

## LB&I Transaction Unit Knowledge Base – International

Library Level	Number	Title
Shelf		Cross-Over
Book	16	Treaties
Chapter	7	Permanent Establishments and Business Profits
Section		

<b>Unit Name</b>	Creation of a Permanent Establishment (PE) through the Activities of a Dependent Agent in the United States	
<b>Primary UIL Code</b>	9450.06	Determination of permanent establishment status

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# Issue and Transaction Overview

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Background:

Under the Internal Revenue Code, a foreign company that carries on a trade or business in the United States is subject to tax at the same progressive rates as U.S. corporations, but only with respect to income effectively connected with its U.S. trade or business. However, if the foreign company elects to be taxed under the provisions of an applicable U.S. income tax treaty, it will generally only be subject to U.S. tax on its profits attributable to a permanent establishment. In general, the nature and amount of activities that would lead to a foreign company being engaged in a U.S. trade or business are broader than those that would create a U.S. permanent establishment.

### Permanent Establishment Concept in U.S. Income Tax Treaties:

In most cases, U.S. income tax treaties define a U.S. permanent establishment to include a fixed place of business in the United States through which the foreign enterprise carries on its business. However, a foreign enterprise will not be deemed to have a U.S. permanent establishment if its activities in the United States are limited to certain activities—generally those of a preparatory or auxiliary nature (see the “Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status” Practice Unit).

A foreign enterprise will also be considered to have a U.S. permanent establishment in respect of activities undertaken on its behalf by a dependent agent who has and habitually exercises in the United States an authority to conclude relevant contracts that are binding on the foreign enterprise. A foreign enterprise will not be deemed to have a permanent establishment in the United States merely because it carries on business in the United States through a broker, general commission agent, or any other agent of an independent status, provided that such person is acting in the ordinary course of his business as an independent agent.

### Permanent Establishment Concept in U.S.-U.K. Income Tax Treaty:

Under Article 5(5) of the U.S.-U.K. Income Tax Treaty, if a U.K. enterprise authorizes a dependent agent to enter into relevant contracts on its behalf in the United States, the U.K. enterprise may have a U.S. permanent establishment in respect of the activities of the agent. The agent must habitually exercise the authority to conclude contracts and the contracts must be binding on the U.K. enterprise.

This Practice Unit examines whether a U.K. company has a U.S. permanent establishment as a result of an agent concluding contracts on its behalf in the United States.

# Issue and Transaction Overview (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Caveats and Explanations:

#### Eligibility for Treaty Benefits

This Practice Unit assumes that the U.K. company qualifies for the benefits of the U.S.-U.K. Income Tax Treaty.

#### Appropriate U.S. Treaty

Remember that every U.S. income tax treaty is different. Although this Practice Unit addresses the meaning of permanent establishment found in the U.S.-U.K. Income Tax Treaty, the test in the treaty you are applying might differ. Therefore, in every case involving a tax treaty, you should carefully review the permanent establishment article and any other applicable articles in the treaty, and any contemporaneous or subsequent protocol(s), memoranda of understanding, or exchange(s) of notes between the treaty countries, to determine if treaty benefits should be granted. In addition, more interpretive guidance may be found in the Treasury Department's Technical Explanation of the treaty/protocol, as well as the Joint Committee on Taxation Report, the Senate Foreign Relations Committee Report, authoritative case law, and guidance issued by the IRS.

#### Technical Explanation and OECD Model

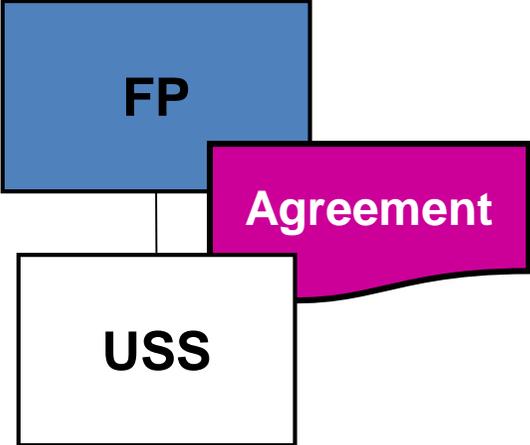
This Practice Unit refers to the Technical Explanation to the U.S.-U.K. Income Tax Treaty and the Commentaries on the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital (OECD Model).

#### Issue Ordering

The issues in this Practice Unit are ordered according to ease of determining a conclusion with respect to this particular fact pattern. For example, in this fact pattern, it seems fairly clear that U.S. Subsidiary's (USS's) negotiated contracts relate to Foreign Parent's (FP's) essential business operations. Therefore, little time should be spent on this issue. However, in a different fact pattern, whether the contracts relate to FP's essential business operations may not be so obvious and it may be necessary to spend additional time examining the issue.

