

Policy Issues Relating to the U.S. Taxation of Foreign Persons Engaged in Business in the United States Through Agents: Some Proposals for Reform

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* The author expresses his appreciation for the valuable assistance of Jennifer Barbee Molnar, Melissa A. Carrig, Alena M. Herranen, Esq. and Lisa Kim, Esq. in the preparation of this Article.

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I. INTRODUCTION

A number of significant international tax policy issues for the United States center on the U.S. taxation of foreign persons engaged in business activity within the United States through agents.

If a foreign corporation (or non-resident alien) is engaged in a trade or business within the United States, it is subject to the usual U.S. corporate (or individual) income tax on the taxable income effectively connected with its U.S. business.¹ A foreign corporation is also subject to the branch profits tax on earnings not invested in the U.S. business.² A foreign corporation (or non-resident alien) is subject to a flat withholding tax of 30 percent on the gross amount of certain categories

1. See I.R.C. §§ 882(a)(1), 871(b)(1). For a comprehensive discussion of the concept of income effectively connected with a United States business see Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689, 689-752 (1987).

2. See I.R.C. § 884. More specifically, the branch profits tax is imposed on the “dividend equivalent amount” as defined in I.R.C. § 884(b). The foreign corporation may also be subject to the branch-level interest tax under § 884(f). This tax as well as the branch profits tax may be reduced under terms of an applicable tax treaty.

of U.S.-source income that is not effectively connected with a U.S. business. The broadest of these categories is fixed or determinable annual or periodical income.³

Thus, under the Internal Revenue Code ("Code"), the threshold question in determining the extent to which a foreign person is subject to U.S. income tax is whether that person is "engaged in a trade or business within the United States."⁴ If a tax treaty is in force between the United States and the country of which the foreign person is a resident, even if the foreign person is engaged in U.S. business, its U.S. business income will usually be exempt from U.S. tax under the treaty if it has no permanent establishment in the United States to which the income is attributable.⁵

In connection with the U.S. taxation of the business income of a foreign corporation or nonresident alien, an important distinction is drawn between doing business in the United States through an independent agent acting in the ordinary course of its business, on the one hand, and doing business in the United States through any other agent, on the other. It is reflected in a number of significant provisions of the Code dealing with the U.S. taxation of the business income of a foreign person. The distinction is also a key element of the definition of permanent establishment contained in treaties for the elimination of double taxation to which the United States is a party and in hundreds of double tax treaties between other countries. In view of the significant role this distinction plays in the U.S. taxation of foreign persons, it is somewhat surprising that the standards to be applied in drawing the distinction are ill-defined, and that there is resulting uncertainty under the Code and regulations as to its application to business activities conducted by foreign persons in the United States through an agent.

On December 17, 1993, the U.S. Treasury Department and the Internal Revenue Service ("IRS") announced a joint Action Plan on International Tax Compliance ("International Action Plan").⁶ The

3. See I.R.C. §§ 881(a)(1), 871(a)(1)(A). The 30 percent withholding tax may be reduced or eliminated under the Code or an applicable tax treaty.

4. I.R.C. §§ 882(a)(1), 871(b)(1).

5. For information regarding the permanent establishment concept see generally JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME ch. 38 (1990); JOHN HUSTON & LEE WILLIAMS, PERMANENT ESTABLISHMENTS: A PLANNING PRIMER (1993); JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C4.05 (1992); ARVID A. SKAAR, PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE (1991).

6. *Tax Compliance in a Global Economy: Statement of Policy and Action Plan*,

Treasury and the IRS noted in the International Action Plan that they intended to review the concepts of “trade or business” and “effectively connected with the conduct of a trade or business” in the light of “the growing sophistication of international business transactions.”⁷ Among other things, they proposed to review “the proper treatment of dependent and independent agents under tax treaties.”⁸ No changes on these topics have as yet been proposed by the Treasury or the IRS.

This Article will begin by discussing the circumstances under which a foreign person will be deemed to be engaged in a trade or business in the United States and by examining a proposal that would introduce a greater level of certainty for tax planners and the IRS. The principal focus of the Article, however, will be on the circumstances under which the United States should impose U.S. income tax on the income of a foreign person from a business conducted, not directly in the United States, but through an agent acting on behalf of the foreign person.

The treatment of agents as permanent establishments under international double taxation treaties has attracted considerable attention from commentators in recent years.⁹ This Article has a broader focus. It will first examine the standards to be applied under the Code when determining whether a foreign person is engaged in a trade or business within the United States as a result of the U.S. activities or facilities of an agent. Second, this Article will consider the distinction between an independent agent acting in the ordinary course of its business and other agents under both the Code and U.S. tax treaties, and the application of this distinction to business activities conducted in the United States by an agent on behalf of a foreign principal. Finally, it will suggest how the Code or regulations could be revised to reduce the uncertainties that currently inhere in these issues.

[Dec.] Daily Tax Rep. (BNA) No. 242, at L-1 (Dec. 17, 1993).

7. *Id.*

8. *Id.* at L-5.

9. See, e.g., ISENBERGH, *supra* note 5, at ch. 38; KUNTZ & PERONI, *supra* note 5, ¶¶ C4.05[2][a]; 3 RUFUS VON THULEN RHOADES & MARSHALL J. LANGER, *INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS*, § 10.02 (1983); SIDNEY I. ROBERTS & WILLIAM C. WARREN, *U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS*, para. IX, at 12 (P.L.I. 1966); SKAAR, *supra* note 5, at pts. 5-6; KLAUS VOGEL, *KLAUS VOGEL ON DOUBLE TAX CONVENTIONS*, 256-67 (1991); KLAUS VOGEL ET AL., *UNITED STATES INCOME TAX TREATIES*, 248-68 (1989); John F. Avery Jones & David A. Ward, *Agents as Permanent Establishments under the OECD Model Tax Convention*, 33 *EUR. TAX'N* 154 (1993); Sidney I. Roberts, *The Agency Element of Permanent Establishment: The OECD Commentaries From the Civil Law View*, 9 *INTERTAX* 396 (1993); Joel Nitikman, *The Meaning of 'Permanent Establishment' in the 1981 U.S. Model Income Tax Treaty: Part 2*, 15 *INT'L TAX J.* 257 (1989); Robert L. Williams, *Permanent Establishments in the United States*, 29 *TAX LAW.* 277, 337-52 (1976).

II. THE CONCEPT OF TRADE OR BUSINESS IN THE UNITED STATES

Although the concept of “a trade or business within the United States” is used in many provisions of the Code relating to the taxation of foreign persons, a comprehensive definition is not to be found either in the Code or in the regulations. There is, however, statutory guidance with respect to the rendering of services in the United States. Section 864(b) provides that “trade or business within the United States” includes “the performance of personal services within the United States at any time within the taxable year” except for performance of a limited amount of services for a foreign employer¹⁰ and certain trading in stocks and securities¹¹ or commodities.¹²

Beyond these statutory rules for services, the foreign person must seek to glean the operative rules on what constitutes being engaged in a U.S. trade or business from a smattering of cases and rulings. Although the existence of a U.S. trade or business is principally an issue of fact, and the result in each case or ruling turns on the particular circumstances presented,¹³ these cases and rulings support a few clear rules applicable in specific contexts. For example, the activity of owning and managing a portfolio of passive investments in stocks and securities does not constitute a trade or business, however extensive it may be.¹⁴ Owning and leasing U.S. real property subject to long-term net leases does not constitute a trade or business even if the foreign owner participates in the lease negotiations.¹⁵ Mere purchase of goods in the United States is not

10. See I.R.C. § 864(b)(1).

11. See I.R.C. § 864(b)(2)(A).

12. See I.R.C. § 864(b)(2)(B).

13. See, e.g., *Commissioner v. Spermacet Whaling and Shipping Co.*, 281 F.2d 646 (6th Cir. 1960). The IRS will not issue a prior ruling on whether a foreign person is engaged in a U.S. trade or business. See Rev. Proc. 91-6, 1991-1 C.B. 413, § 4.01(3).

14. See, e.g., *Higgins v. Commissioner*, 312 U.S. 212, *reh'g denied*, 312 U.S. 714 (1941); *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959). Moreover, under I.R.C. section 864(b)(2)(A)(ii), trading for a foreign person's own account through an agent in the United States with discretionary authority is not a U.S. trade or business except in the case of a foreign corporation the principal business of which is trading in stocks or securities for its own account if its principal office is in the United States. See I.R.C. § 864(b)(2)(A)(ii).

15. See Rev. Rul. 73-522, 1973-2 C.B. 226; see also *Neil v. Commissioner*, 46 B.T.A. 197 (1942) (“mere ownership of [real] property from which income is drawn does not constitute the carrying on of business”); *Herbert v. Commissioner*, 30 T.C. 26 (1958) (holding that a property owner is not engaged in a trade or business where her sole activities in connection within the property consisted of receipt of rentals and payment of taxes, repairs, insurance and mortgage principal and interest); cf. *Schwarcz v.*

a trade or business.¹⁶ Moreover, regular activities in the United States that constitute no more than solicitation by a foreign person of orders by advertisements through the mail, by fax, in printed publications, by radio transmissions emanating from a foreign country or, presumably, over the internet, do not rise to the level of a U.S. business.¹⁷

Business activity of a foreign person in the United States not covered by the foregoing rules of limited scope must generally be “continuous,” “regular” and “considerable” and involve some physical presence of persons or facilities in the United States if it is to constitute engaging in a trade or business in the United States.¹⁸ Thus, if the activities or transactions involved are isolated or sporadic, they will not be considered to constitute a trade or business.¹⁹ Because the cases and rulings have fact patterns that are highly variegated with respect to type and quantity of activities or transactions, uncertainties for the tax planner

Commissioner, 24 T.C. 733 (1955), *acq.*, 1956-1 C.B. 5 (holding owner managing all aspects of one parcel of rental property was engaged in a trade or business).

16. See *U.S. v. Balanovski*, 131 F. Supp. 898 (S.D.N.Y. 1955), *rev'd on other grounds*, 236 F.2d 298 (2d Cir. 1956), *cert. denied*, 352 U.S. 968 (1957), *reh'g denied*, 352 U.S. 1019 (1957) (holding that a foreign partnership is not engaged in a trade or business even though it had a representative in the United States who regularly located suppliers, purchased and paid for goods and inspected and arranged for their shipment).

17. See *Piedras Negras Broadcasting Co. v. Commissioner*, 43 B.T.A. 297 (1941), *aff'd* 127 F.2d 260 (5th Cir. 1942) (holding that broadcasting radio programs, including advertising, from Mexico intended for U.S. listeners did not constitute a U.S. trade or business.); OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, *Selected Tax Policy Implications of Global Electronic Commerce* 20 (Nov. 1996), *reprinted in* Daily Tax Rep. (BNA), Nov. 22, 1996, at L-1 (also available at *U.S. Dep't of the Treasury* <<http://www.ustreas.gov/taxpolicy/internet.html>>) [hereinafter “TREASURY WHITE PAPER”].

18. See, e.g., *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1942); *Commissioner v. Spermacet Whaling and Shipping Co.*, 281 F.2d 646 (6th Cir. 1960); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1955); Rev. Rul. 73-522, 1973-2 C.B. 226. It is unclear to what extent “considerable” adds a substantive requirement to “continuous” and “regular.” It could be deemed to relate to the volume of transactions or to the amount of money involved, to both of these, or to some other factors. Some cases articulate the trade-or-business test in terms of continuous and regular activities without reference to whether they need to be “considerable.” See e.g., *Continental Trading, Inc. v. Commissioner*, 265 F.2d 40 (9th Cir. 1959).

19. See, e.g., *Continental Trading*, 265 F.2d 40; *Herbert*, 30 T.C. 26. The rendering of services is subject to the special rules of section 864(b) discussed in the text accompanying notes 10 through 12. Thus, the rendering of services may be a trade or business even if confined to a single event. See *Johansson v. U.S.*, 336 F.2d 809 (5th Cir. 1964) (holding that participation in three world championship prize fights in the United States during less than 15 months is a trade or business). If racing a horse falls under the services rule, an exception seems to have developed for the first race. See Rev. Rul. 85-4, 1985-1 C.B. 294 (stating that taxes must be withheld on a purse in the absence of definite information filed that such owner has not raced, or does not intend to enter a horse in more than one race in the United States during the taxable year, and U.S. income tax must be withheld from winnings, even if such winnings are ultimately tax exempt under a tax convention).

and tax administrator abound with respect to whether particular activities of a foreign person in the United States constitute a U.S. trade or business. The dramatic growth in international e-commerce has given rise to additional unresolved uncertainties. One worthwhile objective would be to reduce these uncertainties by adopting, in the Code or the regulations, comprehensive rules or standards of greater specificity concerning the circumstances under which a foreign person will be deemed to be engaged in a U.S. trade or business.

