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US Taxation of Cross-Border Enterprise Services

This article examines the US tax rules governing the taxation of enterprise services, including fundamental classification, source, nexus treaty and transfer pricing issues. Special issues raised by the evolving nature of cross-border enterprise services are also considered.

1. Source of Services Income and Nexus for Taxation

1.1. Overview

As explained in greater detail in section 1.2., the United States treats income from services performed in the United States as US-source income. In general, a foreign corporation not engaged in a US trade or business is subject to a 30% withholding tax on its gross fixed or determinable, annual or periodic income, which generally includes most income except income from the sale or exchange of property, with certain exceptions, from US sources.[1] If a foreign corporation is engaged in a US trade or business, it is subject to tax on a net basis with regard to income that is "effectively connected with the conduct of a trade or business within the United States".[2]

Although whether a foreign corporation is engaged in a US trade or business is generally a facts and circumstances inquiry,[3] section 864(b) of the US Internal Revenue Code (IRC) specifically provides that the term "trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year. Accordingly, as a corporation may perform personal services through its employees,[4] services provided in the United States by a foreign corporation's employees generally result in the foreign corporation being engaged in a trade or business in the United States, with the income from the US services generally considered to be effectively connected with such trade or business. The statute provides an exception for certain trading in securities and certain limited services provided by individuals, but no *de minimis* exception is provided for services provided by corporations.[5]

If a foreign corporation is entitled to the benefits of a tax treaty with the United States, however, different rules apply. In general, under the United States' tax treaties, a foreign corporation that earns income from services performed in the United States is generally subject to US tax on that income only if the foreign corporation has a "permanent establishment" in the United States. Further, only the business profits attributable to the permanent establishment (PE) are subject to US tax.

1.2. Source of services income

1.2.1. Opening comments

As stated is section 1.1., compensation for "labor or personal services" performed in the United States is treated as US-source income and may be subject to tax in the United States.[6] Conversely, income from services performed outside of the United States is foreign-source income.[7] The source rule applies "irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time of payment".[8]

The regulations provide a special rule governing the source of income from services performed by a corporation partly within and partly outside the United States. Specifically, the portion of the compensation attributable to the labour or personal services performed within the United States "is determined on the basis that most correctly reflects the proper source of the income under the facts and circumstances".[9] The regulations state that apportionment on a "time basis" is acceptable "in many cases", but providing an example in which apportionment

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1. Sec. 881 IRC.
2. Sec. 882(a)(1) IRC. In order to be effectively connected with a US trade or business, income generally must be US source, with certain exceptions. *See* sec. 864(c)(2), (3) IRC. In addition, certain income from foreign sources that is "attributable to" a US "office or fixed place of business", including rents or royalties for the use of intangible property, is treated as effectively connected with the conduct of a US trade or business. *See* sec. 864(c)(4).
3. The IRS generally does not issue rulings on whether a foreign corporation is engaged in a US trade or business, but may be willing to address the issue in a pre-filing agreement with a taxpayer. *See* sec. 4.01(3), Rev. Proc. 2011-7, 2011-1 I.R.B. 233 and sec. 3.06(2), Rev. Proc. 2009-14, 2009-3 I.R.B. 324 (stating that trade or business issue is "likely suitable" for a pre-filing agreement).
4. US: CA, 1939, *Commissioner v. Hawaiian Philippine Co.*, 100 F. 2d 988 (9th Cir. 1939), cert. denied, 307 US 635 (1939).
5. Sec. 864(b)(1) and (b)(2) IRC. Sec. 864(b)(2) provides exceptions for trading in stocks and securities and certain commodities through a resident broker, commission agent, custodian or other independent agent as well as trading stocks and securities and certain commodities for one's own account.
6. Secs. 861(a)(3) IRC and Treas. Reg. sec. 1.861-4(a) ("Generally, compensation for labor or personal services, including fees, commissions, fringe benefits, and similar items, performed wholly within the United States is gross income from sources within the United States."). Sec. 861(a)(3) provides an exception for services performed in the United States by non-resident alien individuals temporarily present in the United States and whose income from such services does not exceed USD 3,000. There is no similar exception for services provided by corporations.
7. Sec. 862(a)(3) IRC.
8. Treas. Reg. sec. 1.861-4(a)(1).
9. Treas. Reg. sec. 1.861-4(b)(1)(i).

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on a different basis is more appropriate.[10] In the example, a US corporation receives compensation under a contract for services both inside and outside the United States. The employees that provide services in the United States are paid more than employees outside the United States "because of the more sophisticated nature of the services" performed by the US employees. As a result, the regulations conclude that a determination based on payroll costs "would be the basis that most correctly reflects the proper source of the income received under the contract". As the payroll costs for employees performing services under the contract within the United States is two thirds of the total payroll costs associated with the contract, two thirds of the compensation received by the corporation must be sourced to the United States.

