on the accumulated taxable income of a corporation. See I.R.C. § 531. Foreign corporations are generally subject to the tax with respect to their U.S.-source income if any of their shareholders are persons subject to U.S. tax on distributions of the corporation -- that is, shareholders that are (a) U.S. citizens or residents, (b) non-resident aliens taxable under I.R.C. § 871, or (c) foreign corporations that are owned in part by U.S. citizens or residents or by non-resident aliens taxable under I.R.C. § 871. Treas. Reg. § 1.532-1(c).

[11] I.R.C. § 882(c)(2). The failure to file a true and timely tax return generally does not cause a corporation to lose the right to claim a deduction for charitable contributions. Treas. Reg. § 1.882-4(a)(1).

[12] I.R.C. § 882(c)(2). Notwithstanding their failure to file a timely return, foreign taxpayers may still claim a credit under I.R.C. §§ 31 and 33 (withholding taxes on wages and periodical income), § 32 (earned income credit), § 34 (credit for certain uses of gasoline and special fuels), and § 852(b)(3)(D)(ii) (credit for taxes deemed paid by shareholders of regulated investment companies). Treas. Reg. § 1.882-4(a)(1).

(Treas. Reg. § 1.882-4(a)(3)). The regulations also provide that taxpayers must file a true and timely return to claim the deductions allowable under a tax treaty in computing the income attributable to a U.S. permanent establishment.[13] Foreigners claiming an exemption from U.S. tax under a tax treaty may preserve their rights to deductions should their treaty claim prove illusory by filing a protective tax return -- a return that gives identifying information about the taxpayer without giving specifics about the taxpayer's gross income or deductions.[14] Under "rare and unusual circumstances", the tax authorities may grant a waiver of the timely return requirement (Treas. Reg. § 1.882-4(a)(3)(ii)).

To prevent related parties from obtaining unwarranted timing benefits, the I.R.C. provides that a taxpayer, whether domestic or foreign, cannot take a deduction with respect to an amount owed to a related party until the related party includes that amount in its income (I.R.C. § 267(a)(2)). The regulations under I.R.C. § 267(a)(3) provide that a taxpayer cannot generally accrue a deduction for an amount owed to a related foreign party if that amount would constitute investment income subject to withholding in the hands of the recipient (Treas. Reg. § 1.267(a)-3(b)(1)). The deduction is allowed, however, when the amount is actually paid. Except for interest deductions, which are governed by the earnings stripping rules, the requirement of actual payment does not apply if the amount owed would be exempt in the hands of the recipient under a tax treaty. The regulations allow a deduction without actual payment in some other situations that are thought not to involve tax avoidance (Treas. Reg. § 1.267(a)-3(c)(4)).

Foreign corporations may claim the deduction for charitable contributions provided by I.R.C. § 170 whether or not the contributions are related to their U.S. business (I.R.C. §§ 873(b)(2) and 882(c)(1)(B)). Many of the tax credits, such as the general business credit,

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[13] Treas. Reg. § 1.882-4(a)(3)(iii). This regulation is apparently intended to forestall claims by residents of a treaty country that their treaty rights override the requirements of I.R.C. § 882(c)(2). In general, the imposition of reasonable filing deadlines should not be held to violate U.S. income tax treaties.

[14] Treas. Reg. § 1.882-4(a)(3)(iv). Notice of the treaty claim generally is required by I.R.C. § 6114.

that are allowable to domestic taxpayers are allowable to foreign taxpayers as well.[15] Foreign persons may not claim a foreign tax credit, except for the credits granted under I.R.C. §§ 906 and 877 for the foreign taxes paid with respect to foreign-source income (I.R.C. §§ 901(b)(4) and 877(b)).

2. Defining effectively connected income

The I.R.C. definition of "effectively connected income" is convoluted. The general rule is that all of the U.S.-source gross income of a foreign corporation is effectively connected gross income if that corporation is engaged in business within the United States (I.R.C. § 864(c)(1), (3)). An exception to the general rule provides that U.S.-source gross income classified as investment income (fixed or determinable annual or periodical gains, profits and income "periodical, etc. income")) under I.R.C. § 881 is not effectively connected gross income (I.R.C § 864(c)(2), (3)). An exception to that exception provides that periodical, etc. income will be effectively connected gross income under some circumstances.