A. Conduct of U.S. Business Activities Through an Agent

Many foreign corporations and other foreign persons that have a “presence” of some kind in the United States take the position that they are not engaged in trade or business in the United States and therefore do not have income effectively connected with a business that is subject to U.S. corporate or individual tax. One common means of establishing a presence in the United States is to do so through an agent that will usually, but not necessarily, have its own office or other fixed place of business in the United States.

The term “agent” has been broadly defined to include a person who consents to act on behalf of and subject to the control of the principal.²⁰ The term can encompass a wide band of relationships ranging from those between employer and employee to those between principal and an unrelated agent who, in the ordinary course of its business, represents a number of principals. Examples of the latter would include a securities or commodities broker who buys and sells for unrelated principals, a manufacturers’ representative who sells various types of products on behalf of a number of unrelated manufacturers, and a shipping agent who arranges transport for many unrelated shippers. Under Anglo-American common law, an agent may deal with third parties in the name of the principal or may act on behalf of an undisclosed principal, and the principal in either event would be bound by the act of the agent vis-à-vis the third party.²¹

20. See RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958).

21. See *id.* §§ 144, 186. Under civil law regimes, however, if an agent acts for an undisclosed principal, generally the agent but not the principal is bound vis-à-vis the third party. This difference between the common and civil law treatment of agency has contributed to uncertainty concerning the concept of an independent agent acting in the ordinary course of its business under the OECD Model Tax Conventions. See *infra* text accompanying notes 38-43.

B. Imputation of an Agent's Business Activities to Its Foreign Principal

The cases and rulings support what amounts to a general presumption, if not a general rule, that the business activities of an agent in the United States will be imputed to the foreign principal for purposes of determining whether the principal is engaged in a U.S. business.²² This seems an appropriate result when the agency involves a broad measure of control by the principal. However, if the agent is an independent agent acting in the ordinary course of its business, such as the previously mentioned securities or commodities broker, manufacturers' representative or shipping agent, whose regular business is to represent multiple principals, free of comprehensive control by them, the appropriateness of imputation becomes more problematic.²³

The legislative history of certain U.S. tax treaties suggests that, under the Code, selling through an independent agent acting in the ordinary course of its business would constitute engaging in U.S. business.²⁴ This conclusion derives direct support from at least two cases²⁵ and implicit support from a number of cases and rulings that do not discuss, and thus seem to attach no significance to, the distinction between an independent agent acting in the ordinary course of its business and any other agent when deciding whether the U.S. business activities of an agent must be imputed to the foreign principal.²⁶

22. See, e.g., *de Amodio v. Commissioner*, 299 F.2d 623 (3d Cir. 1962); *Handfield v. Commissioner*, 23 T.C. 633 (1955); Rev. Rul. 70-424, 1970-2 C.B. 50.

23. See *ISENBERGH*, *supra* note 5, ¶ 9.17.

24. Arguably, if this were not true, the limited exceptions in sections 864(b)(2)(A)(i) and 864(b)(2)(B)(i) for transactions in stocks and securities and commodities effected through independent agents would have been unnecessary. See *ROBERTS & WARREN*, *supra* note 9, ¶ V/3D(2), at V-47 to V-48.

25. See *de Amodio v. Commissioner*, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962) (holding that the acts of an independent local real estate firm which managed real properties, negotiated leases, arranged for repairs, collected rents, and paid taxes were imputed to the foreign principal who was therefore engaged in a trade or business in the United States); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953); *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955) (holding that the activities of an independent local real estate broker, who was engaged full time in the business of real estate brokerage and property management and who executed leases, rented properties, collected rents, kept books, and paid taxes, were imputed to the foreign principal, who was consequently found to be engaged in a trade or business in the United States).

26. See, e.g., *Handfield v. Commissioner*, 23 T.C. 633 (1955) (holding that U.S. distributor who sold novelty cards for a foreign principal under a consignment contract was an "agent" of the foreign principal through which the principal was considered to be engaging in a trade or business in the United States.).

*C. Imputation of an Agent's Fixed Place of Business to
Its Foreign Principal: The Distinction Between the
Independent Agent Acting in the Ordinary Course
of Its Business and Other Agents*

Although the Code and the regulations do not address the circumstances under which U.S. business activities of an agent may be imputed to a foreign principal, they do contain rules on the question whether, in certain contexts, the office or other fixed place of business of an agent in the United States will be considered to constitute an office or other fixed place of business of the foreign principal. These rules come into play in certain common situations in which U.S. tax consequences turn on whether the income of the foreign person is attributable to a U.S. fixed place of business.

Section 864(c)(4)(B) provides that, in three situations, foreign-source income will be treated as effectively connected with a U.S. trade or business of a foreign person if that person has a U.S. office or other fixed place of business to which the income is attributable. For purposes of this rule, section 864(c)(5)(A) states that the office or fixed place of business of an agent will be disregarded (*i.e.*, not imputed to the foreign principal) unless the agent

- (i) has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation and regularly exercises that authority or has a stock of merchandise from which he regularly fills orders on behalf of such individual or foreign corporation, and
- (ii) is not a general commission agent, broker, or²⁷ other agent of independent status acting in the ordinary course of his business.

This formulation embodies the distinction between an independent agent acting in the ordinary course of its business, covered by clause (ii), and all other agents, covered by clause (i). The fixed place of business of an independent agent acting in the ordinary course of its business will never be imputed to the foreign principal, whereas the fixed place of business of an independent agent acting outside its ordinary course of business or of an agent who is not independent will be so imputed, if the agent has and regularly exercises the requisite power to negotiate and conclude contracts or has a stock of merchandise from which orders are regularly filled. Thus, a key concept for purposes of this statutory

27. I.R.C. § 864(c)(5)(A)(i)-(ii).

imputation is that of the independent agent acting in the ordinary course of its business.²⁸

Section 865(e)(2) provides that income from the sale of personal property (including inventory) by a nonresident attributable to an office or other fixed place of business maintained by the nonresident in the United States will be treated as U.S.-source income.²⁹ As a result, this income will be taxed as income effectively connected with a U.S. business.³⁰ The principles of section 864(c)(5), including the distinction between an independent agent acting in the ordinary course of its business and other agents, apply in determining whether the nonresident has a U.S. office or other fixed place of business.³¹

The distinction between an independent agent and other agents is also reflected in section 864(b)(2), which excludes from services that constitute a U.S. trade or business, trading in stocks or securities or commodities through a “resident broker, commission agent, custodian or other independent agent.” Here, however, there is no requirement that the independent agent be acting in the ordinary course of its trade or business. The addition of this requirement would have been largely, if not completely, superfluous. Agents through whom stocks, securities and commodities are sold are virtually always brokers whose regular course of business is to represent multiple unrelated principals. Section 864(b)(2) is the only Code provision that precludes the imputation of the activities (as distinguished from the fixed place of business) of the independent agent to the foreign principal.

D. Significance of the Independent Agent Acting in the Ordinary Course of Its Business in the Definition of Permanent Establishment Under International Tax Treaties

Beyond its application under the Code, the distinction between an independent agent acting in the ordinary course of its business and other agents plays an important role in the definition of permanent establishment found in the U.S. Treasury’s 1981 and 1996 Model

28. Although the term “dependent” agent has no operative significance, it is used in the regulations to refer to any agent that is not independent. *See, e.g.*, Treas. Reg. § 1.864-7(d)(1) (1972); Treas. Reg. § 1.864-2(c)(2)(i) (as amended in 1975).

29. With respect to sales by a foreign person of inventory property attributable to a U.S. office, § 865(e)(2), which was enacted in the Tax Reform Act of 1986, has virtually supplanted § 864(c)(2)(B). If § 865(e)(2) applies to treat income from sale of personal property as U.S.-source, § 864(c)(4)(B), which applies only to foreign-source income, does not apply. If sales of inventory attributable to a U.S. office are made by a nonresident alien who is not a nonresident as defined in § 865(g) (*e.g.*, because he has a tax home in the United States), § 864(c)(4)(B) may, but § 865(e)(2) will not, apply.

30. *See* I.R.C. § 864(c)(3).

31. *See* I.R.C. § 865(e)(3).

Treaties and in most of the treaties for the elimination of international double taxation to which the United States is a party.³² Article 5, paragraph 5, of the 1981 and 1996 Treasury Models provides that:

[W]here a person—other than an agent of independent status to whom paragraph 6 applies—is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities that person undertakes for the enterprise, unless the activities of the person are limited to those mentioned in Article 5, paragraph 4.³³

Paragraph 4 of article 5 excludes from the definition of permanent establishment, a fixed place of business through which one or more specified activities (hereinafter referred to as “preparatory or auxiliary activities”) are carried on. Article 5, paragraph 6, further states as follows with respect to the independent agent:

An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.³⁴

Paragraphs 5 and 6 of article 5 of the 1981 and 1996 Treasury Models, which incorporate the distinction between the independent agent acting in the ordinary course of its business and other agents, are identical to paragraphs 5 and 6 of article 5 of the 1977 and 1992 OECD Model Tax Conventions³⁵ and are contained in most recent international

32. United States Income Tax Treaty of September 20, 1996, Convention between the United States of America and **** for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, arts. 5(5), (6) (U.S. Dep’t of the Treasury 1996) [hereinafter the 1996 Treasury Model], *reprinted in* 1 Tax Treaties (CCH) ¶ 214, at 10,587 (1996). United States Model Income Tax Treaty of June 16, 1981, Convention between the United States of America and **** for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, arts. 5(5), (6), (U.S. Dep’t of the Treasury 1981) [hereinafter the 1981 Treasury Model], *reprinted in* 1 Tax Treaties (CCH) ¶ 211, at 10,573 (1990).

33. 1996 Treasury Model, *supra* note 32, art. 5(5).

34. *Id.* art. 5(6).

35. Compare OECD COMMITTEE ON FISCAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL (1977) [hereinafter 1977 OECD MODEL] and OECD COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (1992), *reprinted in* 1 Tax Treaties (CCH) para. 191 [hereinafter 1992 OECD MODEL] with 1981 Treasury Model, *supra* note 32, and 1996 Treasury Model, *supra* note 32.

double tax treaties, including those to which the United States is party.³⁶

Thus, under the 1981 and 1996 Treasury Models, the 1977 and 1992 OECD Models, and most double tax treaties in force, the independent agent acting in the ordinary course of its business will never be a permanent establishment of its foreign principal.³⁷ That is, when determining whether an agent constitutes a permanent establishment, neither the activities nor the fixed place of business of such an agent will be imputed to the foreign principal. On the other hand, an independent agent not acting in the ordinary course of its business or a dependent agent will be a permanent establishment of the foreign principal under paragraph 5 of article 5 of the 1981 and 1996 Treasury Models and the 1977 and 1992 OECD Models, if the agent has and habitually exercises the authority “to conclude contracts in the name of the enterprise [*i.e.*, the foreign principal].”

When the phrase “in the name of” the foreign principal is viewed in the light of the conflicting common law and civil law principles of agency, a compelling case has been made for construing “authority to conclude contracts in the name of the enterprise” to mean authority to conclude contracts that are binding on the enterprise (*i.e.*, the foreign principal).³⁸ “In the name of the enterprise” is a literal translation of the French, “*au nom de l’entreprise*.” As noted above, under the common law rule, an agent can bind an unnamed and therefore undisclosed principal. The civil law, however, generally distinguishes between the

36. See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Feb. 22, 1990, U.S.-Spain, arts. 5(5)-(6), S. TREATY DOC. NOS. 16, 4, 5 (1990); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, June 17, 1992, U.S.-Russia, arts. 5(5)-(6), S. TREATY DOC. NO. 39, 12, 13 (1993); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Oct. 8, 1993, U.S.-Slovakia, arts. 5(5)-(6), S. TREATY DOC. NO. 18, (1993); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Mar. 4, 1994, U.S.-Ukraine, arts. 5(5)-(6), S. TREATY DOC. NO. 30, 10, 11 (1994); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 1, 1994, U.S.-Swed., arts. 5(5)-(6), S. TREATY DOC. NOS. 29, 12, 13 (1994); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 6, 1994, U.S.-Port., arts. 5(6)-(7), S. TREATY DOC. NO. 34, 15, 16 (1994).