# Transaction and Fact Pattern

## Creation of a PE through the Activities of a Dependent Agent in the United States

Diagram of Transaction	Facts
 <p>The diagram illustrates the relationship between FP and USS. FP is represented by a blue rectangular box at the top, and USS is represented by a white rectangular box at the bottom. A vertical line connects the bottom of FP to the top of USS. A pink, wavy-edged box labeled 'Agreement' overlaps the vertical line, indicating the existence of an agreement between the two entities.</p>	<ul style="list-style-type: none"><li>▪ FP is a U.K. resident company that runs an international hotel business through owned and franchised hotels.</li><li>▪ In 200X, FP acquired USS, a U.S. corporation. USS owns and operates U.S. hotels.</li><li>▪ USS is FP's U.S. headquarters and its base for running its business in the United States.</li><li>▪ According to the terms of an agreement between FP and USS ("FP-USS Agreement"), USS negotiates franchise contracts on behalf of FP with various U.S. hotels.</li></ul>

# Summary of Potential Issues

## Creation of a PE through the Activities of a Dependent Agent in the United States

<a href="#">Issue 1</a>	Are the contracts concluded by USS related to FP's essential business operations?
<a href="#">Issue 2</a>	Does USS habitually exercise its authority to conclude contracts on behalf of FP?
<a href="#">Issue 3</a>	Are the contracts concluded by USS binding on FP?
<a href="#">Issue 4</a>	Is USS a dependent agent of FP?

# All Issues, Step 1: Initial Factual Development

## Creation of a PE through the Activities of a Dependent Agent in the United States

Article 5(5) of the U.S.-U.K. Income Tax Treaty provides: Where a person - other than an agent of independent status to whom Article 5(6) applies - is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts that are binding on the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of activities that the person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in Article 5(4).

Fact Element	Resources
<p>To identify whether FP may have an unreported U.S. permanent establishment under Article 5(5), look for the following:</p> <ul style="list-style-type: none"> <li>▪ FP may file a Form 1120-F with a Form 8833 and claim that it does not have a U.S. permanent establishment, but FP may indicate on p.1, part E of Form 1120-F that FP has an agent in the United States.</li> <li>▪ USS may attach a Form 5472 to its Form 1120, and the Form 5472 may report a transaction between FP and USS indicative of an agency relationship (e.g., a commission).</li> <li>▪ FP's financial statement notes and the Management Discussion &amp; Analysis may state or indicate that USS concludes contracts on behalf of FP in the United States.</li> </ul>	<ul style="list-style-type: none"> <li>▪ FP's Form 1120-F - <i>U.S. Income Tax Return of a Foreign Corporation</i></li> <li>▪ FP's Form 8833 - <i>Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b) (Attached to FP's Form 1120-F)</i></li> <li>▪ USS's Form 5472 - <i>Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business</i></li> <li>▪ Request and/or review relevant Taxpayer financial statements (FP financial statements, USS financial statements)</li> <li>▪ IRS Internal Research Tools: (Information Document Retrieval System (IDRS), YK1, LB&amp;I Imaging Network (LIN), Governmental Liaison</li> </ul>

# All Issues, Step 1: Initial Factual Development (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

Fact Element	Resources
<p>To identify whether FP may have an unreported U.S. permanent establishment under Article 5(5), look for the following (cont'd):</p> <ul style="list-style-type: none"><li>▪ Internet research may indicate that FP conducts activities through its agent USS.</li><li>▪ Organizational charts by business unit, legal entity, department, division, branch, fixed place of business may indicate a U.S. permanent establishment of FP through USS.</li><li>▪ USS invoices may indicate that USS is habitually concluding contracts on behalf of FP.</li><li>▪ Internal research tools may explain the relationship between FP and USS.</li></ul>	<ul style="list-style-type: none"><li>▪ Request and/or review relevant organizational charts</li><li>▪ Copies of USS invoices issued to customers within the United States related to sales, services, interest, royalties or any other type of income</li><li>▪ IRS Internal Research Tools: (Information Document Retrieval System (IDRS), YK1, LB&amp;I Imaging Network (LIN), Governmental Liaison</li><li>▪ Internet (e.g. Westlaw, Accurint, Bureau van Dijk, Dun &amp; Bradstreet, EDGAR, Other search engines)</li></ul>

# All Issues, Step 1: Initial Factual Development (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

Fact Element	Resources
<p> <b>CONSULTATION:</b> You might determine that FP does not have a permanent establishment and that FP does not carry on a fixed place of business in the United States. However, certain U.S. source income that FP receives may be subject to U.S. withholding tax under the Internal Revenue Code.</p> <p>Establish whether Form 1042-S was filed reporting payments to FP. Consult with the Repatriation/Withholding Practice Network (PN), reference and resource materials as necessary to determine whether it is more appropriate to pursue a case with respect to U.S. withholding instead of a permanent establishment case.</p>	<ul style="list-style-type: none"> <li>▪ USS's Form 1042-S - <i>Foreign Person's U.S. Source Income Subject to Withholding</i></li> <li>▪ Practice Unit - <i>FDAP Income</i>, DCN: RPW/C/08_01-01(2016)</li> <li>▪ USS's transfer pricing documentation</li> </ul>
<p> <b>CONSULTATION:</b> Consult with the Income Shifting Practice Network (PN) reference and resource materials as necessary and review other information such as transfer pricing documentation. Based on the amount of income reported on Form 5472, determine whether the matter is primarily related to the appropriate transfer price for transactions between related parties or is a permanent establishment issue.</p>	

# Issue 1, Step 2: Review Potential Issues

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 1

Are the contracts concluded by USS related to FP's essential business operations?

