

**CROSS-BORDER OUTSOURCING:
U.S. INTERNATIONAL TAX PITFALLS, PRATFALLS, AND
OPPORTUNITIES**

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I. INTRODUCTION

Broadly defined, “outsourcing” occurs when a business contracts with a third party to provide goods or perform services that traditionally have been provided or performed in-house.¹ Faced with increasing global competition, businesses have come to look to outsourcing as a means of gaining a comparative advantage over their competitors.² Outsourcing is thought to benefit a business by allowing it to focus on its “core competencies” or “core activities.” In this way, the business can shift its energy away from peripheral activities that lie outside of its true area of expertise, and instead concentrate more energy on what it does well in order better to differentiate itself from competitors.³ By outsourcing non-core activities, the business may also be able to reduce operating costs by reaping the benefits of a supplier’s lower cost structure,

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¹ ECONOMIST INTELLIGENCE UNIT & ARTHUR ANDERSEN, *NEW DIRECTIONS IN FINANCE: STRATEGIC OUTSOURCING* 3 (1995) [hereinafter *STRATEGIC OUTSOURCING*]; ANDREW KAKABADSE & NADA KAKABADSE, *SMART SOURCING: INTERNATIONAL BEST PRACTICE* 1 (2002); BRIAN ROTHERY & IAN ROBERTSON, *THE TRUTH ABOUT OUTSOURCING* 4-6 (1995).

² *STRATEGIC OUTSOURCING*, *supra* note 1, at 2.

³ *STRATEGIC OUTSOURCING*, *supra* note 1, at 2-3; John Willman, *Contractors Cash in on Battle to Keep down Costs*, *FIN. TIMES*, July 28, 1993, at 9; *OUTSOURCING INST., ARTICLES & INFO: TOP TEN OUTSOURCING SURVEY*, at <http://www.outsourcing.com> (last visited Apr. 21, 2003) [hereinafter *TOP TEN SURVEY*].

which may result from economies of scale or other advantages associated with specialization in the outsourced activity.⁴

Although by no means a novel concept,⁵ the term “outsourcing” did not enter the general lexicon until 1982.⁶ Since that time, there has been such a surge in outsourcing among businesses that two economists have gone so far as to say that “[w]e [now] live in an age of outsourcing.”⁷ Indeed, outsourcing has been described by the *Financial Times* as a “central

⁴ TOP TEN SURVEY, *supra* note 3; see KAKABADSE & KAKABADSE, *supra* note 1, at 1; *The Ins and Outs of Outsourcing*, ECONOMIST, Aug. 31, 1991, at 54 [hereinafter *Ins and Outs*]; Jeffrey Rothfeder et al., *Outsourcing: More Companies Are Letting George Do It*, BUS. WEEK, Oct. 8, 1990, at 148.

⁵ KAKABADSE & KAKABADSE, *supra* note 1, at 2 (describing the outsourcing of tax collection among the Romans as well as the outsourcing of the provision of public services in 18th- and 19th-century England); Willman, *supra* note 3 (“In one sense, there is nothing new in the idea. Since the dawn of capitalism, business has functioned through the division of labour.”).

⁶ MERRIAM-WEBSTER DICTIONARY, available at <http://www.m-w.com> (last visited Apr. 21, 2003).

⁷ GENE M. GROSSMAN & ELHANAN HELPMAN, OUTSOURCING IN A GLOBAL ECONOMY 1 (Nat’l Bureau of Econ. Research, Working Paper No. 8728, 2002); see KAKABADSE & KAKABADSE, *supra* note 1, at 2 (describing a “resurgence” in outsourcing “over the past 15 years”); John A. Byrne, *Has Outsourcing Gone Too Far?*, BUS. WEEK, Apr. 1, 1996, at 26 (“Call it the growth industry of the Nineties. Outsourcing . . . has emerged as the most sweeping trend to hit management since reengineering.”); *Ins and Outs*, *supra* note 4 (“Farming out chunks of production to subcontractors – known to business buffs as outsourcing – has proved one of the more enduring management fads of the past decade.”); *The Outing of Outsourcing*, ECONOMIST, Nov. 25, 1995, at 57 (“Corporate America’s enthusiasm for subcontracting has made this one of the more enduring management fads of the 1990s.”); Willman, *supra* note 3 (noting that outsourcing “is steadily spreading throughout business and industry, and into the public sector”).

element of the new economy,”⁸ and it has even spawned its own trade association – The Outsourcing Institute – which was created in 1993.⁹

As outsourcing has accelerated, the activities that companies will consider outsourcing have come closer and closer to their core businesses.¹⁰ Companies have outsourced everything from “payroll processing, accounting, legal, recruiting, and computer services” to “inventory and pension management, sales – even customer service.”¹¹ In fact, a recent newspaper article recounts how American accounting firms have begun outsourcing individual tax return preparation – a function normally performed by junior accountants in-house – to companies in India.¹² This trend has led some commentators to speak of outsourcing as part of a larger evolutionary process that will eventually culminate in the creation of “virtual” corporations.¹³

⁸ Peter Marsh, *A Sharp Sense of the Limits to Outsourcing*, FIN. TIMES, July 31, 2002, at 14.

⁹ OUTSOURCING INSTITUTE, ABOUT THE OUTSOURCING INSTITUTE, at <http://www.outsourcing.com> (last visited Apr. 21, 2003).

¹⁰ STRATEGIC OUTSOURCING, *supra* note 1, at 2-3; Peter Marsh, *Diversity of Services Increases Steadily: Outsourcing Contracts*, FIN. TIMES, Nov. 18, 1999, at 2; Sina Siwolop, *Outsourcing: Savings Are Just the Start*, BUS. WEEK, May 13, 1996, at 24; Willman, *supra* note 3.

¹¹ Siwolop, *supra* note 10.

¹² Kaja Whitehouse, *Will Your Tax Be Processed in India?*, PITT. POST-GAZETTE, Apr. 7, 2003, at A-9.

¹³ STRATEGIC OUTSOURCING, *supra* note 1, at 1-3; John A. Byrne, *The Virtual Corporation*, BUS. WEEK, Feb. 8, 1993, at 98; Philip Manchester, *Rise of the Virtual Corporation: The Question Is Not if but when*, FIN. TIMES, June 4, 1997, at 12. Some virtual corporations already exist. *See, e.g.*, GROSSMAN & HELPMAN, *supra* note 7, at 1; Richard Gourlay, *Leave It to the Other Guy*, FIN. TIMES, July 5, 1994, at 18; *The Outing of Outsourcing*, *supra* note 7.

As a phenomenon, outsourcing has foreign roots and an international scope. Japanese companies have been described as the pioneers of outsourcing, and the practice has spread through the United States and Europe.¹⁴ Furthermore, as the mention in the previous paragraph of the outsourcing of return preparation makes clear, businesses do not confine themselves to the domestic arena when choosing a provider of outsourced goods or services; the provider is often located in a different country than the outsourcing company.¹⁵ Indeed, “the outsourcing of intermediate goods and business services [has been described as] one of the most rapidly growing components of international trade.”¹⁶

In the face of both this surge in outsourcing and the trend toward outsourcing activities that come closer and closer to a company’s “core,” some commentators have underscored the need for businesses to make an educated decision about whether and what to outsource.¹⁷ This article, which, as its title indicates, is particularly concerned with cross-border outsourcing, is written in the same vein. It provides a non-exhaustive examination of the myriad of

¹⁴ See, e.g., STRATEGIC OUTSOURCING, *supra* note 1, app. 1; *Ins and Outs*, *supra* note 4 (contrasting Western and Japanese experience with outsourcing); *Industry Increases Outsourcing*, FIN. TIMES, Nov. 18, 1996, at 8 (describing the results of a study that indicated that U.K. companies engage in a greater level of outsourcing than companies in any other major economy, having displaced Japanese companies as the leaders in outsourcing); *The Outing of Outsourcing*, *supra* note 7 (describing the pioneering efforts of Japanese companies in outsourcing).

¹⁵ See, e.g., GROSSMAN & HELPMAN, *supra* note 7, at 1-2; Mark Clifford et al., *Different Countries, Adjoining Cubicles*, BUS. WEEK, Aug. 21, 2000, at 182; Pete Engardio, *The Barons of Outsourcing*, BUS. WEEK, Aug. 21, 2000, at 177; Marsh, *supra* note 10; Jeffrey Young, *The Outsourcer*, FORBES, Nov. 6, 1995, at 344.

¹⁶ GROSSMAN & HELPMAN, *supra* note 7, at 2.