37. See HUSTON & WILLIAMS, *supra* note 5, at 142; Avery Jones & Ward, *supra* note 9, at 156.

38. This is the conclusion reached on the basis of a comprehensive comparative law analysis in Avery Jones & Ward, *supra* note 9, at 160-63; see also 1977 OECD MODEL, *supra* note 35, commentary para. 31, at 66; 1992 OECD MODEL, *supra* note 35, commentary para. 32, at C(5)-13; Herbert I. Lazerow, *OECD Draft Influence on United States Tax Treaties*, 26 ARK. L. REV. 115, 130 (1972); Herbert I. Lazerow, *The United States-French Income Tax Convention*, 39 FORDHAM L. REV. 649, 675 (1971).

agent that contracts in the name of its principal and thereby binds the principal (so-called “direct representation”) and the agent that acts in its own name and thereby binds itself but not the principal (“indirect representation”).³⁹ Thus, under civil law, the French formulation of the agent contracting in the name of the principal (*au nom de l'entreprise*) encompasses only an agent that can contract in a way that binds its principal.⁴⁰ In order to reach consistent interpretations of the English version of paragraph 5, construed under common law principles, and the French version, construed under civil law principles, the English version should be interpreted to encompass the authority to conclude contracts binding on the principal whether or not concluded in the name of the principal.⁴¹ This is in fact the currently prevailing view, at least in the common law world,⁴² and it has been embraced in a 1994 amendment to the OECD Commentary to paragraph 5 of article 5 of the 1992 OECD Model, which reads “the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.”⁴³

Article 5, paragraph 7 of the 1980 UN Model Double Taxation Convention Between Developed and Developing Countries utilizes the distinction between an independent agent acting in the ordinary course of its business and other agents but adds the following qualification to the independent agent provision found in the OECD and the Treasury Models: “However, when the activities of such agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph.”⁴⁴

The common thread of the distinction between the independent agent

39. See Avery Jones & Ward, *supra* note 9, at 158.

40. See *id.* at 161.

41. See *id.* at 179.

42. See HUSTON & WILLIAMS, *supra* note 5; Avery Jones & Ward, *supra* note 9.

43. 1992 OECD MODEL (Update 1994), commentary para. 32, at C(5)-13.

44. U.N. DEP'T. OF INT'L ECONOMICS & SOCIAL AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES at 22, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980), reprinted in 1 TAX TREATIES (CCH) ¶ 206, art. 5(7) (1982) [hereinafter 1980 UN MODEL]. The sentence was “a new provision, whose inclusion stemmed from a proposal by members from developing countries to broaden the scope of the definition of a permanent establishment.” U.N. DEP'T OF INT'L ECONOMICS & SOCIAL AFFAIRS, COMMENTARIES ON THE ARTICLES OF THE U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES at 73, U.N. Doc. ST/ESA/102 (1980) [hereinafter 1980 UN MODEL CONVENTION COMMENTARY].

acting in the ordinary course of its business and other agents, as used in the Code and the definition of permanent establishment, is that neither a fixed place of business (in the case of sections 864(b)(2), 864(c)(5)(A), 865(e)(2) and the permanent establishment definition) nor the business activities (in the case of section 864(b)(2) and the permanent establishment definition) of an independent agent acting in the ordinary course of its business should be imputed to the foreign principal for whom the agent is acting.⁴⁵

The policy underlying the role of the distinction in these two contexts seems to be that if an agent is (i) independent of the foreign principal and (ii) represents the principal in the ordinary course of the agent's business of representing such principals, it is inappropriate to impute its fixed place of business or activities to the foreign principal. If the agent is independent⁴⁶ and engaged in its own business of representing principals, the income of the agent, not of the foreign principal, should be taxed.

E. Inconsistent Treatment of the Fixed Place of Business and Business Activities of Independent Agents Under the Code

It is not evident why, if the fixed place of business of an independent agent acting in the ordinary course of its business is not imputed under the Code to a foreign principal, the same should not be true with respect to the business activities of the same independent agent. The policy underlying the treatment of the independent agent's fixed place of business seems equally applicable to the treatment of the independent agent's activities. This consistency is achieved in the income tax treaty definition of permanent establishment, under which neither the fixed place of business nor the activities of an independent agent acting in the ordinary course of its business are imputed to the foreign principal. However, because existing cases and rulings appear to stand in the way, introducing consistency between the treatment of the activities and the fixed place of business of an independent agent acting in the ordinary course of its business will require an amendment to the Code or to the regulations.

45. In the case of section 864(b)(2), the business activities of the independent agent are not imputed to the foreign principal even if the agent is not acting in the ordinary course of its business. *See* I.R.C. § 864(b)(2). However, brokers executing trades in stock and securities or commodities would nearly always represent multiple unrelated principals. *See supra* text following note 31.

46. The question of whether an agent is independent is pivotal and is discussed *infra* Part IV.

III. MODES OF AMENDING EXISTING LAW CONCERNING WHAT CONSTITUTES BEING ENGAGED IN U.S. BUSINESS

A. Proposal for Adoption of a Fixed-Place-of-Business Threshold

The starting point for revision of the present regime for the taxation of foreign persons should be clarification of the definition of “engaged in trade or business within the United States.” An important proposal for clarification was made by the American Law Institute in 1986. The A.L.I. proposed the adoption of a general rule that would restrict U.S. taxation of net business income of a foreign person to the case in which that “person has or is deemed to have a fixed place of business in the U.S. to which such income is attributable.”⁴⁷ The policy basis for this proposal was persuasively described by the ALI reporters as follows:

In defining the “threshold” for the taxation of business profits generally, there are obvious advantages in a rule that draws a “bright line” to the greatest possible extent. This promotes international trade by avoiding uncertainty over whether relatively minimal contacts with a source country will result in the imposition of tax. The “permanent establishment” provisions of the income tax treaties seem to have been adopted with this thought primarily in mind, and the recommended rule would, it is believed, serve the same end.

While the recommended rule represents a theoretical shrinking of U.S. statutory source jurisdiction, this is justified for two reasons.

First, the shrinkage is more apparent than real. Few foreign corporations, at least, actually engage directly in trade or business in the U.S. without establishing a fixed place of business. Certainly in terms of the volume of trade, by far the greatest number of these are companies established in treaty countries, entitled to the benefit of the “permanent establishment” rule.

In addition, the proposed rule should substantially reduce the uncertainty that exists under present law as to the circumstances under which a foreign taxpayer is subject to net basis taxation. The “engaged in trade or business” test is difficult to apply and necessarily leads to somewhat unpredictable results. The requirement that business activities be carried out through a fixed place of business would eliminate most of the marginal cases and simplify administration of the law in this area.⁴⁸

As the A.L.I. reporters suggest, moving the engaged-in-business threshold to business activity conducted through a fixed place of business would obviate the substantial uncertainties for the IRS, and

47. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION: PROPOSALS ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF FOREIGN INCOME OF UNITED STATES PERSONS, commentary on recommendation 19, at 92 (1986) [hereinafter A.L.I. PROPOSAL]. © 1987 by the American Law Institute. Reprinted with permission.

48. *Id.*

taxpayers associated with determining whether business activities not conducted through a fixed place of business can constitute a U.S. business.⁴⁹ It would also eliminate the uncertainty related to deciding whether the business activities (as distinguished from the fixed place of business) of an independent agent acting in the ordinary course of its business should be imputed to the foreign principal.⁵⁰ The foreign person would be subject to U.S. net basis taxation only if it engaged in a U.S. business through a fixed place of business maintained by the foreign person itself or by an agent other than an independent agent acting in the ordinary course of its business.⁵¹ Absent such a fixed place of business, the foreign person could not be subject to U.S. net basis taxation as a result of the activities of an employee or other agent.⁵² While the A.L.I. reporters were writing in the pre-international e-commerce age, it is argued below that, at the current stage of the debate over tax policy toward international e-commerce, the emergence of international e-commerce does not appear to erode the viability of their proposal. However, it does raise new issues such as whether, and under what circumstances, a web site maintained by a foreign person on a server located in the United States should be regarded as a U.S. fixed place of business.

B. Income from Real Property

If Congress adopted the A.L.I. proposal to tie the engaged-in-business concept to the existence of a U.S. fixed place of business, it would be desirable to provide specifically that owning any interest in U.S. real property will be treated as a U.S. trade or business. This rule, also proposed by the A.L.I., would in effect assimilate ownership of U.S. real property to a fixed place of business. The result would be to eliminate the difficult line-drawing required under current law between income under a net lease that, depending on the circumstances, may not be treated as involving a U.S. business and other income from real property that, again depending on the circumstances, may be treated as creating a

49. See *supra* text accompanying notes 13-19.

50. See *supra* text accompanying notes 23-26.

51. Adoption of this rule would require withdrawal of Rev. Rul. 56-165, 1956-1 C.B. 849. Revenue Ruling 56-165 ruled that a foreign person present in the United States to demonstrate its product and solicit orders was engaged in a U.S. business even though there was no fixed place of business in the United States. See Rev. Rul. 56-165, 1956-1 C.B. 849.

52. This rule would be consistent with the treatment of a foreign person earning international communications income, which is sourced and taxed in the United States only if attributable to a U.S. fixed place of business. See *infra* text following note 67.

U.S. business.⁵³ The A.L.I. reporters note that:

The consensus throughout the world strongly supports the source country's right to tax income from real estate located therein; and the U.S. already taxes most of such income on a net basis under existing law, on the ground that the owner is "engaged in trade or business in the United States" (and, when a treaty applies, through a "permanent establishment"). Although the borderline of "doing business" in this context is far from clear, only in the case of property held unproductively or leased under a net lease is the foreign owner likely to fail that test. Even then, it has proved necessary—because of the substantial expenses associated with leased property—to allow the foreign owner to elect to be taxed on a net income basis. Of course, gains from the disposition of real property are taxable under FIRPTA [section 897].⁵⁴

They also note that this rule will have the virtue of being consistent with the rule proposed for business income generally.⁵⁵

Adoption of this rule would also eliminate the need to decide whether the activities of an agent with respect to U.S. real property leased under a net lease constitutes a U.S. business. Moreover, even if the foreign owner of U.S. real property acted in the United States only through an independent agent acting in the ordinary course of its business, the income would still be treated as effectively connected with the owner's U.S. business.⁵⁶

C. International E-Commerce Sales

The growth in international e-commerce transactions involving supply of tangible and intangible property and services over the internet during the last five or six years has probably been the most dramatic development in international business, and its tax policy implications have been the subject of extensive commentary.⁵⁷ This discussion, as well as international e-commerce itself, is still in an early stage and a myriad of important tax policy issues has been identified.⁵⁸ In the

53. See A.L.I. PROPOSAL, *supra* note 47, at 101.

54. *Id.* A possible, but undesirable, exception would be income from mineral royalty interests (and passive working interests).

55. See A.L.I. PROPOSAL, *supra* note 47, at 102.

56. This result would not be changed under the terms of the 1981 and 1996 Treasury Models or the 1977 and 1992 OECD Models.

57. For an introduction to the functioning of e-commerce see generally JOSHUA EDDINGS, *HOW THE INTERNET WORKS* (1994); RAVI KALAKOTA & ANDREW B. WINSTON, *FRONTIERS OF ELECTRONIC COMMERCE* (1997).

58. See, e.g., RICHARD DOERNBERG AND LUC HINNEKENS, *ELECTRONIC COMMERCE AND INTERNATIONAL TAXATION* (1999); Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 *TAX LAW REV.* 507 (1997); Jeffrey Owens, *The Tax Man*

present context, a basic issue is whether international internet transactions call for treatment that is incompatible with the proposal that a foreign person is deemed to be engaged in a U.S. trade or business only if it has established a fixed place of business in the United States.

In late 1996 the U.S. Treasury issued a "White Paper" discussing various tax policy issues presented by international e-commerce.⁵⁹ The Treasury has suggested that a fundamental guiding principle for the analysis of the tax policy issues posed by international e-commerce is neutrality:

[T]he principle of neutrality between physical and electronic commerce requires that existing principles of taxation be adapted to electronic commerce, taking into account the borderless world of cyberspace. An advantage of an approach based on existing principles, in addition to neutrality, is that such an approach is suitable for adaptation as an international standard. Existing principles are, in broad outline, common to most countries' tax laws.⁶⁰

The fixed-place-of-business threshold for finding a foreign person to be engaged in U.S. business could be adopted without jeopardizing the objective of neutrality between electronic and non-electronic commerce.

Insofar as e-commerce involves sale of personal property by a foreign person to a U.S. resident, it is clear that frequently no fixed place of business will be needed or involved. The foreign seller can advertise, solicit sales and conclude sales contracts utilizing the internet with no physical presence of facilities, employees or agents in the United States. For example, the foreign seller could solicit and conclude sales contracts with U.S. customers through a web site maintained on a server located outside the United States. The transaction is analogous to that described as follows in the Treasury White Paper:

[A] foreign person not physically present in the United States who merely solicits orders from within the United States only through advertising and then sends tangible goods to the United States in satisfaction of the orders is unlikely to be engaged in a trade or business in the United States even though such a person is clearly engaged in a trade or business.⁶¹

The concept of a foreign person engaged in U.S. trade or business was largely developed in the context of sales of personal property and provision of services by individuals or entities located in the United

Cometh to Cyberspace, 14 TAX NOTES INT'L 1833 (1997); Joseph L. Andrus, *Determining the Source of Income in a Changing World*, 75 TAXES 839 (Dec. 1997); James D. Cigler & Susan E. Stinnett, *Treasury Seeks Cybertax Answers with Electronic Commerce Discussion Paper*, 8 J. INT'L TAX'N 56 (Feb. 1997).