Explanation of Issue	Resources
<p>As discussed in the Issue and Transaction Overview, a foreign enterprise has a U.S. permanent establishment through a dependent agent if the agent habitually exercises its authority to conclude relevant contracts that are binding on the enterprise.</p> <p>The relevant contracts are those relating to the essential business operations of the foreign enterprise rather than ancillary activities. For example, an agent has no authority to conclude contracts in the name of the foreign enterprise with its customers for the sale of the goods produced by the foreign enterprise, but the agent can enter into service contracts in the name of the foreign enterprise for the foreign enterprise's business equipment used in the agent's office *. If contracts are related to internal operations only, then the contracts are not related to FP's essential business operations. Thus, this contracting authority would not fall within the scope of Article 5(5), even if exercised regularly, because the contracts are not related to the foreign enterprise's essential business operations.</p> <p>*Note: A foreign enterprise may have a U.S. permanent establishment as a result of an agent concluding service contracts in the name of a foreign enterprise. The distinction in this example is that the service contracts relate to equipment used in the agent's office.</p>	<ul style="list-style-type: none"><li>▪ U.S.-U.K. Income Tax Treaty, Art. 5(5)</li><li>▪ TE to U.S.-U.K. Income Tax Treaty, Art. 5(5)</li><li>▪ Commentary on Article 5(5) of the OECD Model (2014)</li></ul>

# Issue 1, Step 3: Additional Factual Development

## Creation of a PE through the Activities of a Dependent Agent in the United States

### [Issue 1](#)

Fact Element	Resources
<ul style="list-style-type: none"><li>▪ Based on the facts of the subject transaction (see Transaction and Fact Pattern slide), it appears that the contracts are related to FP's business. However, taxpayer financial statements, internet research, and a sampling of contracts may be obtained to confirm that:<ul style="list-style-type: none"><li>– Hotel franchising is a core external operation of FP based on the description of FP's business in its financial statements and based on company research.</li><li>– USS is entering into contracts related to a core external business operation of FP.</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ Taxpayer financial statements (FP financial statements, USS financial statements)</li><li>▪ Sampling of contracts entered into by USS on behalf of FP</li><li>▪ Internet (e.g. Westlaw, Accurint, Bureau van Dijk, Dun &amp; Bradstreet, EDGAR, Other search engines)</li></ul>

# Issue 1, Step 4: Develop Arguments

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 1

Explanation of Adjustment	Resources
<p> <b>DECISION POINT:</b> If the contracts are related to the essential business operations of FP, move on to issue 2. If the contracts are unrelated to the essential business operations, FP may still have a U.S. permanent establishment by carrying on a business in the United States (see Article 5(1) of the U.S.-U.K. Income Tax Treaty).</p> <p>As discussed in Step 1, even if FP does not have a U.S. permanent establishment, certain U.S. source income that FP receives from USS may be subject to U.S. withholding tax.</p> <p>As also discussed Step 1, consider reviewing whether transactions between FP and USS are in accordance with the arm's length principle.</p>	<ul style="list-style-type: none"><li>▪ TE to U.S.-U.K. Income Tax Treaty, Art. 5(5)</li><li>▪ Commentary on Article 5(5) of the OECD Model (2014)</li></ul>

# Issue 2, Step 2: Review Potential Issues

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 2

Does USS habitually exercise its authority to conclude contracts on behalf of FP?

Explanation of Issue	Resources
<p>As discussed in the Issue and Transaction Overview, a foreign enterprise has a U.S. permanent establishment through a dependent agent if the agent habitually exercises its authority to conclude relevant contracts that are binding on the enterprise.</p> <p>If was established in Issue 1 that USS executes contracts which are related to the essential business operations of FP, it now must be determined whether USS habitually exercises its authority to conclude contracts on FP's behalf. Whether or not this is the case should be determined based on the commercial realities of the situation.</p> <p>The extent and frequency of activity necessary to conclude that the agent is "habitually exercising" contracting authority will depend on the nature of the contracts and the business of the foreign principal.</p> <p>An agent shall be considered regularly to exercise authority to negotiate and conclude contracts or regularly to fill orders on behalf of his foreign principal only if the authority is exercised, or the orders are filled, with some frequency over a continuous period of time. An agent shall not be considered regularly to negotiate and conclude contracts on behalf of his foreign principal if the agent's authority to negotiate and conclude contracts is limited only to unusual cases or such authority must be separately secured by the agent from his principal with respect to each transaction effected.</p>	<ul style="list-style-type: none"><li>▪ Commentary on Article 5(5) of the OECD Model (2014)</li><li>▪ Treas. Reg. 1.864-7(d)(1)(ii)</li></ul>

