



**A Unified Approach to
Permanent Establishment by
Agent in the U.S.**

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Reprinted from *Tax Notes Int'l*, November 5, 2007, p. 597

Special Reports



A Unified Approach to Permanent Establishment by Agent in the U.S.

by Martin B. Tittle

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Permanent establishment is a tax treaty concept that raises the bar for taxation of foreign companies that do business in the United States. If there is no treaty between the U.S. and the country associated with the foreign company, the U.S. will tax that company's effectively connected income if it is engaged in a U.S. trade or business. If there is a treaty, however, a company may have a U.S. trade or business and still avoid taxation as long as it does not have a PE.

A PE is usually defined as a fixed place of business, like an office or factory. However, a PE can also be created in the absence of a fixed place of business by an agent if the agent is "other than an agent of independent status." For linguistic convenience, such agents are usually called dependent agents.

The rules regarding dependent and independent agents are typically set forth in separate paragraphs

in a tax treaty, and dependent and independent agents are usually discussed and analyzed as if they were separate concepts. That approach is less than ideal because it leaves the reader to cobble together the dividing line between the two.

This article illustrates a unified approach to the issue of agency PE using Article V of the 1980 Canada-U.S. tax treaty¹ as a case study. It begins by defining the terms and phrases in the dependent and independent agent paragraphs of the 1980 treaty. Then it compares those paragraphs with the parallel provisions in the [OECD](#) and [U.S.](#) model treaties and reviews the guidance in the [OECD commentaries](#) and the [model technical explanation that accompanies the U.S. model](#). Finally, the article synthesizes the six elements of agency PE, proposes an order in which they should be evaluated, and explores the relevant cases, rulings, and secondary authorities that flesh out their scope and meaning.

¹A Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital, Signed at Washington on September 26, 1980, as Amended by the Protocols Signed on June 14, 1983, and March 28, 1984, June 13, 1995, and July 29, 1997 (1980 treaty), Art. V, available at <http://www.irs.gov/pub/irs-trty/canada.pdf> (last visited Sept. 17, 2007). The latest protocol, signed September 21, 2007, did not change the independent or dependent agent paragraphs in Article V.

Agency Provisions

The dependent and independent agent provisions in Article V, paragraphs 5 and 7 of the 1980 treaty are typical of those included in recent U.S. treaties. They read as follows:

5. A person acting in a Contracting State on behalf of a resident of the other Contracting State — other than an agent of an independent status to whom paragraph 7 applies — shall be deemed to be a permanent establishment in the first-mentioned State if such person has, and habitually exercises in that State, an authority to conclude contracts in the name of the resident.

7. A resident of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident carries on business in that other 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.

Definitions of Terms

The first order of business in interpreting a tax treaty provision, or any statutory provision for that matter, is to define the terms and phrases in it. There are six important phrases that are unique to these paragraphs. Four are in paragraph 7: “broker,” “general commission agent,” “agent of an independent status,” and “acting in the ordinary course of their business.” The remaining two are in paragraph 5: “person . . . other than an agent of an independent status” and “has, and habitually exercises . . . an authority to conclude contracts.”

None of these phrases are defined in the 1980 treaty, and therefore, according to Article III, paragraph 2 of the treaty, their meanings for U.S. purposes are, with limited exceptions, taken from the meanings currently given to them in U.S. income tax laws. The first of the two phrases in paragraph 5 — “person . . . other than an agent of an independent status” — should be self-defining as the negative, or opposite, of “agent of an independent status.”

All five of the remaining terms are defined in connection with the “Source Rules and Other General Rules Relating to Foreign Income” that make up Part I of U.S. Internal Revenue Code subchapter N (sections 861-865). Treas. reg. section 1.864-7(d)(3)(i) identifies the first three — “broker,” “general commission agent,” and “agent of an independent status” — as synonyms for the term “independent agent” to the extent that those individuals or entities “act in the ordinary course of [their] business.” Then it brings in the fourth term in an example of an “independent agent . . . acting in

the ordinary course of his business in that capacity [i.e., the capacity of ‘independent agent’]”:

[A]n 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.

The reason for defining an independent agent in Treas. reg. section 1.864-7 is to allow its office/fixed place of business to be excluded as a domestic office of the independent agent’s foreign principal. An office not so excluded would expose the foreign principal to tax on non-U.S.-source income and gain that is effectively connected to its U.S. office.

Subparagraph (d)(3) of Treas. reg. section 1.864-7 continues with two more subsections: one regarding the ability of related persons to be independent agents, and a second regarding “otherwise” independent agents who “act in such capacity exclusively, or almost exclusively, for one principal”:

(ii) Related persons. 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. The facts and circumstances of a specific case shall determine whether the agent, while acting for his principal, is acting in pursuance of his usual trade or business and in such manner as to constitute him an independent agent in his relations with the nonresident alien individual or foreign corporation.

(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.

Subparagraph (d)(1) of Treas. reg. section 1.864-7, titled “Dependent Agents,” states two alternative criteria that govern whether the office of “an agent who is not an independent agent” will be attributed to its principal. The first of those criteria is a fair restatement of the last of the five phrases to be

defined: “has, and habitually exercises . . . an authority to conclude contracts.” In the words of subparagraph (d)(1), the agent must first “[have] the authority to negotiate and conclude contracts in the name of the [foreign principal],” and then it must “regularly exercise that authority.” The second criterion, which appears in some older treaties but not in the 1980 treaty, is possession of a stock of merchandise belonging to the foreign principal from which orders are regularly filled on behalf of the principal.

Subparagraph (d)(1)(ii) sets the standards for both attribution criteria:

[A]n agent shall be considered regularly to exercise authority to negotiate and conclude contracts or regularly 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*. This determination shall be made on the basis of the *facts and circumstances* in each case, taking into account the nature of the business of the principal; but, in all cases, the frequency and continuity tests are to be applied conjunctively. Regularity shall not be evidenced by occasional or incidental activity. 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. [Emphasis added.]