¹⁷ See, e.g., STRATEGIC OUTSOURCING, *supra* note 1, at 17-29; Byrne, *supra* note 7; *Ins and Outs*, *supra* note 4.

circumstances under which a decision to outsource the provision of goods or the performance of services to a foreign provider can affect the application of the U.S. international tax regime¹⁸ to the outsourcing business.¹⁹ The purpose of this article is to foster greater awareness of the (sometimes dissonant) tax aspects of cross-border outsourcing and thereby impel businesses and their legal advisors to take a more holistic view of the decision to outsource – a view that encompasses not only the potential *business* benefits and detriments of a decision to outsource, but also the potential *tax* benefits and detriments of such a decision.²⁰

¹⁸ The phrase “U.S. international tax regime” is used as a convenient shorthand for the U.S. tax rules that govern the foreign activities of U.S. taxpayers and the U.S. activities of foreign taxpayers. Unless otherwise indicated, all section references are to the U.S. Internal Revenue Code of 1986, as amended (the “Code”), or the Treasury Regulations promulgated thereunder.

¹⁹ The literature on outsourcing sometimes speaks in terms of the creation of “partnerships” with the provider of outsourced goods or services. *See, e.g.*, Marcus Alexander, “*The Smartest Managers Learn to See Through the Prejudices*”: *The Philosophy of Outsourcing*, FIN. TIMES, Sept. 20, 2002, at 2; Matthew Schifrin, *Partner or Perish*, FORBES, May 21, 2001, at 26. If the relationship between the outsourcing company and the provider of the outsourced goods or services were to rise to the level of a partnership for tax purposes, then a different analysis than the one in the text below would have to be undertaken. Such an analysis is beyond the scope of this article, which focuses on a principal-agent or employer-independent contractor (as opposed to a partnership) relationship. On the distinction between a principal-agent and an employer-independent contractor relationship, see RESTATEMENT (SECOND) OF AGENCY §§ 1, 2, 14N (1958). On the recognition of certain joint undertakings as separate entities for U.S. federal income tax purposes, see Treas. Reg. § 301.7701-1(a)(2) (as amended in 1996). For rules concerning the classification of separate entities as corporations, partnerships, or trusts for U.S. federal income tax purposes, see Treas. Reg. §§ 301.7701-2 to -4 (as amended in 2002, 2001, and 1996, respectively).

²⁰ This article directly considers only the U.S. international tax rules that may be implicated by a decision to outsource. As indicated in the text below, businesses and their legal advisors should also consider the impact of the international tax rules of other countries that may claim a connection with the outsourcing arrangement before reaching a decision on the question whether to outsource. *See infra* Part IV.

The remainder of this article is comprised of three parts. Part II describes a variety of circumstances under which a U.S. person's decision to outsource the provision of goods or the performance of services to a provider in a foreign country ("outbound" outsourcing) will affect the application of the U.S. international tax regime to the U.S. person. Part III describes a variety of circumstances under which a foreign person's decision to outsource the provision of goods or the performance of services to a provider in the United States ("inbound" outsourcing) will affect the application of the U.S. international tax regime to the foreign person. Part IV consists of concluding remarks.

II. OUTBOUND OUTSOURCING

U.S. citizens,²¹ resident aliens,²² and domestic corporations²³ (collectively, "U.S. persons") are subject to U.S. federal income tax with respect to their worldwide income (i.e., regardless of whether it is derived from U.S. or foreign sources).²⁴ If a U.S. person engages in

²¹ Whether an individual is a U.S. citizen is determined under the Immigration and Nationality Act, which is codified at title 8 of the U.S. Code. Treas. Reg. § 1.1-1(c) (as amended in 1974).

²² Section 7701(b) sets forth the rules that apply in determining whether an alien will be classified as a resident or a nonresident of the United States for U.S. federal income tax purposes. I.R.C. § 7701(b) (2003).

²³ Section 7701(a)(4) & (5) defines a "domestic" corporation as a corporation that is "created or organized in the United States or under the laws of the United States or of any State," and defines a "foreign" corporation as any corporation that is not a domestic corporation. I.R.C. § 7701(a)(4)-(5) (2003).

²⁴ Treas. Reg. § 1.1-1(b) (as amended in 1974) ("In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States."); I.R.C. § 11 (2003) ("A tax is hereby imposed for each taxable year on the taxable income of every corporation."); Treas. Reg. § 1.11-1(a) (as amended in 1976)
(continued...)

cross-border activities and derives income from foreign sources, the foreign country that is the source of the income may also claim the right to tax the income. In that case, the U.S. person may be subject to double taxation – in other words, the U.S. person may be required to pay tax on the income both to the United States and to the foreign country that is the source of the income. To mitigate the potential harshness of double taxation, the United States allows U.S. persons to claim a credit against their U.S. federal income tax liability for foreign taxes paid.²⁵

A. SOURCE RULES & FOREIGN TAX CREDIT LIMITATION

The amount of the foreign tax credit allowed to a U.S. person cannot, however, exceed the amount of U.S. federal income tax paid by the U.S. person with respect to its foreign source income.²⁶ This limitation, which is applied separately to nine different categories (or “baskets”) of income set forth in § 904,²⁷ creates an incentive for U.S. persons to maximize the portion of their taxable income that is considered to be derived from foreign sources. An increase in a U.S. person’s foreign source income results in a proportionate increase in its § 904 limitation, which, in turn, results in an increase in the size of the foreign tax credit that the U.S. person can take against its U.S. federal income tax liability.

²⁴ (...continued)
(for purposes of § 11, “[i]t is immaterial that a domestic corporation . . . may derive no income from sources within the United States”).

²⁵ I.R.C. § 901 (2003).

²⁶ I.R.C. § 904(a) (2003).

²⁷ I.R.C. § 904(d) (2003).

Whether income is considered to be derived from U.S. or foreign sources depends upon the nature of the income.²⁸ For example, interest income is generally sourced by reference to the residence of the payer,²⁹ dividends are generally sourced by reference to the place of incorporation of the payer,³⁰ and rents and royalties are generally sourced by reference to the place where the property is used.³¹ In the case of income derived from the sale or other disposition of personal property, the source rules depend on the type of property involved. There are specific rules for sourcing income from the sale or other disposition of inventory property, depreciable personal property, intangible personal property, and stock of foreign affiliates.³² Income from the sale or other disposition of personal property that is not governed by one of these specific rules is normally sourced by reference to the residence of the seller,³³ however, an

²⁸ To determine the portion of its taxable income that is derived from foreign sources, a U.S. person must employ the source rules found in the Code – the determination is *not* made under the laws of the foreign country that imposed the foreign tax. *See, e.g.,* Bank of America v. United States, 680 F.2d 142, 146-47 (Cl. Ct. 1982); Tipton & Kalmbach, Inc. v. United States, 480 F.2d 1118, 1120 (10th Cir. 1973); Black & Decker Corp. v. Commissioner, 62 T.C.M. (CCH) 1204, 1206-07 (1991), *aff'd*, 986 F.2d 60 (4th Cir. 1993).

²⁹ I.R.C. § 861(a)(1) (2003).

³⁰ I.R.C. § 861(a)(2) (2003).

³¹ I.R.C. § 861(a)(4) (2003).

³² I.R.C. § 865(b)-(d), (f) (2003).

³³ I.R.C. § 865(a) (2003). Whether an individual (whether a U.S. citizen, resident alien, or nonresident alien) will be considered a U.S. resident for purposes of sourcing gain from the sale of personal property will depend primarily on where the individual's "tax home" is located. I.R.C. § 865(g)(1) (2003). For this purpose, an individual's tax home is located "at his regular or principal (if more than one regular) place of business, or if the individual has no regular or principal place of business because of the nature of the

(continued...)

exception exists for sales or other dispositions that are made through an office or other fixed place of business outside the seller's country of residence.³⁴

1. SOURCING INCOME FROM INVENTORY PRODUCED BY THE TAXPAYER

Whether activities are conducted by the taxpayer directly or through an independent contractor can sometimes make a difference in determining the source of income derived from the sale or other disposition of personal property. For example, if a taxpayer produces inventory property (in whole or in part) within the United States and sells or exchanges that property outside the United States (or vice versa), then the income from the sale or exchange of this inventory property will be considered to be derived in part from U.S. sources and in part from foreign sources.³⁵ To allocate the income between U.S. and foreign sources, the income from the sale or exchange of the inventory property must be apportioned between sales activity and production activity under one of three methods approved in the Treasury Regulations.³⁶

³³ (...continued)
business, then at his regular place of abode in a real and substantial sense.” Treas. Reg. § 1.911-2(b) (1985); I.R.C. § 865(g)(1) (2003) (incorporating by reference the definition of “tax home” found in § 911). An individual will not, however, be considered to have a tax home in a foreign country for any period during which the individual's abode is in the United States. Treas. Reg. § 1.911-2(b) (1985). Note that the mere maintenance of a dwelling in the United States will not constitute an abode for this purpose. *Id.*

For purposes of sourcing gain from the sale of personal property, a corporation is a resident of the country where it is incorporated. I.R.C. § 865(g)(1)(A)(ii) (2003).