The U.S.-source income of a foreign corporation derived from activities causing it to be engaged in business in the United States is effectively connected income. Assume, for example, that MCo, a foreign corporation, engages in the manufacture of automobiles in Flat Rock, Michigan. These activities cause MCo to be engaged in business within the United States. All of the U.S.-source income derived from manufacturing those automobiles in the United States is effectively connected income.

3. Force of attraction rule

In addition, the U.S.-source income of a foreign corporation engaged in a trade or business within the United States is effectively connected income even if the income is derived from activities that are unrelated to that trade or business. Assume, for example,

[15] See e.g. I.R.C. § 38 (allowing the general business credit to taxpayers without reference to their residence status).

that MCo, the automobile manufacturer described above, makes occasional sales of desk calculators in the United States through independent distributors. Even if MCo's sales activity in the United States with respect to the sale of calculators is insufficient to constitute engaging in business within the United States, the U.S.-source income derived from those sales will be effectively connected income.

The rule illustrated by this example is called the "force of attraction" rule. It once had a much broader application. Prior to the adoption of the 1966 tax act, a foreign person engaged in a trade or business within the United States was taxable on its entire U.S.-source taxable income, including its periodical, etc. income, under rules similar to the rules now governing the taxation of effectively connected income.

The 1966 act introduced the concept of effectively connected income in order to limit the force of attraction rule. The 1966 act provided that periodical, etc. income unrelated to a U.S. business would not be "attracted" to a U.S. business. Instead, the income would be subject to the 30% withholding tax of the I.R.C. or to the lower withholding rate applicable under a tax treaty. The change was made to encourage investment in U.S. stocks, securities and other portfolio assets and to prevent certain foreign persons from avoiding the 30% withholding tax.

The vestige of the force of attraction rule contained in I.R.C. § 864(c)(3) is defensible on two grounds. The first advantage is that it avoids the difficult administrative problems that otherwise would arise in determining whether income of a foreign taxpayer is attributable to a particular business. This problem is particularly acute when a business records some U.S. sales on the books of its U.S. office and records other U.S. sales of the same or similar products on the books of a foreign office.

The second advantage of the force of attraction rule is that it tends to equalize the tax treatment of foreign and domestic taxpayers. The function of the "engaged in business" requirement is to avoid the interference with international commerce that might result from the extension of U.S. tax jurisdiction to foreign persons having only incidental contacts with the United States. Once a foreign person is subject to U.S. tax jurisdiction, however, the inconvenience to the foreign taxpayer of complying with U.S. tax rules with respect to all of its U.S.-source business income is not sufficient to override the goal of tax equity.

The force of attraction principle generally does not apply under U.S. tax treaties. Only income attributable to a U.S. permanent establishment is subject to U.S. tax. To the extent that the foreign person is subject to tax in its country of residence, the fairness problem is solved. The treaty rule creates a serious administrative problem, however, because it requires the IRS to determine whether the U.S.-source income of a foreigner is attributable to a permanent establishment.

4. Effectively connected investment income

In some circumstances, U.S.-source income of a type that normally would constitute non-business periodical, etc. income may be classified as effectively connected income. Whether the U.S.-source periodical, etc. income of a foreign taxpayer is effectively connected with a U.S. trade or business depends on the facts and circumstances of each case. The regulations under I.R.C. § 864(c)(2) provide two tests -- the "asset use" test and the "business activities" test -- that are helpful in determining whether periodical, etc. income is effectively connected income.

