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TAXATION

RICHARD S. LEHMAN*

TAX PLANNING — THE EXPORT OF GOODS TO THE UNITED STATES

Exporting to the United States by foreign manufacturers and producers of needed raw materials is big business. In many instances the nonresident alien (that is nonresident to the United States) has the opportunity to plan the method of its export sales to the United States so as to reduce the United States federal income tax on such sales.

If a nonresident exporter conducts itself in such a manner as to insure that its income is from a source outside of the United States and that none of the income is considered to be effectively connected with a United States trade or business, the profit resulting from the sales should not be subject to federal income tax. This article explores the means by which an exporter to the United States can avoid United States tax on its sales. To avoid the tax, the exporter must structure its sales transactions so that title to the goods passes outside of the territorial jurisdiction of the United States.

Let us assume a trading corporation (the company) organized in Country X desires to make sales of personal property for use and consumption in the United States. The goods will be purchased by the company outside of, and then resold in, the United States. The company will only purchase and resell the goods but not produce, fabricate, add to, or change the goods in any way other than the necessary repacking for shipment. Consideration here will only be given to the taxation of the company exclusive of its relationship to other companies and their shareholders.

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The exporting company will be considered a "foreign corporation" by virtue of I.R.C. §§ 7701(a)(4) and (5)[1]. As such, it may be subject to federal income taxation under I.R.C. §§ 881 or 882. I.R.C. § 881 deals with foreign corporations that are engaged in a trade or business not connected with the United States. However, whether or not the Country X Corporation is subject to taxation under this section is an unsettled question. Certainly an active commercial export business[2] is a "trade or business" for the purposes of the Code.[3] Yet, even though all the sales activities take place outside the United States, there is a question as to whether or not this export trade or business is conducted outside the United States for the purposes of I.R.C. § 881.[4] If it is determined that the foreign corporation is engaged in a trade or business not connected with the United States, it is then subject to a tax only on amounts received from sources within the United States.[5]

Assuming that the Country X Corporation is engaged in a trade or business within the United States, the corporation is taxed under I.R.C. § 882 on all taxable income which is effectively connected with a United States trade or business. Income from the sale of property is effectively connected with a United States trade or business, as a general rule, if it is derived from sources within the United States. In addition, income derived from the sale of personal property from sources outside the United States may be deemed to be connected with a United States trade or business where the corporation maintains an office or fixed place of business within the United States, and the sale was transacted through that office.[6] Therefore, if (1) the foreign corporation can structure its sales so that the income will be derived from a source not connected with the United States and (2) the sales for ultimate consumption in the United States are not made through the corporation's office or fixed place of business in the United States, there is no income subject to United States taxation. The balance of this analysis is concerned with achieving those two criteria which result in no United States tax liability.

First, it is necessary to focus on the manner in which sales must be structured so as to insure that the income from the sale of personal property is indeed considered to be from a source without the United States. The place of payment is not controlling as to the source of income for tax purposes in the sale of personal property.[7]

The rules for determining source of income of foreign corporations for federal income tax purposes are found in I.R.C. §§ 861-863. For purposes of these sections, the sales by the exporter must be completed

in such a manner that title to the goods will pass from the company to the consumer or distributor outside of the United States. Further the situs of the place of payment is not necessarily controlling.[8]

I.R.C. § 862(a)(6) specifically provides that gain derived from the purchase of personal property within the United States and its sale without the United States results in income from sources without the United States. This section does not fit the situation of our foreign company since our company will both purchase and sell its goods without the United States. However, while the statute speaks of purchases without and sales within the United States (or vice versa), it follows *a fortiori* that income from purchases without and sales without the United States would be assigned a source at the place of sale.[9] Therefore, there is little doubt that if the sales to persons or entities in the United States can be completed without the United States, the foreign corporation's income will be considered to have been derived from a source without the United States.

The guide lines determining where a "sale" occurs are contained in Treas. Reg. 1.861-7(c). This regulation provides that:

> a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer or beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

In essence, Treas. Reg. § 1.861-7 provides that the test of "passage of title" will control unless the transaction was so arranged as to avoid federal income tax.

Before examining any pitfalls that may lie in attempting to structure sales outside of the United States, let us view a practical aspect of the passage of title test and consider how it may be accomplished in order to insure that the goods are sold without the United States. The Internal Revenue Service in Revenue Ruling 74-249, 1974-1 C.B. 189, considered thet passage of title test in an export context.[10] The Commissioner ruled

that income from the sale of personal property would be considered from a source without the United States when sales were made to a foreign country under straight bills of lading naming the customer as consignee, but subject to a written agreement providing that title to the goods, responsibility for title to the goods, responsibility for shipment, and risk of loss remained with the seller until the goods reached their destination. This method of doing business may be relied on to insure passage of title without the United States, so long as the substance of the transaction is in conformity with this method. In our situation we will be adopting a business practice somewhat analogous to the ruling. Title to the goods will pass to the buyer in the foreign country, and the goods will then be shipped to the United States. The benefits and burdens of ownership will be upon the buyer from the moment the goods leave Country X.

Of course, some concern must be given to that portion of Treas. Reg. § 1.861-7 which provides that the passage of title test will be ignored if the primary purpose of the transaction is tax avoidance. It is the author's belief that this "tax avoidance" portion of the regulation would not apply to a standard exporting transaction for sale of goods to the United States since a substantial body of case law holds that the intent of the parties as evidenced by the documentation and substance of the transaction must be honored. Thus passage of title to the buyer in the foreign country can have many economic justifications irrespective of any tax benefits. For example, the foreign corporation as seller may wish to avoid all risk of loss stemming from the actual shipment of the goods. This may be accomplished by the passage of title to the buyer in the foreign country prior to shipment.[11]

The unacceptable "tax avoidance" type of transaction was illustrated in *U.S. Gypsum Co. v. United States*, 452 F.2d 445 (7th Cir. 1971). In that case, the so-called owner held title only for the brief period during which the goods were being unloaded. No purpose was found for this split second passage of title other than for tax avoidance, and consequently, the court refused to honor the transaction. However, this is not like the typical case we are considering here.