The general rule that services performed in the United States generate US-source income can be deceptively simple. First, it may not always be obvious whether a function is a "service" or something else. The courts have grappled with this issue for years, with questions about the nature of financial functions having increasing prominence in recent years. Second, once a function is determined to be a service, the place of performance must be ascertained. The nature of commercial activity in the 21st Century may make this question more difficult. Third, statutory and regulatory exceptions to the general rule must be considered.

1.2.2. Service or something else?

1.2.2.1. Initial remarks

The question of whether or not income should be considered derived from services or some other function may arise under various fact patterns. For instance, are payments made for the performance of services that generates intellectual property treated as royalties or as compensation for services? Are financial functions, such as those involving the substitution of one party's credit for another, more similar to services or interest? Should a promise not to perform services be treated as a service?

1.2.2.2. Service or royalty?

The courts have considered whether payments made for the performance of services that create intellectual property should be treated as royalties or income from services. Although several of the cases described in this section involve individuals, they illustrate basic classification issues that may also arise with regard to services provided by enterprises.

For instance, in *Boulez v. Commissioner* (1984),[11] the taxpayer entered into a contract with CBS Records under which the taxpayer agreed to "render services" as a performer and make a certain number of recordings in each year. The recordings became the property of CBS Records. The contract referred to the compensation paid to the taxpayer, however, as "royalties", and tied the amount of the payments to the sales made by CBS Records. The Court concluded that the taxpayer should be considered to have received income from services, not royalties, as the taxpayer had no property right in the recordings.

In *Karrer v. United States* (1957),[12] a Swiss professor and a Swiss company agreed to work jointly on a scientific project. The parties agreed that all commercial rights in processes or formulae or patents developed as a result of the project would belong to the Swiss company, with the professor being paid a percentage of the net proceeds of the sale of any products developed. Commercial products were developed as a result of the projects, and the Swiss company licensed to a US affiliate the rights to exploit the relevant intellectual property in the United States. Although the US affiliate had no contract with the Swiss professor, it paid the professor a percentage of the sales of products relating to the professor's work. The US Internal Revenue Service (IRS) argued that the amounts paid by the US company were royalties, which would be subject to withholding, while the professor argued that the amounts paid were compensation for services performed outside of the United States, which would not be subject to withholding. The Court determined that the Swiss company was the owner of the commercial rights in any discoveries from the scientific projects and that the professor's only interest in the products arose out of his contractual relationship with the Swiss company. As a result, the Court concluded that the professor's income was from services performed outside the United States.

1.2.2.3. Service or interest?

Whether financial functions should be treated as services or something else is another classification issue increasingly encountered. The courts and the IRS have considered whether certain financial functions should be considered analogous to services (sourced by place of performance), interest (sourced by location of payor) or something else under several fact patterns.

In *Bank of America v. United States* (1982),[13] Bank of America received three types of commissions associated with letters of credit. The Court determined that two types of the commissions, acceptance and confirmation commissions, were more in the nature of interest than services because a central feature of the commission was the substitution of Bank of America's credit for that of a foreign bank. The Court noted that Bank of America performed some services in connection with the commissions, but determined that those services were minor compared to the importance of Bank of America's substitution of its own credit. In the case of the third type of commissions, negotiation commissions, the Court determined that Bank of America was performing

10. The regulations provide that "[t]he amount of compensation for labor or personal services performed within the United States determined on a time basis is the amount that bears the same relation to the individual's total compensation as the number of days of performance of the labor or person services by the individual within the United States bears to his or her total number of days of performance or labor or personal services". Treas. Reg. sec. 1.861-4(b)(2)(ii)(E).
11. US: TC, 1984, *Boulez v. Commissioner*, 83 T.C. 584 (1984).
12. US: CC, 1957, *Karrer v. United States*, 152 F. Supp. 66 (Ct Cl. 1957).
13. US: CC, 1982, *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982).

services in the United States and sourced the commissions by analogy to services.

A recent case, *Container Corp. v. Commissioner* (2010),[14] involved the source of a guarantee fee received by a Mexican parent corporation for its guarantee of notes issued by its US subsidiary. The Tax Court determined that the guarantee fee was analogous to a fee for the performance of services. In an unpublished decision, the Fifth Circuit affirmed the Tax Court's decision, in stating that "[the Mexican parent corporation] was being compensated for its promise to stand by in the event a future obligation materialized and not for putting its money at risk at the time of signing the guarantee". The Court concluded that "[u]nder these factual circumstances, the guaranty fees are more analogous to payments for services".