Under the asset use test, U.S.-source periodical, etc. income derived from assets used in a U.S. trade or business is generally treated as effectively connected income (I.R.C. § 864(c)(2)(A)). For example, interest income on a trade receivable acquired in the conduct of a U.S. business is effectively connected income (Treas. Reg. § 1.864-4(c)(2)(ii)(b)). Similarly, interest income derived from the temporary investment of funds needed in the taxpayer's U.S. business is effectively connected income (Treas. Reg. § 1.864-4(c)(2)(v) (Example 1)). An investment asset is generally presumed to be used in a U.S. business if (1) it was acquired from funds generated by that business, (2) the income derived from the use of the asset is retained by the U.S. business, and (3) the persons conducting the U.S. business have control over the asset (Treas. Reg. § 1.864-4(c)(2)(iv)(b)). Stock of a corporation is not treated as an asset held for use in the conduct of a trade or business in the United States (Treas. Reg. § 1.864-4(c)(2)(iii)(a)).

Under the business activities test, U.S.-source periodical, etc. income is also treated as effectively connected income if the activities of the taxpayer in carrying on its U.S. trade or business were a material factor in earning that income (I.R.C. § 864(c)(2)(B) and Treas. Reg. § 1.864-4(c)(3)). Assume, for example, that a foreign corporation has a branch in the United States and the branch arranges for the license of patents to U.S. customers for royalties as a regular part of its business. The activities of the branch are sufficient to make the foreign corporation engaged in business within the United States. The royalty income of the foreign corporation is effectively connected income because the activities of its U.S. branch were a material element in earning the income (Treas. Reg. § 1.864-4(c)(3)(i); cf. Treas. Reg. § 1.864-4(c)(3)(ii) (Example 2)).

In applying the asset use test and the business activities test, the regulations advise that "due regard shall be given to ... whether or not the asset, or the income, gain, or loss, is carried on books of account separately kept for the trade or business" (Treas. Reg. § 1.864-4(c)(4)). Of course, the taxpayer's method of accounting is not controlling. The weight to be given to an accounting method depends on its conformity to accepted accounting practices and the consistency of its application by the foreign taxpayer.

5. Foreign-source effectively connected income

Certain foreign-source income of a foreign person engaged in a U.S. trade or business is treated as effectively connected income under I.R.C. § 864(c)(4). The foreign taxpayer must have an office or other fixed place of business located within the United States, and the foreign-source income must be attributable to that office or other fixed place of business. Prior to the adoption of I.R.C. § 865(e)(2) by the 1986 Tax Reform Act, foreign taxpayers making sales into the United States through a U.S. office would have foreign-source income if they passed title to the goods outside the United States (I.R.C. § 861(a)(6)).

Except in some special cases, income that would constitute foreign-source effectively connected sales income is now characterized as U.S.-source income under I.R.C. § 865(e)(2). As a result, the foreign-source effectively connected rule of I.R.C. § 864(c)(4) has diminished in importance since 1986. The regulations issued under that section remain important, however, because they provide important guidance in determining whether a taxpayer has a fixed place of business in the United States and whether income is attributable to that fixed place of business.

6. Source of income on sales of tangible property

The source of gross income from the purchase and sale of personal property is generally determined under I.R.C. § 865. Subject to many important exceptions, I.R.C. § 865 provides that income from the sale of personal property has its source in the country where the seller is resident. Most income derived from the purchase and sale of personal property is governed by one of the exceptions to the "residence of the seller" rule. One exception, discussed here, applies to the sale of property that satisfies the definition of inventory property contained in I.R.C. § 865(h)(1). In general, inventory property is personal property sold in the normal course of a taxpayer's business.

Under I.R.C. § 865(b), the source of income derived from the purchase and sale of inventory property is determined under the source rules of I.R.C. §§ 861(a)(6) and 862(a)(6). Under these sections, income from the purchase and sale of inventory property has its source in the country where the goods are deemed to have been sold. The regulations and a long line of court cases hold that the place of sale is generally the place where title to the goods passed to the buyer (Treas. Reg. § 1.861-7(c)). From a policy perspective, this rule is unsupportable. It gives the taxpayer the power to avoid U.S. tax jurisdiction simply by making formal title pass to the buyer outside the United States.

Policymakers in the United States are well aware that the "passage of title" rule is contrary to sound policy. Various administrations, Democratic and Republican, have attempted to repeal it, only to be defeated by the lobbying efforts of the U.S.-based multinational companies that benefit from it.[16] In 1986, the Reagan Administration proposed its outright repeal. That effort was defeated, however, because of a Congressional fear that elimination of the rule for inventory property might have a negative impact on U.S. exports.