Once it is established that title to the goods has passed successfully without the United States and the income is from a source without the United States for United States tax purposes, the first qualification of non-taxability is established. The second qualification is to insure that the goods sold to the United States have not been sold through an office or fixed place of business in the United States.

In essence, Treas. Reg. §§ 1.864-5(a) and 1.864-5(b)(3)(i), which control the sales of personal property resulting in income from without the United States, provide that: Income from sources without the United States shall be treated as effectively connected with a United States trade or business only if it consists of income from property held primarily for sale where the sale is outside the United States but through the office or other fixed place of business which the foreign corporation has in the United States irrespective of the destination to which such property is sent for use, consumption, or disposition.

In order for the foreign corporation not to be considered to have an office or fixed place of business in the United States, all of the corporation's business within the United States must be done either through: (1) independent agents; (2) dependent agents that have no authority to conclude contracts for the corporation and do not carry stock of the corporation's goods; or (3) a related corporation which is carrying on its own separate business in the United States.

With respect to independent agents Treas. Reg. § 1.864-7(d)(2) provides:

> The office or fixed place of business of an independent agent . . . shall not be treated as the office or other fixed place of business of his principal who is a . . . foreign corporation, irrespective of whether such agent has authority to negotiate and conclude contracts in the name of his principal, and regularly exercises that authority . . . .

Treas. Reg. § 1.864-7(d)(3) defines an independent agent for purposes of our tax planning as follows:

> . . . the 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.[12]

Treas. Reg. § 1.864-7(d)(1)(i), which considers the use of *dependent agents*, states:

> In determining whether a nonresident alien individual or a foreign corporation has an office or a foreign corporation has

> an office or other fixed place of business, the office or other fixed place of business of an agent who is not an independent agent, as defined in subparagraph (3) of this paragraph, shall be disregarded unless such agent (a) 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 (b) has a stock of merchandise belonging to the nonresident alien individual or foreign corporation from which orders are regularly filled on behalf of such alien individual or foreign corporation . . . .

Therefore it would appear that if the dependent agents are so restricted, then all of the substantive work is done by the foreign office, and not by the dependent agents in the United States. Consequently, the profit should properly accrue outside the United States.

Treas. Reg. § 1.864-7(d)(1)(i) discusses the use of a corporation related to the actual foreign trading corporation in such a way as to insure that its activities do not result in *it* being considered an office of its foreign parent. The regulation states:

> A person who purchases goods from a nonresident alien individual or foreign corporation shall not be considered to be an agent for such alien individual or foreign corporation for purposes of this paragraph where such person is carrying on such purchasing activities in the ordinary course of its own business, even though such person is related in some manner to the nonresident alien individual or foreign corporation.

In other words, a foreign corporation can sell its goods through its own subsidiary and not be considered to have an office here as a result of the subsidiary's presence. However, the subsidiary must actually have its own business independent of the foreign parent.

The foreign corporation will not be considered to have an office or fixed place of business in the United States if its sales are arranged either (1) through an agent with certain very limited powers, (2) a related person who makes sales in the course of its own separate trade or business, or (3) through an independent agent.

In summary, if the foreign exporter will earn income from sources without the United States for purposes of I.R.C. § 882, title to the goods sold to the United States passes outside the territorial limits of the United States. Moreover, the income must not be attributable to an office or fixed place of business maintained by the exporter within the United States.

NOTES

[1]I.R.C., §7701(a)(5) states in pertinent part, "the term 'foreign' when applied to a corporation means a corporation . . . which is not domestic." I.R.C. §7701(a)(4) states in part "the term 'domestic' when applied to a corporation . . . means created or organized in the United States or under the laws of the United States or any state or territory."

[2]"Export" in this context refers to exporting from a foreign country to the United States.

[3]A.P. Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960).

[4]*See* United States v. Balanovski, 236 F.2d 298 (2d Cir. 1956) and the decision it reversed at 131 F.Supp. 898 (S.D.N.Y. 1954). *See also* Linen Thread Co. Ltd., 14 T.C. 725, 736 (1950).

[5]I.R.C. §881(a) and Treas. Reg. §1.881-1.

[6]I.R.C. §864(c)(4)(B)(iii).

[7]Commissioner v. East Coast Oil Co., 85 F.2d 79 (5th Cir. 1936) *aff'g* 31 B.T.A. 558 (1935).

[8]When personal property is produced (in whole or in part) within the United States, an allocable portion of the sales income is subject to federal income tax even if the property is sold without the United States. I.R.C. §863 and Treas. Reg. §1.863-3. The definition of 'produced' for purposes of this section includes created, fabricated, manufactured, extracted, processed, cured or aged.

[9]BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, §17-5 (3d ed. 1971).

[10]Rev. Rul. 74-249 was concerned with the question of whether a domestic corporation could obtain those special tax benefits available to domestic corporations which qualify as Western Hemisphere Trade Corporations. I.R.C. §921. The issue of source of income is identical in that context to the present one and both I.R.C. §§921 and 882 have been used interchangeably at times in referring to the Treasury Regulation with which we are concerned.

[11]*See* RonRico Corp., 44 B.T.A. 1130 (1944).

[12]Treas. Reg. §1.864-7(d)(3).