59. See TREASURY WHITE PAPER, *supra* note 17.

60. *Id.* at 16.

61. *Id.* at 20.

States. However, as put in the Treasury White Paper:

Electronic commerce, on the other hand, may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. From a certain perspective, electronic commerce does not seem to occur in any physical location but instead takes place in the nebulous world of cyberspace. Persons engaged in electronic commerce could be located anywhere in the world and their customers will be ignorant of, or indifferent to, their location.⁶²

There will, of course, be cases in which foreign suppliers of goods on the internet will find that business considerations make it necessary to have fixed places of business in the United States, where goods ordered on the net can be demonstrated, returned, or serviced. In such cases, the foreign person will clearly have a U.S. trade or business. But in some cases there may be computer data and software associated with sales through a web site or software agent maintained on a server located in the United States that will not by itself be sufficient to be treated as a U.S. business. For example, a foreign person may solicit and accept orders for goods from U.S. customers through a web site or software agent on a computer server maintained by an independent Internet Service Provider (ISP) in the United States. Even if the ISP's server were regarded as a fixed place of business,⁶³ it could not be imputed to the foreign seller if the ISP merely hosts the seller's web site and is not an agent of the seller, and, even if the ISP were an agent, it would be an independent agent acting in the ordinary course of its business.⁶⁴ Accordingly, the fixed place of business could not be imputed to the foreign seller.⁶⁵ Moreover, it has been suggested that because a server can be located anywhere outside the United States without detriment to U.S. customers who are indifferent to its location,⁶⁶ the existence of a

62. *Id.*

63. See WORKING PARTY NO. 1 ON TAX CONVENTIONS AND RELATED QUESTIONS, OECD COMMITTEE ON FISCAL AFFAIRS, THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN THE CONTEXT OF ELECTRONIC COMMERCE: PROPOSED CLARIFICATION OF THE COMMENTARY ON ARTICLE 5 OF THE OECD MODEL TAX CONVENTION, available in 19 TAX NOTES INT'L 1288, 1290, para 5 (1999) (also available at <<http://www.oecd.org>>) [hereinafter WORKING PARTY DRAFT].

64. *See id.*

65. See I.R.C. § 864(c)(5)(A). See also *infra* text accompanying note 149.

66. See WORKING PARTY NO. 1 ON TAX CONVENTIONS AND RELATED QUESTIONS, OECD COMMITTEE ON FISCAL AFFAIRS, THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN THE CONTEXT OF ELECTRONIC COMMERCE: PROPOSED CLARIFICATION OF THE COMMENTARY ON ARTICLE 5 OF THE OECD MODEL TAX CONVENTION: REVISED DRAFT FOR COMMENTS available in 20 TAX NOTES INT'L 1199,

server, even if maintained by the foreign person in the United States, should not, by itself, be treated as constituting a U.S. trade or business and even more clearly should not be treated as a U.S. fixed place of business.⁶⁷

Finally, the treatment of international communications income appears to support the appropriateness of requiring a fixed place of business threshold to support U.S. taxation of sales to U.S. customers by foreign persons in international e-commerce. This income, which is defined in Code section 863(e)(2) as including income from any international transmission of communications or data to or from the United States, seems clearly to encompass a portion of international e-commerce, and, under section 863(e)(1), international communications income earned by a foreign person is sourced and taxed in the United States only if attributable to a U.S. fixed place of business.

In short, nothing in the borderless world of international e-commerce seems to vitiate the validity of requiring a fixed place of business in the United States as the threshold for finding a foreign person to be engaged in a business here, subject to determining when, if ever, a web site on a U.S. server maintained by a foreign seller should be deemed a fixed place of business. This conclusion is, of course, without prejudice to the possible development in the future of a distinct regime for taxation of the income from international e-commerce transactions in the country of the customer.⁶⁸ A distinct regime would presumably not necessarily be compatible with the neutrality principle.

D. Services Income

If Congress were to adopt a fixed place of business taxation threshold for business income generally, along the lines proposed by the A.L.I., substantial considerations would nonetheless support retaining the

1203, para. 5 (2000) [hereinafter WORKING PARTY REVISED DRAFT].

67. A number of commentators have taken the position that a U.S. server maintained by a foreign person does not, by itself, constitute a U.S. permanent establishment under article 5(6) of OECD and Treasury Models. See Richard L. Doernberg, *Electronic Commerce and International Tax Sharing*, 16 TAX NOTES INT'L 1013, 1015 (1998); Avi-Yonah, *supra* note 58, at 533. See also WORKING PARTY REVISED DRAFT, *supra* note 66, para. 5. If a server located in the U.S. hosts a web site software agent, different considerations may be presented. See *infra* text accompanying note 144.

68. Possibly such a regime might involve setting a minimum amount of income from sales to local customers as the threshold for source-based taxation or taxing income attributable to the number of "bits" transmitted from the foreign seller's server to the domestic customer's browser in response to orders by the customer. See ARTHUR J. CORDELL ET AL., *THE NEW WEALTH OF NATIONS: TAXING CYBERSPACE* 89 (1997); Avi-Yonah, *supra* note 58 (citing Walter Hellenstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 497 (1997)).

current rules reflected in section 864(b) concerning income from services rendered in the United States.

For purposes of analysis, income from services may be divided into the following three categories:⁶⁹

1. A person's income from the performance of services in an independent capacity, such as legal, medical, engineering or entertainment services, performed as an independent contractor;
2. A person's income from the performance of dependent services as an employee; and
3. Income derived by a person, such as theatrical impresario or sports promoter, from the performance of services of another person, such as an entertainer or athlete.

Income from services, including the compensation of an independent contractor or an employee, is generally subject to U.S. tax on a net income basis, although, as a collection mechanism, U.S.-source compensation paid to a nonresident alien may be subject to withholding

69. The 1996 Treasury Model, *supra* note 32, recognizes seven categories of income from services:

- (1) An individual's income from the performance of services in an independent capacity, which are exempt from tax in the source country unless attributable to a regularly available fixed base in the source country. *See id.* art. 14.
- (2) An individual's income from the performance of dependent services as an employee, which are taxable in the source state, subject to an exemption for an individual present in the source state for not more than 183 days whose compensation is paid by a non-resident employer (or permanent establishment or fixed place of business outside the source state). *See id.* art. 15.
- (3) An individual's income from the performance of services as an entertainer or as an athlete, whose compensation is taxed in the source country unless it does not exceed \$20,000 for the taxable year. *See id.* art. 17.
- (4) Income that accrues to another person from the performance of an entertainer or athlete, which is taxable in the country in which the services are rendered, unless neither the entertainer nor the athlete (nor related persons) participated directly or indirectly in the profits of the services provider. *See id.*
- (5) Services income of those whose business is providing the services of others which is presumably treated as business profits exempt from tax in the source country if not attributable to a permanent establishment there. *See id.* art. 7.
- (6) Compensation for services as a company director which may be taxed by the country in which the company is a resident. *See id.* art. 16.
- (7) Compensation for services to a government of a country (or political subdivision) which is taxable by that country except in some cases when the services are rendered in the other country by a resident thereof. *See id.* art. 19.

tax on the gross income earned.⁷⁰

Under the Code at present, all of these categories of income from services rendered in the United States are subject to tax on a net basis as income effectively connected with a U.S. business, except for the specific instances noted above in which, under section 864(b)(2), services income is exempted from tax. In the context of examining the definition of engaging in U.S. business, the issue for review is whether the general rule advocated above that net basis taxation should be exercised only if the foreign person has a fixed place of business in the United States should be applied to any or all of the classes of services income previously identified.

As recognized by the A.L.I. reporters, the treatment of services income involves considerations not necessarily involved in other types of business income. The uncertainties and administrative difficulties inherent under the existing case law and rulings in determining whether other business activities rise to the level of engaging in a U.S. business are largely absent when income from services rendered by foreign persons in the United States are involved. A “bright line” readily administrable rule is already reflected in the source rule itself. As the A.L.I. reporters observe, “it is relatively simple to determine whether services are or are not physically performed in the U.S. and the existence of a fixed place of business does not appear necessary to remove doubt.”⁷¹ Although the rise of e-commerce and the sale of services on the internet raise many issues with respect to whether, for tax purposes, a particular transaction should be characterized as a rendering of services, as a license of intangible property or as something else, it remains relatively straightforward to determine where services of a person are performed. Even in the case of software marketed in international e-commerce, the location at which the services that generate the software are performed can often be identified. Thus, the considerations that support linking the threshold for taxation of income from other business activities to the existence of a U.S. fixed place of business are of greatly diminished significance in the context of services income.

Services in the United States generating large amounts of income can often be performed without a fixed place of business. In many cases, they will be rendered in facilities, such as a theatre or stadium, maintained by others. Moreover, while the foreign person performing the services, for example an entertainer or athlete, may be here only

70. See Rev. Rul. 70-543, 1970-2 C.B. 173. A foreign corporation can avoid withholding on compensation for services rendered in United States by filing a statement with the withholding agent that the income is effectively connected with a U.S. trade or business. Treas. Reg. §1.1441-4 (as amended in 1990).

71. A.L.I. PROPOSAL, *supra* note 47, at 96.

fleetingly, a withholding obligation on the U.S. person paying the compensation will normally facilitate enforcing compliance.

Article 17 of the 1996 Treasury Model states that income derived by a resident of the other contracting state from the performance of personal services of an independent character in the other state is exempt from the latter's tax unless the individual has a fixed base⁷² regularly available in that other state for the purpose of performing his activities. Although many foreign persons rendering services in the United States would be exempt from U.S. tax under similar terms in existing U.S. tax treaties, highly compensated persons such as entertainers and athletes need not be treated so favorably under the Code, whatever rule may be negotiated for purposes of U.S. tax treaties. There seems little policy foundation for exempting such persons from U.S. tax under the Code on the ground that they have no U.S. fixed place of business or fixed base. Article 17 of the 1996 Treasury Model does not exempt highly compensated entertainers and athletes with respect to income exceeding \$20,000. If negotiated in the context of a tax treaty, the terms of article 17 strike a reasonable balance in narrowing U.S. taxing jurisdiction over income from services rendered in the United States by an entertainer or athlete who resides in a foreign treaty country.

Although generally eschewing the fixed place of business threshold for services income, the A.L.I. reporters propose treating the providing or furnishing of services by others as business profits and thus subject to the fixed-place-of-business threshold. The reporters support this proposal by suggesting that the furnishing of services of others is more closely analogous to the profit from the sale of goods than the rendering of other services.⁷³

This approach, however, involves its own difficulties. Furnishing of services is quite different from the sale of goods, as the reporters appear to acknowledge in rejecting the fixed-place-of-business test for taxation of the compensation of a foreign independent contractor. When

72. See 1996 Treasury Model, *supra* note 32, art. 17. The Treasury's Technical Explanation notes, following the OECD Commentary, state that fixed base is "understood to be similar, but not identical, to that of the term 'permanent establishment.'" Treasury Department Technical Explanation of the United States Model Income Tax Convention, art. 14, para. 1, *reprinted in* 1 Tax Treaties (CCH) ¶214A, at 10,633-16 (1996), *and in* RICHARD L. DOERNBERG & KEES VAN RAAD, THE 1996 UNITED STATES MODEL INCOME TAX CONVENTION: ANALYSIS, COMMENTARY AND COMPARISON, Technical Explanation, art. 14, para. 1, pt. 201 (1997) [hereinafter Technical Explanation].

73. See A.L.I. PROPOSAL, *supra* note 47, at 96.

considering how to handle the services of the person whose services consist of furnishing the services of others, the analogy of the person who performs services in an independent capacity seems more apt than the analogy of the sale of goods. There does not appear to be a meaningful distinction to be drawn between the person, like the theatrical impresario or sports promoter, whose services in the United States involve providing the services of another and the services performed in an independent capacity by an engineer. Often the party furnishing the services of others will be able to do so without creating a U.S. fixed place of business. The U.S. activities of the theatrical impresario or sports promoter can often be performed from premises outside the United States. Any activities performed in the United States, like the activities of the entertainers or athletes, can be performed on the theater or sports arena premises or other premises maintained by an independent third party. It is difficult to perceive a persuasive basis for allowing the large amounts of income earned by foreign impresarios or promoters to escape U.S. taxation merely by avoiding having a fixed-place-of-business in the United States.

