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Tax Alert

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Distribution Arrangements Between Non-U.S. Suppliers and Their U.S. Subsidiaries: Avoiding a U.S. Permanent Establishment and Other U.S. Tax Matters

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Many suppliers of products from Canada, the United Kingdom, Sweden and other non-U.S. countries ("non-U.S. suppliers") seek to distribute their products in the United States through their wholly owned U.S. subsidiaries. In doing this, a non-U.S. supplier should structure its operations to avoid being treated as having a U.S. permanent establishment under the applicable U.S. income tax treaty. If the U.S. business activities are carried out by a U.S. subsidiary but are not structured properly, the non-U.S. supplier may be deemed to have a U.S. permanent establishment. If a U.S. permanent establishment exists, the non-U.S. supplier may be required to file U.S. federal and state income tax returns and pay U.S. federal and state income tax on a portion of its profits attributable to the U.S. operations.

This Tax Alert examines various distribution arrangements between a non-U.S. supplier and its U.S. subsidiary and how such arrangements can result in a U.S. permanent establishment if not properly structured. It also discusses how the non-U.S. supplier may still be required to file a "protective" U.S. federal income tax return even if the applicable tax treaty exempts the non-U.S. supplier from U.S. income tax. Failure to file such a return (or an extension) by March 15, 2006 may result in a $10,000 penalty being imposed for calendar year 2005.

In addition, this Tax Alert addresses state income tax requirements, and state and local sales tax requirements.

Background of U.S. Federal Income Tax Rules

Conducting a Trade or Business in the U.S.

A non-U.S. corporation that at any time in a year has income that is "effectively connected with the conduct of a trade or business within the United States" will be subject to U.S. federal income tax.

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Whether a non-U.S. supplier will be treated as conducting a U.S. trade or business depends on all the facts and circumstances. The threshold level of activity is relatively low. Any one of the following activities could subject a non-U.S. supplier to U.S. federal income tax:

- The non-U.S. supplier ships goods to the U.S. and title to the product passes in the U.S.
- The non-U.S. supplier's employees or agents travel regularly in the U.S. to make sales calls or to engage in marketing activities, demonstrate products, or solicit orders.
- The non-U.S. supplier's employees or agents travel regularly in the U.S. to assist customers with installations, training or servicing products.
- The non-U.S. supplier stores product at a warehouse in the U.S.

U.S. Treaty Protections – Permanent Establishment

A non-U.S. supplier that has income that is effectively connected with a U.S. trade or business may not be liable for U.S. federal income tax if the non-U.S. supplier is entitled to claim the benefits of an applicable U.S. income tax treaty. In a typical U.S. income tax treaty, a non-U.S. corporation will be subject to U.S. tax on its business profits only if it carries on business in the U.S. through a U.S. "permanent establishment." A permanent establishment is a fixed place of business through which a non-U.S. corporation carries on a business, including (i) a place of management, (ii) a branch, (iii) an office, or (iii) a factory.

Under a typical U.S. income tax treaty, the following fixed places of business are not considered a permanent establishment:

- The use of facilities for storage, display, or delivery of goods or merchandise.
- The maintenance of a stock of goods or merchandise for storage, display and delivery or for processing by another person.
- The purchase of goods in the U.S.
- The collection of information in the U.S.
- Advertising, supplying information or scientific research done in the U.S. that is preparatory or secondary to the business.

Accordingly, a non-U.S. supplier that maintains inventory in a U.S. warehouse will not by that reason alone be treated as having a U.S. permanent establishment.

U.S. Subsidiary Acting as an Agent That Creates a U.S. Permanent Establishment

A non-U.S. supplier may be treated as having a U.S. permanent establishment if its U.S. operations are carried out by a U.S. subsidiary acting as an agent of the non-U.S. supplier. The idea seems to be that since a non-U.S. company that conducted business in the U.S. itself would have a U.S. permanent establishment, it should not be able to avoid permanent establishment treatment by conducting business through a U.S. agent where the non-U.S. company continues to bear the risk of loss and exercise control over the U.S. operations.

