THE I.R.S. APPROACH TO DEPENDENT AGENT STATUS

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When foreign corporations have certain activities in the U.S., the question often arises as to whether a taxable presence exists in the U.S. for Federal income tax purposes. Under U.S. Federal tax law, a foreign corporate taxpayer with direct activities or operations in the U.S. is subject to U.S. corporate income tax and branch profits tax if it has a U.S. trade or business generating effectively connected income.[1] Recently, the I.R.S. Large Business and International division published an international practice unit ("I.P.U.") addressing the creation of a P.E. through the activities of a "dependent agent."

In general, the permanent establishment ("P.E.") article of a treaty between the foreign taxpayer's jurisdiction and the U.S. will govern U.S. tax treatment of the foreign taxpayer's U.S. activities, if the taxpayer is eligible and elects for treaty benefits.[2] Often, the treaty definition of a P.E. is, in effect, less stringent in that it allows for the exemption from a taxable presence when under U.S. domestic laws, a taxable presence would have been determined. In other words, the treaty is more generous than the U.S. definition of a U.S. trade or business and foreign taxpayers are able to generate income from U.S. activities – within certain limitations – without being deemed to create a taxable presence. For example, treaties in their current form exclude certain preparatory and auxiliary activities from the definition of a P.E. while expressly including certain activities of a dependent agent. In recent years, however, the scope of the P.E. exceptions has been tightened in order to limit base erosion.[3]

The recent I.P.U. bases its discussions on the U.S.-U.K. Income Tax Treaty (the "U.K. Treaty") and provides valuable information as to how the I.R.S. will audit tax returns in order to detect the presence of a U.S. dependent agent concluding contracts on the taxpayer's behalf in the U.S.

It is worthwhile noting that the I.P.U. assumes that the taxpayer is otherwise eligible for U.K. Treaty benefits and emphasizes that its discussion is based on the U.K. Treaty. It is thus important to bear in mind that all income tax treaties are different and that the results may vary depending on the provisions of a particular treaty.

The relevant P.E. definition under Article 5 of the U.K. Treaty reads as follows:

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1 In comparison, certain passive income derived by foreign corporations from U.S. sources is subject to U.S. taxation by means of withholding, *e.g.*, so-called fixed or determinable, annual or periodic ("F.D.A.P.") income.

2 Such as residency for treaty purposes and meeting one of the tests under the limitation of benefits article.

3 See, *e.g.*, "Permanent Establishments Become More Permanent: The Dwindling Preparatory and Auxiliary Activities Exception," *Insights* 6, no. 3 (2019) and "O.E.C.D. Receives Public Comments on Proposed Changes to the Model Tax Convention," *Insights* 4, no. 10 (2017).

ARTICLE 5

Permanent Establishment

. . .

5. Notwithstanding the provisions of paragraphs 1 and 2 of this Article, where a person – other than an agent of an independent status to whom paragraph 6 of this Article 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 of this Article 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.

CLUES TO THE EXISTENCE OF A DEPENDENT AGENT P.E.

The I.P.U. provides guidance to I.R.S. agents (which is similarly helpful for taxpayers) as to how to determine the potential presence of a dependent agent based on available information, including documentation provided by the taxpayer. For illustrative purposes, the I.P.U. is based on the following fact pattern:

- A U.K. company active in the hotel business has an international presence through owned and franchised hotels.
- The U.K. company is the sole owner of a U.S. subsidiary that owns and operates hotels in the U.S.
- The U.S. subsidiary acts as the U.K. company's U.S. headquarters.
- The U.K. company and the U.S. subsidiary entered into an intercompany agreement pursuant to which the subsidiary negotiates franchise contracts with U.S. hotels on behalf of the parent company.

The I.P.U. advises agents to look at four main sources of information:

- Information submitted by the taxpayer (such as Forms 1120-F, *U.S. Income Tax Return of a Foreign Corporation*; Forms 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*; Forms 8833, *Treaty-Based Return position Disclosure under Section 6114 or 7701(b)*; or financial statements, indicating the use of a U.S. agent or commissions paid to an agent[4])
- Information received from the taxpayer upon I.R.S. request (such as the companies' financial statements, organizational charts, and copies of invoices issued by the U.S. subsidiary to U.S. customers that relate to certain types of income)

[4] Part E of Form 1120-F; Part IV line 21 of Form 5472.