The facts and circumstances standard is paramount. Merely satisfying the “authority to negotiate and conclude” and “regular exercise” criteria is not enough to make an agent dependent. Independent agents can regularly conclude contracts for the principal without endangering their independence. What makes an agent dependent is the fact that, in its relationship with the principal, it is not running its own business, but rather is just serving as a domestic surrogate.

An employee is usually treated as a dependent agent under the rules in subparagraph (d)(1) if her foreign employer does not have an office or fixed place of business in the United States. However, if the employer *does* have an office and the employee usually works in that office, then the employer will be taxable by virtue of the office, and whether the employee also satisfies the dependent agent criteria is irrelevant.

The technical explanation to the 1980 treaty makes clear that a dependent agent does not have to maintain an office or other fixed place of business for its activities to constitute a PE of its principal. This is diametrically different from the standard in

Treas. reg. section 1.864-7(d)(1)(i), which requires that a dependent agent have an office for the principal to be deemed to have an office or other fixed place of business.

What makes an agent dependent is the fact that, in its relationship with the principal, it is not running its own business, but rather is just serving as a domestic surrogate.

The difference is not just a matter of the substitution of language, with the 1980 treaty referring to a PE and 1.864-7(d)(1)(i) referring to an “office or other fixed place of business.” In the Treasury regulation, a dependent agent must *have* an office for the foreign principal to be deemed to have one. If the 1980 treaty were perfectly parallel, it would say that a dependent agent must *have* a PE, which would then be attributed to the foreign principal. Instead, the treaty says a dependent agent *is* a PE — apparently a “walking, talking,” fully mobile PE — of the foreign principal.

The OECD Commentary

Having defined the relevant terms, the next step is to compare Article V, paragraphs 5 and 7 in the 1980 treaty with the parallel provisions in the OECD and U.S. model tax treaties. Comparison with the OECD model is relevant because the commentaries on the OECD model are sometimes applied by both U.S. courts and the IRS in interpreting the PE articles of U.S. tax treaties. The same is true of the U.S. model and the accompanying technical explanation.

When using either the OECD model or the OECD commentaries as authority, note that the changes made in these documents from time to time do not necessarily indicate that the “previous wording resulted in consequences different from those of the modified wording. Many amendments are intended to simply clarify, not change, the meaning of the articles or the commentaries, and such a *contrario* interpretations would clearly be wrong in those cases.”

OECD model Article V, paragraph 6 — the independent agent paragraph — is very similar to Article V, paragraph 7 of the 1980 treaty, bearing in mind the 1980 treaty’s substitution of “resident of a Contracting State” for the OECD model’s term “enterprise.” It reads as follows:

6. 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.

OECD model Article V, paragraph 5 is organized differently from Article V, paragraph 5 in the 1980 treaty in that it includes both the dependent agent provision and a reference to other, related provisions that appear in Article V, paragraph 6 of the 1980 treaty. It reads as follows:

5. Notwithstanding the provisions of paragraphs 1 and 2 [the basic “fixed place of business” PE rule and the “deemed PE” exemplars], where a person — other than an agent of an 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 which that person undertakes for the enterprise, unless the activities of such person are limited to those 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.

The OECD commentary on Article V, paragraphs 5 and 6 is extensive. The following annotated version of it includes, in the footnotes, cross-references to parallel language in the model technical explanation as well as citations to cases that illustrate or rely on the commentary.

The OECD commentary regarding Article V, paragraph 6 is presented first because a PE-by-agent analysis needs to begin with the question, “Is the putative agent independent?” Only if an agent fails to qualify as independent will the analysis proceed to dependence issues and factors. The numbers preceding each paragraph are the paragraph numbers from the portion of the commentary that addresses Article V. Italicized words and phrases in the commentary are emphases inserted by the author unless otherwise noted.

36. [The basic rule for independent agents.] Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status,² it cannot be taxed in

²See *de Amodio v. Comm’r*, 34 T.C. 894, 909 (1960) (finding (1) that Amodio had no PE because the agent dealing with Amodio’s real properties was “a broker or independent agent acting in the ordinary course of his business as such”; (2) that Amodio was therefore entitled to a preferential treaty rate on
(Footnote continued in next column.)

the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business (cf. paragraph 32 above).³ Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article [model Art. V] for the sake of clarity and emphasis.

37. [The standards to be applied.] 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*,⁴ and
- b) he acts in the *ordinary course of his business* when acting on behalf of the enterprise.⁵ [Emphasis added.]

38. [Basic criteria for the two independence standards.] 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.⁶ Another important criterion will be whether the *entrepreneurial risk* has to be borne by the person or by the enterprise the person represents.⁷ [Emphasis added.]

38.1 [Parent-subsidiary note.] In relation to the test of legal dependence, it should be noted that 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. This is

interest and dividends; and (3) that Amodio’s gains from sale of U.S. real property were nevertheless taxable even in the absence of a PE).

³Cf. model technical explanation, *infra*, at text accompanying note 21.

⁴See *Taisei Fire and Marine Ins. Co. v. Comm’r*, 104 T.C. 535, 552-556 (1995) (applying the legal and economic independence standards in the context of a U.S. reinsurer and four Japanese insurance companies that were unrelated both with respect to each other and with respect to the U.S. reinsurer).

⁵Cf. model technical explanation, *infra*, at text accompanying note 22.

⁶Cf. model technical explanation, *infra*, at text accompanying note 23.

⁷The model technical explanation addresses this issue more expansively. See *infra* text accompanying note 24.

consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.⁸

38.2 [Additional independence criteria.] The following considerations should be borne in mind when determining whether an agent may be considered to be independent.

38.3 [Legal independence: results vs. manner.] An independent agent will typically be responsible to his 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.⁹ He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

38.4 [Legal independence: freedom within the scope of authority.] Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.¹⁰

38.5 [Legal independence: provision of information.] It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in

the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

38.6 [Economic independence: multiple principals.] Another factor to be considered in determining independent status is the *number of principals* represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.¹¹ [Emphasis added.]