Congress did agree, however, to repeal the passage of title rule of I.R.C. §§ 861(a)(6) and 862(a)(6) with respect to inventory property imported into the United States by non-resident taxpayers through a U.S. office or other fixed place of business. Under the office source rule, contained in I.R.C. § 865(e)(2), the income generated by such sales produces U.S.-source income, regardless of where title passes. The office source rule incorporates by reference the provisions of I.R.C. § 864(c)(5) (relating to the definition of foreign-source income effectively connected with a trade or business) for determining whether a taxpayer has a fixed place of business and whether income is attributable to that fixed place of business.[17]

C. Engaged in trade or business

1. In general

Neither the I.R.C. nor the regulations define the phrase "engaged in trade or business within the United States". The definition of this phrase must be gleaned from a reading of court cases and administrative determinations and from the practices of the IRS. The I.R.C. adds a gloss to the understanding of that phrase by specifying that a taxpayer performing services within the United States is generally engaged in trade or business there (I.R.C. § 864(b)). A few other I.R.C. rules give additional content to that phrase.

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[16] U.S.-based multinational companies use the passage of title rule to inflate the amount of foreign-source income they derive from the manufacture of goods in the United States and their sale abroad. These companies care deeply about the amount of their foreign-source income because an increase in that amount often allows them to increase their allowable foreign tax credits by increasing the limitation on the credit.

[17] I.R.C. § 865(e)(3). In general, an office must be a material factor in the production of an item of income for that income to be attributed to the office.

A foreign corporation may be engaged in a trade or business within the United States on account of its own activities or on account of the activities conducted on its behalf by employees or agents. Indeed, by its nature, a corporation can only act through its employees or agents; thus, any meaningful rule of nexus, as applied to corporations, must provide that the activities of employees and agents result in nexus for the principal.

Whether the activities of an agent are attributable to its principal depend on the nature of the agent's business and the control that the principal exercises over the agent. The activities within the United States of an independent agent, such as a freight forwarder, would not generally be attributed to its principal. In contrast, the activities of an agent would generally be attributed to its principal if the agent has no independent status or has very limited powers to act without approval. A U.S. subsidiary of a foreign corporation is not treated as the agent of its parent unless it performs the functions of an agent.[18]

A foreign corporation engaged in a trade or business within the United States at any time during a taxable year is treated as engaged in that trade or business for the entire taxable year (Treas. Reg. § 1.881-1(b)(2)). In general, activities of one taxable year do not carry over to make a taxpayer engaged in a trade or business in another taxable year.[19]

A foreign corporation that is a partner in a partnership is treated as engaged in a trade or business within the United States if the partnership is so engaged (I.R.C. § 875(1)). Similarly, a foreign corporation that is the beneficiary of a trust which is engaged in a trade or business within the United States is treated as being engaged in such trade or

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[18] See Rev. Rul. 70-424, 1970-2 *C.B.* 150 (holding that a subsidiary corporation, acting as an agent for its foreign parent, caused the parent to be engaged in business within the United States).

[19] The taxation of deferred payments, however, does depend on the status of the taxpayer in the year the activities giving rise to the payments were conducted. I.R.C. § 864(c)(6), (7).

business within the United States (I.R.C. § 875(2)). These rules are necessary because partnerships, and certain trusts and estates that distribute their income to their beneficiaries, are not themselves taxable on their effectively connected income.

2. Purchase and sale of tangible personal property

A foreign taxpayer deriving income from the sale of inventory property through regular and sustained activities conducted within the United States is engaged in a trade or business within the United States. Inventory property is generally defined to be property sold by the taxpayer in the ordinary course of its business (I.R.C. § 865(i)(1)). Casual sales of inventory property do not constitute engaging in a trade or business, absent special circumstances.[20] The threshold of sales activity necessary to be engaged in a trade or business, however, is low relative to the high threshold established by the permanent establishment concept found in virtually all tax treaties.

