Presentation:

International Income Taxation
Chapter 11: International Sale of Goods
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Choices for export sales entity arrangements:

1) U.S. sales office/export subsidiary
2) Foreign country subsidiary
3) Independent local agent
4) Dependent local agent
5) Internet – websites

Cf., discussion of inbound U.S. investment.
1) No tax if no representative office in the jurisdiction – dependent upon local law.

2) Tax liability if a local agent unless that agent is “independent” of U.S. principal or in some events if a dependent agent without contract concluding authority.

3) Foreign country tax liability if a local country subsidiary (but possible exception if the corporate “place of mind and management” is elsewhere).

Trade-Off: Direct Sale versus Local CFC
Assuming foreign country income tax jurisdiction exists – U.S. tax planning objective is to limit foreign taxes to assure no excess foreign tax credits arise.

Consider: §904(d)(1)(I) general limitation basket and §904(d)(3) look-through rules.

U.S. FTC objectives: generate income as (i) foreign source, (ii) low taxed and (iii) FTC general limitation category.

Review Question: How are export sales of US manufacturer sourced?
A bilateral income tax treaty between the foreign destination country and the U.S. (or, perhaps, between a third jurisdiction and the destination country) may moderate local tax jurisdiction:

1) Permanent Establishment:
   Threshold for taxation of business profits (Article 5) per treaty (“fixed place or “commercial activity”).

2) Profit Attribution
   A. Treaty Art. 7(1): only income attributable to the P.E., or
   B. Force of attraction rule?

3) Tax deduction treatment of expenses.
   A. Treaty Art. 7(3) allows deduction for expenses incurred by PE
   B. Domestic rules?

Review Question: How are export sales of US manufacturer sourced?
Cosmos, U.S. corporation, makes export sales to independent distributor in Korea that buys from Cosmos and resells for its own account. Cosmos has no sale office Belgium. Minimal contacts in Korea. Minimal contacts in Korea. **No Cosmos P.E.**

Is income realized by Cosmos on these sales subject to Korean income tax? **No**

Treaty Art. 8(1) (page 889).
Cosmos employees has (and exercised) authority to accept orders when visiting the distributor in Belgium.

P.E. would exist in Korea because Cosmos employees are deemed to be persons acting on behalf of Cosmos – they have and habitually exercise authority to conclude sales contracts in the name of Cosmos. Article 9(4)(a) (p. 891).
Distributor in Greece and Cosmos export division employees had no authority to negotiate a sale but only to solicit and accept orders on the standard terms and conditions of sale as required by the Cosmos.

Greece treaty, Article II(1)(i) (p. 888), requires that an agent (including an employee?) must have authority to negotiate and conclude contracts for foreign enterprise before being a P.E.
What is the possible authority (without P.E. status) if an agent is in Belgium or Korea?

Agent as independent only if legally and economically independent of the principal.

What is the degree of control by the principal in these situations? Limited control?

Agents here seem to be independent (do they have their own risk of loss?).
Market research and purchasing offices established in Korea and Greece:

1) Korea treaty – Article 9(3)(e) market research and advertising as an exception to P.E. status and Article 9(3)(d) purchasing office does not create a P.E.

2) Greek treaty – no counterpart of Article 9(3). See Article II(1)(i) regarding possible exemption for preparatory activities such as advertising but the treaty has no provision for purchasing activities.
Locally manufactured components are resold by the Cosmos offices to Korea or Greek manufacturers.

1) Korea—See Article 9(5)(b) (p. 891) indicating that the Article 9(3)(d) exemption does not apply if all or part of the goods purchased in Belgium are sold by Cosmos for use, consumption or disposition in Belgium.

2) Greece—same result. See Article II(1) (p. 887-8).
Engineers in Belgium & Greece

Officers with staffs of engineers to (a) provide advice to potential customers and (b) provide after-sales warranty services.

1) Korea treaty – no explicit exemption from P.E. characterization and not of a preparatory or auxiliary character.

2) No exemption under the Greece treaty.

So, probably P.E.s in both situations.

Possible solution: secondment of personnel to local affiliate, but note position of India about secondment arrangements.
Warehouses in All Countries

Are warehouses exempt from a P.E. classification?

1) Belgium treaty – Article 5(4)(a) and (b), yes (p. 892)

2) Korean treaty – Article 9(3)(a) and (b), yes (p. 890)

3) Greece treaty – Article II(1) – a warehouse is not excluded from P.E. classification (note: agent with a “stock of goods”). (p. 887-8)
Products shipped for local processing before delivery to local distributors who purchase under export orders accepted in U.S. Exclusion from P.E. definition for a stock of goods belonging to the enterprise for processing by another enterprise?

Belgium treaty: Article 5(4)(c) exception appears applicable with no carve-out.

Korea treaty: Article 9(5) makes clear that the Article 9(3)(c) exception does not apply if goods are sold into Korea.