38.7 [Partial independence: effect of mixing dependent and independent activities.] 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. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed *in respect of this particular activity* to be a permanent establishment,¹² since he is

⁸This sentence is correct as far as it goes, but it should be noted that paragraph 41 also indicates that a subsidiary will not create a dependent-agent PE for its parent if it "acts in the ordinary course of its business as an independent agent." See OECD commentary at Art. V, para. 41. See also paragraph 38.7 of the commentary to Art. V, in the text accompanying notes 12-13, which discusses the effect of a single agent who acts both independently and dependently regarding different activities.

⁹See *Taisei*, *supra* note 4, at 541, 552 (stating that "[i]t is freedom in the manner by which the agent performs [his] duties that distinguishes him as independent," and noting that the only restrictive duty in this case was the net acceptance limit imposed by the contract with each Japanese insurance company).

¹⁰*Id.*

¹¹*Cf.* model technical explanation, *infra*, at text accompanying note 25.

¹²*But cf.* OECD commentary at Art. V, para. 30 (setting a different standard for "general rule," fixed place of business PEs, namely that performance of "PE-free" activities (as enumerated in OECD model Art. V(4)) in a fixed place of business that otherwise qualifies as a PE causes the PE-free activities to lose that character and become taxable under Art. VII — Taxation of Business Profits) and Treas. reg. section 1.864-7(d)(2).

thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.¹³ [Emphasis added.]

38.8 [Defining “ordinary course of business.”] In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent’s trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent’s trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent’s activities do not relate to a common trade.

39. [Special rule for insurance companies.] According to the definition of the term “permanent establishment” an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 [of article V] or if it carries on business through a person within the meaning of paragraph 5 [that is, through a dependent agent]. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD Member countries include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of

this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

Regarding OECD model Article V, paragraph 5, which addresses dependent agents, the commentary says:

31. [The basic rule for dependent agents.] It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2 [of Article V]. This provision intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. The paragraph was redrafted in the 1977 Model Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.

32. [The standards to be applied.] Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents, i.e. persons, *whether or not employees of the enterprise*, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies and need not be residents of, nor have a place of business in, the State in which they act for the enterprise. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities *in* the State concerned.¹⁴ Therefore, paragraph 5 proceeds on the basis that only persons having the *authority to conclude contracts* can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise’s participation in the business activity in the

¹³See *infra* text accompanying note 19. In the second sentence of paragraph 38.7, the “activities . . . mentioned at the end of paragraph 5” are the PE-free exceptions that are included in Art. V(6) of the 1980 treaty and Art. V(4) of the OECD model.

¹⁴See Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, 547 (1991) (noting that the concept of PE is intended to address trade *in* a state, not trade *with* a state).

State concerned.¹⁵ The use of the term “permanent establishment” in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases. [Emphasis added.]

32.1 [Dependence factors.] Also, the phrase “authority to conclude contracts in the name of the enterprise” does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; 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. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise *routinely approves* the transactions. [Emphasis added.]

33. [More dependence factors.] The authority to conclude contracts must cover contracts *relating to operations which constitute the business proper* of the enterprise.¹⁶ It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person’s activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only.¹⁷ Moreover the authority has to be *habitually exercised* in the other State; whether or not this is the case should be *determined on the basis of the commercial realities* of the situation. A person who is *authorised to negotiate all elements and details* of a contract in a way binding on the enterprise can be said to exercise this authority “in that State,” even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that

the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise. Since, by virtue of paragraph 4 [which lists types of activities that will not be considered PEs], the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.¹⁸ [Emphasis added.]

33.1 [What is “habitual exercise”?] The requirement that an agent must “habitually” exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. 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 principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 [the independent agent paragraph in the OECD model] would be relevant in making that determination.

34. [Extent of dependence, once established.] Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a person exercises the authority to conclude contracts in the name of the enterprise.¹⁹

35. [Fixed place of business overrides agency determination.] Under paragraph 5, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in

¹⁵The model technical explanation quotes the last part of this sentence. See *infra* text accompanying note 27.

¹⁶*Cf.* model technical explanation, *infra*, at text accompanying note 28.

¹⁷*Cf.* model technical explanation, *infra*, at text accompanying note 29.

¹⁸ *Cf.* model technical explanation, *infra*, at text accompanying note 26.

¹⁹*Cf. supra* text accompanying note 13 (noting, in paragraph 38.7 of the OECD commentary to Art. V, that if a dependent agent also acts as an independent agent for the same principal, he would be deemed to be a PE only with respect to his dependent agent activities).

mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.²⁰

The U.S. Model Treaty

The independent and dependent agent paragraphs in the U.S. model are almost identical to those in the OECD model. U.S. model Article V, paragraph 6, the independent agent paragraph, adds the words “as independent agents” to the end of the paragraph, making the final clause read “provided that such persons are acting in the ordinary course of their business *as independent agents*.” (Emphasis added.) U.S. model Article V, paragraph 5, the dependent agent paragraph, makes only one, nonsubstantive change in the middle of the paragraph: The OECD clause “authority to conclude contracts *in the name of* the enterprise” is changed to read “authority to conclude contracts *that are binding on* the enterprise.” (Emphasis added.)

The model technical explanation is generally much less expansive regarding agency than the OECD commentary.

The model technical explanation is generally much less expansive regarding agency than the OECD commentary. Passages in the model technical explanation that are also addressed by the commentary are identified with cross-referencing footnotes.

Regarding U.S. model Article V, paragraph 6, the independent agent paragraph, the model technical explanation says:

Under paragraph 6, an enterprise is not deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as an independent agent.²¹ Thus, there are two conditions that must be satisfied: the agent must be both legally and economically independent of the

enterprise, and the agent must be acting in the ordinary course of its business in carrying out activities on behalf of the enterprise.²²

Whether the agent and the enterprise are independent is a factual determination. Among the questions to be considered are the extent to which the agent operates on the basis of instructions from the enterprise. An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.²³

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 the activities it performs is not economically independent and therefore is not described in paragraph 6.²⁴

Another relevant factor in determining whether an agent is economically independent is whether the agent has an exclusive or nearly exclusive relationship with the principal. Such a relationship may indicate that the principal has economic control over the agent. A number of principals acting in concert also may have economic control over an agent. 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

²²Cf. OECD commentary, *supra*, at text accompanying note 5.

