

**BOMBAY MANAGEMENT ASSOCIATION  
EIGHTH ANNUAL  
INTERNATIONAL TAX PROGRAM**

**ATTRIBUTION OF InverWorld, INCOME  
TO UNITED STATES PERMANENT  
ESTABLISHMENTS**

**14.40 – 15.20  
Saturday, December 7, 2002  
Second Day of Program  
Mumbai, India**

**Walter T. Raineri,<sup>JD/CPA</sup>  
Fenwick & West LLP  
Palo Alto, CA**

Copyright 1999 to 2001 by Walter T. Raineri. All rights reserved.

Foreign  
company

YS  
Sub

foreign  
pshp

Branch

Trust



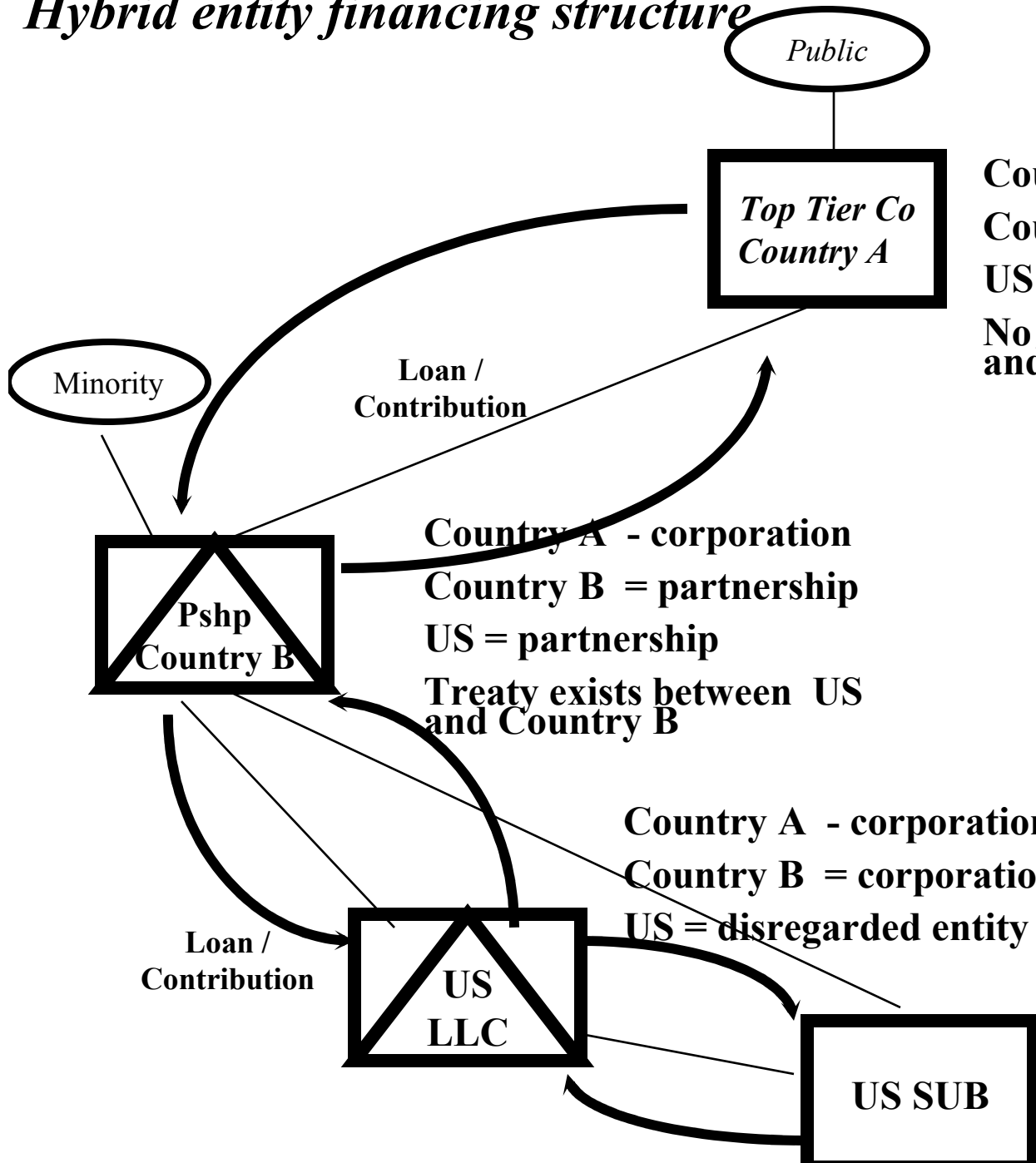
Hybrid  
Partnership

Reverse Hybrid  
partnership