In 2010, Congress enacted a specific sourcing rule for "guarantees of indebtedness" in sections 861(a)(9) and 862(a)(9) of the IRC.[15] These provisions reverse the result in *Container Corp.* and provide that a guarantee fee is sourced, like interest, to the residence of the obligor. The new sourcing rule applies prospectively to guarantees issued after the date of enactment, i.e. 27 September 2010.

The IRS has also considered the source of standby loan commitment fees, i.e. fees paid to a financial institution in exchange for the institution agreeing to make available funds for borrowing. In Private Letter Ruling 7808038, the IRS concluded that commitment fees paid by a US person to a foreign corporation were not payments of interest. Rather, the IRS determined that the fees were "payments made in order to secure the availability of funds upon need" and should be treated like services. As "all relevant services with respect to the available funds" were performed outside the United States, the fees were treated as foreign-source income.

1.2.2.4. Covenants not to compete and other agreements not to perform services

The courts have also considered whether or not an agreement not to perform a service should be sourced under the service source rules. In *Korfund Co. v. Commissioner* (1943),[16] the Tax Court determined that income from an agreement not to compete in the United States should be sourced not as services income, but, rather, as income from "interests in property in [the United States]" and, therefore, constituted US-source income. Several other cases and rulings involving athletes have considered the source of income received by individuals under agreements not to play for other teams.[17]

1.2.3. Determining the place of performance: overview

Whether services should be considered to have been performed in the United States may not always be apparent, especially given the rise of electronic transactions (*see* section 1.2.5.). Still, as a general rule, an enterprise is not considered to have performed services in the United States without some physical presence in the United States.

For instance, in *Piedras Negras Broadcasting Co. v. Commissioner* (1942),[18] the Board of Tax Appeals and Fifth Circuit looked to the place of income-producing activity to determine a radio station's source of income. In that case, a Mexican radio station broadcasted from Mexico (with its broadcasting facilities and other property in Mexico), but the station's programming was targeted at US listeners, 95% of the station's income came from US advertisers, and the radio station met with advertisers and received mail in the United States. The Fifth Circuit concluded that:

> the source of income is the situs of the income-producing service. The repeated use [in the statute] of the words within and without the United States denotes a concept of some physical presence, some tangible and visible activity. If income is produced by the transmission of electromagnetic waves that cover a radius of several thousand miles, free of control or regulation by the sender from the moment of generation, the source of that income is the act of transmission. All of respondent's broadcasting facilities were situated without the United States, and all of the services it rendered in connection with its business were performed in Mexico.

1.2.4. Special rules

1.2.4.1. Initial remarks

Special sourcing rules exist for certain functions that may involve services, but that are considered to have a unique nature that warrants a special rule. Several of these rules are discussed in sections 1.2.4.2. to 1.2.4.6.

1.2.4.2. Manufacturing

Income from the sale of manufactured products may be regarded as partially attributable to the sale of property and partly attributable to services. The source rule for income from the sale of manufactured products reflects this dual character. Under Treas. Reg. Sec. 1.863-3, income from the sale of inventory that is produced in the United States and sold outside the United States (or vice versa) is treated as partly US source and partly foreign source. The regulations provide for three allocation methods: (1) the 50/50 method, under which one half of the gross income from the sale is considered attributable to production activity and one half is considered to be attributable to sales activity; (2) the independent factory price (IFP) formula, under which the amount of the gross sales price equal to the independent factory price is treated

14. US: TC, 2010, *Container Corp. v. Commissioner*, 134 T.C. 122 (2010), aff'd 107 A.F.T.R. 2011-1831 (5th Cir. 2011).
15. Secs. 861(a)(9) and 862(a)(9) of the IRC and Tax Relief, Unemployment Ins. Reauthorization, and Job Creation Act of 2010, H.R. 4853, Pub. L. No. 111-312 (2010).
16. US: TC, 1943, *Korfund Co. v. Commissioner*, 1 T.C. 1180 (1943).
17. *See* Rev. Rul. 2004-109, 2004-50 I.R.B. 958 (treating sign-on bonus as compensation for performance of services); CCA 200219011 (treating sign-on bonus as compensation for services); US; TC, 1984, *Linseman v. Commissioner*, 82 T.C. 514 (1984) (sign-on bonus for agreement not to play for other teams sourced under services rule); and Rev. Rul. 74-108, 1974-1 C.B. 248 (treating sign-on bonus under agreement precluding soccer player from playing for other teams as analogous to forfeiture of a "right to act"), revoked by Rev. Rul. 2004-109.
18. US: BTA, 1942, *Piedras Negras Broadcasting Co. v. Commissioner*, 43 B.T.A. 297 (1941), aff'd 127 F.2d 260 (5th Cir. 1942).