# Issue 2, Step 3: Additional Factual Development

## Creation of a PE through the Activities of a Dependent Agent in the United States

### [Issue 2](#)

Fact Element	Resources
<ul style="list-style-type: none"><li>▪ Review the sampling of contracts and determine whether USS habitually exercises its authority to conclude contracts as compared to the industry and the commercial realities of the situation.<ul style="list-style-type: none"><li>– How many contracts did USS enter into on behalf of FP as compared to other FP agents entering into franchise contracts in other countries?</li><li>– How many contracts did USS enter into compared to prior years?</li><li>– Consult with other IRS teams working in the franchise industry to determine industry norms.</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ Sampling of contracts entered into by USS on behalf of FP</li><li>▪ Sampling of contracts entered into by other FP agents on behalf of FP</li></ul>

# Issue 2, Step 4: Develop Arguments

## Creation of a PE through the Activities of a Dependent Agent in the United States

### [Issue 2](#)

Explanation of Adjustment	Resources
<p> <b>DECISION POINT:</b> If USS habitually exercises its authority to conclude contracts, move on to issue 3. If USS does not habitually exercise its authority to conclude contracts, FP may still have a U.S. permanent establishment by carrying on a business in the United States (see Article 5(1) of the U.S.-U.K. Income Tax Treaty).</p> <p>As discussed in Step 1, even if FP does not have a U.S. permanent establishment, certain U.S. source income that FP receives from USS may be subject to U.S. withholding tax.</p> <p>As also discussed Step 1, consider reviewing whether transactions between FP and USS are in accordance with the arm's length principle.</p>	<ul style="list-style-type: none"><li>▪ Commentary on Article 5(5) of the OECD Model (2014)</li></ul>

# Issue 3, Step 2: Review Potential Issues

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 3

Are the contracts concluded by USS binding on FP?

Explanation of Issue	Resources
<p>As discussed in the Issue and Transaction Overview, a foreign enterprise has a U.S. permanent establishment through a dependent agent if the agent habitually exercises its authority to conclude relevant contracts that are binding on the enterprise.</p> <p>Only agents having the authority to conclude contracts can lead to a permanent establishment for the foreign enterprise maintaining them. In such a case, the agent must have sufficient authority to bind the foreign enterprise's participation in the business activity in the United States.</p> <p>An agent who is authorized to negotiate all elements and details of a contract in a way binding on the foreign enterprise can be said to exercise this authority "in that State," even if that contract is signed by another person or if the agent has not formally been given a power of representation if the other person's responsibilities are merely ministerial. An agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not finalize) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.</p> <p>NOTE: The OECD Model uses the phrase "in the name of the enterprise" rather than the phrase "binding on the foreign enterprise" used in the U.S.-U.K. Income Tax Treaty. There is no substantive difference.</p>	<ul style="list-style-type: none"><li>▪ Commentary on Article 5(5) of the OECD Model (2014)</li><li>▪ TE to U.S.-U.K. Income Tax Treaty, Art. 5(5)</li></ul>

# Issue 3, Step 3: Additional Factual Development

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 3

Fact Element	Resources
<ul style="list-style-type: none"><li>▪ Based on the sampling of contracts, the FP-USS Agreement and employee interviews, evaluate whether USS is authorized to negotiate all elements and details of a contract in a way binding on FP.</li><li>▪ Does FP need to have final approval of the USS contracts?</li><li>▪ Even if USS is required to send all contracts to FP for approval, does FP exercise its authority of final approval (e.g., does it ever amend or cancel contracts entered into by USS)?</li></ul>	<ul style="list-style-type: none"><li>▪ Sampling of contracts entered into by USS on behalf of FP</li><li>▪ FP-USS Agreement</li><li>▪ Employee interviews to determine if USS is authorized to negotiate all elements and details of the contract and whether there is any actual exercise of an approval process by FP</li></ul>

# Issue 3, Step 3: Additional Factual Development (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 3

Fact Element	Resources
<p> <b>CONSULTATION:</b> Consider travel, as necessary to interview relevant officers and employees of FP if discussions with USS employees and officers are inconclusive. Discuss with Exchange of Information (EOI) personnel whether on-site interviews of FP employees may be permitted by the government authorities and whether an invite letter is necessary. Obtain IRS approval using Official Travel Form 1321, an official government passport and travel funds.</p> <p>Consult with the Information Gathering PN reference and resource materials as necessary to decide the appropriate procedures for conducting FP employee interviews and for requesting information. If necessary, customers may be interviewed. Consult with Counsel to determine appropriate summons procedures.</p>	<ul style="list-style-type: none"> <li>▪ IRM 4.10.3.2 - <i>Interviews: Authority and Purpose</i></li> <li>▪ Form 1321 - <i>Authorization for Official Travel</i></li> <li>▪ Practice Unit - <i>Using Alternative Means to Obtain Foreign Based Evidence</i>, DCN: IGI/9460.02_01(2013)</li> <li>▪ Practice Unit - <i>Issuing a Formal Document Request When a US Taxpayer is Unresponsive to an IDR</i>, DCN: IGA/9460.02_02(2013)</li> </ul>