³⁴ I.R.C. § 865(e) (2003).

³⁵ I.R.C. §§ 865(b), 863(b) (2003).

³⁶ Treas. Reg. § 1.863-3(b) (as amended in 1998).

The income from sales activity and from production activity is then sourced under separate rules. The income allocated to sales activity is sourced by reference to the place where title to the goods passed from the seller to the purchaser.³⁷ The income allocated to production activity is sourced where the production assets are located.³⁸ For this purpose, “the only production activities that are taken into account . . . are those conducted directly by the taxpayer,” and “production assets include only tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory.”³⁹ Thus, in determining the source of income from the sale or exchange of inventory property produced by the taxpayer, production activities engaged in by independent contractors will not be taken into account.⁴⁰ Consequently, if a U.S. person outsources a portion of its production activity to a foreign provider, the portion of its production income that is considered to be derived from foreign sources will not be increased at all – even though part of the production income is, in fact, attributable to activity in a foreign country.

2. SOURCING INCOME FROM SALES THROUGH A FOREIGN OFFICE

As described above, income from the sale or other disposition of personal property that is not sourced under a specific rule is sourced by reference to the residence of the seller.⁴¹ If,

³⁷ Treas. Reg. § 1.861-7(c) (1957); Treas. reg. § 1.863-3(c)(2) (as amended in 1998) (incorporating by reference the source rules found in Treas. Reg. § 1.861-7(c)).

³⁸ Treas. Reg. § 1.863-3(c)(1)(i)(A), -3(c)(1)(ii) (as amended in 1998).

³⁹ Treas. Reg. § 1.863-3(c)(1)(i)(A)-(B) (as amended in 1998).

⁴⁰ T.D. 8687, 1996-2 C.B. 47, 50.

⁴¹ I.R.C. § 865(a) (2003).

however, such a sale or other disposition of property by a U.S. resident is attributable to a foreign office or other fixed place of business maintained by the taxpayer, then the income from the sale or other disposition will be sourced outside the United States so long as “an income tax equal to at least 10 percent of the income from the sale is actually paid to a foreign country with respect to such income.”⁴²

For purposes of determining whether a U.S. resident maintains an office or other fixed place of business in a foreign country, “[t]he office or other fixed place of business of an independent agent . . . shall not be treated as the office or other fixed place of business of his principal.”⁴³ An independent agent is defined as “a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity.”⁴⁴ The office or fixed place of business of any other agent will be imputed to the foreign principal only if the agent either (i) has the authority to negotiate and conclude contracts in the name of the U.S. principal and regularly exercises that authority or (ii) has a stock of merchandise belonging to the U.S. principal from which orders are regularly filled on behalf of the U.S. principal.⁴⁵ Accordingly, if a U.S. person wishes to increase its foreign source income by availing itself of this source rule for sales through a foreign office, it must be careful to outsource its foreign sales activity only to a provider that is a dependent agent who either (i) has and regularly exercises the

⁴² I.R.C. § 865(e)(1) (2003).

⁴³ Treas. Reg. § 1.864-7(d)(2) (1972); I.R.C. § 865(e)(3) (2003) (incorporating by reference the principles of § 864(c)(5) for purposes of determining whether a taxpayer has an office or other fixed place of business).

⁴⁴ Treas. Reg. § 1.864-7(d)(3)(i) (1972).

⁴⁵ Treas. Reg. § 1.864-7(d)(1)(i) (1972).

authority to conclude contracts in the name of the U.S. person or (ii) has a stock of merchandise belonging to the U.S. person from which orders are regularly filled on its behalf.

B. CONTROLLED FOREIGN CORPORATION REGIME

The Code contains a number of “anti-deferral” regimes that are designed to combat the erosion of the U.S. tax base that may occur when U.S. persons defer taxation by earning income through a foreign corporation. Tax may be deferred in this way by exploiting the differences between the taxation of domestic and foreign persons. As described above, the United States taxes its citizens, residents, and domestic corporations on a worldwide basis; however, as described more fully below,⁴⁶ the United States generally taxes foreign persons only on their income from domestic sources.⁴⁷ Because the United States also respects the status of corporations as separate legal entities, U.S. persons are able to reduce their domestic tax liability by interposing a foreign corporation between them and assets or businesses that produce foreign source income.⁴⁸ For example, if a U.S. person were to create a foreign corporation to hold assets that produce foreign source income or to operate a foreign business, the U.S. person would

⁴⁶ See *infra* Part III.

⁴⁷ OFFICE OF TAX POLICY, DEP’T OF TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY at ix-x (2000) [hereinafter TREASURY REPORT ON SUBPART F]; BRIAN J. ARNOLD, THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS: AN INTERNATIONAL COMPARISON 3 (Can. Tax Found. Paper No. 78, 1986).

⁴⁸ TREASURY REPORT ON SUBPART F, *supra* note 47, at 1-3.

be able to defer U.S. tax on the income generated by those assets or that business until the foreign corporation paid a dividend.⁴⁹

To counter the potentially harmful effects of such deferral, the United States enacted its “controlled foreign corporation” regime (also referred to as “Subpart F”) in 1962.⁵⁰ This regime eliminates deferral both with respect to a controlled foreign corporation’s passive income (e.g., interest, dividends, rents, and royalties)⁵¹ and with respect to its income derived from mobile business operations that are easily transferred to low- or no-tax jurisdictions.⁵² For purposes of Subpart F, a foreign corporation is a controlled foreign corporation (“CFC”) if more than 50% of the total combined voting power or total value of the stock of the foreign corporation is owned by

⁴⁹ This deferral would redound to the U.S. person’s benefit so long as the tax imposed by the foreign jurisdiction of incorporation were lower than that imposed by the United States, and naturally, the value of deferral would be maximized if the foreign corporation were incorporated in a low- or no-tax jurisdiction (i.e., a tax haven). ORG. FOR ECON. CO-OPERATION & DEV., STUDIES IN TAXATION OF FOREIGN SOURCE INCOME: CONTROLLED FOREIGN COMPANY LEGISLATION 10-12, 16 (1996) [hereinafter OECD CFC REPORT]; ARNOLD, *supra* note 47, at 5-6. Moreover, due to the time value of money, the longer the U.S. person could defer repatriation of income from the foreign corporation, the greater the reduction that would be achieved in the U.S. tax burden. OECD CFC REPORT, *supra*, at 16; ARNOLD, *supra* note 47, at 6.

⁵⁰ Revenue Act of 1962, Pub. L. No. 87-834, § 12, 76 Stat. 960, 1006-31 (1962) (currently codified as amended at §§ 951-64). For a description of the events leading up to the enactment of Subpart F, see TREASURY REPORT ON SUBPART F, *supra* note 47, at 8-9, 12-22.

⁵¹ I.R.C. § 954(c) (2003).

⁵² *See, e.g.*, I.R.C. § 954(d)-(e) (2003).

“U.S. shareholders.”⁵³ To be counted as a “U.S. shareholder,” a U.S. person must own 10% or more of the total combined voting power of the foreign corporation.⁵⁴

The U.S. shareholders of a CFC are required currently to include in income their pro rata share of the CFC’s “Subpart F income” for the year.⁵⁵ Among other things, Subpart F income includes “foreign personal holding company income” and “foreign base company sales income.”⁵⁶

1. CALCULATING FOREIGN PERSONAL HOLDING COMPANY INCOME

“Foreign personal holding company income” generally consists of passive income. For example, foreign personal holding company income includes dividends; interest; rents; royalties; annuities; and net gains from the sale or exchange of (i) property that gives rise to foreign personal holding company income, (ii) an interest in a trust, partnership, or real estate mortgage investment conduit, or (iii) property that does not give rise to income.⁵⁷ A choice between conducting activities directly or through an independent contractor takes on importance when applying exceptions to the definition of foreign personal holding company income for certain dividends and interest and certain rents and royalties.

⁵³ I.R.C. § 957(a) (2003).

⁵⁴ I.R.C. § 951(b) (2003).

⁵⁵ I.R.C. § 951(a)(1)(A) (2003).

⁵⁶ I.R.C. §§ 952(a)(2), 954(a)(1)-(2) (2003).

⁵⁷ I.R.C. § 954(c)(1)(A)-(B) (2003).