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as attributable to production activity, with the balance of the sales price treated as attributable to sales activity; and (3) the books and records method, under which the portion of the sale attributable to production and sales activities is based on the taxpayer's books and records.[19] Once the taxpayer's income has been split between production and sales activities under one of these methods, the income attributable to production activity is apportioned between US and foreign sources on the basis of the relative basis of production assets, while the income attributable to sales activity is apportioned between US and foreign sources on the basis of relative gross sales.[20]

1.2.4.3. Transportation services

Section 863(c) of the IRC provides for special source rules in respect of "transportation income", which is defined as any income derived from, or in connection with the use, or hiring or leasing for use, of a vessel or aircraft, or the performance of services directly related to the use of a vessel or aircraft.[21] The source of transportation income is generally determined by reference to the points of departure and destination of the given vessel on each voyage. Accordingly, income from transportation that begins and ends in the United States is treated as entirely from US sources.[22] If the transportation begins or ends in the United States (but not both), half of the transportation income is generally sourced to the United States.[23] Certain personal service income is subject to the general rules for the sourcing of services and not the transportation income source rules.[24]

1.2.4.4. Space and ocean activities

Section 863(d)(1)(B) of the IRC provides for special sourcing rules for space and ocean activities, which include "any activity conducted in space" and "any activity conducted on or under water, not within the jurisdiction of a foreign country, possession of the United States, or the United States".[25]

The regulations distinguish space and ocean activities involving services from those involving other functions, such as communications activities and sales of property. If a transaction is characterized under the regulations as the performance of a service, such service is treated as a space or ocean activity in its entirety when any part of the service is performed in space or international waters. Services are considered to be performed in space or international water if "functions are performed, resources are employed, or risks are assumed in space or international water, regardless of whether performed by personnel, equipment, or otherwise".[26] A service is, however, treated as space or ocean activity only to the extent of the activity performed in space or international water if the taxpayer can demonstrate the separate values of the services performed in space or international water and the services performed outside space or international water.[27] A service is also not treated as a space or ocean activity if the taxpayer can demonstrate that the value of the service attributable to performance in space and international water is *de minimis*.[28]

Section 863(d) of the IRC generally provides that income derived from a space or ocean activity is sourced in the United States if derived by a US person and sourced outside the United States if derived by a non-US person.[29] The regulations provide, however, that space and ocean income are not considered to be US source, even if derived by a US person, "to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries".[30] Conversely, space or ocean income is considered to be US source, even if derived by a non-US person, if derived by a controlled foreign corporation or a foreign person engaged in a US trade or business, but not to the extent such income is attributable to non-US functions, resources or risks.[31]

The regulations provide an example involving a US corporation that operates satellites with sensing equipment that can determine how much heat and light certain plants emit and reflect.[32] The US corporation analyses the data from offices located in the United States and provides a farmer with the data, which the farmer uses in growing crops. The value of the services attributable to performance in space is assumed not to be *de minimis*. As a result, the US corporation's activities are space activities to the extent the value of its service transaction is attributable to performance in space, and the income will be US source, unless attributable to functions, resources, or risks outside the United States.

1.2.4.5. Communications income

Section 863(e) of the IRC provides a special source rule for international communications income, which is defined as "all income derived from the transmission of communications or data from the United States to any foreign country (or possession of the United States) or from any foreign country (or possession of the United States) to the United States".[33] The statute provides that half of any international communications income is treated as US

19. Treas. Reg. sec. 1.863-3(b)(1) (50/50 method); Treas. Reg. sec. 1.863-3(b)(2) (the IFP method); and Treas. Reg. sec. 1.863-3(b)(3) (the books and records method).
20. Treas. Reg. sec. 1.863-3(c).
21. Sec. 863(c)(3) IRC. Under section 887 of the IRC, non-resident alien individuals and foreign corporations are subject to a 4% tax on their gross US-source transportation income, with certain exceptions.
22. Sec. 863(c)(1) IRC.
23. Sec. 863(c)(2) IRC.
24. Sec. 863(c)(2)(B) IRC.
25. Sec. 863(d)(1)(B) IRC. "Space or ocean activity" does not include, however, any income giving rise to transportation income, which is covered by sec. 863(c), international communications income, which is covered by sec. 863(e), or any activity with respect to mines, oil and gas wells, or other natural deposits to the extent within the United States or any foreign country or possession of the United States.
26. Treas. Reg. sec. 1.863-8(d)(2)(ii).
27. Treas. Reg. sec. 1.863-8(d)(2)(ii)(B).
28. Id.
29. Sec. 863(d)(1) IRC.
30. Treas. Reg. sec. 1.863-8(b)(1).
31. Treas. Reg. sec. 1.863-8(b)(2)(ii), (iii).
32. Treas. Reg. sec. 1.863-8(g), Ex. 8.
33. Sec. 863(e)(2) IRC.