- Internal I.R.S. research tools (including the Information Document Retrieval System ("I.D.R.S."), Yk1 Readiness ("YK1"), the LB&I Imaging Network ("L.I.N."), and the Office of Governmental Liaison)
    - The I.D.R.S. is a system enabling certain I.R.S. employees to have instant visual access to certain taxpayer accounts.[5]
    - YK1 is a research, analysis, and statistics development application that can display visual connections between entities that may engage in abusive tax avoidance transactions. It focuses on partnerships, S-corporations, and trusts. The links between the entities is generally based on K-1 relationships, parent-subsidiary relationships, or spousal relationships. The information the application uses to link entities and individuals are corporate, partnership, S-corporation, trust, and individual income tax returns.
    - L.I.N. turns certain paper or electronically filed tax returns into PDF format for easier access.[6]
    - Finally, Governmental Liaison is an I.R.S. office that partners with state tax agencies and Federal and local government agencies to improve voluntary compliance and make tax administration more efficient.[7]
- Readily available information on the internet

If the agent concludes that no agent relationship exists, the I.P.U. cautions I.R.S. agents to still look for withholdable F.D.A.P. payments and make certain that the appropriate transfer pricing rules are applied.

ANALYZING THE PRESENCE OF A DEPENDENT AGENT P.E.

To determine the presence of a dependent agent P.E., the I.P.U. proceeds with four successive steps:

1. Determine whether the contracts concluded by the potential agent related to the foreign taxpayer's essential business operations.
2. Determine whether the potential agent habitually exercises its authority to conclude contracts on behalf of the foreign taxpayer.
3. Determine whether the contracts concluded by the potential agent bind the foreign taxpayer.
4. Determine whether the potential agent is a dependent agent of the foreign taxpayer.

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5 IRS, "Section 14 - Integrated Data Retrieval System (IDRS)."

6 Treasury Inspector General for Tax Administration, "Successfully Processing Large Corporate Tax Returns Electronically Was a Major Accomplishment, but Eliminating More Compliant Returns from the Audit Stream Is a Work in Progress," (May 19, 2011).

7 "Information for Governmental Liaisons," I.R.S., last reviewed Aug. 17, 2018.

Step 1: Relation to Foreign Principal's Essential Business Operations

The I.P.U. reiterates what the technical explanations to Article 5(5) already provide: The contracts referred to by the U.K. Treaty are those relating to the essential business operations of the enterprise rather than ancillary activities.

What is somewhat surprising here is that the I.P.U. includes an example that is based on the Commentary on Article 5(5) of the 2014 version of the O.E.C.D. Model Tax Convention (the "Model Convention"). As explained in the preamble to the Technical Explanation of the U.K. Treaty, both the U.S. Model Treaty and the 2000 Model Convention have been taken into account in negotiating the U.K. Treaty. Yet, the I.P.U. refers to the 2014 Model Convention and not to the 2000 one. Even more interesting is the fact that the I.P.U. does not use the most recent version of the Model Convention, which was released in 2017 and incorporates changes under the O.E.C.D.'s B.E.P.S. initiative, in particular Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status).[8]

"The authority to enter into binding contracts on behalf of the foreign taxpayer does not in and of itself create a dependent agent P.E."

The example essentially states that the mere fact of having the authority to enter into binding contracts on behalf of the foreign taxpayer does not in and of itself create a dependent agent P.E. The authority to conclude the contracts must relate to the essential business operations of the foreign taxpayer. As a result, the authority to conclude service contracts for the foreign taxpayer's business equipment used in the agent's U.S. office does not create a dependent agent P.E.

The I.P.U. then explains that even if the contracts are related to foreign taxpayer's business operations, agents should investigate further and determine whether the contracts relate to a core external activity of the foreign taxpayer, as opposed to essential business operations. This determination can be made by looking at the foreign taxpayer's financial statements or sample contracts entered into by the agent on behalf of the foreign taxpayer, or by conducting internet research.

If the contracts are not related to the foreign taxpayer's essential business operations, a P.E. may still exist under a different provision, such as "carrying on a business in the U.S."

Step 2: Habitual Exercise of Authority to Conclude Contracts on Behalf of Foreign Principal

The I.P.U. advises that this determination must be based on the "commercial realties" of each case. The nature of the contracts and the business of the foreign taxpayer must be taken into account. For this purpose, I.R.S. agents are advised to review some contracts to assess the potential agent's authority to conclude contracts in the context of the industry and commercial realities of the particular case. This assessment is made by (i) comparing the number of contracts the potential agent signed on behalf of the foreign principal with the number signed by the foreign principal's agents in other countries, (ii) determining how many contracts the potential agent entered into compared to prior years, and (iii) communicating with other I.R.S. teams working in the industry to determine industry norms.

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[8] The 2017 Model Convention was approved by the O.E.C.D. Committee on Fiscal Affairs on September 28, 2017, and by the O.E.C.D. Council on November 23, 2017.