²³Cf. OECD commentary, *supra*, at text accompanying note 6.

²⁴Cf. OECD commentary, *supra*, at text accompanying note 7.

²⁰Cf. Treas. reg. section 1.864-7(e).

²¹Cf. OECD commentary, *supra*, at text accompanying note 3.

case must be addressed on the basis of its own facts and circumstances.²⁵

Regarding U.S. model Article V, paragraph 5, the dependent agent paragraph, the technical explanation says:

Paragraphs 5 and 6 specify when activities carried on by an agent on behalf of an enterprise create a permanent establishment of that enterprise. Under paragraph 5, a dependent agent of an enterprise is *deemed to be* a permanent establishment of the enterprise if the agent has and habitually exercises an authority to conclude contracts that are binding on the enterprise. If, however, his activities are limited to those activities specified in paragraph 4 which would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the agent is not a permanent establishment of the enterprise.²⁶ [Emphasis added.]

The OECD Model uses the term “in the name of that enterprise” rather than “binding on the enterprise” [which, as noted, is the comparable phrase used in the U.S. model]. This difference is intended to be a clarification rather than a substantive difference. As indicated in paragraph 32 to the OECD Commentaries on Article 5,²⁷ paragraph 5 of the Article is intended to encompass persons who have “sufficient authority to bind the enterprise’s participation in the business activity in the State concerned.”

The contracts referred to in paragraph 5 are those relating to the essential business operations of the enterprise, rather than ancillary activities.²⁸ For example, if the agent has no authority to conclude contracts in the name of the enterprise with its customers for, say, the sale of the goods produced by the enterprise, but it can enter into service contracts in the name of the enterprise for the enterprise’s business equipment used in the agent’s office, this contracting authority would not fall within the scope of the paragraph, even if exercised regularly.²⁹

²⁵*Cf.* OECD commentary, *supra*, at text accompanying note 11.

²⁶*See* 1980 treaty at Art. V(6); *cf.* OECD commentary, *supra*, at text accompanying note 18.

²⁷*See supra* text accompanying notes 14-15.

²⁸*Cf.* OECD commentary, *supra*, at text accompanying note 16.

²⁹*Cf.* OECD commentary, *supra*, at text accompanying note 17.

There is one additional model authority that may be consulted for additional information on agency concepts in U.S. law: the *Restatement of the Law (Third) Agency*, published by the American Law Institute. The IRS has, in the past, occasionally cited an earlier version of the *Restatement* in interpreting the PE articles of U.S. tax treaties.

The Six Elements

As the definitions and model treaty interpretations make clear, there are six elements to be evaluated in making an agency determination. The first three are the criteria for an independent agent: legal independence, economic independence, and acting in the ordinary course of the agent’s business. An independent agent must satisfy all three of the criteria. If it fails any one of them, it cannot be an independent agent and the analysis continues to the three dependent agent elements: authority to contract, habitual use of that authority, and the subject of the contracts, which must be the principal or core business of the principal.

Usually, if evaluation of the first three elements shows the agent to be independent, the analysis will stop because the definition of a dependent agent in Article V, paragraph 5 of the 1980 treaty excludes independent agents. However, as noted, paragraph 38.7 of the OECD commentary to Article V takes a different position, saying that it is possible for an independent agent to also be a dependent agent if it satisfies the three dependence elements and acts outside the ordinary course of its business.

The Independence Elements

Legal Independence

The first independence element — legal independence — requires that the agent be “responsible to his principal for the result of his work but not subject to significant control with respect to the manner in which that work is carried out,” according to OECD Article V commentary, paragraph 38.3. Detailed instructions from the principal, or comprehensive control by it, are not compatible with independence.

In *Taisei*, for instance, when one of the four Japanese insurance companies represented by U.S. reinsurance agent Fortress Re requested insertion of a clause in its contract that would restrict Fortress’s freedom regarding gross acceptance limits, Fortress refused, and the company acquiesced.³⁰ On another occasion, Fortress insisted on retroceding a larger percentage of the reinsurance contracts it handled to one of its subsidiaries, despite objections from three of the four Japanese companies. Based on

³⁰*See Taisei, supra* note 4, at 541.

these and other similar examples of independence, the U.S. Tax Court concluded that “[a]s an agent, Fortress had complete discretion over the details of its work. As an entity, Fortress was subject to no external control. In sum, Fortress was legally independent of petitioners.”

Rev. Rul. 90-80, 1990-2 C.B. 170, presents an almost exact opposite of *Taisei* in its second set of facts. D, a foreign citizen and resident, contracts with C, a U.S. citizen and resident, for C to execute barter transactions in the U.S. using D’s funds. “C will act only on behalf of D in these transactions, will be under D’s management and control, and will have no other employment during 1989.” The ruling concludes that “C is not an independent agent because C has no other employment during 1989 and is under D’s management and control. Therefore, under Article 5 of the [1981 U.S. model tax] Convention, D has a permanent establishment in the United States in 1989 by virtue of the activities C undertakes for D.”

In an analogous nontreaty context, Inverworld Inc. (INC), a U.S. subsidiary of Inverworld Ltd., a Cayman Islands corporation, was limited in its selection of the banks from which it could purchase certificates of deposit and term deposits by detailed instructions from Inver Group’s executive committee. Those instructions included criteria “relating to the bank’s size, equity, profitability, size of deposits, assets and liabilities ratios, and standing with the FDIC or FSLIC.”³¹ Based on this and similar facts, the Tax Court concluded “that INC was not an ‘independent agent’ within the meaning of section 1.864-7(d)(3), Income Tax Regs.”

An untitled 1992 field service advisory that includes factors illustrating legal independence is discussed separately at the end of the “Independence Elements” subsection.

Economic Independence

The second independence element — economic independence — requires both that the agent not be insulated from economic risk and that the agent not be too heavily reliant on any one principal. These aspects of economic independence are frequently evaluated in terms of the entrepreneurial risk the agent bears and the number of principals it serves. OECD Article V commentary, paragraphs 38 and 38.6.