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source, while half is treated as foreign source.[34] International communications income earned by a foreign person is treated as foreign source, except that international communications income earned by a foreign person and attributable to a US office or fixed place of business is treated as US source.[35]

The regulations further differentiate between income derived from international communications activity, which is sourced as described above, income derived from US communications activity, which is sourced to the United States whether earned by a US or foreign person, income derived from foreign communications activity, which is treated as foreign source whether earned by a US or foreign person, and income derived from space and/or ocean communications activity, which is sourced under section 863(d) of the IRC and the regulations thereunder, as discussed previously in this section. Income from international communications activity is income derived from communications activity when the taxpayer is paid to transmit between a point in the United States and a point in a foreign country (or US possession) or foreign-originating communications (i.e. communications with a beginning point in a foreign country or US possession) from a point in space or international water to a point in the United States.[36] Income from US communications activity is derived from communications activity when the taxpayer is paid to transmit between two points in the United States or, in general, between the United States and a point in space or international water.[37] Income from foreign communications activity is income derived from communications activity when the taxpayer is paid to transmit between two points in a foreign country or countries (or a US possession or possessions), between a foreign country and a US possession or between a foreign country (or US possession) and a point in space or international water.[38] Income from space and/or ocean communications activity is income derived from communications activity when the taxpayer is paid to transmit between a point in space or international water and another point in space or international water.[39]

The regulations provide that communications activity includes the delivery by transmission of communications or data, including the provision of capacity to transmit communications, but does not include delivery of communications other than by transmission.[40] A taxpayer derives communications income only if the taxpayer is both paid to transmit and bears the risk of transmitting the communications.[41]

Whether income is derived from international communications activity, US communications activity, foreign communications activity or space and/or ocean communications activity is determined by identifying the two points between which the taxpayer is paid to transmit the communication.[42] The taxpayer must establish the two points using "any consistently applied reasonable method to establish one or both endpoints".[43] Where the taxpayer cannot establish the two points between which the taxpayer is paid to transport the communication, the income derived from the relevant activity is treated as US source.[44]

1.2.4.6. Software

US Treasury regulations also address characterization issues raised by transactions involving a computer program. Specifically, Treas. Reg. Sec. 1.861-18 treats a transaction involving the transfer of a computer program or the provision of services or of know-how with regard to a computer program as: (1) a transfer of a copyright right in the computer program; (2) a transfer of a copy of a computer program; (3) the provision of services for the development or modification of a computer program; or (4) the provision of know-how regarding computer programming techniques.[45] A transaction may consist of one or more of the four categories, in which case each component is generally treated as a separate transaction, unless a component is *de minimis*.[46] The classification of a transaction in one of the categories applies for only certain international tax provisions of the IRC, including the source rules and rules governing the taxation of non-resident aliens and corporations, as well as sections 367 and 482.[47] The preamble to the final regulations also indicates that the regulations "are intended to apply for purposes of applying and interpreting U.S. tax treaties".[48]

Whether a transaction involving a newly-developed or modified computer program is treated as the provision of services or another transaction "is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties, as evidenced by their agreement and conduct, as to which party is to own the copyright and related rights in the computer program and how the risks of loss are allocated between the parties".[49] The provision of information with regard to a computer program is treated as the provision of know-how if the information relates to computer programming techniques, is furnished under conditions preventing unau-

34. Sec. 863(c)(1)(A) IRC.
35. Sec. 863(c)(1)(B)(i) and (ii) IRC.
36. Treas. Reg. sec. 1.863-9(h)(3)(ii).
37. Treas. Reg. sec. 1.863-9(h)(3)(iii).
38. Treas. Reg. sec. 1.863-9(h)(3)(iv).
39. Treas. Reg. sec. 1.863-9(h)(3)(v).
40. Treas. Reg. sec. 1.863-9(h)(1)(i). The regulations further provide that provision of content or any other additional service provided along with, or in connection with, a non-*de minimis* communications activity must be treated as separate non-communications activity unless *de minimis*. Id. An activity is treated as *de minimis* to the extent that the value attributable to such activity is *de minimis*. Id.
41. Id. Accordingly, where a taxpayer provides customers with access to its database, which the customer accesses by phone, but where the telephone service used is provided by a third party and the taxpayer assumes no responsibility for the transmission of the information via telephone, the taxpayer is not considered to be paid to transmit communications and does not derive income from communications activity. Instead, the taxpayer is considered to derive income from provision of content or provision of services to its customers. Treas. Reg. sec. 1.863-9(j), Ex. 1.
42. Treas. Reg. sec. 1.863-9(f)(3)(i).
43. Id.
44. Treas. Reg. sec. 1.863-9(f).
45. Treas. Reg. sec. 1.861-18(b)(1).
46. Treas. Reg. sec. 1.861-18(b)(2).
47. Treas. Reg. sec. 1.861-18(a)(1).
48. T.D. 8785 (19 Oct. 1988).
49. Treas. Reg. sec. 1.861-18(d).