A. SAME-COUNTRY EXCEPTION

Dividends and interest are excluded from a CFC's foreign personal holding company income (and, therefore, will not cause the CFC's U.S. shareholders to have a current inclusion in income) if the dividends and interest are received: (i) from a related person,⁵⁸ (ii) the related person is a corporation that is organized under the laws of the same country under the laws of which the CFC is organized, and (iii) the related person uses a substantial part of its assets in a trade or business located in that same foreign country.⁵⁹ When enacting this exclusion, Congress indicated that it "saw no reason for taxing the U.S. shareholders on dividends received by a controlled foreign corporation from a related party where the U.S. shareholder would not have been taxed if he had owned the stock of the related party directly."⁶⁰

Under the third prong of this exception, the related person must be engaged in a trade or business in its country of incorporation. For this purpose, "trade or business" is defined as "a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit."⁶¹ Normally, this "group of activities must . . . include every

⁵⁸ The definition of "related person" is found in § 954(d)(3). Treas. Reg. § 1.954-2(b)(4)(i)(A)(1) (as amended in 2003).

⁵⁹ I.R.C. § 954(c)(3)(A)(i) (2003). For exceptions to the same-country exception, see I.R.C. § 954(c)(3)(B)-(C) (2003).

⁶⁰ S. REP. NO. 87-1881, at 83 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3304, 3386; *see* H.R. CONF. REP. NO. 87-2508, at 29 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3732, 3749-50 (indicating that the House had generally receded and allowed the Senate version of Subpart F to be enacted into law).

⁶¹ Temp. Treas. Reg. § 1.367(a)-2T(b)(2) (1986); Treas. Reg. § 1.954-2(b)(4)(iii) (as amended in 2003) (incorporating by reference the principles of § 367(a) for purposes of determining whether the trade or business requirement has been met).

operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit.”⁶² These activities do not, however, have to be carried out entirely by the CFC, because the Treasury Regulations specifically provide that “one or more of such activities may be carried on by independent contractors under the direct control of the foreign corporation.”⁶³

The third prong of this exception additionally requires the foreign corporation to use a substantial part of its assets in this trade or business located in its country of incorporation. The Treasury Regulations contain detailed rules for determining the location of assets for this purpose. These rules specifically provide that the activities of an agent or independent contractor will be taken into account when determining the location of intangible personal property used in the trade or business as well as when determining the location of inventory or dealer property that is manufactured and sold or purchased and re-sold in the trade or business.⁶⁴

B. ACTIVE RENTS AND ROYALTIES EXCEPTION

Rents and royalties are excluded from a CFC’s foreign personal holding company income (and, therefore, will not cause the CFC’s U.S. shareholders to have a current inclusion in income) if they are derived in the active conduct of a trade or business and are received from an unrelated

⁶² Temp. Treas. Reg. § 1.367(a)-2T(b)(2) (1986).

⁶³ *Id.*

⁶⁴ Treas. Reg. § 1.954-2(b)(4)(vii), -(viii)(A) (as amended in 2003).

person.⁶⁵ The Treasury Regulations contain an exclusive list of situations in which rents and royalties will be considered to be derived in the active conduct of a trade or business.⁶⁶

Rents are considered to be derived in the active conduct of a trade or business only if they are derived from leasing:

- Property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;
- Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;
- Personal property ordinarily used by the lessor in the active conduct of a trade or business – if the property is being leased temporarily during a period when the property would, but for such leasing, be idle; or
- Property that is leased as a result of the performance of marketing functions by the lessor – if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.⁶⁷

Royalties are considered to be derived in the active conduct of a trade or business only if they are derived from licensing:

- Property that the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind; or

⁶⁵ I.R.C. § 954(c)(2)(A) (2003). For this purpose, “related person” is defined in § 954(d)(3). I.R.C. § 954(c)(2)(A) (2003); Treas. Reg. § 1.954-2(b)(6) (as amended in 2003).

⁶⁶ Treas. Reg. § 1.954-2(b)(6) (as amended in 2003); T.D. 8618, 1995-2 C.B. 89, 94.

⁶⁷ Treas. Reg. § 1.954-2(c)(1) (as amended in 2003).

- Property that is licensed as a result of the performance of marketing functions by such licensor, but only if the licensor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.⁶⁸

In contrast to the treatment of dividends and interest under the same-country exception, it appears that the Treasury Regulations do not take activities performed by independent contractors into account when determining whether a CFC derives rents or royalties in the active conduct of a trade or business. First, several of the situations listed above specifically require the CFC to perform the relevant functions “through its own officers or staff of employees.” Second, an example in the Treasury Regulations clearly indicates that a CFC that finances others in the development of patented items in return for an ownership interest in the patents will not be considered to derive the royalties that it receives for the use of those patents in the active conduct of a trade or business.⁶⁹ Finally, when applying the safe-harbor provisions for establishing that a CFC’s marketing activities are substantial in relation either to the amount of rents or to the amount of royalties received (which is determined by comparing active leasing or licensing expenses with adjusted leasing or licensing profit),⁷⁰ the Treasury Regulations specifically provide that amounts paid to agents or independent contractors (other than amounts paid for insurance, utilities, and capitalized repairs in connection with a lease) will not be taken into

⁶⁸ Treas. Reg. § 1.954-2(d)(1) (as amended in 2003).

⁶⁹ Treas. Reg. § 1.954-2(d)(3), ex. 5 (as amended in 2003). The example further indicates that the CFC did not “maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the patents.” *Id.*

⁷⁰ Treas. Reg. § 1.954-2(c)(2)(ii), -2(d)(2)(ii) (as amended in 2003).

account.⁷¹ Thus, even though both of these exceptions are designed to exclude what is, in essence, active business income from the definition of “foreign personal holding company income,” they take contrary approaches to factoring the activities of independent contractors into the calculus.

2. CALCULATING FOREIGN BASE COMPANY SALES INCOME

“Foreign base company sales income” is income derived in connection with: (i) “the purchase of personal property from a related person and its sale to any person,” (ii) “the sale of personal property to any person on behalf of a related person,” (iii) “the purchase of personal property from any person and its sale to a related person,” or (iv) “the purchase of personal property from any person on behalf of a related person.”⁷² Income derived in connection with such purchases and sales will, however, be excluded from foreign base company sales income if either: (i) the property is manufactured in the CFC’s country of organization;⁷³ (ii) the property is sold for use, consumption, or disposition in the CFC’s country of organization;⁷⁴ or (iii) the property is manufactured, produced, or constructed by the CFC in whole or in part from personal property that it has purchased.⁷⁵

⁷¹ Treas. Reg. § 1.954-2(c)(2)(iii)(D), -2(c)(2)(iv)(C), -2(d)(2)(iii)(D), -2(d)(2)(iv)(C) (as amended in 2003).

⁷² I.R.C. § 954(d)(1) (2003).

⁷³ I.R.C. § 954(d)(1)(A) (2003).

⁷⁴ I.R.C. § 954(d)(1)(B) (2003).

⁷⁵ Treas. Reg. § 1.954-3(a)(4)(i) (as amended in 2002).

It is with respect to the last of these three exclusions that a choice between conducting activities directly or through an independent contractor takes on importance. In 1975, the Internal Revenue Service (the “Service”) ruled that the activities of a contract manufacturer could be counted as activities of the CFC itself for purposes of this exclusion.⁷⁶ But after suffering setbacks in the Tax Court in pressing for a consistent application of the theory behind this ruling,⁷⁷ the Service revoked the ruling (generally prospectively⁷⁸) in December 1997.⁷⁹ The Service now takes the position that the activities of a contract manufacturer *cannot* be imputed to a CFC for purposes of calculating the CFC’s foreign base company sales income. Thus, if a CFC

⁷⁶ Rev. Rul. 75-7, 1975-1 C.B. 244, *revoked by* Rev. Rul. 97-48, 1997-2 C.B. 89. This attribution came at a price, however, because the taxpayer was required to treat the contract manufacturer as a branch for purposes of the branch rule in § 954(d)(2), which is described *infra* note 80.

⁷⁷ *Vetco, Inc. v. Commissioner*, 95 T.C. 579 (1990) (rejecting application of the branch rule to a contract manufacturer); *Ashland Oil, Inc. v. Commissioner*, 95 T.C. 348 (1990) (same).

⁷⁸ I say “generally” prospectively because the Service does indicate that a taxpayer may rely on Revenue Ruling 75-7 to attribute the activities of a contract manufacturer to a CFC in taxable years beginning before December 8, 1997; however, the taxpayer may do so only if it also treats the contract manufacturer as a branch for purposes of § 954(d)(2). Rev. Rul. 97-48, 1997-2 C.B. 89. For a discussion of the branch rule, see *infra* note 80. One commentator has described this transition rule as “questionable” because, although it “is consistent with the Service’s view that attribution and the branch rule cannot be applied separately, . . . this position amounts to a rejection, by administrative fiat, of the Tax Court’s decisions in *Ashland* and *Vetco*.” Patricia R. Lesser, *Contract Manufacturing: Does Rev. Rul. 97-48 Raise More Questions Than It Answers?*, 39 TAX MGMT. MEMORANDUM S-86, S-89 (1998).