Economic independence was an issue in *Taisei*. The IRS argued against reinsurance agent Fortress Re’s economic independence, saying that it “bore no entrepreneurial risk because its operating expenses

were covered by a management fee, and because it was guaranteed business due to the creditworthiness of the [four Japanese] reinsurers on whose behalf it acted.”

Economic independence requires both that the agent not be insulated from economic risk and that the agent not be too heavily reliant on any one principal.

The Tax Court rebutted both these arguments, saying that Fortress had to acquire sufficient business to produce the gross premiums on which its management fee was based and that Fortress’s experience, ability, and access to profitable reinsurance contracts would attract other clients should one of the Japanese companies choose to terminate its contract. The fact that Fortress had turned down overtures from a fifth Japanese insurance company in the recent past buttressed the latter point.

The court also noted that Fortress had been paid an average of \$9 million per year by the four Japanese companies, and it said this was “not the kind of sum paid to a subservient company.” Therefore, the court concluded that Fortress was economically independent of its principals.

LTR 7816031 (Jan. 18, 1978) provides a different, more technical slant on economic independence. A British Columbia corporation (CanCo) that had been giving its U.S. subsidiary (USCo) a commission on U.S. sales decided to switch to a consignment arrangement. Goods would be shipped to strategic locations in the U.S. and stored in public warehouses at USCo’s expense. Title would remain with CanCo until just before a sale, at which time it would pass to USCo in exchange for an arm’s-length price. USCo would set its own prices and not have to account for proceeds from its sales to CanCo.

The IRS noted that a similar structure involving a Canadian company and an unrelated U.S. trading company had been analyzed in Rev. Rul. 63-113, 1963-1 C.B. 410. That ruling held that:

under the concepts of the [1942 Canada-U.S. treaty], the absence of a [PE], on the part of an enterprise having business dealings in the country concerned, is based in part upon the premise that such business dealings are through a commission agent, broker or other independent agent. Under the agreement in the instant case, it is doubtful that even such a limited [independent] agency is established. It is clear, however, that no general [that is, dependent] agency is established. Instead, the relationship between the [Canadian] corporation and the [U.S.] company is more in the

³¹*Inverworld, Inc. v. Comm’r*, T.C. Memo. 1996-301, 71 T.C.M. 3231, 3237-7.

nature of seller and purchaser, since the power the company has in determining when title to the consigned goods passes from the corporation is exercisable only as a purchaser.

The same conclusion was applied to CanCo and USCo.

If title had never passed to USCo, but instead had remained with CanCo when USCo sold the goods, then USCo would have been deemed CanCo's dependent agent and CanCo would have had a U.S. PE.

Two nontreaty examples are also helpful in fleshing out the U.S. interpretation of economic independence. In Rev. Rul. 70-424, 1970-2 C.B. 150, a U.S. corporation, Q, agreed with an unrelated foreign corporation, M, that it would:

- be M's only agent in the U.S.;
- not sell the same kind of products of any other company except with M's express permission;
- not take a financial interest in any competitor of M;
- not sell M's products outside the U.S. or to any competitor of M without express permission;
- assume full responsibility for the sales of M's product and act as guarantor; and
- accept M's partial indemnification for loss in any single year of the contract.

Based on these facts, the IRS determined that "the arrangement is one of ordinary principal and [dependent] agent through which M carries on its activities in the United States and thus is engaged in trade or business within the United States. M is, therefore, subject to the provisions of section 882 of the Internal Revenue Code of 1954."

The first two factors above have sometimes been confused because they both involve exclusivity. Regarding the first, the fact that Q is M's only U.S. agent has no bearing on Q's economic independence, TAM 8147001 (Jan. 3, 1979) notwithstanding. If it did, then every small foreign manufacturer that agrees to sell exclusively in the U.S. through Wal-Mart or another large retailer would be in danger of having a dependent-agent PE. It is the second factor — the agreement not to sell competing products — that, with other factors, saps Q's economic independence.

In *Inverworld*, the second nontreaty example, the Tax Court used the following analysis as partial support for its holding that Inverworld Inc. (INC) was a dependent agent of its Cayman Islands parent, Inverworld Ltd. (LTD):

The record shows that INC had few clients other than LTD and LTD's clients. The services that INC performed were almost exclusively for LTD, such as bookkeeping, effecting trades in securities, generating client statements, and

effecting currency exchange transactions. The percentage of INC's gross revenues derived from LTD were as follows: 94.1 percent in 1985, 99.1 percent in 1986, 91.8 percent in 1987, 94.0 percent in 1988, and 95.8 percent in 1989. Moreover, the record does not establish that INC marketed its services to clients on its own. Based on the record in the instant case, we conclude that INC was not an "independent agent" within the meaning of section 1.864-7(d)(3), Income Tax Regs.³²

An untitled IRS 1992 field service advisory that includes factors illustrating economic independence is discussed separately at the end of the "Independence Elements" subsection.

Ordinary Course of Business

The final independence element — whether a legally and economically independent agent is acting in the "ordinary course of [its] business" — is frequently a nonissue in U.S. treaty jurisprudence and agency rulings. For example, in *Taisei*, the landmark case discussed above, the IRS simply conceded that Fortress Re was acting in the ordinary course of its business in contracting with the four Japanese insurance companies.³³

When "ordinary course" *does* have to be addressed, it is frequently decided summarily. For instance, Rev. Rul. 55-617, 1955-2 C.B. 774, says simply:

[a Belgian] corporation does extensive business in the United States through the medium of a commission agent and thus is engaged in trade or business within the United States. . . . Article II(1)(f) of the [Belgium-U.S. tax treaty] provides . . . [that an] enterprise of one of the contracting States shall not be deemed to have a [PE] in the other contracting State merely because it carries on business dealings in such other contracting State through a bona fide commission agent or broker acting in the ordinary course of his business as such. . . . Accordingly, it is held that a Belgian corporation constituting a Belgian enterprise, selling all or some of its products in the United States through the medium of a commission agent acting in the ordinary course of his business as such, and having no permanent establishment in the United States, is exempt, under the provisions of Article III of the [treaty] from United States tax."