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thorized disclosure and is considered property subject to trade secret protection.[50]

1.2.5. Special issues raised by electronic transactions

Cross-border business transactions are increasingly conducted through electronic means. Income earned from these transactions may not, however, clearly fit within the existing source rules. Further, if a transaction is characterized as a service, the place of performance may not be clear or may lead to a result that some would find undesirable as a policy matter.

Certain rules do provide guidance on the characterization of certain transactions conducted through electronic means or involving the transfer of electronic content. The software regulations provide rules for classifying transactions involving computer software program, while the communications income rules address the source of income from the transmission of data. The proper characterization of other transactions, however, may not be clear. For instance, is providing access to a proprietary database over the internet more akin to a service, a sale of goods or a licence?

Where an electronic transaction is characterized as a service, the income from that service is sourced to the United States if the services are considered to have been performed from the United States. As discussed in section 1.2.3., the place of performance standard generally requires physical presence in the United States. As a result, in the proprietary database example, assuming the transaction involves a service rather than one of the alternative characterizations, if the provider creates and updates the database from outside the United States, the place of performance appears to be outside the United States. Accordingly, the income earned from providing access to the database appears to be foreign-source income.

The extent to which the United States' international tax rules should evolve in the face of increasing electronic transactions is debatable. For instance, to what extent are clear characterization rules necessary or desirable? Do electronic transactions raise significant base erosion concerns? Should the services source rule be amended to take into account other factors, such as the location of servers, which themselves are highly mobile? Or, should the existing framework be retained? Is source-based taxation with regard to this type of income simply too problematic? Despite focus on these questions by tax policymakers and commentators over the last several decades and the continued importance of electronic commerce, no clear consensus has emerged.[51]

2. Tax Treaties

2.1. The general rule

If a foreign corporation is entitled to the benefits of a tax treaty with the United States, the source and trade or business rules described above generally do not apply. Rather, under US tax treaties, business profits of an enterprise of one contracting state, which may include income from services, are generally taxable in the source state only if the enterprise carries on business in the source state through a PE in that state. Further, only the business profits attributable to the PE are generally taxable by the source state.

Although individual tax treaties may vary, recent US tax treaties generally define a "permanent establishment" as "a fixed place of business through which the business of an enterprise is wholly or partly carried on".[52] Such a fixed place of business may include, but is not limited to, a place of management, a branch, an office, a factory, a workshop or a mine or other place of extraction of natural resources.[53] The maintenance of a fixed place of business for certain specified purposes does not, however, give rise to a PE.[54]

In certain circumstances, the activities of an agent may constitute a PE, even where a foreign business does not have a physical presence in the United States. Under the US Model (2006), an agent that acts on behalf of an enterprise generally gives rise to a PE in a contracting state if it "has and habitually exercises in [that contracting state] an authority to conclude contracts that are binding on the enterprise".[55] This rule does not apply, however, if the activities undertaken by the agent are limited to certain specified activities that, if exercised through a fixed place of business, would not give rise to a PE. Further, the use of an independent agent does not give rise to a PE "provided that such persons are acting in the ordinary course of their business as independent agents".[56]

2.2. Special treaty rules

2.2.1. Opening comments

Some of the United States' tax treaties modify the general rule described in section 2.1. Several of these special rules are discussed in sections 2.2.2. to 2.2.5., with a focus on those rules most relevant to services.

2.2.2. Services PEs

Some of the United States' tax treaties provide that the provision of services in a contracting state by an enterprise resident in the other contracting state may give rise to a PE in the first state if the services are provided for a certain specified period of time, even if the enterprise providing the services does not have a PE in the other contracting state under the general rule described in

50. Treas. Reg. sec. 1.861-18(e).
51. *See*, for example, US Department of Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* p. 33 (1996); J. Owens, *The Tax Man Cometh to Cyberspace*, Tax Notes Intl., p. 1833 (2 June 1997); P.A. Glicklich, S.H. Goldberg & H.L. Levine, *Internet Sales Pose International Tax Challenges*, 84 J. Taxn., p. 325 (1996); and J.D. Cigler, H.C. Burritt & S.E. Stinnett, *Cyberspace: The Final Frontier for International Tax Concepts?*, 7 J. Intl. Taxn., p. 340 (1996).
52. *US Model Income Tax Convention* art. 5(1) (15 Nov. 2006), Models IBFD.
53. Art. 5(2) *US Model* (2006).
54. Art. 5(4) *US Model* (2006).
55. Art. 5(5) *US Model* (2006).
56. Art. 5(6) *US Model* (2006).