A non-U.S. supplier may be treated as having a U.S. permanent establishment if the U.S. subsidiary has the authority to negotiate and conclude contracts in the name of the non-U.S. supplier and regularly exercises that authority. To avoid this treatment, at a minimum the non-U.S. supplier must approve the prices and contracts outside the U.S. Close questions

may arise if a course of conduct is established whereby the U.S. subsidiary regularly negotiates the price and other important terms with the U.S. customer and the terms are typically approved by the non-U.S. supplier without change.

In addition, a non-U.S. supplier may be treated as having a U.S. permanent establishment if the non-U.S. supplier has a stock of goods in the U.S. from which orders are regularly filled by the U.S. subsidiary on behalf of the non-U.S. supplier.

A U.S. subsidiary also could be treated as an agent that gives rise to a permanent establishment if the non-U.S. supplier bears substantially all the risks of the operations in the U.S. and exercises control over the manner in which U.S. operations are carried out. This issue is exacerbated in the case of a parent company-subsidiary relationship, where the subsidiary has virtually an exclusive relationship with the parent company.

Distribution Arrangements

The possibility of creating a U.S. permanent establishment needs to be considered by the non-U.S. supplier in structuring and drafting distribution arrangements with its U.S. subsidiary. Some common distribution arrangements in the U.S. are as follows.

Independent Distributor Model. Under this approach, the U.S. subsidiary acts as an independent company and distributor. The non-U.S. supplier sells its product to the U.S. subsidiary, with title passing outside the U.S. The U.S. subsidiary performs the marketing and sales efforts in the U.S., makes the sales to U.S. customers, and bears the risk of loss that the product in the U.S. will be damaged, that prices will fall, or that the U.S. customer does not pay. Because the U.S. subsidiary bears substantially all of the risk of loss, the U.S. subsidiary typically will have higher profits than under other approaches. From a business perspective, the independent distributor approach may be used if there is a desire for U.S. customers to deal with a U.S. company.

Commission Model. Under this approach, the U.S. subsidiary serves as the sales representative or commission agent for the non-U.S. supplier. The U.S. subsidiary solicits sales in the U.S. Actual sales are made by the non-U.S. supplier to the U.S. customer from inventory maintained by the non-U.S. supplier in a warehouse in the U.S. The non-U.S. supplier bears the risks that the product will be damaged in storage, that prices will decline, and that the customer does not pay. Because the non-U.S. subsidiary bears substantially all of the risk of loss, the U.S. subsidiary typically will have lower profits than under other approaches. The U.S. subsidiary must bear the risk that its sales and marketing efforts will not be adequate to pay the cost of its operations. Depending on how operations actually are conducted, this approach carries some risks that a permanent establishment will be found.

Consignment Model. Under this approach, the U.S. subsidiary markets and solicits sales from U.S. customers. In form, the U.S. subsidiary sells product directly to the U.S. customer. At the time a sale is made, title to the product transfers from the non-U.S. supplier to the U.S. subsidiary and then from the U.S. subsidiary to the U.S. customer. Accordingly, title is with the non-U.S. subsidiary while the product is stored in a U.S. warehouse. However, the U.S. subsidiary bears the risk that the customer will not pay. The U.S. Internal Revenue Service permitted this arrangement in a letter ruling where the U.S. subsidiary bore the cost of shipping and the risk of loss or damage to the product while it was in the U.S. Due to

risk of loss considerations, the U.S. subsidiary typically will have more profits under this approach than under the commission approach.

Commissionaire Model. In a commissionaire approach, which is common in Europe, the distributor acts in its own name but for the account of the principal. However, using a commissionaire will often lead to a permanent establishment in the U.S., unless the agent fully acts as an independent agent.

Regardless of the approach adopted, care must be taken to conduct operations so as to avoid a permanent establishment. As a general matter, the more the risk of loss is shifted to the non-U.S. supplier, the greater the risk of creating a U.S. permanent establishment.