# Issue 3, Step 4: Develop Arguments

## Creation of a PE through the Activities of a Dependent Agent in the United States

### [Issue 3](#)

Explanation of Adjustment	Resources
<p> <b>DECISION POINT:</b> If USS has the authority to bind FP, proceed to Issue 4. If USS does not have the authority to bind FP, FP may still have a U.S. permanent establishment by carrying on a business in the United States (see Article 5(1) of the U.S.-U.K. Income Tax Treaty).</p> <p>As discussed in Step 1, even if FP does not have a U.S. permanent establishment, certain U.S. source income that FP receives from USS may be subject to U.S. withholding tax.</p> <p>As also discussed Step 1, consider reviewing whether transactions between FP and USS are in accordance with the arm's length principle.</p>	<ul style="list-style-type: none"><li>▪ Commentary on Article 5(5) of the OECD Model (2014)</li></ul>

# Issue 4, Step 2: Review Potential Issues

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 4

Is USS a dependent agent of FP?

Explanation of Issue	Resources
<p>As discussed in the Issue and Transaction Overview, a foreign enterprise has a U.S. permanent establishment through a dependent agent if the agent habitually exercises its authority to conclude relevant contracts that are binding on the enterprise.</p> <p>First, determine whether USS is an agent of FP. After determining whether USS is an agent, the question is whether USS is an independent or dependent agent.</p> <p>Under common law, agency is generally defined as the consent by one person to another that the other will act on his behalf and subject to his control and consent by the other so to act.</p> <p>A dependent agent is a person, whether or not an employee of the foreign enterprise, who is not an independent agent. Such persons may be individuals or companies and need not be residents of, nor have a place of business in, the United States.</p> <p>An independent agent is both legally and economically independent of the foreign enterprise. It is a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business in that capacity.</p>	<ul style="list-style-type: none"> <li>▪ Rev. Rul. 74-330 - Foreign Entertainers; 'Single Loan-Out' Arrangement</li> <li>▪ Rev. Rul. 74-331 - Foreign Entertainers; 'Double Loan-Out' Arrangement</li> <li>▪ <i>Handfield v. Comm'r</i> - 23 TC 633 (1955)</li> <li>▪ Commentary on Article 5(5) of the OECD Model (2014)</li> <li>▪ TE to U.S.-U.K. Income Tax Treaty, Art. 5(6)</li> <li>▪ Commentary on Article 5(6) of the OECD Model (2014)</li> <li>▪ <i>Taisei Fire &amp; Marine Ins. Co., Ltd. v. Comm'r</i> - 104 TC 535 (May 2, 1995), acq., AOD CC-1995-012</li> <li>▪ Treas. Reg. 1.864-7(d)</li> </ul>

# Issue 4, Step 2: Review Potential Issues (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

### [Issue 4](#)

Explanation of Issue	Resources
<p><u>Factors Indicating Dependency:</u></p> <p><u>#1: Agent is Subject to Significant Control and Detailed Instruction:</u>            An independent agent will typically be responsible to his foreign principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. The agent will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the foreign enterprise relies on the special skill and knowledge of the agent is an indication of independence.</p> <p><u>#2: Agent Does not Bear Business Risk:</u>            Whether a person is economically independent of the foreign enterprise represented depends on the extent of the obligations which this person has versus the enterprise. An important criterion is whether the business risk is borne by the person or by the foreign enterprise the person represents. 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 foreign enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the foreign principal. Conversely, an agent that bears little or no risk from the activities it performs is not economically independent.</p>	<ul style="list-style-type: none"> <li>▪ Commentary on Article 5(6) of the OECD Model (2014)</li> <li>▪ TE to U.S.-U.K. Income Tax Treaty, Art. 5(6)</li> <li>▪ <i>Taisei Fire &amp; Marine Ins. Co., Ltd. v. Comm'r</i> - 104 TC 535 (May 2, 1995), acq., AOD CC-1995-012</li> </ul>

# Issue 4, Step 2: Review Potential Issues (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

### [Issue 4](#)

Explanation of Issue	Resources
<p><u>Factors Indicating Dependency (cont'd):</u></p> <p><u>#2: Agent Does not Bear Business Risk (cont'd):</u></p> <p>If it is industry practice for the principal to reimburse the agent for certain operating expenses, the payment of such expenses will not indicate that the agent does not bear business risk.</p> <p>If the agent is required to generate business to earn a profit, this indicates that the agent bears business risk.</p> <p>If the agent is able to secure contracts solely due to its relationship with the principal, this indicates that the agent does not bear business risk.</p> <p>If the agent earns a significant portion of the income generated by the contracts, this indicates that the agent bears business risk.</p> <p>If the agent bears the cost of failed contracts or sales, this indicates that the agent bears business risk.</p>	<ul style="list-style-type: none"> <li>▪ <i>Taisei Fire &amp; Marine Ins. Co., Ltd. v. Comm'r</i> - 104 TC 535 (May 2, 1995), acq., AOD CC-1995-012</li> <li>▪ <i>Handfield v. Comm'r</i> - 23 TC 633 (1955)</li> </ul>