⁷⁹ Rev. Rul. 97-48, 1997-2 C.B. 89. The Service noted that its revocation of this long-standing administrative practice would harmonize its position on the treatment of contract manufacturing under § 954(d) with its position on the treatment of contract manufacturing under § 863(b), which, as described above, governs the manner in which income from inventory property produced (in whole or in part) within the United States and sold outside the United States (or vice versa) is sourced. *Id.*; see *supra* Part II.A.1.

directly manufactures, produces, or constructs property, it may qualify for an exclusion from the definition of foreign base company sales income and its U.S. shareholders may, therefore, be entitled to defer their income from the CFC. If, however, those same activities are conducted by an independent contractor on behalf of the CFC, deferral may no longer be possible and the CFC's U.S. shareholders may, as a result, face a current inclusion in income under Subpart F.⁸⁰

⁸⁰ A CFC that manufactures, produces, or constructs property itself may in any event have foreign base company sales income if those activities are conducted through a branch outside of the CFC's country of organization. In this situation, a CFC and its branch will be treated as separate corporations for purposes of calculating the CFC's foreign base company sales income if the use of the branch "has substantially the same tax effect as if the branch were a wholly-owned subsidiary of the CFC." I.R.C. § 954(d)(2) (2003); Treas. Reg. § 1.954-3(b)(1)(ii)(a) (as amended in 2002).

Under the Treasury Regulations, to determine whether the use of a branch has substantially the same effect as if the branch were a wholly-owned subsidiary, the income of the CFC must first be allocated between the branch and the remainder of the CFC. Treas. Reg. § 1.954-3(b)(1)(ii)(b) (as amended in 2002). The use of the branch will be considered to have the same effect as if the branch were a wholly-owned subsidiary if:

income allocated to the remainder of the controlled foreign corporation . . . is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of the country in which the branch or similar establishment is located.

Id. For a description of the history and purpose of the branch rule, see *Ashland Oil, Inc. v. Commissioner*, 95 T.C. at 354-56.

C. CROSS-BORDER CORPORATE REORGANIZATIONS

Section 367 contains a number of rules that may modify the corporate nonrecognition provisions in the Code when applied to transfers involving foreign corporations.⁸¹ In particular, § 367(a) addresses the treatment of outbound transfers of property to foreign corporations in otherwise tax-free liquidations, § 351 transfers, and corporate reorganizations. Section 367(a) generally denies nonrecognition treatment to these transfers by providing that, “for purposes of determining the extent to which gain shall be recognized on such a transfer,” the recipient foreign corporation shall not “be considered to be a corporation.”⁸² Nevertheless, § 367(a) goes on to except “property transferred to a foreign corporation for use by such foreign corporation in the

⁸¹ I.R.C. § 367 (2003). Professor Peroni describes the purposes of current § 367(a) as follows:

In its current statutory form, section 367 has two basic purposes. First, it seeks to prevent U.S. persons from obtaining inappropriate deferral and other tax avoidance benefits from outbound transfers of appreciated property to foreign entities that are not subject to U.S. income tax on their foreign source income (i.e., such foreign entities are subject to U.S. income tax only on their U.S. trade or business income and certain other U.S. source income) In addition, section 367 attempts to ensure that U.S. shareholders owning stock in a controlled foreign corporation do not escape U.S. tax on their share of the untaxed earnings of the foreign corporation (i.e., those earnings on which any current U.S. income tax has been deferred) through a corporate reorganization or other transaction that shifts those untaxed earnings to another entity which is not a controlled foreign corporation. Thus, in this context, section 367 serves as a backstop to the anti-deferral rules in subpart F of the Code.

Robert J. Peroni, *A Response to Dean Thompson's Paper on the Impact of Code Section 367 and the European Union's 1990 Council Directive on Tax-free Cross-border Mergers and Acquisitions*, 66 U. CIN. L. REV. 1271, 1272-73 (1998).

⁸² I.R.C. § 367(a)(1) (2003).

active conduct of a trade or business outside of the United States” from its purview.⁸³ Thus, if the active conduct of a trade or business requirement is satisfied, the foreign corporation receiving the property *will* be treated as a corporation for purposes of applying the corporate nonrecognition provisions in the Code.⁸⁴

Whether the activities of a foreign corporation will constitute a trade or business is determined based on a review of all of the facts and circumstances.⁸⁵ For this purpose, “trade or business” is defined as “a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit.”⁸⁶ Normally, this “group of activities must . . . include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit.”⁸⁷ These activities do not, however, have to be carried out entirely by the foreign corporation, because the Treasury Regulations specifically provide that “one or more of such activities may be carried on by independent contractors under the direct control of the foreign corporation.”⁸⁸

If a foreign corporation is determined to be conducting a trade or business, then it must next be determined whether it is actively conducting that trade or business. This determination is

⁸³ I.R.C. § 367(a)(3)(A) (2003). For a list of property that does not qualify for this exception, see I.R.C. § 367(a)(3)(B) (2003) and Temp. Treas. Reg. § 1.367(a)-5T (1986).

⁸⁴ Temp. Treas. Reg. § 1.367(a)-2T(a)(1) (flush language) (1986).

⁸⁵ Temp. Treas. Reg. § 1.367(a)-2T(b)(2) (1986).

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

also based on a review of all of the facts and circumstances.⁸⁹ A foreign corporation is considered actively to be conducting a trade or business “only if the officers and employees of the corporation carry out substantial managerial and operational activities.”⁹⁰ Although incidental activities of the trade or business may be carried out by independent contractors, “[i]n determining whether the officers and employees of the corporation carry out substantial managerial and operational activities . . . , the activities of independent contractors shall be disregarded.”⁹¹ As a result, although the activities of independent contractors will be taken into account in determining whether the activities of a foreign corporation constitute a trade or business, these same activities will *not* be taken into account in determining whether that trade or business is actively conducted by the foreign corporation.

In the case of a trade or business that produces rents or royalties, the determination whether the foreign corporation actively conducts its trade or business will be made using the principles (discussed above⁹²) that apply for purposes of the active rents and royalties exception to the definition of foreign personal holding company income under Subpart F.⁹³ As that discussion indicated, it appears that the Treasury Regulations likewise do not take into account

⁸⁹ Temp. Treas. Reg. § 1.367(a)-2T(b)(3) (1986).

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *See supra* Part II.B.1.b.

⁹³ Temp. Treas. Reg. § 1.367(a)-2T(b)(3) (1986); *see* Priv. Ltr. Rul. 200020018 (Feb. 15, 2000) (indicating that the Treasury Regulation listed in Temp. Treas. Reg. § 1.367(a)-2T(b)(3) was withdrawn and replaced by Treas. Reg. § 1.954-2(c) and (d)).

the activities of independent contractors in making the determination whether a foreign corporation is actively conducting a leasing or licensing business.

III. INBOUND OUTSOURCING

Foreign corporations and foreign individuals who are classified as nonresident aliens for U.S. federal income tax purposes⁹⁴ (collectively, “foreign persons”) are subject to U.S. federal income tax on a more limited basis than U.S. citizens, resident aliens, and domestic corporations. Foreign persons are subject to U.S. federal income tax with respect to two general categories of income: (i) U.S. source passive investment income and (ii) income that is derived from a U.S. trade or business. Given the business nature of outsourcing, this article will focus on how the decision to outsource can affect the manner in which the United States taxes the business income of foreign persons.

A foreign person is subject to U.S. federal income tax with respect to its income that is “effectively connected with the conduct of a trade or business within the United States” (hereinafter referred to as “effectively connected income”).⁹⁵ Effectively connected income is subject to tax on a net basis (i.e., after the allowance of deductions connected with the trade or business giving rise to the income) at the same graduated rates that apply to U.S. persons.⁹⁶ To have effectively connected income, a foreign person must generally both (i) be engaged in a trade or business within the United States *and* (ii) derive income that is effectively connected with the

⁹⁴ See *supra* notes 21-23 for a discussion of the relevant definitional provisions.

⁹⁵ I.R.C. §§ 871(b), 882(a)(1) (2003).

⁹⁶ I.R.C. §§ 871(b)(1), 882(a)(1) (2003) (incorporating by reference §§ 1, 11, and 55). In the case of individuals, these rates currently reach as high as 38.6%, and in the case of corporations, they currently reach as high as 35%.

conduct of that trade or business. The impact of a decision to outsource on each of these requirements will be discussed separately below.