A foreign corporation can engage in business in the United States without having a U.S. office or other U.S. fixed place of business. It is enough simply to be engaged in sustained and purposeful activities in the U.S. marketplace, other than solicitation through the mail, television, radio or similar medium.

Foreign taxpayers that regularly purchase and sell investment assets, such as stocks and securities, or that trade in commodities are engaged in a trade or business within the United States under some conditions.[21] Fairly extensive investment activities, however, might not constitute engaging in a trade or business.[22] The case law has not developed

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[20] See e.g. *Linen Thread Co. v. Commissioner*, 14 T.C. 725 (1950) (holding that two unplanned and unsolicited U.S. sales by a foreign corporation resulting in a profit of about USD 150 did not constitute engaging in a trade or business in the United States).

[21] See e.g. *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950), cert. denied, 341 U.S. 925 (1951) (holding that a non-resident alien who earned large sums from investment activities while present in the United States during World War II was engaged in business).

[22] See e.g. *Chang Hsiao Liang v. Commissioner*, 23 T.C. 1040 (1955) (holding that a non-resident alien who managed an active investment portfolio through a U.S. agent was not engaged in business within the United States).

clear tests, but generally a taxpayer engaging in multiple transactions for short-term gains is likely to be treated as engaged in business, unless one of the statutory exceptions for trading in securities or commodities is applicable. For example, a foreign corporation was treated as engaged in a trade or business in the United States when it regularly purchased certificates of deposit in the United States for its customers through a dependent agent that acted on its behalf as a resident broker.[23] To encourage investment activities in the United States, Congress has provided that a foreign taxpayer will not be treated as engaged in business within the United States as a result of trading in stocks and securities for its own account or trading through an independent resident broker, commission agent, custodian or other independent agent (I.R.C. § 864(b)(2)).

III. U.S. TAXATION OF INCOME DERIVED FROM ELECTRONIC SALES OF PERSONAL PROPERTY WITHIN THE UNITED STATES

A. Overview

As explained in II., a foreign corporation selling personal property into the United States is taxable only on its effectively connected income. It can avoid having effectively connected income either by not engaging in business in the United States or by not having U.S.-source income. Because the "engaged in business" threshold is low, however, the first option is not likely to be available to a foreign corporation that engages in substantial business activities within the United States.

The second option -- not having any U.S.-source income -- is available only if the foreign corporation is able (1) to pass title to goods that it then sells to U.S. customers outside the United States and (2) to avoid having a U.S. office (or other fixed place of business). If the foreign corporation has a U.S. office, the passage of title rule for determining the place of sale is overridden by the office source rule. Under the office source rule, the place of sale, and thus the source of the income, is the place where the office is located.

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[23] *Inverworld, Inc. v. Commissioner*, T.C. Memo. 1996-301 (1996), T.C. Memo. 1997-226 (1997) (supplemental opinion affirming prior opinion and denying rehearing).

The advent of electronic commerce threatens to make hash of this statutory scheme. Electronic commerce gives remote sellers direct access to all U.S. consumers with access to the Internet. Customers can log onto the remote seller's web site, select products for purchase from an online catalogue, and consummate the sale online by filling out a form and charging the purchase to their personal credit card. Remote sellers can pass title to the goods outside the United States without difficulty by inserting some boilerplate language in the sales agreement. If these electronic sales are viewed as made through a U.S. office, the office source rule applies and the income from the electronic sales is taxable as effectively connected income. If, however, the virtual office is not treated as an "office" for purposes of the office source rule, the income derived from the electronic sales will escape U.S. taxation and will probably escape taxation everywhere else as well.

As discussed above, a foreign corporation cannot have effectively connected income unless it is engaged in business in the United States. The mere use of a web site electronically present in the United States to advertise products or to give ordering information to potential customers clearly would not constitute engaging in business in the United States. Such use of a web site is strongly analogous to use of the mail, television and radio for solicitation. Only if the web site is used to make actual sales of goods or to make delivery of goods held for sale would the use constitute engaging in business.