# Issue 4, Step 2: Review Potential Issues (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

### [Issue 4](#)

Explanation of Issue	Resources
<p><u>Factors Indicating Dependency (cont'd):</u></p> <p><u>#3: Principal-Agent Exclusive Relationship:</u></p> <p>An exclusive or nearly exclusive relationship with the foreign principal may indicate that the foreign principal has economic control over the agent due to the limited scope of the agent's activities and the agent's dependence on a single source of income. However, an agent may be economically independent notwithstanding an exclusive relationship with the foreign 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.</p> <p>An agent's agreement not to sell competing products, not to enter into contracts with others or not to take a financial interest in a competitor of the foreign principal may indicate that the agent is dependent.</p> <p>The control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent.</p>	<ul style="list-style-type: none"> <li>▪ TE to U.S.-U.K. Income Tax Treaty, Art. 5(6)</li> <li>▪ Commentary on Article 5(6) of the OECD Model (2014)</li> <li>▪ <i>Taisei Fire &amp; Marine Ins. Co., Ltd. v. Comm'r</i> - 104 TC 535 (May 2, 1995), acq., AOD CC-1995-012</li> <li>▪ Rev. Rul. 70-424 - Section 882 - Tax on Income of Foreign Corporations Connected With United States Business.</li> <li>▪ U.S.-U.K. Income Tax Treaty, Art. 5(7)</li> <li>▪ Treas. Reg. 1.864-7(d)(1)(i)</li> </ul>

# Issue 4, Step 3: Additional Factual Development

## Creation of a PE through the Activities of a Dependent Agent in the United States

### [Issue 4](#)

Fact Element	Resources
<p><u>#1: Agent is Subject to Significant Control and Detailed Instruction:</u></p> <ul style="list-style-type: none"><li>▪ Determine whether FP exerts significant control over and provides detailed instructions with respect to the manner in which USS carries out its work.<ul style="list-style-type: none"><li>– Based this on employee interviews, the FP-USS Agreement and USS franchise contracts.</li></ul></li><li>▪ Do FP employees assist with the negotiations?</li><li>▪ Does FP provide detailed instructions on the manner in which to conduct the negotiations?<ul style="list-style-type: none"><li>– Based on employee interviews and company and industry research, consider whether FP relies on USS's special skill and knowledge.</li></ul></li><li>▪ Did USS have experience in the U.S. hotel franchise industry prior to its acquisition by FP?</li><li>▪ Does FP draw on this knowledge?</li><li>▪ Did USS change its manner of conducting business as a result of FP's instruction?</li></ul>	<ul style="list-style-type: none"><li>▪ FP-USS Agreement</li><li>▪ FP and USS employee interviews</li><li>▪ Sampling of franchise contracts entered into by USS on behalf of FP</li><li>▪ Internet (e.g. Westlaw, Accurint, Bureau van Dijk, Dun &amp; Bradstreet, EDGAR, Other search engines)</li></ul>

# Issue 4, Step 3: Additional Factual Development (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 4

Fact Element	Resources
<p><u>#2: Agent Does not Bear Business Risk:</u></p> <ul style="list-style-type: none"> <li>▪ Determine whether USS bears business risk with respect to its negotiation of the franchise contracts.               <ul style="list-style-type: none"> <li>– Does FP reimburse USS’s operating expenses, and if so, is this standard for the industry?</li> </ul> </li> <li>▪ Review the financial statements, tax filings, and the FP-USS Agreement to determine if FP reimburses USS’s operating expenses.</li> <li>▪ Request agreements similar to the FP-USS Agreement entered into between FP and other worldwide affiliates to determine if it is standard practice for FP to reimburse such expenses.</li> <li>▪ Review the FP-USS Agreement to determine if USS is required to generate business to earn a profit; or, does FP bear the cost of failed negotiations/contracts?</li> <li>▪ Conduct company and industry research to determine if USS has a successful business apart from FP.</li> <li>▪ Based on the FP-USS Agreement, tax filings, income statements and a sampling of USS franchise contracts, does USS earn a significant portion of the income generated by the contracts? Or, is USS allocated a relatively minor share of the profits?</li> </ul>	<ul style="list-style-type: none"> <li>▪ Taxpayer financial statements (FP financial statements, USS financial statements)</li> <li>▪ FP’s Form 1120-F - <i>U.S. Income Tax Return of a Foreign Corporation</i></li> <li>▪ FP-USS Agreement</li> <li>▪ Agreements between FP and other worldwide affiliates similar to the FP-USS Agreement</li> <li>▪ Tax planning documents, including slide decks, internal correspondence, tax research, memos, or opinions</li> <li>▪ USS’s Form 1120 - <i>U.S. Corporation Income Tax Return</i></li> <li>▪ Sampling of franchise contracts entered into by USS on behalf of FP</li> <li>▪ Tax planning documents, including slide decks, internal correspondence, tax research, memos, or opinions</li> </ul>