Moreover, the A.L.I. reporters acknowledge that distinguishing between the performance of services and the furnishing of services “requires some safeguard to prevent tax-motivated structuring of entities to ‘provide’ the services of individuals. Without this, a taxpayer could form a legal entity that would ‘hire’ him for a nominal salary and then provide his services to third parties in the U.S.”⁷⁴ This avoidance potential is dealt with by proposing that the fixed-place-of-business threshold be eliminated when the services of an “owner-employee” are being furnished. An owner-employee for this purpose would be defined as “any person having a 10 percent or greater interest in the capital or income of the foreign person providing such person’s services.”⁷⁵

The perceived need to set up complex and potentially manipulable rules to deal with avoidance brings into question the wisdom of exempting the person furnishing services of others from the general rule that net income from services performed in the United States should be subject to U.S. tax. This, together with the undesirability of permitting the impresario or promoter to avoid U.S. tax on large profits generated by services rendered in the United States by not operating from its own U.S. fixed place of business, supports retaining section 864(b) in its present form and eliminating the fixed-place-of-business threshold altogether with respect to services income.

Finally, it seems clearly appropriate to update section 864(b)(1),

74. *Id.* at 97.

75. *Id.* at 96.

which provides that services performed for a foreign employer do not constitute a U.S. business if the nonresident alien employee does not earn in excess of \$3,000 and is not present in the United States more than 90 days in the tax year. While rather peripheral in the overall scheme of things, this provision is obviously of importance to foreign persons who may be covered by it. Inflation over the many years since the \$3,000 limit was adopted argues for increasing it substantially.⁷⁶

*E. Exceptions for the Independent Agent Under a
Fixed-Place-of-Business Rule*

If, as the A.L.I. has proposed, Congress were to adopt the fixed place of business (including owned U.S. real property) as the touchstone of taxability for business income (other than services income) of foreign persons, at least one exception to its broad sweep would seem appropriate. The same policy justifications that underlie the non-imputation-of-a-fixed-place-of-business rule of section 864(c)(5)(A) and the exclusion of the fixed place of business of an independent agent acting in the ordinary course of its business from the definition of permanent establishment would argue for exempting from U.S. tax net profits of a foreign person attributable to the fixed place of business in the United States of an independent agent acting in the ordinary course of its business. It follows from the previous discussion of income from real property and services income that this exemption should not apply if the independent agent is involved in representing a foreign person who owns U.S. real property or who will perform services or furnish the services of others in the United States. If a nonresident alien actress and her foreign impresario are represented by independent U.S. agents, both the actress and the impresario should be taxed on income generated by performances in the United States.

F. A Minimum Step Towards Clarification

If Congress declines to adopt the A.L.I. proposal with the

76. The A.L.I. Reporters propose a two-pronged de minimis rule which utilizes both an amount test and a presence test. If the total amount of compensation received is no more than \$5,000, it is exempt without reference to presence in the United States. Beyond this floor amount, income of up to \$50,000 could be received without tax if earned at a rate not exceeding \$1,000 per day while present in the United States. See A.L.I. PROPOSAL, *supra* note 47, at 99.

modifications suggested above, a minimum step should be taken toward clarification of what constitutes being engaged in a U.S. trade or business. This step would involve adoption of the rule that the U.S. business activities of an independent agent acting in the ordinary course of its business may not be imputed to the foreign principal in determining whether the latter is engaged in a trade or business in the United States.

Adoption of this rule would be desirable for a number of reasons. First, it would eliminate the persistent uncertainties of existing law concerning under which circumstances the business activities of an independent agent will be imputed to the foreign principal.⁷⁷ Second, it would eliminate the inconsistency between (i) the cases and rulings that impute the activities of an independent agent to the foreign principal and (ii) section 864(b), which precludes imputation of the business activities relating to trading in stocks, securities or commodities of an independent agent to the foreign principal, and sections 864(c)(5)(A), 864(c)(4)(B) and 865(e)(3), which preclude imputation of the independent agent's fixed place of business to the foreign principal. The policies that support non-imputation in the situations covered by the Code seem applicable as well to the activities of the independent agent acting in the ordinary course of its business in other contexts, subject to the exceptions discussed above, for income from U.S. real property owned by, and income from services performed in the United States by, the foreign principal. Indeed, because a fixed place of business can often be identified more readily than business activities, administrative convenience and certainty support non-imputation of activities of an independent agent more strongly than non-imputation of a fixed place of business. Third, this change would be consistent with the rule of non-imputation of the activities and facilities of the independent agent acting in the ordinary course of its business reflected in the definition of permanent establishment found in the 1981 and 1996 Treasury Models, the 1977 and 1992 OECD Models, the 1980 U.N. Model, and in most tax treaties in force.

If this rule is adopted, a correlative change with respect to an agent's fixed place of business should also be made. The rule of sections 864(c)(5)(A), 864(c)(4)(B) and 865(e)(3), which prohibits imputation of the fixed place of business of an independent agent acting in the ordinary course of business in specified contexts, should be adopted as a general rule. That is, this non-imputation-of-a-fixed-place-of-business rule should be applied generally in determining whether a foreign principal is engaged in U.S. trade or business. Extending the non-imputation rule to

77. See *supra* text accompanying notes 20-26.

the business activities of an independent agent acting in the ordinary course of its business would involve no inconsistency with the Code or with a clearly defined principle reflected in case law or rulings but would, on the contrary, involve an extension of the policies reflected in the Code sections discussed above. Therefore, there would appear to be no barrier to effecting this change by regulation.

If the minimum step proposed in this section is adopted, neither the business activities nor the fixed place of business of an independent agent acting in the ordinary course of its business would generally be imputed to the foreign principal, and the foreign principal could not generally be deemed to be engaged in U.S. business even though that agent had and habitually exercised the power to conclude contracts in the name of and binding on the foreign principal.⁷⁸

G. Imputation of Activities or Facilities of Other Agents to the Foreign Principal

If the minimum change discussed in the preceding section is adopted, the question would remain: Under what circumstances should the business activities or fixed place of business of an agent other than an independent agent acting in the ordinary course of its business be imputed to the foreign principal? One possibility would be to adopt the rule reflected in section 864(c)(5)(A) and to impute the business activities and fixed place of business of an agent to the foreign principal if the agent has and regularly exercises the authority to negotiate and conclude contracts in the name of the foreign principal or has a stock of merchandise from which the agent regularly fills orders on behalf of the foreign principal. However, in order to bring the statutory formulation more in line with international tax principles reflected in the definition of permanent establishment of the 1981 and 1996 Treasury Models⁷⁹ and of the 1977 and 1992 OECD Models,⁸⁰ some changes should be made. First, the power to negotiate should be eliminated in favor of giving

78. Income from U.S. real property would be treated as effectively connected with a U.S. business even if the foreign owner were represented in the U.S. solely by an independent agent acting in the ordinary course of its business. *See supra* Part III.B. Income from services performed in the United States would continue to be governed by section 864(b). *See supra* Part III.D.

79. 1981 Treasury Model, *supra* note 32, art. 5(5).

80. 1977 OECD MODEL, *supra* note 35, art. 5(5), at 27; 1992 OECD MODEL, *supra* note 36, art. 5(5), at M-11.

controlling significance to the authority, regularly exercised, to conclude contracts. Second, the reference to maintenance of a stock of goods from which orders are regularly filled should be eliminated as irrelevant.⁸¹

Finally, to remove the ambiguity inherent in the concept of power of the agent to conclude contracts “in the name of” his foreign principal, the Code and the regulations should be revised to give controlling significance to the regularly exercised power of an agent who is not an independent agent acting in the ordinary course of its business to conclude contracts “binding” on the foreign principal. This change would accommodate the common law rule under which an agent may bind an undisclosed principal vis-à-vis a third party, the 1994 change to the OECD Commentary, and article 5(5) of the 1996 Treasury Model adopting this position.⁸²

IV. DISTINGUISHING BETWEEN AN INDEPENDENT AGENT ACTING IN THE ORDINARY COURSE OF ITS BUSINESS AND OTHER AGENTS

Whether or not the distinction between the independent agent acting in the ordinary course of its business and other agents is accorded relevance extending beyond that accorded it in the sections of the Code currently invoking it and in the tax treaty definition of permanent establishment, the regulations should be revised to provide more specific guidance on how the distinction should be drawn.

A. *The Existing Regulations*

Since under section 864(c)(5)(A) the fixed place of business of an independent agent acting in the ordinary course of its business is not imputed to the foreign principal, the regulations need only define the concepts of “independent agent” and “acting in the ordinary course of its business.” Every other agent (including the independent agent acting outside its ordinary course of business) is subject to the rule that its fixed place of business will be imputed to the foreign principal if the agent has and regularly exercises the authority to negotiate and conclude contracts in the name of the principal or if the agent has a stock of merchandise from which it regularly fills orders on behalf of the principal.⁸³ Thus, the

81. The 1977 and 1992 OECD Models and most modern tax treaties exclude the maintenance of a stock of goods at a fixed place of business from which deliveries are made from the definition of permanent establishment. See 1977 OECD MODEL, *supra* note 35, art. 5(4), at 26; 1992 OECD MODEL, *supra* note 35, art. 5(4) at M-10.

82. See *supra* text accompanying notes 42-43.

83. This assumes that the proposal that the fixed place of business of the other

focus of the regulations should be on defining “independent agent acting in the ordinary course of its business.” The regulations’ focus, however, is frustratingly blurred. The regulations state simply that for purposes of the rule embodied in section 864(c)(5)(A):

[T]he term “independent agent” means a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity. Thus, for example, an agent who, in pursuance of his usual trade or business, and for compensation, sells goods or merchandise consigned or entrusted to his possession, management, and control for that purpose by or for the owner of such goods or merchandise is an independent agent.⁸⁴

It is a tautology to define an independent agent as an “agent of independent status,” and to illustrate the concept of independent agent by the consignment agent seems inappropriate, because the term consignment agent is broad enough to encompass an agent who would not qualify as independent under the existing case law⁸⁵ or, more importantly, under the criteria enunciated by the Commentary to the 1977 and 1992 OECD Models.⁸⁶ The regulations make no attempt to define the concept of “acting in the ordinary course of his business”, although, as an example of an “independent” agent, they cite an agent who in pursuance of his usual business, and for compensation, sells goods consigned to his possession by the owner.⁸⁷

The regulations endorse, as follows, the generally applicable proposition of international tax jurisprudence that, at least in the absence of special circumstances, the separate identity of a related corporation will be respected:

The determination of whether an agent is an independent agent for purposes of this paragraph shall be made without regard to facts indicating that either the agent or the principal owns or controls directly or indirectly the other or that a third person or persons own or control directly or indirectly both. For example, a wholly owned domestic subsidiary corporation of a foreign corporation which acts as an agent for the foreign parent corporation may be treated as acting in the capacity of independent agent for the foreign parent corporation.⁸⁸

agent be imputed only if the agent has and habitually exercises the authority to conclude contracts binding on his principal is not adopted. *See supra* text accompanying notes 68-69.

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

85. *See, e.g., Handfield v. Commissioner*, 23 T.C. 633 (1955).

86. *See infra* text accompanying note 72.

87. *See* Treas. Reg. § 1.864-7(d)(3).

88. Treas. Reg. § 1.864-7(d)(3)(ii).

Because the distinction between independent and dependent agents is not involved as such in section 864(c)(5)(A), the use in the regulations of the term “dependent agent” is unnecessary and makes little contribution to defining the independent agent acting in the ordinary course of its business. In any event, the regulations do not define “dependent agent,” but state only the obvious point that “ordinarily an employee of a nonresident alien individual or a foreign corporation shall be treated as a dependent agent.”⁸⁹

B. The Commentary to the 1977 and 1992 OECD Models on the Definition of Independent Agent

Beyond the inadequate definitional efforts reflected in the regulations, the most explicit and authoritative attempt to describe the distinction between an independent agent acting in the ordinary course of its business and other agents is found in the identical Commentaries to the 1977 and 1992 OECD Models.⁹⁰ Article 5, paragraph 6 of the 1977 and 1992 OECD Models states the rule (echoed in the 1981 and 1996 Treasury Models and most international tax treaties in force) as follows:

An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.⁹¹

Under the scheme of the 1977 and 1992 OECD Models, the 1981 and 1996 Treasury Models, and most recent treaties in force, an agent that is not an independent agent acting in the ordinary course of its business will be treated as a permanent establishment of its foreign principal only if it has and habitually exercises in a Contracting State the authority to conclude contracts in the name of the foreign principal. Even activities involving habitual exercise of the power to conclude contracts do not result in creation of a permanent establishment if they are “limited to those [auxiliary or preparatory activities] mentioned in paragraph 4, which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”⁹² The activities and facilities of an

89. Treas. Reg. § 1.864-7(e). The regulation goes on to state that when an employee in the ordinary course of his duties regularly carries on business of the employer through a fixed place of business of the employer, the employer shall be considered to have a fixed place of business. *See id.*

90. 1977 OECD MODEL, *supra* note 35, Commentary [hereinafter 1977 OECD CONVENTION AND COMMENTARY] para. 6, pt. 37; 1992 OECD MODEL, *supra* note 35, Commentary [hereinafter 1992 OECD CONVENTION AND COMMENTARY] para. 6, pt. 38.