³²*Id.* at 3237-20.

³³See *Taisei*, *supra* note 4, at 554.

LTR 7739020 (June 29, 1977) contains more than conclusions, but just barely. X, a German association, buys from Z, a U.S. corporation, computer hardware that Z has leased to M, another U.S. corporation. X appoints N as its agent “to receive the rental income and to make certain disbursements,” and it “grant[s] certain contingent authority to Z for purpose of effectuating a sale or a re-lease of the Equipment in the event of non-renewal of the lease with M pursuant to the provisions of a written remarketing agreement.”

In concluding that N and Z will be operating in the ordinary course of business, the ruling relies on the following statements: “It is represented that both N and Z are independent agents acting in the ordinary course of business. N merely receives and disperses rental income. Z has regularly engaged in this type of transaction for several years. The authority to be exercised by Z is only contingent, and it is consistent with Z’s ordinary business practice.”

With this relative dearth of persuasive authority, a U.S. court that wanted to move beyond or add to the explanation in the OECD commentary would likely turn to Treas. reg. section 1.864-7(d)(3)(i), which provides the definition of an “independent agent . . . acting in the ordinary course of his business in that capacity.” As noted above, that definition is that an agent acts in the ordinary course of his business as an agent when he acts “in pursuance of his usual trade or business.” Unfortunately, the phrase “his usual trade or business” is ambiguous. It could refer to an industry standard — that is, what is usual in the kind of trade or business that the agent pursues — or it could refer to an individual standard — what is or has become usual in the individual agent’s business over the years.

To support and refine that definition, the court might turn to Arvid A. Skaar’s classic reference work *Permanent Establishment: Erosion of a Tax Treaty Principle*.³⁴ Skaar first points out that the purpose of the “ordinary course of business” test is to emphasize the distinction between dependent agents, whose activity is synonymous with the business of their principals, and independent agents, who have businesses of their own with activities distinct from those of the principal.³⁵ Skaar then examines four cases — from Germany, the Netherlands, the U.K., and Belgium — all of which look to “what is typical for the industry rather than typical for that particular agent.” Finally, he states his own point of view:

The conclusion of the present writer is that the business of the agent himself is a relevant argument if the activity *in casu* is outside his

ordinary course of business. This position has support in the wording of the text of the model treaty. [Skaar is referring to the phrase “the ordinary course of *their* business” (emphasis added), which also appears in Article V, paragraph 7 of the 1980 treaty.] . . . However, if the activity is within the agent’s ordinary business, the determinative argument must be what is “ordinary” in that particular line of business. This view has firm support in the case law.

This is perhaps the broadest possible reading of “ordinary course of business.” The latter position, in which the activity in question lies within what is usual in the putative agent’s industry, is supported by the four cases Skaar has presented before his conclusion. The former position — that an agent may be acting in the ordinary course of his business even if the activity in question lies outside industry norms — allows agents to operate on the cutting edge of their industries without losing their independent status.

To support this view, Skaar cites *Container*, a 1984 German Supreme Court decision, in which “[t]he Court stated generally that the business activity may still be within the ordinary course of the agent’s business if the activity is within the scope of the industry’s activities in the future.”

If a court were faced with an agent with more than one “usual trade or business,” it might look to Klaus Vogel, who notes that the independent agent provision in OECD model Article V, paragraph 6:

provides only that the agent act within the ordinary scope of his business; he need not act within the scope of his *principal* business. Thus, Article V(6) does not preclude the possibility that an agent may engage ordinarily in more than one business. For example, an attorney who sidelines as a real estate broker may constitute an independent agent both in the context of his law practice and in the context of his real estate business. However, it is likely that more emphasis will fall on the legal and economic independence criteria in such cases.

Whether an activity falls within the ordinary course of the agent’s business depends on the nature of the industry, including custom and usage, and must be examined within the context of the individual case. Moreover, the overall business activity of the agent, rather than the circumstances surrounding a particular contractual relationship, should control. A truly independent agent is especially likely to be able to negotiate different arrangements with different principals, based on economic and other factors, and the fact that the relationship with one principal differs from the relationship with another principal should not

³⁴See Skaar, *supra* note 14, at 515-522.

³⁵See *id.* at 515.

prevent the agent from satisfying the “ordinary business” requirement, if each relationship otherwise falls within the general scope of his overall business activity.³⁶ [Emphasis in original; internal citations omitted.]

1992 IRS Field Service Advisory

The field service advisory, which was released on January 17, 1992, reads more like a private letter ruling because it addresses questions regarding a particular taxpayer that was in the process of being audited. However, it contains the following general text regarding the determination of whether an agent is independent:

In order to establish whether an agent is independent, this office [the Office of Special Counsel International] has developed a list of eleven factors that should be considered. These factors have not yet been published and presently are for internal IRS use only. No relative weight has been assigned to each factor. Generally, if an agent satisfies a majority of these factors the agent will be considered independent.

ELEVEN FACTORS THAT ARE INDICIA OF INDEPENDENT AGENT STATUS.

1. The agent’s activities on behalf of the foreign enterprise are generally free from detailed instructions and comprehensive control by the enterprise. [This factor addresses legal independence.]
2. The agent controls the decision of whether to procure the services of third parties in the agent’s conduct of its commercial activities, [the preceding text relates to legal independence] and where such services are required, the agent hires and supervises the third parties and bears the cost of their services without reimbursement from the foreign enterprise. [The latter portion of the sentence relates to economic independence.]
3. The agent’s operations are generally separate from business operations of the foreign enterprise [the preceding text relates to legal independence], and the two generally do not share functions (other than stewardship function performed by the foreign enterprise in relation to its investment in the domestic subsidiary, see Treas. Reg. Sec. 1.861-8(e)(4)). [The latter portion of the sentence relates to economic independence.]
4. The agent is generally not required to submit regular reports to the foreign enterprise

concerning activities on its behalf. [This factor addresses legal independence.]