Greece: Warehouse creates PE under Article II(1) by itself.
Problem 10
Out-Of-Country Delivery

Products shipped for local processing before being delivered to out-of-country distributors.

Belgium (Art. 5(4)(C)) (p. 892) and Korea (Art. 9(3)(c)) treaties (p. 890)— no P.E. exists.

Greece treaty – P.E. without regard to where the products are sold (Article II(1)) (p. 887-8).

Further Variation:
Why Have The Below Trading Pattern?
Subsidiaries as permanent establishments? No.*

*This position was an early foundational premise for eliminating international double taxation in the League of Nations debates. See Wells & Lowell, Homeless Income: Collection at Source is the Linchpin, 65 Tax Law Review __ (2012).

These subsidiaries act as “independent distributors”. Not regarded as a P.E. of Cosmos under any of the three treaties:

- Belgian Treaty, Article 5(7)
- Korea Treaty, Article 9(7)
- Greece Treaty, Article II(1)

See OECD Commentary (p. 896).
Subsidiaries function as agents of Cosmos and employees of subsidiaries regularly negotiate export sale contracts and enter into contracts on behalf of Cosmos for commissions paid to subsidiaries. Sales are made directly by Cosmos to local customers.

If the subsidiaries function as agents and exercise authority specified, then P.E. status not because they are controlled subsidiaries but because they are exercising authority as an agent. See Article 5(5) of Belgium treaty; Article 9(4)(a) of Korea treaty; Article II(1)(i) of Greece treaty.
Cosmos has three divisions: radios, refrigerators, and toys. Toy division has sales offices in Belgium, Germany, and Greece. Other two divisions handle sales by solicitation in country but home office acceptance of orders. Each toy division’s sales office constitute a P.E. Impact on other income?

Greece – “force of attraction” per Article III(1)
Belgium – no force of attraction per Article 7(1).
Korea – no force of attraction per Article 8(1)
Tax treaty impact:

1) Includible gross income is the “arm’s length” standard;* and
   *The endorsement of the “arm’s length standard” was an early foundational premise for eliminating international double taxation in the League of Nations debates. See Wells & Lowell, Homeless Income: Collection at Source is the Linchpin, 65 Tax Law Review 535 (2012).

2) Attributable Expenses (including non-local country expenses G&A, etc. expenses) are deductible.

   Belgium: Art. 7(2) & (3) (p. 893)
   Korea: Art. 8(2) & (3) (p. 889)
   Greece: Art. III(2) (p. 888)
U.S. architectural firm designed Belgian, Korean and Greece hotels – design activities occurred in the its U.S. offices. Temporary offices at building sites with employees of U.S. firm responsible for supervision.

Project completed within one year.

Income tax exposure in foreign country?

Belgium treaty: No PE. Article 5(3) provides a 12 month construction exception.

Korea treaty: PE. Article 9(2)(h) and 3(f) provide a 6 month construction exception.

Greece: PE. There is no construction exception for any time period.
Computer equipment as a P.E. where located in a foreign country. Fixed situs?

Distinction between equipment and software.

Distinction between website and server.

Independent service provider (ISP) as not an agent.
Website on a server maintained by an ISP in Brazil. Orders transmitted to U.S. from the website. Orders will be filled from U.S.

No fixed business place in Brazil for Cosmos.

If the ISP is an “agent”, then the status of agent’s activities would be as “preparatory and auxiliary” (since not concluding contracts binding on Cosmos).
Website accepts orders and the customer tenders payment to the website.

Website then issues delivery instructions to the U.S. warehouse.

Website is not an “agent”. Need for a “human agent”? Computer program ok? Correct result if the website is established and controlled by Cosmos?
Cosmos owns the server in Brazil.

The server will be treated as a “fixed place of business”.

Therefore, the server will constitute a P.E. in Brazil.

Remember that “P.E.” is a tax treaty term and Brazil has no tax treaty with the U.S.
Cosmos owns, maintains and operates the server located in Bermuda.

The server cannot be a fixed place of business in Brazil.

Therefore, no P.E. in Brazil.

But, should the server’s physical location be controlling (or irrelevant) in this context?
Problem 5
Physical Status Controlling?

Should a website and server located outside the destination country be treated as precluding P.E. status for purposes of tax jurisdiction in the destination country?

Too much emphasis on traditional jurisdictional concepts?
Choices:

1) U.S. corporation, including a special purpose U.S. subsidiary.

2) Foreign corporation – including third country corporation. Categorized as a CFC for Subpart F purposes.

3) Previously, FSC (or, earlier, DISC; note, however, interest-charge DISC); or, (illegal) gross income exclusion.
Foreign corporation not subject to U.S. income tax, except for U.S. activities and income.

Assume foreign source income received for:

1) Services performed at a location outside the United States.

2) Sale of inventory if the title passes outside the United States.
Pay a commission for the sales activities rendered in the foreign jurisdiction.