91. *Id.*

92. 1977 OECD CONVENTION AND COMMENTARY, *supra* note 90, art. 5(5).

independent agent acting in the ordinary course of its business can never result in that agent's being deemed a permanent establishment of his foreign principal.

The Commentaries to the 1977 and 1992 OECD Models discuss the definition of independent agent as follows:

A person will come within the scope of paragraph 6—i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts—only if

- a) he is independent of the enterprise both legally and economically, and
- b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents. A subsidiary is not to be considered dependent on its parent company solely because of the parent's ownership of the share capital.⁹³

Because of the widespread adoption of the OECD definition of permanent establishment in the 1981 and 1996 Treasury Models, and in double tax treaties around the world, any attempt to develop with greater specificity, for purposes of the Code and regulations, the distinction between the independent agent acting in the ordinary course of its business and other agents should hew to the general lines embodied in the OECD Commentaries.⁹⁴

C. Meaning of Independent Agent

As noted above, the OECD Commentary states that an agent will be independent⁹⁵ of the foreign principal only if independent "both legally

93. 1977 OECD CONVENTION AND COMMENTARY, *supra* note 90, paras. 36-37; 1992 OECD CONVENTION AND COMMENTARY, *supra* note 90, paras. 37-38.

94. See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II: PROPOSALS ON UNITED STATES INCOME TAX TREATIES 4 (1992) ("A country should depart from the internationally accepted policies embodied in the OECD Model only for strong reasons."). © 1992 by The American Law Institute. Reprinted with permission.

95. Although the distinction drawn in paragraphs 5 and 6 of the 1977 and 1992 OECD Models is between the independent agent acting in the ordinary course of its business and all other agents, the OECD Commentary makes imprecise use of the term "dependent agent" to refer to any agent who is not an independent agent acting in the ordinary course of its business. See 1977 OECD CONVENTION AND COMMENTARY, *supra* note 90, para. 31; 1992 OECD CONVENTION AND COMMENTARY, *supra* note 90, para. 32.

and economically.”⁹⁶ It goes on to state that independence turns on “the extent of the obligations which this person has vis-à-vis the enterprise.”⁹⁷

The only elaboration of the concept of *legal* independence is a “control” test, stating that “[w]here the person’s commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise.”⁹⁸ The only flesh offered for the bones of *economic* independence is an “entrepreneurial-risk” test, stating that an “important criterion will be whether the entrepreneurial risk has to be borne by the person or the enterprise the person represents.”⁹⁹

1. Control Test

Although there is some overlap between the criteria for distinguishing an independent contractor from an employee and the criteria for distinguishing an independent from a dependent agent, the issues are distinct. The control test criterion of detailed instructions or comprehensive control is an important criterion utilized in both contexts,¹⁰⁰ and it is clear that the employee cannot qualify as an independent agent. The more difficult question is under what circumstances will a non-employee be deemed to be subject to detailed instructions or comprehensive control by the foreign principal that will preclude qualification of the agent as independent.

To focus on the agent involved in the sale of goods, the most significant elements of the criteria of detailed instructions and comprehensive control should be the extent to which the principal controls the manner in the agent carries on its business and the scope of the agent’s negotiating authority. If the principal exercises broad control over the manner in which the agent conducts day-to-day business operations on behalf of the principal, the agent should not be considered independent. Even in the absence of such control, if the agent is authorized only to accept orders for the sale of goods on terms and conditions, including price, dictated by the principal, or on the principal’s standard terms and conditions of sale, including price, the agent should not be treated as independent. Conversely, if the agent is empowered to negotiate with the customer significant terms of the sales

96. 1977 OECD CONVENTION AND COMMENTARY, *supra* note 90, para. 36; 1992 OECD CONVENTION AND COMMENTARY, *supra* note 90, para. 37.

97. *Id.*

98. 1977 OECD MODEL CONVENTION AND COMMENTARY, *supra* note 92, para. 37, at 67; 1992 OECD MODEL CONVENTION AND COMMENTARY, *supra* note 92, para. 38, at C(5)-15.

99. *Id.*

100. *See id.*

agreement, including prices, the agent should be treated as not being subject to detailed instructions or comprehensive control. This should also be the result even if the principal fixes reasonable parameters concerning conditions of sale and prices that may not be exceeded by the agent although, within those parameters, the agent is vested with discretion. A significant measure of control by the principal is inherent in the concept of agency, and the principal cannot be expected to allow the agent to negotiate prices or other terms that will result in losses or other business disadvantages for the principal.

In *Taisei Fire and Marine Insurance Co. v. Commissioner*,¹⁰¹ Fortress Re. Inc., a U.S. corporation that had, and regularly exercised, the authority to conclude reinsurance contracts on behalf of a group of Japanese insurance companies, was held not to constitute a U.S. permanent establishment under the United States-Japan Tax Treaty because it was legally and economically independent of its foreign principals.¹⁰² In discussing the IRS's argument that Fortress lacked legal independence as a result of gross limits on the amount of insurance Fortress could write and on the amount of net premiums the insurance it wrote would generate, the court stated:

Respondent agrees that Fortress had independence with respect to day-to-day operations, but then argues that its actions were restricted by gross acceptance limits and limits on net premium income. However, even if there were such restrictions, they would not necessarily constitute control. The gross acceptance limit and net premium income both relate to the total exposure of petitioners [the Japanese insurance companies], and even an independent agent only has authority to perform specific duties for the principal. It is freedom in the manner by which the agent performs such duties that distinguishes him as independent.¹⁰³

The 1980 UN Model Double Taxation Convention Between Developed and Developing Countries expands the definition of permanent establishment by excluding from the concept of independent agent, an agent whose activities are "devoted wholly or almost wholly on behalf of the foreign principal."¹⁰⁴ This change, which was proposed by certain developing countries to recognize that, in such a case, the agent should be deemed to have lost his independence,¹⁰⁵ is a departure

101. 104 T.C. 535 (1995).

102. *See id.*

103. *Id.* at 552.

104. 1980 UN MODEL CONVENTION, *supra* note 44, para. 6.

105. *See* 1980 UN MODEL CONVENTION COMMENTARY, 85 T.N.I. 41-67 (Nov. 20, 1985).

from the 1977 and 1992 OECD Models and seems unnecessarily inflexible. A more appropriate rule is one set forth in the Treasury regulations as follows:

(iii) *Exclusive agents.* Where an agent who is otherwise an independent agent within the meaning of subdivision (i) of this subparagraph acts in such capacity exclusively, or almost exclusively, for one principal who is a nonresident alien individual or a foreign corporation, the facts and circumstances of a particular case shall be taken into account in determining whether the agent, while acting in that capacity, may be classified as an independent agent.¹⁰⁶

Under this more flexible rule, an agent could be considered to be independent even though he functions exclusively for a single principal if, for example, the exclusivity results from the fact that the agent is starting up its operations, which are expected eventually to involve representation of multiple principals, or from the fact that the principal is the sole supplier of the particular product concerned. The Technical Explanation to the 1996 Treasury Model Treaty elaborates on the more flexible rule as follows:

The limited scope of the agent's activities and the agent's dependence on a single source of income may indicate that the agent lacks economic independence. It should be borne in mind, however, that exclusivity is not in itself a conclusive test: an agent may be economically independent notwithstanding an exclusive relationship with the principal if it has the capacity to diversify and acquire other clients without substantial modifications to its current business and without substantial harm to its business profits. Thus, exclusivity should be viewed merely as a pointer to further investigation of the relationship between the principal and the agent. Each case must be addressed on the basis of its own facts and circumstances.¹⁰⁷

Should the agent be deemed to lose its independence if the agent is a sole agent in the United States for the foreign principal and is placed under significant restrictions on its freedom to engage in competitive activities? For example, in Rev. Rul. 70-424,¹⁰⁸ the agent, who was the sole agent of the foreign principal for sales of its products in the United States, was not permitted to make sales of the same kind of products of any other producer without the principal's consent. The agent also agreed not to sell its principal's products to purchasers outside the United States or to any competitor or to take a financial interest in a competitor without its principal's consent. If the agent is both a sole sales agent for the foreign principal's products and is prohibited from selling similar products of a competitor, it would seem reasonable to assimilate the agent to the exclusive agent and apply the standards

106. Treas. Reg. § 1.864-7(d)(3)(iii).

107. DOERNBERG & VAN RAAD, *supra* note 72.

108. Rev. Rul. 70-424, 1970-2 C.B. 150 (holding that as a result of its agent's activities the principal is engaged in a U.S. trade or business).

discussed above. If, however, the agent under these circumstances represents multiple principals with respect to other products or holds itself out ready to do so, the agent should not be precluded from qualifying as independent if the other tests for independence are met.

To enable taxpayers to plan with reasonable certainty and IRS agents to enforce the law with reasonable consistency and fairness, the regulations should be expanded to deal with these and other issues related to identifying the independent agent acting in the ordinary course of its business. The criteria to be applied in establishing an agent's independence and examples illustrating application of the basic rules in common contexts, such as international sales and leases of personal property, the procurement of services and e-commerce transactions should be covered. These rules could be applied not only in the context of the Code provisions applicable to the independent agent in the United States representing a foreign principal, but also for purposes of identifying an independent agent who is excluded from the definition of permanent establishment under the U.S. tax treaties. In the latter case, however, there is the added constraint that the formulation adopted should be consistent with that articulated by the OECD Commentary, and it must be consistent with the views of the other state that is a party to the treaty concerned.

2. *Significance of the Terms "Broker" and "General Commission Agent"*

What is the significance in the defining of an independent agent of the references in article 5, paragraph 6 of the 1977 and 1992 OECD Models and the 1981 and 1996 Treasury Models to a "broker" or "general commission agent" apparently as examples of agents of independent status? The references have been reported to have their roots in the League of Nations draft model tax convention of 1927 and in 1925 U.K. tax legislation.¹⁰⁹ The 1933 League of Nations draft model convention excluded from the definition of permanent establishment (i) a "broker who places his services at the disposal of an enterprise in order to bring it into touch with customers . . . even if his work is to a certain extent continuous or is carried on at regular intervals" and (ii) "a commission agent (*commissionnaire*), who acts in his own name for one or more

109. The origin of article 5(6) is discussed in Avery Jones & Ward, *supra* note 9, at 163-66.

enterprises and receives a normal rate of compensation.”¹¹⁰

Treas. Reg. § 1.864-7(d)(3)(i), the Technical Explanation to the 1996 Treasury Model, and the 1977 and 1992 OECD Commentaries fail to offer definitions of broker and general commission agent, but, by referring to “broker, general commission agent or any *other agent* of an independent status acting in the ordinary course of his business” imply that a broker and general commission agent are examples of independent agents acting in the ordinary course of business.¹¹¹ The regulation also misleadingly illustrates the concept as follows: “Thus, for example, an agent who, in pursuance of his usual trade or business, and for compensation, sells goods or merchandise consigned or entrusted to his possession, management, and control for that purpose by or for the owner of such goods or merchandise is an independent agent.”¹¹²

Under the common law, the broker and commission agent could be given the power to bind the principal even if the principal were undisclosed.¹¹³ In describing the independent agent whose fixed place of business will not be imputed to a foreign principal under section 864(c)(5)(A), Treas. Reg. § 1.864-7(d)(2) makes the assumption that an independent agent may be given the power to conclude contracts in the name of, and therefore presumably binding upon, its foreign principal. It states:

(2) Independent agents. The office or other fixed place of business of an independent agent, as defined in subparagraph (3) of this paragraph, shall not be treated as the office or other fixed place of business of his principal who is a nonresident alien whether such agent has authority to negotiate and conclude contracts in the name of his principal, and regularly exercises that authority, or maintains a stock of goods from which he regularly fills orders on behalf of his principal.¹¹⁴

It is anomalous, and possibly the result of a failure to bridge the gap between the common law and civil law worlds, that “broker” was translated into French as *courtier* and commission agent as *commissionnaire* because contracts entered into by the *courtier* and the *commissionnaire* normally do not bind the principal.¹¹⁵ The *courtier* brings the parties together but does not conclude contracts binding on either; the *commissionnaire* concludes contracts binding on itself, not the principal.¹¹⁶ Because neither could bind the principal, neither could be deemed to constitute a permanent establishment under article 5,

110. *Id.* at 166.