5. The entrepreneurial risk of the agent’s activities on behalf of the foreign enterprise is substantially borne by the agent. [This factor addresses economic independence.]
6. The agent is not an exclusive agent and, over a substantial period of time, the agent represents clients other than the foreign enterprise and affiliated companies. [This factor addresses economic independence.]
7. The agent regularly offers its services to the general public. [This factor addresses economic independence.]
8. The agent is compensated for activities conducted on behalf of the foreign enterprise at the market rate for similar services. [This factor addresses economic independence.]
9. The foreign enterprise does not reimburse the agent for its ordinary and necessary trade or business expenses. [This factor addresses economic independence.]
10. The agent contributes a significant part of the materials, equipment, and resources necessary to conduct its commercial activities on behalf of the foreign enterprise. [This factor addresses economic independence.]
11. The agent makes long-term investments in the facilities and other resources used in its commercial activities on behalf of the foreign enterprise. [This factor addresses economic independence.]

Seven of those factors (numbers 5-11) relate exclusively to economic independence, two factors (numbers 1 and 4) deal exclusively with legal independence, and the remaining two (numbers 2 and 3) address both legal and economic independence. Although the treaty at issue in this FSA is the 1946 South Africa-U.S. income tax treaty, the factors presented do not appear to be limited in any way to that particular treaty.

The statement that “generally, an agent [that] satisfies a majority of these factors . . . will be considered independent” seems like a casual observation that probably should not be taken literally. As noted, 7 of the 11 factors — a clear majority — address only economic independence, and it is highly unlikely that an agent without legal independence would nevertheless be considered to be independent on the basis of economic factors alone.

The Dependence Elements

Authority to Conclude Contracts

The first dependence element requires that an agent have “an authority to conclude contracts in the name of the resident” if it is to constitute a dependent-agent PE.

³⁶Klaus Vogel et al., *United States Income Tax Treaties* 261-262 (updated to March 1996).

In Rev. Rul. 55-282, 1955-1 C.B. 634, a Canadian investment corporation gave “an agent in the United States . . . a discretionary power of attorney to purchase and sell United States securities and to keep records of the Canadian corporation in [the U.S.]” The discretionary power was held sufficient to create a dependent-agent PE, but if it had not been sufficient, the power to keep records could have been a factor in finding an office PE under Article V, paragraph (2)(c).³⁷

Rev. Rul. 90-80 addresses whether a dependent-agent PE could be created for a foreign principal by the acts of the principal’s U.S. partner. Fact pattern 1 in the ruling posits B as a foreign taxpayer and A as a domestic taxpayer. Each contributes \$10,000 to a fund that A uses to buy goods that are then bartered for profit. That business venture constitutes a partnership under U.S. law, and for two parallel and individually sufficient reasons, B has a U.S. PE. First, A maintains an office that is attributable to B under the aggregate theory of partnership.³⁸ Second, and more important for this section, because A has the authority to engage to conclude contracts on behalf of the partnership:

A’s activities performed on behalf of the Partnership are those of a general agent and therefore, come within the purview of Article 5(5) [of the 1981 U.S. model tax treaty — the dependent agent paragraph]. Since the Partnership has a permanent establishment in the United States under Article 5 of the [model] Convention, B is also treated as having a permanent establishment in the United States.

The ruling briefly summarizes the holdings in the *Donroy* and *Unger* cases, but these authorities, while discussing agency principles, do not directly support the ruling’s attribution-of-dependent-agency conclusion. On the contrary, each of them finds that the office PE of a partnership is attributable to each of the individual partners.

LTR 8131059 (May 11, 1981) and Rev. Rul. 80-15, 1980-1 C.B. 365, illustrate situations in which authority to conclude contracts is lacking. In the private letter ruling, M, a domestic corporation, is the exclusive U.S. sales agent for O, a Finnish entity that operates somewhat like a U.S. cooperative corporation.³⁹ The same Finnish shareholders own both M and O. M has an office and 24 employees, and it receives commissions on the sales it makes. M

acts as a selling and marketing agent, and O fixes the prices and terms of sale; accepts, or sometimes rejects, proposed orders; fixes the terms of payment; and creates the invoices for each sale. M does not buy and sell as a principal and generally does not sell out of consigned goods. The ruling holds that:

[A]lthough M may be a dependent agent of O, M does not have and habitually exercise in the United States an authority to conclude contracts in the name of O. M has neither pricing authority nor the right to accept or reject the orders that it solicits in the United States. These functions are reserved solely to O. Thus, we find that M is not the permanent establishment in the United States of either O or M’s and O’s 18 shareholders.

If O had simply opened a U.S. office to handle its sales, that would have created a PE. See Rev. Rul. 62-31, 1962-1 C.B. 367.

In Rev. Rul. 80-15, an Italian corporation (X) set up a U.S. trust for the purpose of suing a U.S. corporation for unpaid patent royalties. The trustee was authorized only to commence the suit, settle the claim, and remit any moneys received to X. Because the trustee’s authority was limited and did not include “the general authority to negotiate or conclude contracts on behalf of X,” the trust did not constitute a dependent-agent PE of X.

Finally, two interesting questions: First, what if an agent does not have authority to conclude contracts but does so anyway? According to Huston and Williams, a Dutch lower court held in 1978 that the agent’s unauthorized actions created a PE for the Swiss principal.⁴⁰ Second, what if a dependent agent has authority to conclude some contracts but must secure special permission for others? Andersen notes that it is likely that the agent would constitute a PE with respect to all the contracts.⁴¹

Habitual Use of Authority

The second dependence element — that the agent’s authority to conclude contracts be exercised habitually — serves as a surrogate in the dependent agency context for the “permanence” that is required of a general rule, fixed-place-of-business PE. As noted, whether authority to contract is habitually exercised should be determined based on the facts and circumstances of the agency, including the nature of the contracts, the business of the principal, and other relevant “commercial realities.”

³⁷See *Consolidated Premium Iron Ores, Ltd. v. Comm’r*, 265 F.2d 320, 325-326 (6th Cir. 1959).