If related: Issue concerning an appropriate §482 allocation for the services rendered.

Avoid having any activities of the foreign corporation conducted in the United States. But, possible Subpart F exposure for these sales activities (FBCo sales income).
Purchase and Sale Approach

Purchase at arm’s length price and then sell outside the United States.

§862(a)(6) re sourcing rule outside the U.S.

Title passage test under Reg. §1.861-7(c) (i.e., where does title pass to the buyer?)

Passage of title at the port of destination?

Might have FBC sales income for Subpart F.
Defining foreign company sales income status - §954(d). Possible issue concerns whether the “manufacture” of the product by the foreign subsidiary has occurred to enable an escape from the “foreign base company sales income” definition.

Note: Dave Fischbein Mfg. Co. case., p. 911 (i.e., “significant” major assembly).
§954(d)(2), i.e., the “branch rule”.

What objective of establishing a sales branch outside country where manufacturing occurs? (or, a manufacturing branch?)

Effect of branch rule treatment is to cause the “deemed subsidiary” to be treated as (1) a wholly owned subsidiary of U.S. corporation, (2) a CFC, and (3) a party to the sale transaction with FBC sales income.
CFC incorporated in country M. CFC purchased metal ore in U.S. and Canada from related persons. Conversion of ore accomplished by CFC under contract with unrelated foreign corporation in Country O.

Only contractual relationships between CFC and unrelated foreign corporation, but here treated by IRS as a branch.

But, higher income tax rate in sales country!
Issues concerning foreign branch rule:

1) Does the §954(d)(2) branch rule apply to a contract manufacturing arrangement between a CFC and an unrelated corporation? Not in this situation.

2) Is the “manufacturing branch” rule in the regulations invalid? Not determined in this case.
Rev. Rul. 97-48 attempted to revoke both key holdings of Rev. Rul. 75-7:

1. Stated that attribution of activities of contract manufacturer cannot be attributed to a CFC for purposes of the branch rule for purposes of determining FBCSI status. Thus, conceding the Ashland Oil holding.

2. Stated that the manufacturing activity cannot be treated as undertaken by the CFC if contract manufacturing for FBCSI rule of §954(d)(2). This was the taxpayer favorable aspect of Rev. Rul. 75-7.

IRS eventually walked back Rev. Rul. 97-48 and issued Treas. Reg. §1.954-3(a)(4)(iv). In the preamble to the regulations, the IRS stated that “the use of contract manufacturing arrangements has become a common way of manufacturing products because of the flexibility and efficiencies it affords.” The Treasury Department then stated that “the updated rules in this area are important to the continued competitiveness of U.S. businesses operating abroad.”
U.S. corp. has manufacturing subsidiary in The Netherlands and establishes a branch office of Dutch corporation in Switzerland.

Swiss branch handles sales of Dutch manufactured products to non-Dutch customers. Tax rate disparity exists.

Applicability of the foreign branch rule when goods are manufactured in The Netherlands and sold through Swiss branch? Yes.
Alternative situation of:
1) Dutch manufacturing branch of a

2) Swiss CFC. The Swiss corporation handles sales of products manufactured by the manufacturing branch.

Reg. §1.954-3(b)(1)(ii) applies a reverse tax-rate disparity test. Manufacturing branch treated as a separate wholly owned sub.
Problem 3  
Contract Manufacturing Branch §954(d)(2)  

Key facts:
1) PM Bermuda owns work-in-progress (CM purchases for account of PM Bermuda)

2) PM Bermuda supervises CM’s manufacturing process sufficiently to have made a “substantial contribution” to the manufacturing process.

Thus, PM Bermuda meets the manufacturing exception.
Alternative situation of Juicer Singapore.

Scenario (a): Juicer Singapore has made a substantial contribution

Scenario (b): Employees of Juicer Singapore make quality review checks and monthly site visits. These activities are minor and may not represent a substantial contribution by Juicer Singapore. The US parent’s employee cannot be attributed to Juicer Singapore.

Scenario (c): Retention of power to direct changes is probably not a substantial contribution by itself unless there is evidence of active oversight.

Scenario (d): Unclear, but Juicer Singapore probably prevails in its position that it has made a substantial contribution to the manufacturing process.
Deferral of tax on taxable income attributable to $10 million or less of qualified export receipts for each tax year.

Interest charge imposed on the shareholders of the DISC.

Taxable income of the DISC attributable to qualified export receipts that exceed $10 million is deemed distributed but the DISC is not disqualified.
ADM argument that 4 percent of qualified export receipts from agricultural exports is permitted in establishing the transfer price for determining DISC taxable income.

ADM position that even if combined taxable income from the export transactions is zero it can still allocate four percent of the gross to the DISC.

Held: no such allocation permitted.
Export financing interest is excluded from a separate basket for passive income for FTC purposes.

Included in the general limitation basket.