111. *See id.* (emphasis added).

112. Treas. Reg. § 1.864-7(d)(3)(i).

113. *See Avery Jones & Ward, supra* note 9, at 158.

114. Treas. Reg. § 1.864-7(d)(2).

115. *See Avery Jones & Ward, supra* note 9, at 156.

116. *See Roberts, supra* note 9, at 399-400, 412-13.

paragraph 5, at least under the interpretation given that provision in the Anglo-American authorities,¹¹⁷ which was adopted by the OECD in 1994.¹¹⁸

We are left with the conundrum: Why was broker translated as *courtier*, and general commission agent as *commissionnaire* when, under the common law, both the broker and commission agent could bind undisclosed principals while, under the civil law, neither the *courtier* nor the *commissionnaire* could generally do so? Were these simply examples of mistranslation which escaped scrutiny over the years until recent analysis focused on the inconsistency? Or is the difference between common law and civil law with respect to the meaning of an independent agent and the role of paragraphs 5 and 6 of article 5 of the 1977 and 1992 OECD a more fundamental one?

One commentator has suggested in an extensive analysis that the use of the terms *courtier* and *commissionnaire* to illustrate the concept of independent agent reflects the fact that under civil law only the agent that cannot bind its principal (indirect representation), such as the *courtier* and the *commissionnaire*, is included in the concept of independent agent and is excluded from the definition of permanent establishment.¹¹⁹ Under this analysis any agent who has and habitually exercises authority to conclude contracts binding on its principal, except contracts involving preparatory and auxiliary activities, constitutes a permanent establishment even though it is otherwise independent of the foreign principal.¹²⁰

This analysis produces a result diametrically opposed to the usual common law analysis (and the one adopted in this Article) of the concept of the independent agent and the meaning of paragraphs 5 and 6 of article 5 of the 1977 and 1992 OECD Models and of the 1981 and 1996 Treasury Models. Under the usual common law analysis, even if the independent agent acting in the ordinary course of business habitually concludes contracts in the name of and binding on the foreign principal, it does not constitute a permanent establishment.¹²¹ Whether the agent concludes contracts in the name of and binding upon the foreign

117. See Avery Jones & Ward, *supra* note 9, at 162; cf. Roberts, *supra* note 9, at 399.

118. See 1992 OECD MODEL (Update 1994), commentary para. 36, at C(5)-15.

119. See Roberts, *supra* note 9, at 400.

120. See *id.*

121. See HUSTON & WILLIAMS, *supra* note 5, at 136; Avery Jones & Ward, *supra* note 9, at 178.

principal is irrelevant to the question whether the agent will be deemed to be independent.¹²²

Whatever the civil lawyer's view of what constitutes an independent agent, in the English version of article 5 of the OECD Models viewed through the eyes of the common lawyer, the key concept is that of the independent agent acting in the ordinary course of its business. The references to broker and general commission agent appear to add nothing of substance.

It has therefore been persuasively suggested that the references to broker and general commission agent should be deleted from the OECD Model Convention and from the 1996 Treasury Model because they are not expressions that are currently used in their original sense and because they have been mistranslated into French.¹²³ They should also be dropped from the Code and regulations. At best they now function only as dubiously valid illustrations of the concept of the independent agent acting in the ordinary course of its business. This is the concept that needs to be defined. The use of the terms broker and general commission agent is more likely to obfuscate than illuminate. The use of "general commission agent" is particularly open to the objection that it is not now, if it ever was, a generally understood term of art, and one can readily envisage agents who receive commissions for representing their foreign principals (and therefore fall under the generic rubric of commission agent) but who do not meet the tests set forth in the OECD Commentary for independence.

3. *Entrepreneurial-risk Test*

The entrepreneurial-risk criterion will clearly be met if the agent is compensated exclusively on an arm's length commission basis with the results that it both bears the risk that its expenses will not be exceeded by its commission income and enjoys the prospect of gain if the reverse is true. The Technical Explanation of the 1996 Treasury Model emphasizes risk of loss as follows:

In determining whether the agent is economically independent, a relevant factor is the extent to which the agent bears business risk. Business risk refers primarily to risk of loss. An independent agent typically bears risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. Conversely, an agent that bears little or no risk from that [sic] activities it performs is not economically

122. Avery Jones & Ward, *supra* note 9, at 167, 179.

123. *See id.*

independent. . . ¹²⁴

If the financial arrangements between foreign principal and U.S. agent involve the principal's guaranteeing the agent against loss, for example, by paying a commission equal to the agent's expenses *plus* (i) a profit equal to a specified percentage of those expenses or (ii) a specified amount for each item sold, the agent should not be deemed to bear the entrepreneurial risk required for independence.¹²⁵ If the entrepreneurial risk is shared between agent and principal, the Technical Explanation of the 1996 Treasury Model states that "an agent that bears little or no risk" is not economically independent.¹²⁶ One reasonable approach might be to provide that an agent will be deemed to meet the entrepreneurial-risk test of independence only if it must bear a significant portion (*e.g.*, at least 20 percent) of any losses attributable to the activities of the agent on behalf of the foreign principal. For example, if the foreign principal manufactures goods in a foreign country and the goods are sold through an agent in the United States that is not subject to detailed instructions or comprehensive control by the foreign principal, and if the agent agrees to bear 25 percent of any losses incurred by the agent in connection with the agent's sales of the goods concerned, the agent should be regarded as independent.

4. Significance of Agent's Remuneration

Another matter to be considered is whether the level of compensation received by the agent from the principal should be regarded as relevant to the issue of the agent's independence. The 1927 League of Nations draft model tax convention excluded a "bona-fide agent of independent status (broker, commission agent, etc.)" from the definition of permanent establishment.¹²⁷ The accompanying commentary stated that "the words '*bona-fide* agent of independent status' were intended to imply absolute independence, both from the legal and economic points of view. The agent's remuneration must not be below what would be regarded as a

124. Technical Explanation, *supra* note 72, art. 5, para. 6, at 10,629; DOERNBERG & RAAD, *supra* note 72, Technical Explanation, art. 5, para. 6, pt. 81.

125. *Cf.* Rev. Rul. 70-424, 1970-2 C.B. 150, in which the foreign principal agreed to share equally with the U.S. agent any loss up to a specified amount during any one year during the life of the contract.

126. Technical Explanation, *supra* note 72, art. 5, para. 6, at 10,629; DOERNBERG & RAAD, *supra* note 72, Technical Explanation, art. 5, para. 6, pt. 81.

127. *See* Avery Jones & Ward, *supra* note 9, at 164.

normal remuneration.”¹²⁸

In 1929, the League of Nations committee of tax experts drafted two exceptions to the permanent establishment definition, one for a broker and the other for a commission agent “who acts in his own name for any number of undertakings and receives the normal rate of commission.”¹²⁹

According to one commentator, the policy underlying the latter requirement was that the agent’s commission was the amount of gross income (less deductions) on which a branch of the foreign principal that carried on the same activities as a commission agent would be taxed. If the only business activity was conducted through a commission agent whose income would be subject to tax in the source country, there would be no further income to be taxed by that country and thus no tax revenue would be lost by excluding the agent from the definition of permanent establishment.¹³⁰

This analysis seems an oversimplification. The commission agent will certainly be taxed by its country of residence on its net income, but there may be additional income, for example, from a sale of goods, that is earned by the principal and that can appropriately be taxed in the source country in which the buyer is located. There is no reason to assume that all of the income from the transaction attributable to the sale in which that agent plays a role is reflected in the agent’s commission. The agent’s compensation should depend on the scope of the agent’s authority and functions, which can vary widely from agent to agent, depending on business exigencies. Moreover, even if an independent agent’s commission represented the income from the sale properly taxable in the source country, the same point could be made with respect to an independent agent acting outside the ordinary course of its business. It would be difficult, if not impossible, to develop criteria that would establish different levels of compensation as normal for both an independent agent acting in the ordinary course of its business and an independent agent acting outside the ordinary course of its business. Accordingly, it does not seem appropriate to use “normal compensation” as a criterion for identifying an independent agent. This conclusion may derive implicit support from the fact that the post-World War II OECD Model Commentaries and the Technical Explanation to the 1996 Treasury Model have not included a reference to normal compensation in discussing the meaning of an independent agent acting in the ordinary

128. *Id.*

129. *Id.* This exception was also adopted in the 1933 League of Nations draft model convention.

130. See Mitchell B. Carroll, League of Nations Fiscal Committee, *Methods of Allocating Taxable Income*, 4 TAXATION OF FOREIGN AND NATIONAL ENTERPRISES 193 (1933).

course of its business.

However, it should be acknowledged, as noted above, that the formulation of an agent's compensation may be relevant to whether the agent bears the required entrepreneurial risk. If the agent is paid a commission equal to its expenses plus a percentage of sales, the agent bears no risk of loss. The same may be the case if the agent's compensation is formulated in some other way that exceeds an arm's length level. These circumstances would clearly be relevant to determining whether the agent bears entrepreneurial risk. Indeed, under the OECD Commentaries and the Technical Explanation to the 1996 Treasury Model, the only significance of the manner and level of the agent's compensation would appear to be its bearing on whether entrepreneurial risk is present.¹³¹

D. Meaning of "Acting in the Ordinary Course of Its Business"

To fall within the terms of section 864(c)(5)(A) of the Code, article 5, paragraph 6 of the 1977 and 1992 OECD Models, article 5, paragraph 6 of the 1981 and 1996 Treasury Models, and the corresponding paragraph in most U.S. tax treaties now in effect, an independent agent must act on behalf of the foreign principal in the ordinary course of the agent's business.¹³² The Commentary to the 1977 and 1992 OECD Models elaborates as follows: "Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations."¹³³

There has been some debate concerning whether the phrase "acting in the ordinary course of its business" refers to the independent agent's own business, or to the business of independent agents generally.¹³⁴ However, the use in article 5, paragraph 6 of the 1977 and 1992 OECD Models of the words "provided that such persons are acting in the

131. See *supra* text accompanying note 93.

132. The Commentaries to the 1977 and 1992 OECD Models state that the agent will come within the scope of paragraph 6—and be excluded from the permanent establishment definition—only if "he acts in the ordinary course of his business when acting on behalf of the enterprise [*i.e.*, the principal]." 1977 OECD MODEL CONVENTION AND COMMENTARY, *supra* note 90, para. 36, at 67; 1992 OECD MODEL CONVENTION AND COMMENTARY, *supra* note 90, para. 37, at (5)-15.

133. 1977 OECD CONVENTION AND COMMENTARY, *supra* note 90, art. 5 para. 6, pt. 37; 1992 OECD CONVENTION AND COMMENTARY, *supra* note 90, art. 5 para. 6, pt. 38.

134. See Avery Jones & Ward, *supra* note 9, at 172-75.

ordinary course of *their* business”¹³⁵ seems clearly to adopt the former view, and this conclusion is not contradicted by the Commentaries.

Section 864(c)(5)(A) refers to the “agent of independent status acting in the ordinary course of his business.” The regulations, however, introduce an interior inconsistency by referring to “or other agent of an independent status acting in the ordinary course of his business *in that capacity*.”¹³⁶ The emphasized words imply that the focus may be on what independent agents as a group generally do, rather than on the particular agent’s business, which is clearly the focus of section 864(c)(5)(A).

Under the formulation of the acting-in-the-ordinary-course-of-business test found in the 1977 and 1992 OECD Models (and in section 864(c)(5)(A) of the Code), a shipping agent that regularly enters into leases for containers binding on its foreign principals would be regarded as acting in the ordinary course of its business even if shipping agents in general do not typically enter into container leases binding on their principals.¹³⁷ In any amendment to the regulations, the words “in that capacity” should be deleted. The 1996 Treasury Model seems ambiguous on the point, referring to such persons “acting in the ordinary course of their business as independent agents.”¹³⁸ To eliminate the ambiguity, this phrase could usefully be revised to refer to such person “acting in the ordinary course of its business.”

The acting-in-the-ordinary-course-of-business test would also appear to imply that the agent must be compensated and must either be actually engaged in representing multiple foreign principals or hold itself out as ready and able to engage in such multiple representation.¹³⁹ The paradigm would be the manufacturers’ representative that acts, or holds itself out as ready and willing to act, as sales agent for one or more categories of products manufactured by multiple suppliers.

It has been argued that, viewed from a civil law perspective, whether an independent agent is acting in the ordinary course of its business is determined by whether it habitually concludes contracts that are binding on the foreign principal.¹⁴⁰ If so, the agent may not qualify as an

135. 1977 OECD MODEL, *supra* note 35, art. 5, para. 6; 1992 OECD MODEL, *supra* note 35, art. 5, para. 6 (emphasis added).