³⁸See *Donroy, Ltd. v. United States*, 301 F.2d 200, 206-207 (9th Cir. 1962). See also *Unger v. Comm’r*, 936 F.2d 1316, 1320 (D.C. Cir. 1991); *Johnston v. Comm’r*, 24 T.C. 920, 923 (1955).

³⁹LTR 8131059 (May 11, 1981).

⁴⁰See John Huston and Lee Williams, *Permanent Establishments: A Planning Primer*, at 89 and n.56 (1993).

⁴¹See Richard E. Andersen and Peter H. Blessing, *Analysis of United States Income Tax Treaties*, section 3.02(3)(b)(v) n.342 and text accompanying.

In Rev. Rul. 80-15, discussed *supra*, an Italian corporation set up a trust to pursue litigation in the U.S. and empowered the trustee to take limited measures to effect the purpose of the trust. The trust was not a PE, because the trustee's powers were limited. However, if they had not been limited — if the trustee had been given a general authority to conclude contracts for the corporation, but only during the pendency of the litigation — the trust might still not have been a PE because it was intended to be temporary. As long as the actual time the trust operated did not undermine that temporary intent, it might be argued that the trustee's actual exercise of authority was not habitual.

The second dependence element serves as a surrogate in the dependent agency context for the 'permanence' that is required of a general rule, fixed-place-of-business PE.

In making such an argument against “habitual exercise” on temporal grounds, it might be possible to analogize to the temporal aspect of the permanence requirement under Article V, paragraph 1. In the past, there has often appeared to be a one-year rule for fixed-place-of-business PEs: Foreign businesses whose presence in the U.S. lasted less than one year were often deemed not to be PEs, with the converse being true for those whose stay lasted 12 months or more.

If this quasi-standard were applied analogously to the habitual use requirement, then agents who exercise their authority to conclude contracts for periods longer than 12 months would be more likely to create dependent-agent PEs for their principals than those whose exercise of authority is more truncated. This rule of thumb could, of course, be set aside by factual circumstances, including the unexpected early termination of a business effort that was intended to be permanent, or the death of an agent combined with an inability by the principal to find a suitable replacement.

The notion of a temporal aspect to habitual exercise brings to mind the well-known Swiss logging machine ruling, Rev. Rul. 56-165, 1956-1 C.B. 849. A Swiss inventor brought a demonstration model of his logging equipment to the U.S. for a series of on-site demonstrations and sales presentations over a projected two-year period. He was conclusively held to have a PE despite the fact that he had no fixed place of business and no dependent agent. If, instead of coming to the U.S. personally, the inventor had engaged an agent to do his demonstrations, and if the one-year rule for fixed-place-of-business

PEs had been extended as a temporal guide for habitual exercise, then (assuming sales were made and contracts were concluded) the two-year time span of the demonstration/tour would have been probative for this element of dependent agency.

Skaar argues that habitual exercise should not be considered an agency parallel to the permanence requirement of physical PEs, but rather should be considered an analog of the fixed-place-of-business requirement that business be conducted *through* the PE. That analogy would work for business activities that usually involve a continual flow of sales or transactions based on contract. However, it would be inadequate for businesses like consultancy services, in which a single contract may cover more than a year of business activity. Skaar concludes that:

one contract in the course of two years cannot be considered a habitually exercised authority, even if the business in question does not require more than one contract for this period of time. Thus, an employee who concludes one contract on behalf of a consultancy firm or a construction enterprise is not an agent of the company in terms of the agency clause. To constitute a PE, this enterprise has to meet the conditions of the basic rule or the construction clause. Moreover, the sole purpose of reiteration cannot be sufficient to establish an agency PE. The same must also apply to the prolongation of existing contracts.

Apart from a few general guidelines, nothing but negative conclusions can be drawn: The absolute frequency of business assignments is not decisive for the regularity of the agent's activity in terms of the “habitual exercise test.” What is decisive is the relative frequency, compared to the nature of the business involved. A general rule governing the permitted length of the intervals between the agent's exercise of his power, and the reasons for these intervals, cannot be established.

Core Business of Principal

The final dependence element — that the contracts created by the agent's habitual exercise of authority must concern the core business of the principal — is directly related to the fixed-place-of-business requirement that the business of the foreign resident or enterprise be “wholly or partly carried on” through the PE. Article V, paragraph 6 of the 1980 treaty gives examples of the kinds of activities that do not concern the principal's core business and therefore cannot be the basis for a dependent-agent PE. It also includes a catchall phrase in subparagraph (e) — “similar activities which have a preparatory or auxiliary character” — that (according to the 1980 treaty's technical explanation) is open-ended and thus not limited by *ejusdem generis* to

activities that are of the same character or class as the three enumerated activities that precede it.

Rev. Rul. 80-15, which has provided examples of the prior two dependence elements, serves again for this final element. As noted, the ruling addresses a trust set up by an Italian corporation for the purpose of suing a U.S. corporation for unpaid patent royalties. Unless the business of the Italian corporation were the pursuit of litigation, which does not appear to be the case, any dependent agency otherwise created by the trust or the trustee would fail because the business of the trust is not the core business of its principal.

Addendum: *Lewenhaupt v. Commissioner*

Absent thus far in this discussion is one case frequently cited regarding agency PE: *Lewenhaupt v. Commissioner*.⁴² The reason is that its relevance

today is limited. While the decision mentions PE, it does not turn on PE, but rather on treaty provisions and interpretative regulations that allow taxation of real property gains regardless of the presence of a PE. There is conclusory dictum that says that “[t]he meaning of the term ‘permanent establishment’ as used in the [1939 Sweden-U.S. tax] convention is substantially identical with the meaning of the words ‘United States business or office’ as used in section 211(b) of the [1939 Internal Revenue] Code,” and there is also a determination that Lewenhaupt’s real property gains were taxable because he was engaged in a U.S. business through the “considerable, continuous, and regular” activities of the cousin/professional real estate broker who managed his U.S. real estate interests. However, the court did not need to make a PE determination, and the absence of that determination makes the case shaky even as persuasive authority. ♦

⁴²*Lewenhaupt v. Comm’r*, 20 T.C. 151 (1953).