Foreign corporations engaged in the electronic commerce business in the United States may be able to invoke the protection of a tax treaty even if a virtual office is treated as an office under the I.R.C. Under Arts. 5 and 7 of the typical tax treaty, a foreign corporation entitled to treaty benefits is not taxable by the United States on its business profits unless the profits are derived through a permanent establishment located in the United States. The treaty issue is whether a virtual office constitutes a permanent establishment.

The policy advantages of treating a virtual office as an "office" for tax purposes are substantial. Such treatment would result in a level playing field for electronic sales and other types of sales and would avoid the very substantial risk that corporations engaged in electronic commerce will avoid all taxes by shifting their income to tax haven countries. This article, however, does not address these policy issues in detail. The focus here is on analysing current U.S. law. In III.B., the article addresses the question whether an electronic presence through a web site that functions like a "bricks and mortar" office is an "office" for purposes of the office source rule. The article then addresses (in III.C.) the question whether a virtual office constitutes a permanent establishment under U.S. tax treaties.

B. Status of a virtual office under the office source rule

The regulations under I.R.C. § 864(c) provide that an office or other fixed place of business is a place, site, structure or similar facility through which a foreign person engages in a trade or business (Treas. Reg. § 1.864-7(b)(1)). Absent special circumstances, a foreign corporation will not be deemed to have a U.S. office because a related party, such as its U.S. subsidiary, has such an office. Limited guidance is given in the regulations as to what constitutes an office or other fixed place of business. I.R.C. § 865(e)(3) provides that the principles developed under I.R.C. § 864(c)(5) are to be applied in determining whether a taxpayer has an office for purposes of the office source rule and whether income is attributable to that office.

The regulations under I.R.C. § 864(c)(5) make no specific reference to electronic commerce or virtual offices. This silence is not surprising in that the regulations were issued long before the advent of the Internet and electronic web sites. In giving some content to the term "office or other fixed place of business," Treas. Reg. § 1.864-7(b)(1), issued in 1972, provides:

> As a general rule, an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which a nonresident alien individual or a foreign corporation engages in a trade or business.

One might argue that a web site is not a "fixed facility" within the meaning of the above language because the web site appears on the computer of potential customers only if the customers have their computer turned on and the browser pointed to the web site address. In response, two points can be made. First, the requirement of a "fixed facility" is only a general rule, not an absolute requirement. Second, Treas. Reg. § 1.864-7(b)(1) goes on to provide that a "fixed facility may be considered an office or other fixed place of business whether or not the facility is continuously used by a nonresident alien individual or foreign corporation". A reasonable interpretation of this qualifying language is that the term "fixed" refers to the fixed availability of the facility. A web site, although not fixed on any particular computer screen, is fixed in the sense that it is available whenever the computer user wishes to access it.

In addition, Treas. Reg. § 1.864-7(b)(1) specifically provides that "a store or other sales outlet" constitutes a fixed place of business. A web site used to sell goods can fairly be described as a "sales outlet". Of course, it is also possible to define "sales outlet" in a way that would not include a web site. The core argument for treating a web site through which sales are actually made as an office or sales outlet is that such a web site performs the functions typically associated with a traditional office or sales outlet. This argument has force, but it is not dispositive.

The simple fact is that the current regulations do not address in a meaningful way the question whether a web site used to make sales to customers constitutes an office or other fixed place of business. No mention is made in the regulations of the possibility of an electronic presence constituting an office. At the same time, there is no language that can fairly be read as requiring that the "office" be a traditional office. For example, there is no suggestion that the "office" must have employees or agents present or that it must have any particular type of physical attributes. On the contrary, the regulations provide that "due regard" should be given to "the physical facilities actually required by the taxpayer in the ordinary course of the conduct of his trade or business" (Treas. Reg. § 1.864-7(b)(2)). In the case of a foreign corporation making remote sales over the Internet, the only "physical facilities" required to conduct its U.S. business are the electronic images projected on the computer screen of its potential customers.

There is little doubt that, if a virtual office constitutes an office under I.R.C. § 865(e)(3), the income earned from electronic sales made through the web site would be attributed to that office. According to the relevant regulations, income will be attributed to a U.S. office (or other fixed place of business) if the office is a "material factor" in the production of the income and the office regularly carries on the activities from which the income was derived (I.R.C. § 864(c)(5)(B)). To be a material factor in the earning of income, the U.S. office "must be an essential economic element" in the realization of the income (Treas. Reg. § 1.864-6(b)(1)).