136. Treas. Reg. § 1.864-7(d)(3) (emphasis added).

137. See Avery Jones & Ward, *supra* note 9, at 173, n. 218 (citing a 1983 Bundesfinanzhof decision in which a German shipping agent was held to act in the ordinary course of its business when it leased containers on behalf of and concluded contracts binding on its U.S. principal although it was not common for shipping agents to conclude container leases on behalf of their principals).

138. 1996 Treasury Model, *supra* note 31, art. 5(6).

139. See HUSTON & WILLIAMS, *supra* note 5, at 134.

140. See Roberts, *supra* note 9, at 400.

independent agent acting in the ordinary course of its business. Only if the agent cannot bind its principal, can it qualify.¹⁴¹ This civil law analysis does not fit comfortably with the common law principle under which all contracts made by agents, whether independent or not, may bind that principal, whether or not the principal is disclosed,¹⁴² and it seems inconsistent with the Anglo-American authorities.¹⁴³

The OECD Commentary regards as the touchstone to determining when an agent is acting in the ordinary course of its business whether the activities of the agent belong, economically, to the sphere of its own operations rather than the sphere of the foreign principal's business. At least when the agent represents multiple principals or holds itself out as prepared to do so, this test is met. The regulations should also be revised to make explicit the requirement that the agent must either represent multiple principals or hold itself out as ready and able to do so.

E. Application of the Agent Rules to E-Commerce

In traditional international commerce, agents have been persons or juridical entities physically located in the country of the customers who engage in activities related to the sale, leasing or licensing of property or the rendering of services on behalf of a foreign principal.

In international e-commerce, a foreign seller, lessor or licensor of property or service provider may operate a web site that can function as a kind of software agent. Such an agent can carry out a variety of activities including the conclusion of contracts related to commercial transactions on behalf of and binding on the foreign principal. Like a human agent, a web site software agent may assist the U.S. customer to find the product or service desired, answer customer questions, solicit an order, negotiate contract terms within prescribed limits, conclude the sales contract, arrange for shipping and handle credit arrangements and

141. *See id.*

142. *See supra* text accompanying notes 38-43; Avery Jones & Ward, *supra* note 9, at 158.

143. In *Taisei Fire and Marine Ins. Co. v. Commissioner*, 104 T.C. 535 (1995), the Commissioner conceded that a U.S. corporation that concluded reinsurance contracts on behalf of the petitioners, four Japanese property and casualty insurance companies, was acting in the ordinary course of its business. *See supra* text accompanying notes 38-43; HUSTON & WILLIAMS, *supra* note 5, at 128, 259; Avery Jones & Ward, *supra* note 9, at 158. *But see* Nitikman, *The Meaning of "Permanent Establishment" in the 1981 U.S. Model Income Tax Treaty, Part II*, 15 INT'L TAX J. 259 (1989).

payment.¹⁴⁴ If the web site software agent is operated from a server owned by the foreign principal and located outside the United States, under current tax rules, it would not open the door to U.S. taxation of the income generated by the transaction because there would be no U.S. business activities, and, obviously, no U.S. fixed place of business. Similarly, under the 1992 OECD Model, the 1996 Treasury Model Treaty and under most U.S. treaties in force, a web site software agent on a server owned by the foreign principal and located outside the United States could not be treated as a U.S. permanent establishment. There would be no fixed place of business in the United States and no person in the United States with power to enter into contracts binding on the foreign principal.

However, if the web site software agent is operated from a server located inside the United States, is there a possibility that the foreign principal will be subject to U.S. tax on income generated by sales to U.S. customers? For purposes of analysis we may assume that the web site software agent will regularly conclude sales contracts binding on its foreign principal. Under existing law, if the web site software agent could be assimilated to a human or juridical agent, the activities of the software agent might be attributed to the foreign principal who, as a result, might be deemed to be engaged in a U.S. business. Alternatively, the foreign seller's regular contacts with U.S. customers through its web site might be treated as a U.S. business. If the U.S. server were owned by the foreign principal, although there is no authority on point, it might be treated as a U.S. fixed place of business. In this event, income from the sale of goods would be subject to U.S. tax under section 865 (e)(2)(A).

Under the 1992 OECD Model, the 1996 Treasury Model and most current U.S. treaties, if the web site software agent with the power to regularly conclude contracts binding on its foreign principal were maintained on a server owned by the foreign principal and located in the United States, while the law is uncertain, it might be treated as a U.S. permanent establishment which would permit U.S. taxation of income attributable to it. The OECD's Working Party No. 1 on Tax Conventions and Related Questions has been drafting new paragraphs on international e-commerce for the Commentary on article 5 of the OECD Model. In a revised draft summarizing positions on various issues, the Working Party has noted that some countries have suggested that fixed automated equipment may be a permanent establishment even if it does not require "on-site human intervention for its operation."¹⁴⁵ On the

144. See DOERNBERG & HINNEKENS, *supra* note 58, at 112.

145. WORKING PARTY DRAFT, *supra* note 63, at 1290, para. 4.

other hand, it has been argued that participation of human personnel in connection with the equipment is a prerequisite to finding a permanent establishment.¹⁴⁶ It has also been argued that the location of the server is irrelevant to the customer, who has access to the seller's goods or services wherever the customer has an internet connection. Accordingly, the foreign internet seller should not be regarded as having a U.S. fixed-place-of-business.¹⁴⁷

If the U.S. server is owned by an independent ISP, then even if (i) the foreign seller is deemed to be engaged in U.S. business, (ii) the server is a fixed place of business of the ISP and (iii) the ISP is an agent of the seller, under section 864(c)(5)(A), the server could not be imputed to the foreign principal, and if title to the goods were passed to the U.S. customers outside the United States, the income would be exempt from U.S. tax under sections 865(b) and 862(a)(6). Moreover, if the server is owned by an independent ISP, the web site software agent would not appear to constitute a permanent establishment either because the ISP (and its server) would be hosting the web site software agent for a fee, not an agent or, if an agent, because the ISP would be an independent agent acting in the ordinary course of its business.¹⁴⁸ Furthermore, neither the web site software agent nor the server would appear to be a "person" who could be deemed to be a permanent establishment under article 5(5) because it has and habitually exercises the power to conclude contracts binding on the foreign principal under article 5(5).¹⁴⁹

Another question is whether a web site software agent on a server maintained by an independent ISP could be assimilated to a human agent and therefore be regarded as a "person" with the power to conclude contracts that could be considered a permanent establishment of the foreign seller under article 5(5). The OECD Working Party suggests a negative answer,¹⁵⁰ which is endorsed by internet businesses.¹⁵¹ However, rising pressure from countries in which customers are concentrated might result in a reassessment of this conclusion. For example, it could be argued that a web site software agent hosted on a U.S. server, even if owned by an ISP, might be assimilated to a human

146. See Carol A. Dunahoo, *E-Commerce Tax Study Group Responds to OECD Request*, 20 TAX NOTES INT'L 297, 299 (Jan. 2000).

147. See WORKING PARTY REVISED DRAFT, *supra* note 66, para. 5.

148. See *id.* para. 15.

149. See *id.*

150. *Id.*

151. See e.g., Dunahoo, *supra* note 146, at 298.

agent, and the rules and suggested changes discussed above relating to business transactions conducted in the United States through human agents might be applied.

At this early stage in the development of international e-commerce, the proper characterization of a foreign seller's web site software agent on a server located outside the United States or on a server located inside the United States owned by an independent ISP to handle U.S. sales transaction calls for caution. But under existing rules, it appears that neither arrangement would constitute a U.S. fixed place of business or a permanent establishment. If the web site software agent is hosted on a server in the United States owned by the foreign seller, there is greater risk that a U.S. fixed place of business and a U.S. permanent establishment could be deemed to be created.

V. SUMMARY OF PROPOSALS

This Article focuses on issues related to foreign persons engaging in a business in the United States through agents, and it suggests a number of changes that could be made by Congress in the Code and by the Treasury and the IRS in regulations that would reduce the uncertainties and anomalies of existing law and facilitate planning and compliance by taxpayers and administration by the IRS.

The broadest of the proposals relates to clarifying the circumstances under which a foreign person will be deemed to be engaged in a trade or business in the United States. Congress should adopt a general rule that would treat a foreign person as having income effectively connected with a U.S. business only if the foreign person has a fixed place of business in the United States to which the income is attributable. The result should be the same if there is imputed to the foreign person the U.S. fixed place of business of an agent. Under this change, a foreign person would not be held to be engaged in a U.S. business as a result of U.S. business activities of employees or other agents not conducted through a U.S. fixed place of business. This change would eliminate uncertainties under existing law concerning when business activities of an agent should be imputed to the foreign principal and whether those activities rise to the level of a U.S. business.

The rule under section 864(c)(5)(A) that a fixed place of business of an independent agent acting in the ordinary course of its business may not be imputed to a foreign principal is now applied only to certain types of income in specific contexts. It should be retained and broadened to constitute a general rule applicable to all types of income, except for income from real property and services. The other rule of section 864(c)(5)(A) that permits imputation to a foreign principal of the fixed

place of business of any other agent (*e.g.*, an agent who is not independent) should also be retained, and it, too, should be made a general rule applicable to all types of income. However, the existing rule that calls for imputation only if such other agent has either (i) the regularly exercised authority to negotiate and conclude contracts in the name of the foreign person or (ii) a stock of merchandise from which orders are regularly filled should be revised to reflect more up-to-date international tax principles. Under this proposed change, the fixed place of business of an agent other than an independent agent acting in the ordinary course of its business would be imputed to the foreign principal only if the agent has, and habitually exercises, the power to conclude contracts binding on the principal. This would be the only instance in which the U.S. fixed place of business of such a U.S. agent would be imputed to a foreign principal.

The proposed general rule, under which a foreign person would be subject to U.S. net basis tax only with respect to income attributable to a U.S. fixed place of business, would be subject to two exceptions:

First, all income of a foreign person from U.S. real property would be treated as effectively connected with a U.S. business even if the foreign person has no U.S. fixed place of business, or, put differently, ownership of U.S. real property would be assimilated to a U.S. fixed place of business. The result would be the same even if the foreign person acts in the United States exclusively through an independent agent acting in the ordinary course of its business.

Second, the existing rules of section 864(b) relating to services performed in the United States would be retained. Under these rules, services income would be treated as effectively connected with a U.S. business even in the absence of a U.S. fixed place of business, subject to the existing Code exceptions for certain trading in stocks and securities or in commodities and de minimis compensation for performance of services for a foreign employer. These exceptions would also be retained, but the amount of compensation (\$3,000) that may be received by an employee of a foreign employer free of U.S. income tax should be increased substantially. Unless one of the Code exceptions (or another contained in an applicable tax treaty) applies, income from services performed by a foreign person in the United States directly, or with the involvement of a U.S. independent agent acting in the ordinary course of its business, would be subject to U.S. tax as income effectively connected with a U.S. business. Thus, all of the income from services

rendered in the United States by a highly paid nonresident alien entertainer or athlete or by a nonresident alien impresario or promoter who arranges for the performance of services by another would be taxable under the Code.

If the proposed changes in the definition of what constitutes being engaged in a U.S. business are not adopted, the regulations, and possibly the Code as well, should be amended to provide that the U.S. business activities (as well as a fixed place of business) of an independent agent acting in the ordinary course of its business should not be imputed to the foreign principal in determining whether the latter is engaged in a U.S. trade or business.

Finally, whether or not any or all of the foregoing proposed changes are adopted, the regulations under section 864(c) and under U.S. tax treaties should be amended to provide detailed and workable standards that must be met in order to establish that an agent in the United States is an independent agent acting in the ordinary course of its business. These standards should involve elaborations of the “control” test and the “entrepreneurial-risk” test set forth in the Commentaries to the 1977 and 1992 OECD Models and in the Technical Explanation of the 1996 Treasury Model and should include examples illustrating the application of the criteria in a variety of factual contexts.

International e-commerce raises a number of as yet unresolved issues. Among others, these include whether an internet server located in the United States, owned by a foreign seller and hosting a web site software agent involved in sales to U.S. persons can be treated as a fixed place of business under the Code or as a permanent establishment under U.S. tax treaties and under what circumstances income generated through such a software agent hosted on a U.S. server can, if the server is owned by an independent ISP, be insulated from U.S. tax under the Code or a tax treaty. However these questions and others may eventually be answered, the answers are not likely to be incompatible with the changes proposed above in the tax rules relating to the conduct of business in the United States by foreign persons through agents. These changes appear to accommodate adequately the advent of international e-commerce and could be applied to international e-commerce sales to U.S. persons without violating the principle of neutrality between traditional international commerce and international e-commerce.