Hybrid  
Branch

Hybrid  
US Sub

# Hybrid entity financing structure



Country A - corporation  
 Country B = corporation  
 US = corporation

No treaty exists between US and Country A

**Because Country A and Country B treats the US LLC as a corporation, the US treaty with Country A or Country B may not apply**

Country A - corporation  
 Country B = partnership  
 US = partnership  
 Treaty exists between US and Country B

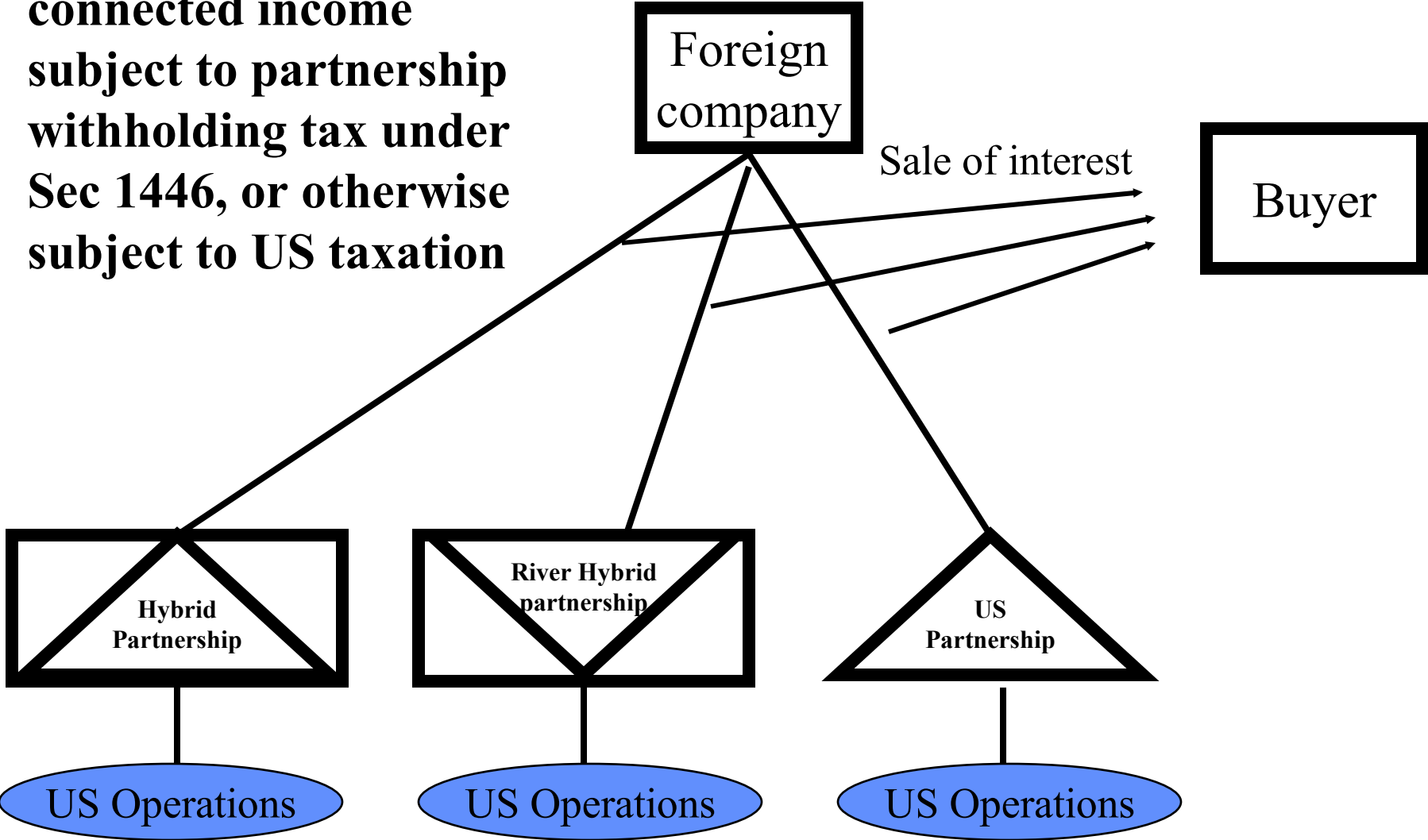
Country A - corporation  
 Country B = corporation  
 US = disregarded entity