A. THRESHOLD FOR TAXATION

1. CODE: U.S. TRADE OR BUSINESS

Neither the Code nor the Treasury Regulations contain a general definition of the term “trade or business within the United States.” The lack of a general definition notwithstanding, the Code does address whether the performance of personal services and the trading of stocks, securities, and commodities will be included within the ambit of this term. On the one hand, the Code provides that “the performance of personal services within the United States at any time within the taxable year”⁹⁷ constitutes a trade or business within the United States. This rule applies to foreign corporations as well as to individuals.⁹⁸ Furthermore, it appears that this rule may apply to foreign corporations that perform personal services within the United States through non-employee agents.⁹⁹

⁹⁷ I.R.C. § 864(b) (2003). A minor exception to this categorical rule exists for certain nonresident aliens (but *not* foreign corporations) who perform personal services within the United States. To qualify for this exception (and the reason why it is described as minor), the nonresident alien cannot be present in the United States for more than 90 days during the taxable year *and* the compensation for his/her services cannot exceed \$3,000. I.R.C. § 864(b)(1) (2003).

⁹⁸ Commissioner v. Hawaiian Philippine Co., 100 F.2d 988, 991 (9th Cir.), *cert. denied sub nom.*, Helvering v. Hawaiian Philippine Co., 307 U.S. 635 (1939); *see* Rev. Rul. 60-55, 1960-1 C.B. 270.

⁹⁹ *See InverWorld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231, 3237-18 to 3237-30 (1996); Rev. Rul. 74-331, ex. 1, 1974-2 C.B. 281; Gen. Couns. Mem. 35,447 (Aug. 17, 1973).

On the other hand, the Code provides that a foreign person (including a dealer in stocks, securities, or commodities) will *not* be engaged in a trade or business within the United States merely by reason of trading in stocks, securities, or commodities¹⁰⁰ through a resident broker, commission agent, custodian, or other independent agent.¹⁰¹ To qualify for this safe harbor, the foreign person cannot at any time during the taxable year have an office or other fixed place of business within the United States through which or by the direction of which the transactions are effected.¹⁰² The volume of securities and commodities transactions effected by the foreign person is irrelevant to the application of this safe harbor provision.¹⁰³

Outside of these two statutory enclaves of relative clarity, whether a foreign person will be considered engaged in a trade or business within the United States depends entirely on the facts and circumstances of the individual case.¹⁰⁴ In determining whether the facts and circumstances warrant a finding that the foreign person is engaged in a trade or business within

¹⁰⁰ “Commodities” include only commodities “of a kind customarily dealt in on an organized commodity exchange,” and only “if the transaction is of a kind customarily consummated at such place.” I.R.C. § 864(b)(2)(B)(iii) (2003).

¹⁰¹ I.R.C. § 864(b)(2)(A)(i), -(B)(i) (2003); Treas. Reg. § 1.864-2(c)(1) (as amended in 1975). A separate safe harbor exists for foreign persons (other than dealers) who trade in stocks, securities, and commodities for their own account. I.R.C. § 864(b)(2)(A)(ii), -(B)(ii) (2003).

¹⁰² I.R.C. § 864(b)(2)(C) (2003).

¹⁰³ Treas. Reg. § 1.864-2(c)(1), -(d)(1) (as amended in 1975).

¹⁰⁴ *See* Rev. Rul. 88-3, 1988-1 C.B. 268 (indicating that “the determination whether a taxpayer is engaged in a trade or business within the United States is highly factual” and that “[s]uch a determination is not ordinarily made in an advance ruling”); Rev. Proc. 2003-7, § 4.01(3), 2003-1 I.R.B. 233 (containing the most recent reaffirmation of this position).

the United States, the courts generally look to see if the U.S. activities of the foreign person are considerable, continuous, and regular.¹⁰⁵ Thus, isolated, non-continuous, and casual transactions will generally not support a finding that the foreign person is engaged in a trade or business within the United States.¹⁰⁶

In determining the extent of a foreign person's activities in the United States, the activities of the foreign person's agent (whether dependent or independent) will generally be attributed to it.¹⁰⁷ As a result, a foreign person who owned U.S. rental real estate was held to be engaged in a trade or business within the United States after the activities of local real estate agents were attributed to him.¹⁰⁸ These agents negotiated and renewed leases, arranged for repairs, collected rents, and paid taxes and assessments on the foreign person's behalf.¹⁰⁹ In addition, a foreign person that sold unidentified products was held to be engaged in a trade or

¹⁰⁵ See, e.g., *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940); *de Amodio v. Commissioner*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618, 634 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960).

¹⁰⁶ See, e.g., *Linen Thread Co. v. Commissioner*, 14 T.C. 725, 736-37 (1950) (two small, isolated transactions were not a U.S. trade or business); *Pasquel v. Commissioner*, 12 T.C.M. (CCH) 1431 (1953) (participation in a single, isolated transaction was not a U.S. trade or business). *Contra* Rev. Rul. 58-63, 1958-1 C.B. 624, *amplified by* Rev. Rul. 60-249, 1960-2 C.B. 264 (providing that a foreign person's entry of a race horse in a single race in the United States constituted a U.S. trade or business).

¹⁰⁷ Richard Crawford Pugh, *Policy Issues Relating to the U.S. Taxation of Foreign Persons Engaged in Business in the United States Through Agents: Some Proposals for Reform*, 1 SAN DIEGO INT'L L.J. 1, 8 (2000); Jessica L. Katz & Charles T. Plambeck, *U.S. Income Taxation of Foreign Corporations*, 908 Tax Mgmt. (BNA) at A-15 to A-16 (2000).

¹⁰⁸ *de Amodio*, 34 T.C. at 906.

¹⁰⁹ *Id.*

business in the United States after the activities of a domestic corporation were attributed to it.¹¹⁰ The domestic corporation acted as the foreign person's exclusive agent for the sale of its products in the United States.¹¹¹ Furthermore, the Service has ruled that a foreign person who held oil and gas leases through a trust was engaged in a trade or business within the United States after the activities of a corporation were attributed to the trust (and, through the trust, to him).¹¹² This corporation engaged in operating, extractive, and sales activities with respect to the property that was subject to the oil and gas leases held indirectly by the foreign person.¹¹³

2. TREATY: PERMANENT ESTABLISHMENT

If a foreign person is a resident of a country with which the United States has concluded an income tax treaty and the foreign person otherwise qualifies for the benefits of that treaty, then the foreign person may choose to have the provisions of the income tax treaty preempt the (normally less beneficial) U.S. federal income tax rules described above.¹¹⁴ Of particular relevance to the instant discussion is the business profits article of the U.S. Model Treaty, which limits the United States' ability to tax effectively connected income to situations where the

¹¹⁰ Rev. Rul. 70-424, 1970-2 C.B. 150; *see* Rev. Rul. 55-617, 1955-2 C.B. 774 (finding a foreign person to be engaged in a trade or business in the United States after attributing to it the activities of "a commission agent acting in the ordinary course of his business as such").

¹¹¹ Rev. Rul. 70-424, 1970-2 C.B. 150.

¹¹² I.R.C. § 875(2) (2003).

¹¹³ Tech. Adv. Mem. 8029005 (Mar. 27, 1980).

¹¹⁴ I.R.C. § 894(a) (2003).

foreign person has a “permanent establishment” in the United States.¹¹⁵ The U.S. Model Treaty’s permanent establishment threshold for taxation is generally perceived to be easier to apply (and to plan around) than the more ethereal engaged in trade or business threshold found in the Code.

A “permanent establishment” is generally defined to include a place of management, an office, a branch, or other fixed place of business.¹¹⁶ An agent who carries on activities on behalf of a foreign person may also constitute a permanent establishment of the foreign person in the United States, but only if the agent is a dependent agent who has and habitually exercises the authority to conclude contracts in the United States that are binding on the foreign person.¹¹⁷ A

¹¹⁵ U.S. MODEL INCOME TAX CONVENTION art. 7(1) (1996), *reprinted in* 1 Tax Treaties (CCH) ¶ 214.07 (2003) [hereinafter CCH Treaties]. Because each income tax treaty is negotiated separately and can contain its own unique provisions, this article will generally employ the U.S. Model Income Tax Convention (“U.S. Model Treaty”) as a reference point for the sake of simplifying the discussion.

¹¹⁶ *Id.* art. 5(1)-(2), *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214.05.

¹¹⁷ *Id.* art. 5(5), *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214.05. The Treasury Department limits the class of contracts that the dependent agent must have the power to conclude as follows:

The contracts referred to in paragraph 5 are those relating to the essential business operations of the enterprise, rather than ancillary activities. For example, if the agent has no authority to conclude contracts in the name of the enterprise with its customers for, say, the sale of the goods produced by the enterprise, but it can enter into service contracts in the name of the enterprise for the enterprise’s business equipment used in the agent’s office, this contracting authority would not fall within the scope of the paragraph, even if exercised regularly.