# Issue 4, Step 3: Additional Factual Development (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

### [Issue 4](#)

Fact Element	Resources
<p><u>#3: Principal-Agent Exclusive Relationship:</u></p> <ul style="list-style-type: none"><li>▪ It is very likely that USS, as a wholly-owned subsidiary of FP, has an exclusive relationship with FP. However:<ul style="list-style-type: none"><li>– Review the FP-USS Agreement to determine if USS has agreed to refrain from conducting franchise operations with non-FP clientele.</li><li>– Conduct company research, review financials, and interview employees to determine if USS has the ability to conduct operations for non-FP clientele.</li></ul></li><li>▪ Did USS's business prior to its acquisition by FP involve entering into franchise contracts?</li><li>▪ Does USS rely on FP's expertise or can it conduct its business apart from FP?</li></ul>	<ul style="list-style-type: none"><li>▪ FP-USS Agreement</li><li>▪ Taxpayer financial statements (FP financial statements, USS financial statements)</li><li>▪ Tax planning documents, including slide decks, internal correspondence, tax research, memos, or opinions</li><li>▪ Internet (e.g. Westlaw, Accurint, Bureau van Dijk, Dun &amp; Bradstreet, EDGAR, Other search engines)</li></ul>

# Issue 4, Step 4: Develop Arguments

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 4

Explanation of Adjustment	Resources
<p>Review the information gathered in Steps 1 and 3 and determine if there are facts to support that USS is a dependent agent of FP:</p> <ul style="list-style-type: none"><li>▪ Does FP exert significant control over and provide detailed instruction with respect to the manner in which USS carries out its work? Does FP rely on the unique skills and expertise of USS?</li><li>▪ Does FP bear all business risk with respect to the negotiation of franchise contracts in the United States?</li><li>▪ Is USS reliant on its exclusive relationship with FP for profitability, and/or, is USS limited in its ability to conduct business for anyone other than FP (This may indicate a dependent agent, but must be considered in conjunction with other factors.)?</li></ul>	<ul style="list-style-type: none"><li>▪ U.S.-U.K. Income Tax Treaty, Art. 5(5)-(7)</li><li>▪ Commentary on Article 5(5),(6) the OECD Model (2014)</li><li>▪ TE to U.S.-U.K. Income Tax Treaty, Art. 5(5),(6)</li><li>▪ <i>Taisei Fire &amp; Marine Ins. Co., Ltd. v. Comm’r</i> - 104 TC 535 (May 2, 1995), acq., AOD CC-1995-012</li><li>▪ <i>Handfield v. Comm’r</i> - 23 TC 633 (1955)</li><li>▪ Rev. Rul. 70-424 - Section 882 - Tax on Income of Foreign Corporations Connected With United States Business.</li></ul>

# Issue 4, Step 4: Develop Arguments (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

### Issue 4

Explanation of Adjustment	Resources
<p> <b>DECISION POINT:</b> If, based on the factors set forth in Issue 4, USS is a dependent agent of FP, consider pursuing a position in which FP is deemed to have a permanent establishment in the United States in respect of the activities undertaken by USS.</p> <p>The facts may also lead to the determination that FP has a U.S. permanent establishment by carrying on a business in the United States. This could be the case whether or not USS is a dependent agent or an independent agent*.</p> <p>*Note: There is an exception to the creation of a permanent establishment by an independent agent acting in the ordinary course of its business.</p>	<ul style="list-style-type: none"> <li>▪ U.S.-U.K. Income Tax Treaty, Art. 5(5)-(7)</li> <li>▪ Commentary on Art. 5(5),(6) of the OECD Model</li> <li>▪ TE to the U.S.-U.K. Income Tax Treaty, Art. 5(5),(6)</li> <li>▪ <i>Taisei Fire &amp; Marine Ins. Co., Ltd. v. Comm'r</i> - 104 TC 535 (May 2, 1995), acq., AOD CC-1995-012</li> <li>▪ <i>Handfield v. Comm'r</i> - 23 TC 633 (1955)</li> <li>▪ Rev. Rul. 70-424 - Section 882 - Tax on Income of Foreign Corporations Connected With United States Business.</li> </ul>
<p> <b>CONSULTATION:</b> To the extent that there are strong indicators of a permanent establishment but there is still incomplete information, refer to the Information Gathering PN reference and resource materials, as necessary. Under Article 27 (Exchange of Information and Administrative Assistance) of the U.S.-U.K. Income Tax Treaty, information may be obtained from the United Kingdom about the extent of FP's activities in the United States.</p>	<ul style="list-style-type: none"> <li>▪ IRM 4.60.1 - <i>Exchange of Information</i></li> <li>▪ U.S.-U.K. Income Tax Treaty, Art. 27</li> <li>▪ Practice Unit - <i>Using Alternative Means to Obtain Foreign Based Evidence</i>, DCN: IGI/9460.02_01(2013)</li> </ul>