Again, the I.R.S. defers to the Commentary on the 2014 Model Convention.[9] Interestingly, the I.P.U. also cites Treas. Reg. §1.864-7(d)(1)(ii) but omits part of the regulation. The regulation reads as follows; the emphasized part is not included in the I.P.U.:

> An agent shall be considered regularly to exercise authority to negotiate and conclude contracts or regularly to fill orders on behalf of his foreign principal only if the authority is exercised, or the orders are filled, with some frequency over a continuous period of time. **This determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the business of the principal; but, in all cases, the frequency and continuity tests are to be applied conjunctively. Regularity shall not be evidenced by occasional or incidental activity.** An agent shall not be considered regularly to negotiate and conclude contracts on behalf of his foreign principal if the agent's authority to negotiate and conclude contracts is limited only to unusual cases or such authority must be separately secured by the agent from his principal with respect to each transaction effected. [Emphasis added.]

This raises the question of whether the I.R.S. will not apply the frequency and continuity tests conjunctively in the future. The view expressed by the I.R.S. in past rulings, however, was contrary to this interpretation and in line with the definition of a U.S. trade or business developed under case law.[10] Under this concept, a U.S. trade or business requires activities that are continuous, regular, and considerable – whereas occasional and incidental activities are not deemed sufficient to create a taxable presence.[11]

Step 3: Binding Force of Contracts on Foreign Principal

This step evolves around the question of whether the agent has authority to enter into the contracts. This determination is highly factual, and a substantive approach is encouraged. Thus, the mere fact that a person outside the U.S. signs the contract does not automatically mean that the potential agent is not a P.E. if the responsibilities of the person signing are mostly clerical.

Agents are advised to look at the following or proceed with the following:

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9 Again, it does not use the most recent version. Contrary to the latest version of the U.S. Model Treaty, which was issued in 2016 and did not include Technical Explanations, the 2017 Model Convention was released with changes to the Commentary.

10 See *Pinchot v. Commr.*, 113 F.2d 718, 719 (2d Cir. 1940); *de Amodio v. Commr.*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); *Spermacet Whaling & Shipping Co. v. Commr.*, 30 T.C. 618, 634 (1958), aff'd, 281 F.2d 646 (6th Cir. 1960).

11 Note in this context that the performance of services is held to a much lower standard whereby even a single occurrence may create a taxable presence for a foreign taxpayer in the U.S. See, *e.g.*, Rev. Rul. 70-543, 1970-2 CB 172, Rev. Rul. 85-4, 1985-1 CB 294, Treas. Reg. §1.864-2(a). An exception only applies to employees and independent contractors under certain conditions which, given a dollar amount threshold of $3,000 has a very limited scope. Code §§861(a)(3) and 864(b)(1).

- Sample contracts
- Employee interviews
- The agreement between the potential agent and the foreign principal
- Whether the foreign principal needs to have final approval of the contract and, if so, whether the foreign principal actually amends or cancels certain contracts

If necessary, I.R.S. agents are advised to travel and even interview customers. The appropriate procedures, including securing of travel funds or legal counsel, are outlined.

Step 4: Dependent Agent Status

Once the presence of an agent has been determined, the dependent or independent nature of the agent must be investigated. The I.P.U. provides a list of factors indicating dependency:

"I.R.S. agents are advised to travel and even interview customers."

- **Significant Control and Detailed Instructions:** I.R.S. agents are instructed to base this determination on employee interviews, the agreement between the agent and the foreign principal, or any other contracts between the parties (in the example, the franchise contract). The I.P.U. provides a list of questions to be answered in conducting this determination.
- **Absence of Business Risk:** The mere reimbursement of expenses, if aligned with industry practices, is not determinative. If the agent's income is indexed on the income generated by the contracts, this indicates the presence of a business risk. In determining the presence of a business risk, I.R.S. agents are instructed to review several documents, including the financial statements, tax filings, and any agreements the foreign principal entered with other worldwide affiliates that are similar to the one between the agent and the foreign principal.
- **Economic Control Over the Agent Due to the Exclusive Nature of the Agent-Foreign Principal Relationship:** Among the documents that should be reviewed are tax planning documents, such as slide decks, internal correspondence, tax research, memos, or opinions.

If strong indicators for a dependent agent P.E. exist but the I.R.S. agent cannot reach a conclusion, the I.P.U. advises the applicable treaty's exchange of information and administrative assistance article be used to request information from the foreign principal's home jurisdiction.

CONCLUSION

What is of particular interest for foreign taxpayers with operations in the U.S. is that the I.P.U. does not shy away from incurring expenses but instead seems to encourage I.R.S. agents to investigate on an international scale. In any event, in a post-B.E.P.S. world foreign taxpayers are advised to closely monitor activities by agents operating on their behalf to mitigate exposure to creating a taxable presence in the U.S.