U.S. TREASURY DEP’T, TECHNICAL EXPLANATION OF THE UNITED STATES MODEL INCOME TAX CONVENTION, art. 5(5) (1996) [hereinafter TECHNICAL EXPLANATION], *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214A, at 10,629. Furthermore, a dependent agent will not be considered a permanent establishment of the foreign person with respect to activities of an auxiliary or preparatory character that, if carried on by the
(continued...)

foreign person will not, under any circumstances, be deemed to have a permanent establishment in the United States if it conducts business through a broker, general commission agent, or any other agent of an independent status, provided that the agent is acting in the ordinary course of its business as an independent agent.¹¹⁸

To be considered an independent agent, an agent must be both legally *and* economically independent of the foreign person.¹¹⁹ If an agent is “subject to detailed instructions regarding the conduct of its operations or comprehensive control” by the foreign person, then the agent will not be considered legally independent of the foreign person.¹²⁰ Whether an agent is economically independent of the foreign person will depend on whether the agent “bears business risk,” which

¹¹⁷ (...continued)
foreign person itself through a fixed place of business, would not constitute a permanent establishment under article 5(4) of the U.S. Model Treaty. U.S. MODEL INCOME TAX CONVENTION, art. 5(5) (1996), *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214.05.

¹¹⁸ *Id.* art. 5(6), *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214.05.

¹¹⁹ TECHNICAL EXPLANATION, *supra* note 117, art. 5(6), *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214A, at 10,629; *see* MODEL TAX CONVENTION ON INCOME AND ON CAPITAL cmt. art. 5(6), ¶ 37 (Org. for Econ. Co-operation & Dev. 2000) [hereinafter OECD COMMENTARY].

¹²⁰ TECHNICAL EXPLANATION, *supra* note 117, art. 5(6), *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214A, at 10,629; *see* Taisei Fire & Marine Ins. Co. v. Commissioner, 104 T.C. 535, 552-55 (1995), *acq.*, 1995-2 C.B. 1; OECD COMMENTARY, *supra* note 119, cmt. art. 5(6), ¶ 38.

“refers primarily to the risk of loss.”¹²¹ A dependent agent is any agent other than an agent of independent status acting in the ordinary course of its business as such.¹²²

3. SUMMARY

To summarize, the decision to outsource will, with one exception, generally not affect the determination whether a foreign person has exceeded the threshold for taxation of its business income under the Code. Accordingly, a foreign person will be engaged in a trade or business within the United States whether it performs personal services or carries on regular, continuous, and considerable activities in the United States directly or through an agent. Nevertheless, despite the general imputation of an agent’s activities to its foreign principal, a foreign person that is a dealer in stocks, securities, or commodities – and that would be engaged in a trade or business within the United States if it had an office in the United States and regularly executed trades through that office¹²³ – will *not* be engaged in a trade or business within the United States

¹²¹ TECHNICAL EXPLANATION, *supra* note 117, art. 5(6), *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214A, at 10,629; *see Taisei Fire & Marine Ins. Co.*, 104 T.C. at 555-56; OECD COMMENTARY, *supra* note 119, cmt. art. 5(6), ¶ 38.

¹²² *See* TECHNICAL EXPLANATION, *supra* note 117, art. 5(5)-(6), *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214A, at 10,628.

¹²³ The fact that a foreign person fails to qualify for the safe-harbor will not automatically cause the foreign person to be considered to be engaged in a trade or business within the United States; instead, whether the foreign person is engaged in a trade or business within the United States “shall be determined on the basis of the facts and circumstances in each case.” Treas. Reg. § 1.864-2(e) (as amended in 1975). For example, in *InverWorld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231, 3237-30 (1996), the Tax Court held that a foreign dealer in stocks or securities that failed to qualify for the safe-harbor was engaged in a trade or business within the United States by reason of “[r]eceiving client funds, monitoring interest rates, effecting trades, collecting and disbursing dividends and interest, maintaining customer account information, and valuing portfolios” in the United States either directly or through agents.

if it conducts those same activities through a resident broker, commission agent, custodian, or other independent agent.

The decision to outsource will be of broader importance in determining whether a foreign person has exceeded the threshold for taxation under a treaty.¹²⁴ If a foreign person directly conducts activities in the United States through a permanent establishment, then the foreign person will be subject to tax in the United States. If, however, the foreign person chooses to outsource these activities to a provider in the United States and that provider either (i) can be classified as an independent agent acting in the ordinary course of its business or (ii) even if a dependent agent, can perform its functions without having the authority to conclude contracts on behalf of the foreign person, then the foreign person will *not* have a permanent establishment in the United States and will *not* be subject to U.S. federal income tax on its business profits associated with the outsourced activities.

B. DETERMINING THE TAX BASE

1. CODE: EFFECTIVELY CONNECTED INCOME

Once a foreign person has been found to be engaged in a trade or business within the United States, the amount of the foreign person's taxable income that is effectively connected with the conduct of that trade or business must be determined – as it is only that portion of its taxable income that will be subject to U.S. federal income tax.¹²⁵ Whether a foreign person's

¹²⁴ See, e.g., Rev. Rul. 81-78, 1981-1 C.B. 604, *amplified by* Rev. Rul. 84-17, 1984-1 C.B. 308.

¹²⁵ I.R.C. §§ 871(b), 882(a) (2003).

income will be considered effectively connected with the conduct of a U.S. trade or business depends, in large part, on whether that income is derived from U.S. or foreign sources.

The source rules that apply to U.S. persons, which were generally described above,¹²⁶ apply equally to foreign persons. Thus, the rules described above for sourcing income derived from the sale of inventory property that is produced within the United States and sold without the United States (or vice versa) will apply equally to foreign persons.¹²⁷ Likewise, there is an analogous source rule that applies to income derived from the sale or other disposition of personal property through an office or other fixed place of business located outside the seller's country of residence.¹²⁸ Under this rule, the income from any sale or other disposition of property¹²⁹ by a foreign person will generally be sourced in the United States if the foreign person maintains an office or other fixed place of business in the United States and the sale or other disposition is attributable to that office or fixed place of business.¹³⁰ When applying this rule, “[t]he office or other fixed place of business of an independent agent . . . shall not be treated as

¹²⁶ See *supra* Part II.A.

¹²⁷ See *supra* notes 35-39 and accompanying text.

¹²⁸ See *supra* notes 41-44 and accompanying text.

¹²⁹ Note that this rule applies to income from the sale or other disposition of *any* property, and not just property sourced by reference to the residence of the seller, as was the case with the rule that applies to sales made by a U.S. person through a foreign office. I.R.C. § 865(e)(2)(A) (2003) (“Notwithstanding any other provisions of this part . . .”).

¹³⁰ *Id.* Note that there is an exception from this rule for income from the sale or other disposition of inventory property, provided that (i) the inventory property is sold for use, disposition, or consumption outside the United States and (ii) a foreign office or other fixed place of business of the taxpayer materially participated in the sale. I.R.C. § 865(e)(2)(B) (2003).

the office or other fixed place of business of his principal.”¹³¹ An independent agent is “a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity.”¹³² The office or fixed place of business of any other agent will be imputed to the foreign principal only if the agent either (i) has the authority to negotiate and conclude contracts in the name of the foreign principal and regularly exercises that authority or (ii) has a stock of merchandise belonging to the foreign principal from which orders are regularly filled on behalf of the foreign principal.¹³³

With these source rules in mind, a foreign person’s effectively connected income can be determined. A foreign person’s U.S. source investment income and U.S. source capital gains will be considered effectively connected with the conduct of a U.S. trade or business if either (i) the income is derived from assets used in (or held for use in) the conduct of the trade or business or (ii) the activities of the trade or business were a material factor in the realization of the income.¹³⁴ Under the residual force of attraction principle, all other U.S. source income of a foreign person is automatically “treated as effectively connected with the conduct of a trade or business within the United States.”¹³⁵

¹³¹ Treas. Reg. § 1.864-7(d)(2) (1972); I.R.C. § 865(e)(3) (2003) (incorporating by reference the principles of § 864(c)(5) for purposes of determining whether a taxpayer has an office or other fixed place of business).

¹³² Treas. Reg. § 1.864-7(d)(3)(i) (1972).

¹³³ Treas. Reg. § 1.864-7(d)(1)(i) (1972).

¹³⁴ I.R.C. § 864(c)(2) (2003).

¹³⁵ I.R.C. § 864(c)(3) (2003).

A foreign person's foreign source income will be considered effectively connected with the conduct of a U.S. trade or business only under limited circumstances.¹³⁶ First, the foreign person must have an office or other fixed place of business within the United States. Second, the foreign source income must fall within one of the following three statutorily-prescribed categories:

- Rents or royalties derived in the active conduct of the trade or business;
- Dividends or interest (i) derived in the active conduct of a banking, financing, or similar business within the United States or (ii) received by a corporation the principal business of which is trading in stocks or securities for its own account; or
- Income derived from the sale or exchange (outside the United States) of inventory property through the U.S. office or fixed place of business (unless the inventory property is sold or exchanged for use, consumption, or disposition outside the United States and a foreign office or other fixed place of business of the foreign person participated materially in the sale).