Country A = corporation  
 Country B = corporation  
 US = corporation

## **TAXATION OF US OPERATIONS OF A FOREIGN CORPORATION UNDER NON TREATY RULES**

- **US Trade Or Business**
- **US Source Income Effectively Connected With a US Trade Or Business**
  - **Asset Use Test**
  - **Business Activities Test**
- **Foreign Source Income Effectively Connected With a US Trade Or Business.**
- **US Office or Other Fixed Place of Business**
- **Dependent Agents**
- **Independent agents**
- **Attribution of Income to a US office**
  - **Material Factor Test**
  - **Other Factors**
- **US Source Income Not Effectively Connected with a US Trade or Business or US Office: Withholding Taxes Generally.**

**The issue is whether the foreign partner has any US effectively connected income subject to partnership withholding tax under Sec 1446, or otherwise subject to US taxation**



# **US 1996 MODEL TREATY APPROACH TO INCOME ATTRIBUTION TO PERMANENT ESTABLISHMENTS**

## **Definition of a US Permanent Establishment under the 1996 US Model Treaty**

**a place of management**

**a branch**

**an office**

**a factory**

**a workshop**

**any place of extraction of natural resources**

## **Building or Construction Site**

## **Exceptions to General PE Rule**

**Storage Exception**

**Inventory Warehouse**

**Consignment Inventory Warehouse**

**Purchasing Office**

**Preparatory or Auxiliary Activities Office**

**Combination or Liaison Office**

**Office of Independent Agent**

**No Exception For Certain Depend Agent Activities**

**No PE Merely By Ownership Of The Stock Of A US Subsidiary**

# **Attribution of Income to US PE under 1996 US Model Treaty**

## **General