Do You Have Business Profits From a United States Permanent Establishment?

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One of the most common issues which arises in the international tax planning area is whether a foreign person or entity is subject to U.S. income tax as a result of his or its U.S.-based business activities. The Internal Revenue Code and the Treasury Regulations include a complex set of rules for purposes of making this determination, which are further interpreted by various U.S. court cases. However, foreigners who qualify for benefits under a bilateral United States income tax convention (for example, the U.S. treaties with Barbados, Jamaica, and Trinidad and Tobago) may elect to apply a somewhat different set of U.S. taxation rules. In this regard, the use of certain "business profits" and "permanent establishment" treaty provisions may in effect permit the avoidance of U.S. income taxes that would otherwise be due in the absence of these provisions.

In general, foreign persons are subject to U.S. income tax on "effectively connected income" generated by the conduct of a trade or business in the United States. A U.S. trade or business may exist for such purposes either through direct U.S.-based activities or through those of a U.S. "dependent agent," among other potential circumstances. A typical scenario giving rise to U.S. income tax occurs where either the foreign person or his dependent agent has a U.S. office or fixed place of business from which the business activities emanate.

In contrast, the permanent establishment concept is often more flexible than these general rules, and may allow for a higher degree of business activity without causing the imposition of tax. Most U.S. income tax treaties provide that an "enterprise" of one treaty country is only taxable in the other treaty country if either the enterprise or its dependent agent has a "permanent establishment" in the other treaty country to which certain "business profits" are attributable. The types of income which constitute business profits vary substantially between different treaties.

U.S. tax treaty permanent establishment articles generally include three separate tests to determine whether an enterprise of one treaty country has a sufficient presence in the other treaty country to qualify as a permanent establishment: an asset test, an agency test, and an activity test. The details of these tests differ from treaty to treaty, and each one must be individually analyzed to determine the potential applicability of such tests to a particular fact situation. For example, under the activity test of the U.S.-Jamaica income tax treaty, certain U.S.-based warehouse, research, and showroom-type activities and facilities are not deemed to be U.S. permanent establishments. This treaty provision may be utilized in appropriate circumstances to

establish a U.S. base for a Jamaican company without the fear of creating a related U.S. tax liability.

Due to the obvious potential repercussions of not having a proper and thorough understanding of these permanent establishment rules, business planners should be extremely careful to review any potentially applicable tax treaty to avoid unanticipated results. Ongoing U.S. professional tax advice is highly recommended to continually determine whether the foreign enterprise's U.S. activities fall within these rules. In addition, consultations with local fiscal experts are essential to ensure the achievement of the lowest possible overall tax liability.