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section 2.1. These provisions are exceptions to the United States' normal treaty policy and usually only appear in the United States' tax treaties with developing countries. One notable exception is the recent protocol to the Canada–United States Income and Capital Tax Treaty (1980),[57] which contains a services PE provision.[58]

Many of the services PE provisions in the United States' tax treaties provide that an enterprise has a PE in a state when services are provided in that state for a certain number of days. For instance, under the India–United States (1989),[59] Jamaica–United States (1980)[60] and Thailand–United States (1996)[61] Income Tax Treaties, the provision of services for more than 90 days within a 12-month period generally gives rise to a PE.[62] Additional factors are also relevant in recent services PE provisions, for example, the Bulgaria–United States Income (2007)[63] and Canada–United States Income and Capital (1980) Tax Treaties, which consider how much revenue is derived from the services as well as the status of the customers for whom the services are performed.

Under the 2007 protocol to the Canada–United States Income and Capital Tax Treaty (1980), an enterprise of one contracting state is deemed to have a PE in the other contracting state if either of two tests is satisfied. First, an enterprise may be considered to have such a PE if services are performed in the other state by an individual who is present in that state for a period or periods exceeding 183 days or more in any 12-month period and, during that time, more than 50% of the gross active business revenue of the enterprise consists of income derived from the services performed in that other state by that individual.[64] Second, an enterprise may be considered to have a services PE if services are provided in that other state for an aggregate of 183 days or more in any 12-month period with regard to the same or connected project for customers who are either residents of that other state or who maintain a PE in that other state and the services are provided in respect of that PE.[65] Under this second test, the services must be provided for customers who are either residents of the other state or maintain a PE in that state. According to the Technical Explanation to the protocol:

> [t]he intent of this requirement is to reinforce the concept that unless there is a customer in the other State, such enterprise will not be deemed as participating sufficiently in the economic life of that other State to warrant being deemed to have a permanent establishment.

2.2.3. *Technical services*

All of the United States' tax treaties contain an article addressing the right to tax royalties paid for the use of property. Some tax treaties also contain special rules for services provided in connection with transactions giving rise to royalties.

For instance, the India–United States Income Tax Treaty (1980) includes a special provision permitting withholding tax on payments made for certain technical services. Under the tax treaty, payments for "fees for included services" may be subject to a 10% or 15% withholding tax, the withholding rate depending on the type of service provided.[66] A "fee for included services" includes "payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel)" if such services are "ancillary and subsidiary to the application or enjoyment of the right, property or information" for which a royalty payment is made, or "make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design". Amounts paid for certain services are, however, excluded, including services relating to the sale of property, other than intellectual property, teaching in or by educational institutions and services for the personal use of the individual(s) making the payment. A memorandum of understanding between India and the United States further describes the scope of "included services".

57. *Convention Between Canada and the United States of America with respect to Taxes on Income and on Capital* (26 Sept. 1980) (as amended through 2007), Treaties IBFD [hereinafter *Can.–U.S. Tax Treaty*].
58. *See* A. Bennett, *Mundaca Emphasizes Services P.E. Provision in U.S.–Canada Tax Treaty is Not U.S. Policy*, 27 Tax Mgt. Wkly. Rpt., p. 112 (28 Jan. 2008).
59. *Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (12 Sept. 1989), Treaties IBFD [hereinafter *India–U.S. Tax Treaty*].
60. *Convention Between the Government of the United States of America and the Government of Jamaica for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (21 May 1980), Treaties IBFD.
61. *Convention Between the Government of the United States of America and the Government of the Kingdom of Thailand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (26 Nov. 1996), Treaties IBFD.
62. The United States' tax treaties with China, the Czech Republic, Indonesia, Kazakhstan, the Philippines, Portugal and the Slovak Republic also contain services PE provisions.
63. *Convention Between the Government of the United States of America and the Government of the Republic of Bulgaria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (23 Feb. 2007), Treaties IBFD.
64. Art. V(9) *Can.–U.S. Tax Treaty*. According to the Technical Explanation to the Protocol, "the term 'gross active business revenues' shall mean the gross revenues attributable to active business activities that the enterprise has charged or should charge for its active business activities, regardless of when the actual billing will occur or of domestic law rules concerning when such revenues should be taken into account for tax purposes. Such active business activities are not restricted to the activities related to the provision of services. However, the term does not include income from passive investment activities."
65. In an Exchange of Notes with respect to the protocol to the *Can.–U.S. Tax Treaty*, Canada and the United State agreed that projects are considered to be connected if they "constitute a coherent whole, commercially and geographically". According to the Technical Explanation, "[t]he determination of whether projects are connected should be determined from the point of view of the enterprise (not that of the customer), and will depend on the facts and circumstances of each case. In determining the existence of commercial coherence, factors that would be relevant include: 1) whether the projects would, in the absence of tax planning considerations, have been concluded pursuant to a single contract; 2) whether the nature of the work involved under different projects is the same; and 3) whether the same individuals are providing the services under the different projects. Whether the work provided is covered by one or multiple contracts may be relevant, but not determinative, in finding that projects are commercially coherent."
66. Art. 12 *India–U.S. Tax Treaty*.