To be a material factor in earning income from the sale of inventory property, a U.S. office must generally actively participate "in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale" (Treas. Reg. § 1.864-6(b)(2)(iii)). It is generally enough that the order was received by a U.S. office for the office to materially participate in the sale, even if the order was unsolicited, as long as the office is held out to customers as a place where orders may be sent (Treas. Reg. § 1.864-6(b)(2)(iii)). Given this language, it would be difficult for a foreign corporation to argue successfully that a web site did not materially participate in a sale that was made through the web site.

C. A virtual office as a permanent establishment

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 located in the United States and the profits are attributable to that permanent establishment (see e.g. Art. 7(1) of the United States Model Income Tax Convention of 20 September 1996 (U.S. Model)). A permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on (see e.g. Art. 5(1) of the U.S. Model); the examples given include an office, a branch, a place of management, a factory, a workshop and a mine (see e.g. Art. 5(2) of the U.S. Model).

The term "office" is not defined in any of the U.S. tax treaties. No attempt is made in the permanent establishment article, for example, to distinguish between a "bricks and mortar" office and a virtual office. The term used is "office," without adornment or qualification. As a result, its meaning, for purposes of interpreting the permanent establishment clause of a U.S. tax treaty, is its meaning under U.S. law, unless the context requires otherwise (see e.g. Art. 3(2) of the U.S. Model). As discussed above, it is unclear under U.S. law whether a foreign corporation that operates a web site in the United States as a virtual office has a U.S. office for tax purposes.

1. Speculating on original intent

In interpreting the unclear language of a treaty, the intent of the parties should prevail.[24] The permanent establishment concept embodied in U.S. tax treaties is based on the OECD Model. That concept itself is quite ancient, and the model treaties that embody it were drafted before electronic commerce was developed. It seems remote in the extreme, therefore, that governments negotiating a tax treaty prior to the development of electronic commerce intended to bargain away their right to tax income derived from what would become a major method of exploiting their markets.

In speculating about the intent of the parties negotiating a permanent establishment clause before the development of electronic commerce, it may be useful to engage in the following thought experiment. Assume that some visionary informed representatives of two countries negotiating a tax treaty that some time in the future a powerful new form of commerce would be developed that would allow residents of one contracting state to sell goods directly to customers in the other contracting state without the need for a traditional office made of bricks and mortar. The representatives were then asked to decide whether they wanted their government to be foreclosed by the permanent establishment clause from taxing the profits arising in their country from the exploitation of this new technology. The only plausible assumption is that no sane

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[24] See Vienna Convention on the Law of Treaties, Art. 31(1) ("A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.") The United State is not a signatory to this Convention, but does accept it as an authoritative statement of customary international law.

negotiators acting in the best interests of their respective countries and without pressure from entrenched special interests would intentionally negotiate away that right.

2. The new OECD Commentary

Whatever the intent of the original permanent establishment clause, the OECD, in its role as keeper of the dominant model tax convention, has decreed that a web site that constitutes a virtual office does not constitute a permanent establishment for purposes of Art. 5 of the OECD Model.[25] The OECD interpretation was developed though a joint undertaking between representatives of the OECD Member countries and the major multinational companies (MNEs) engaged in electronic commerce. It would appear that most of the OECD countries and the MNEs reached an early consensus that source countries should be precluded by treaty from taxing income derived from electronic commerce.[26] To their credit, Portugal and Spain refused to join this consensus and have formally dissented from the resulting interpretation of Art. 5.

3. Newly minted physical presence test

The new OECD Commentary states that a virtual office cannot be a permanent establishment because a permanent establishment requires a "physical presence". This argument is wrong as a matter of law and a matter of physics. It fails on legal grounds because it has no support in the language of Art. 5 or in the prior OECD Commentary. The test is newly minted and, as such, has no relevance in interpreting the existing language of Art. 5.