Finally, this income must be "attributable" to the foreign person's U.S. office or other fixed place of business.

In determining whether the foreign person has a U.S. office or other fixed place of business, "[t]he office or other fixed place of business of an independent agent . . . shall not be treated as the office or other fixed place of business of his principal."¹³⁷ An independent agent is "a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity."¹³⁸ The office or fixed place of business of any

¹³⁶ I.R.C. § 864(c)(4) (2003).

¹³⁷ I.R.C. § 865(c)(5)(A) (2003); Treas. Reg. § 1.864-7(d)(2) (1972).

¹³⁸ Treas. Reg. § 1.864-7(d)(3)(i) (1972).

other agent will be imputed to the foreign principal only if the agent either (i) has the authority to negotiate and conclude contracts in the name of the foreign principal and regularly exercises that authority or (ii) has a stock of merchandise belonging to the foreign principal from which orders are regularly filled on behalf of the foreign principal.¹³⁹

2. TREATY: ATTRIBUTABLE TO PERMANENT ESTABLISHMENT

Due to the inextricable relationship in treaties between the threshold for taxation and the definition of the tax base for business profits, the business profits of a foreign person that are attributable to outsourced activities will be subject to U.S. federal income tax only under limited circumstances. Under a treaty, a foreign person will be subject to U.S. federal income tax only if the provider of outsourced goods or services cannot both (i) be classified as an independent agent acting in the ordinary course of its business and (ii) perform its functions without having (and habitually exercising) the authority to conclude contracts on behalf of the foreign person.

In such a case, the foreign person will be taxed on the portion of its profits that is “attributable” to its U.S. permanent establishment (i.e., the dependent agent). The amount of profits attributable to the U.S. permanent establishment is determined using the arm’s length principle; in other words, a permanent establishment is attributed the profits “that it would have earned had it been an independent enterprise engaged in the same or similar activities under the same or similar circumstances.”¹⁴⁰ While this concept of profits “attributable” to a permanent

¹³⁹ I.R.C. § 865(c)(5)(A) (2003); Treas. Reg. § 1.864-7(d)(1)(i) (1972).

¹⁴⁰ TECHNICAL EXPLANATION, *supra* note 117, art. 7(2), *reprinted in* 1 CCH Treaties, *supra* note 115, ¶ 214A, at 10,631.

establishment is similar to the Code concept of “effectively connected income,” the two concepts are not identical.¹⁴¹

Under the U.S. Model Treaty, only business profits that are derived from the permanent establishment’s assets or activities will be attributed to it.¹⁴² This is similar to the “asset use” and “business activities” tests that apply under the Code in determining whether a foreign person’s U.S. source investment income and U.S. source capital gains are effectively connected with the conduct of a U.S. trade or business.¹⁴³ The U.S. Model Treaty does not, however, contain the limited force of attraction principle that applies to all other U.S. source income under the Code.¹⁴⁴

When a foreign person’s permanent establishment is a dependent agent (and not an office or factory or some other fixed facility), application of the arm’s length principle becomes complicated. The difficulties have been described as follows:

Because the permanent establishment is a legal fiction rather than a real business with a physical presence in the jurisdiction, there generally is no documentation from which to discern the scope or attributes of the permanent establishment or against which to evaluate comparable transactions. This may give rise to practical difficulties in applying the arm’s length standard. In addition, there is the thorny question of what level of profits the deemed permanent establishment should be attributed, if any, over and above the dependent agent’s arm’s length compensation.¹⁴⁵

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ Katz & Plambeck, *supra* note 107, at A-105; *see also* Chang Hee Lee, *Instability of the* (continued...)

3. SUMMARY

The impact of a decision to outsource is not as profound when calculating the foreign person's U.S. tax base as it is when determining whether the foreign person has exceeded the threshold for taxation in the United States. Nonetheless, the decision to outsource may affect the includibility of foreign source income in the tax base under the Code, because the existence of a U.S. office or other fixed place of business (whether actual or imputed) is a necessary prerequisite to taxing that income. Under treaties, the decision to outsource takes on importance when the provider of outsourced goods or services is deemed to be a permanent establishment of the foreign person. In that situation, determining the amount of profits attributable to the provider's activities is, as a practical matter, somewhat more difficult than if the outsourcing company had established its own physical presence in the United States.

IV. CONCLUSION

The purpose of this article has been to sensitize businesses and their legal advisors to the potential tax consequences of cross-border outsourcing. The U.S. international tax regime, which is implicated by cross-border outsourcing, is notorious for its complexity – a complexity that we have found in abundance when viewing the regime through the lens of outsourcing. Although a certain measure of complexity is a natural concomitant of any maturing set of legal rules, the complexity of the U.S. international tax regime – and, more particularly, of the rules relating to outsourcing – cannot be attributed entirely to a closer reflection of economic

¹⁴⁵ (...continued)
Dependent Agency Permanent Establishment Concept, 27 TAX NOTES INT'L 1325, 1331-34 (2002).

realities.¹⁴⁶ Rather, the excess complexity in both cases appears to stem in great part from a failure to take an integrated approach to formulating U.S. international tax policy.¹⁴⁷

The ad hoc approach to the treatment of outsourcing is evident even in the limited survey set forth in this article. The selected rules described above reflect an entire spectrum of different ways in which the treatment of outsourcing might be approached. At one end of the spectrum, the activities of all providers of outsourced goods or services are taken into account (e.g., in making most determinations whether a foreign person is engaged in a trade or business within the United States). In other situations, the activities of the provider of outsourced goods or services are disregarded only if the provider qualifies as an independent agent (e.g., the safe harbor under § 864(b) for trading in stocks, securities, or commodities). In yet other situations, the activities of a provider of outsourced goods or services are disregarded unless the provider has (and habitually exercises) the authority to conclude contracts binding on its principal (or, under the Code, has a stock of merchandise belonging to the principal from which orders are regularly filled on the principal's behalf) (e.g., the source rule for sales through an office and the rules for determining whether a foreign person's foreign source income is effectively connected income, which both apply the principles of § 864(c)(5)). Finally, at the other end of the spectrum, the activities of a provider of outsourced goods or services are wholly disregarded in all circumstances (e.g., in calculating foreign base company sales income under § 954(d) and in

¹⁴⁶ See Anthony C. Infanti, *Spontaneous Tax Coordination: On Adopting a Comparative Approach to Reforming the U.S. International Tax Regime*, 35 VAND. J. TRANSNAT'L L. 1105, 1111 (2002).

¹⁴⁷ For a proposal to reform the U.S. international tax regime to remedy the lack of uniformity in addressing when the activities of U.S. agents will be attributed to their foreign principals, see Pugh, *supra* note 107, at 15-48.

sourcing income from the sale of inventory property produced by the taxpayer under § 863(b)). What this spectrum of rules lacks, however, is a truly unifying rationale or theme that explains why different rules are adopted in different situations.

The Service itself has underscored the ad hoc nature of the development of these rules and their general lack of integration. In 1998, when the Service reversed nearly a quarter century of administrative practice under Subpart F by revoking Ruling 75-7, it noted, almost by way of aside, that this reversal of course would have the effect of harmonizing the Service's treatment of outsourced activity when calculating foreign base company sales income under § 954(d) with its treatment of outsourced activity when sourcing income from inventory property produced by the taxpayer under § 863(b).¹⁴⁸ That the Service was apparently not troubled by this inconsistency in treatment in the decades before its losses in the *Ashland Oil* and *Vetco* cases is particularly telling.

This internal complexity of the U.S. international tax rules relating to outsourcing is only compounded when the problem is viewed from a broader perspective that takes into account the fact that “cross-border” outsourcing necessarily crosses borders.¹⁴⁹ Other countries with a connection to the outsourcing arrangement may also claim the right to tax all or a portion of the income generated by the arrangement, which makes a review of their international tax rules an indispensable part of any systematic planning process. These countries, as sovereign entities, are free to adopt international tax rules that are different from – and that conflict with – those of the

¹⁴⁸ See *supra* note 79.

¹⁴⁹ See *Infanti*, *supra* note 146, at 1119-1123.

United States, thereby creating an additional, external form of complexity that taxpayers must address in the planning process.

Until such time as steps are taken to reduce both the internal and external complexity of the international tax rules relating to outsourcing, businesses and their legal advisors will require a thorough familiarity and facility with the myriad of U.S. (and foreign) tax ramifications that can flow from a decision to outsource before they will be able accurately to assess the potential tax benefits and detriments of a given cross-border outsourcing arrangement. It is only with such in-depth awareness of the issues that businesses and their legal advisors will be able to avoid the pitfalls and pratfalls that are an unavoidable byproduct of the excessive complexity of the U.S. international tax regime and, at the same time, unearth the opportunities that sometimes lie hidden among them.