Rule**

## **Relationship to Effectively Connected Income Concepts**

## **Asset and Activity Tests**

## **Divergence from OECD Model Treaty on the Use of Profit Allocation Methodologies**

## **Allocation of Deductions to a PE**

### **Booking Location Not Controlling**

### **Establishing the Relationship of an Expense to a PE**

## **Method of Accounting Issues**

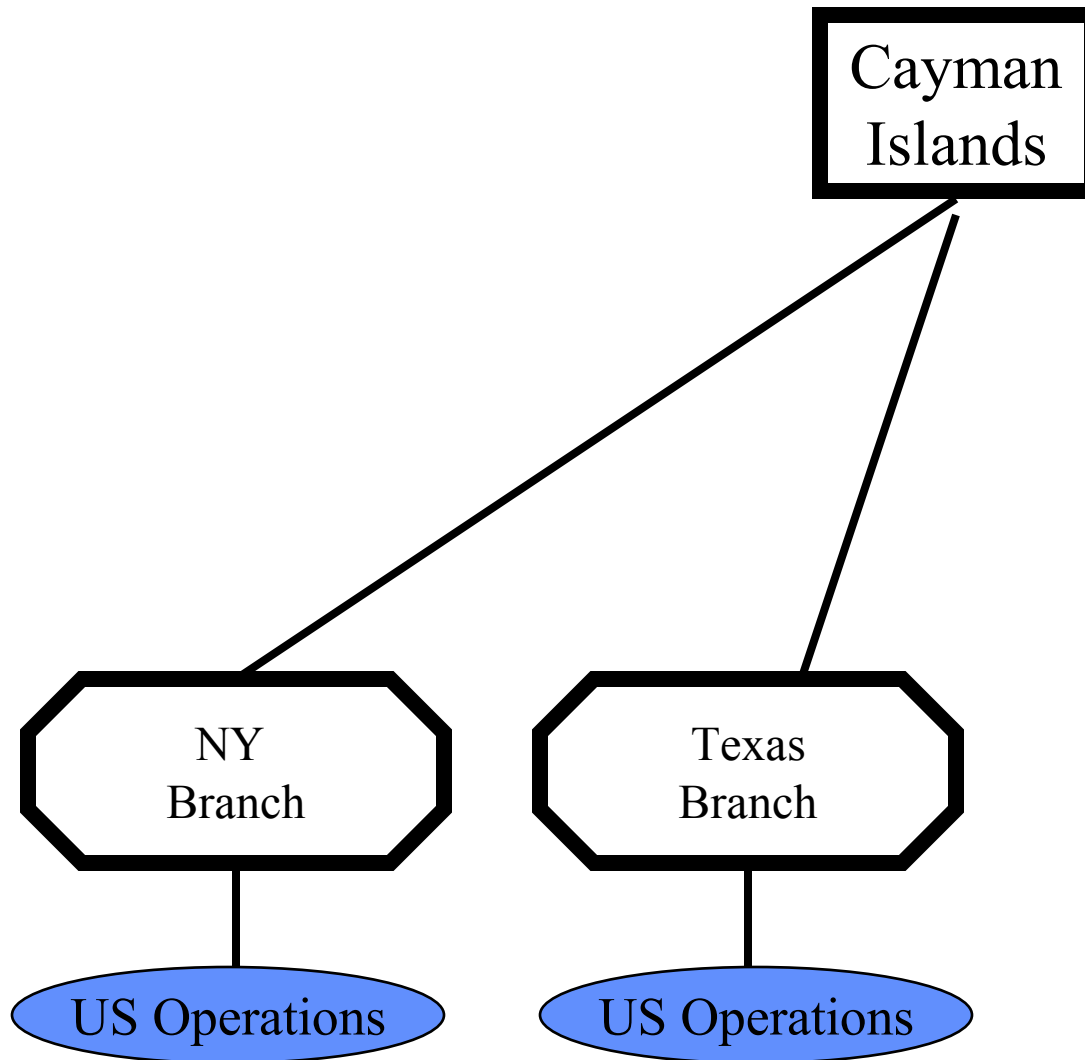
## **Coordination With Other Provisions**

## **Nature of Business Activity**

## **Location and Timing of Payment is Irrelevant**



***InverWorld, Ltd. v. Commissioner: A Case Study in How Not To Do Business in the US***



***InverWorld, Ltd. v. Commissioner: A Case Study in How Not To Do Business in the US.***

**First Holding.** InverWorld, Inc was InverWorld, Ltd.'s agent, but that InverWorld, Inc was not an independent agent.

**Second Holding.** The court held that all of InverWorld Ltd. income was "effectively connected with the conduct of a trade or business within the United States.

**Third Holding.** The court ruled that InverWorld, Ltd. is not liable for withholding tax on the interest paid, but the dividends paid to its shareholders are subject to the 30 percent tax on nonresident alien individuals.

**Fourth Holding.** The court denied InverWorld, Ltd.'s deductions for direct costs claimed because InverWorld Ltd. never filed a US tax return.

**Fifth Holding.** The court agreed with the IRS that InverWorld Ltd.'s income should be allocated to InverWorld, Inc under § 482 and that InverWorld Ltd. was not entitled to deduct a correlative adjustment, again because InverWorld Ltd. had filed no tax returns for the years in issue.