The newly minted physical presence test also fails as a matter of physics. According to the new OECD Commentary, a web site is "a combination of software and electronic data"

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[25] New OECD Commentary, supra note 4, Para. 42.2.

[26] It is interesting to note that the OECD has acted forcefully, with the cooperation of MNEs, to preserve taxation at source under the European VAT.

and "does not in itself constitute tangible property".[27] This description of a web site is inaccurate. The issue to be decided is whether a remote seller's web site appearing on the computer screen of a potential customer constitutes a permanent establishment of the remote seller when it operates as a virtual office. The images appearing on that screen are tangible. Like all visible matter, they are made up of small particles of matter that are themselves invisible to the eye. Although the form of those images is controlled by software, the images themselves are not software. They are real and tangible, not an apparition.[28] Nor are they intangible, as that term has been understood in legal parlance for centuries.

In the author's view, the proper test is a functional test. A virtual office should be considered a permanent establishment of its owner if it is used to perform the functions of a traditional office. Of course, the various exceptions applicable to a "bricks and mortar" office should apply to a virtual office as well. Thus, a virtual office used merely for preliminary or auxiliary activities, within the meaning of Art. 5(4) of the OECD Model or U.S. Model, would not be treated as a permanent establishment. In general, a virtual office would constitute a permanent establishment only if it is used to make actual sales of goods or services on a more than casual basis.

4. Impact of the new OECD Commentary on U.S. tax treaties

The United States is part of the consensus that led to the adoption of the new OECD Commentary on Art. 5. It is reasonable to infer, therefore, that the United States does not consider a virtual office located in the United States to be a permanent establishment under its tax treaties. The new Commentary, however, is not binding on countries that

[27] New OECD Commentary, supra note, Para. 42.2.

[28] The new OECD Commentary goes on to assert that the computer files stored on the hard drive of an independent service provider cannot constitute a permanent establishment because they are intangible and have no "location". Id., Para 42.3. This assertion is odd in the extreme. Obviously, those files are located on that hard drive, and the files obviously have a physical presence and can be altered by physical means. For example, they can be corrupted and even destroyed if the hard drive is hit by a hammer or exposed to a strong magnetic field. In addition, the files obviously change some physical aspects of the hard drive.

are not part of the consensus. Portugal and Spain, for example, have formally registered exceptions to the new OECD Commentary, and many countries having treaties with the United States are not members of the OECD and have not agreed to be bound by the new Commentary.

It is unclear whether the United States is prepared to give corporations resident in countries that are not part of the consensus the benefit of the exemption from source taxation provided by the new Commentary. The United States may be reluctant, for example, to exempt from tax a corporation resident in Portugal or Spain that is engage in electronic commerce in the United States through a virtual office when a U.S. corporation engaged in comparable activities in Spain or Portugal would be taxable in those countries.

IV. CONCLUDING REMARKS

The United States has developed an ornate set of statutory rules for taxing foreign corporations on business income derived from operations in the United States. These rules operate in an intelligent manner with respect to the sale of goods into the United States through a U.S. office. If the foreign corporation selling goods into the United States does not have an office or other fixed place of business in the United States, however, it can avoid U.S. source jurisdiction by arranging for title to the goods to pass outside the United States. With the advent of electronic commerce, this loophole is being substantially enlarged. By setting up a web site on the Internet, a remote seller can have direct contact with U.S. consumers without having a traditional office or sales outlet. To maintain some coherence to the U.S. tax rules, therefore, it is necessary for the United States to treat a virtual office created through the use of a web site on the Internet as an office for tax purposes.

Unfortunately, the United States is moving in exactly the wrong direction in its treatment of income derived from electronic commerce. It has played an important role in fashioning a consensus among most OECD countries that a virtual office does not constitute a permanent establishment. It will now be difficult for the United States to take the position that a virtual office constitutes an "office" under its domestic legislation. As a result, foreign corporations engaging in electronic commerce in the United States will probably not need to utilize a tax treaty to gain an exemption from U.S. source taxation. In many cases, a foreign corporation will be able to set itself up in a tax haven country and enjoy the benefits of an exemption from U.S. source taxation and an exemption from residence taxation.