United States Income Tax Return Filing Requirements

Effectively Connected Income But No U.S. Permanent Establishment. If a non-U.S. supplier has income that is effectively connected with a U.S. trade or business (for example, by maintaining a stock of product in a U.S. warehouse), but does not have a permanent establishment in the U.S. under an applicable income tax treaty, the non-U.S. supplier must still file a U.S. corporate federal income tax return. The non-U.S. supplier must file to disclose the U.S. source income and the treaty-based position. The return can show zero U.S. taxable income. If a non-U.S. supplier is uncertain as to whether it has income that is effectively connected to a U.S. trade or business, it should consider filing a U.S. federal corporate income tax return as a protective measure.

If a filing is required, the due date for filing generally is the 15th day of the third month following the end of the fiscal year of the business. If the fiscal year is a calendar year, then the filing deadline for 2005 is March 15, 2006 (an extension can also be filed).

If a non-U.S. supplier files late, but no tax is due because of the treaty exemption, no interest and penalties will apply if a second deadline is met. For corporations, this deadline is 18 months after the original due date. This extended due date may provide a non-U.S. supplier with an opportunity to avoid interest and penalties from the failure to file a U.S. tax return for 2003.

If a corporate non-U.S. supplier misses the second deadline and relies on a treaty position to claim an exemption, a penalty of $10,000 may be charged for each item of income. It is possible that the penalty could be waived if the non-U.S. supplier establishes to the satisfaction of the Internal Revenue Service that the failure was not due to willful neglect.

Non-U.S. Supplier Has Taxable Presence in the U.S. If a non-U.S. supplier has income that is effectively connected to a U.S. trade or business and there is no treaty that applies to exempt the income, or a U.S. permanent establishment in fact exists, the same filing requirements set forth above apply. If a corporate non-U.S. filer misses the second deadline, it may be denied the ability to use deductions and may be taxed on its gross income. Accordingly, it may be important for a non-U.S. supplier that does not believe it is subject to U.S. federal net income taxation to file a "protective return" showing zero U.S. taxable income in order to protect its ability to claim deductions in case the non-U.S. supplier is later determined to have a taxable presence in the U.S.

U.S. Federal Transfer Pricing Rules

Under U.S. federal inter-company transfer pricing rules, the charge to the U.S. subsidiary for the product or the commission paid to the U.S. subsidiary must be an arm's-length amount. Taxpayers can protect themselves from penalties if they keep contemporaneous documentation supporting the position that the prices charged were fair and at arm's length.

U.S. State Taxation

Even if a non-U.S. supplier does not have a U.S. permanent establishment, the states in which the non-U.S. supplier has "nexus" may impose state income tax. Technically, states are not bound by U.S. treaties. In general, it is easier for a non-U.S. supplier to have nexus in a state than to have a permanent establishment. For example, if a non-U.S. supplier has its goods stored in New York State, the state would require the non-U.S. supplier to file tax returns and pay state income tax on a portion of its worldwide taxable income.

In addition, state sales tax needs to be considered. If title to products passes in the U.S., the non-U.S. supplier may be required to withhold sales tax and remit it to the appropriate state. State sales tax may be avoided if a "resale" certificate is obtained from the purchaser, but this exemption may require the non-U.S. supplier to register with the state.

Each state also has its own tax return filing requirements and deadlines. These typically differ from the U.S. federal income tax return requirements and deadlines.

What to Do

Non-U.S. suppliers that distribute products in the U.S. through their U.S. subsidiaries need to pay careful attention to U.S. federal income tax rules, as well as to state and local income tax and sales tax rules. For example, even a non-U.S. supplier that can claim an exemption from federal income tax under an applicable U.S. income tax treaty may still be required to (i) file a protective U.S. income tax return with the proper form attached taking the treaty position, (ii) file a state income tax return and possibly pay state income tax, and (iii) file state sales tax returns and possibly pay state sales tax. Failure to comply with any one of these requirements can result in substantial penalties.

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