# Index of Referenced Resources

## Creation of a PE through the Activities of a Dependent Agent in the United States

Form 1042-S - *Foreign Person's U.S. Source Income Subject to Withholding*

Form 1120 - *U.S. Corporation Income Tax Return*

Form 1120-F - *U.S. Income Tax Return of a Foreign Corporation*

Form 1321 - *Authorization for Official Travel*

Form 5472 - *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

Form 8833 - *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b) (Attached to FP's Form 1120-F)*

IRM 4.10.3.2 - *Interviews: Authority and Purpose*

IRM 4.60.1 - *Exchange of Information*

Treas. Reg. 1.864-7(d)

Rev. Rul. 70-424

Rev. Rul. 74-330

Rev. Rul. 74-331

Practice Unit - *FDAP Income*

Practice Unit - *Issuing a Formal Document Request When a US Taxpayer is Unresponsive to an IDR*

Practice Unit - *Using Alternative Means to Obtain Foreign Based Evidence*

# Index of Referenced Resources (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

*Handfield v. Comm'r* - 23 TC 633 (1955)

*Taisei Fire & Marine Ins. Co., Ltd. v. Comm'r* - 104 TC 535 (May 2, 1995), acq., AOD CC-1995-012

Article 5(5) of the U.S.-U.K. Income Tax Treaty

Article 27 of the U.S.-U.K. Income Tax Treaty (Exchange of Information and Administrative Assistance)

Commentary on Article 5(5) of the OECD Model (2014)

Commentary on Article 5(6)-(7) of the OECD Model (2014)

TE to U.S.-U.K. Income Tax Treaty, Art. 5(5)

TE to U.S.-U.K. Income Tax Treaty, Art. 5(6)

Tax planning documents, including slide decks, internal correspondence, tax research, memos, or opinions

Taxpayer financial statements (FP financial statements, USS financial statements)

Transfer pricing documentation

Agreements between FP and other worldwide affiliates similar to the FP-USS Agreement

Organizational charts

Copies of USS invoices issued to customers within the United States related to sales, services, interest, royalties or any other type of income

FP-USS Agreement

# Index of Referenced Resources (cont'd)

## Creation of a PE through the Activities of a Dependent Agent in the United States

Sampling of contracts entered into by other FP agents on behalf of FP

Sampling of contracts entered into by USS on behalf of FP

Sampling of franchise contracts entered into by USS on behalf of FP

Employee interviews to determine if USS is authorized to negotiate all elements and details of the contract and whether there is any actual exercise of an approval process by FP

IRS Internal Research Tools: (Information Document Retrieval System (IDRS), YK1, LB&I Imaging Network (LIN), Governmental Liaison

# Training and Additional Resources

Creation of a PE through the Activities of a Dependent Agent in the United States	
Type of Resource	Description(s)
SABA sessions	<ul style="list-style-type: none"> <li>▪ <i>Intro to Treaties</i> - 2015 Centra</li> <li>▪ <i>IBC Aspects of Treaties</i> - 2014 Centra</li> <li>▪ <i>IBC 2011 CPE - Jurisdiction to Tax</i> - 2011 CPE Centra</li> </ul>
Other Training	<ul style="list-style-type: none"> <li>▪ 2011 International Training Phase II Module F (Taxation of Foreign Corporations)</li> </ul>
Reference Materials	<ul style="list-style-type: none"> <li>▪ Pub. 901 - <i>U.S. Tax Treaties</i></li> <li>▪ International Bureau of Fiscal Documentation (IBFD) Tax Treaties Database (Westlaw)</li> <li>▪ <i>Anderson - Analysis of United States Treaties</i> Chapter 3 (Definition of "Permanent Establishment")</li> <li>▪ <i>Kuntz &amp; Peroni - U.S. International Taxation</i> Para. C4.05 (Business Profits and Permanent Establishments)</li> </ul>

# Glossary of Terms and Acronyms

Term/Acronym	Definition
EOI	Exchange of Information
FDAP	Fixed, Determinable, Annual, and Periodical
FP	Foreign Parent
IDR	Information Document Request
IRM	Internal Revenue Manual
JTT	Jurisdiction to Tax
OECD	Organization for Economic Cooperation and Development
OECD Model	OECD Model Tax Convention on Income and on Capital
PE	Permanent Establishment
PN	Practice Network
USS	U.S. Subsidiary

# Index of Related Practice Units

<b>Associated UIL(s)</b>	<b>Related Practice Unit</b>	<b>DCN</b>
9450.07	<i>Creation of a Permanent Establishment (PE) through the Activities of Seconded Employees in the United States</i>	TRE/T/16_06-01
9450.07	<i>Preparatory and Auxiliary Treaty Exception to Permanent Establishment Status</i>	TRE/T/16_07-03
9424.01	<i>FDAP Income</i>	RPW/C/08_01-01(2016)
9460.02	<i>Issuing a Formal Document Request When a US Taxpayer is Unresponsive to an IDR</i>	IGA/9460.02_02(2013)
9460.02	<i>Using Alternative Means to Obtain Foreign Based Evidence</i>	IGI/9460.02_01(2013)