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2.2.4. *Artistes and sportsmen*

Most of the United States' tax treaties have a special rule governing income earned by entertainers (or "artistes") and athletes (or "sportsmen") (collectively, "entertainers"). For instance, under article 16(1) of the US Model (2006), the source state may tax income derived by an entertainer resident in the other treaty state in connection with a performance by the entertainer, where the gross amount of such income exceeds USD 20,000.[67] Article 16(1) does not, however, apply to income other than that from a performance, such as royalties or product endorsements.[68]

Article 16(1) generally applies to individuals, as business entities generally are not themselves entertainers. Under article 16(2), however, the source state may tax income relating to performances that is earned by a person other than the performer, such as a corporation, regardless of whether or not the income is attributable to a PE in the source state. The purpose of this rule is to prevent entertainers from circumventing the general rule by using "star companies", which act as the nominal income recipient with regard to a performance and pay the entertainer a modest salary for his services, thereby potentially avoiding source state taxation, as the company does not have a PE. Article 16(2) does not apply, however, where the contract under which the performance activities are performed permits the person other than the performer to designate the individual to perform services. As the US Model (2006) Technical Explanation explains:

> [t]he premise of this rule is that, in a case where a performer is using another person in an attempt to circumvent the [general rule], the recipient of the services of the performer would contract with a person other than that performer (i.e., a company employing the performer) only if the recipient of the services were certain that the performer himself would perform the services. If instead the person is allowed to designate the individual who is to perform the services, then likely the person is a service company not formed to circumvent the [general rule].

2.2.5. *Other special rules*

In addition to those discussed in sections 2.2.2. to 2.2.4., US tax treaties often have several other special rules pertaining to the taxation of services performed by individuals, as opposed to enterprises. These special rules include those applying to fees paid for services performed as a director of a company,[69] payments relating to pensions and annuities, social security benefits, alimony, and child support[70] and payments received by students, apprentices, or business trainees.[71]

3. Transfer Pricing

3.1. Introductory remarks

The US tax authorities are increasingly focused on whether or not US taxpayers are able to shift income overseas, including through transfers of intangible assets. Services transactions may sometimes raise these or similar issues. For instance, how should a service transaction between related parties be priced when the transaction involves both services and the transfer of intangibles? What if the arrangement involves services and the use, but not transfer, of an intangible? Sections 3.2. and 3.3. consider these issues.

3.2. Pricing of controlled services transactions

In 2009, the US Treasury and the IRS finalized regulations governing the transfer pricing of intercompany services, thereby replacing prior services regulations promulgated in 1968.[72] Under the regulations, the amount charged in a controlled services transaction must be determined under one of the listed methods, which are: (1) the services cost method; (2) the comparable uncontrolled services price method; (3) the gross services margin method; (4) the cost of services plus method; (5) the comparable profits method; (6) the profit split method; and (7) an unspecified method.

A controlled services transaction is defined as any activity by one member of a group of controlled taxpayers that results in a benefit to one or more other members of the controlled group.[73] The definition of activity is broad and includes "the performance of functions, assumption of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge [as well as] making available to the recipient any property or resources of the renderer".[74]

Although a full discussion of the transfer pricing of service transactions is outside the scope of this article, the treatment of transactions involving both services and the transfer of intangible property in the final regulations is discussed in greater detail in section 3.3.

3.3. Services and "embedded intangibles"

US tax law includes special rules to deter taxpayers from moving offshore intangible property developed in the United States, thereby shifting income that would otherwise be taxable in the United States. Under section 482 of the IRC, "[i]n the case of any transfer (or license) of intangible property... the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible". Another provision, section 367(d), imposes a toll tax on outbound transfers of intangibles.

67. Art. 16 *US Model* (2006).
68. *Technical Explanation to the 2006 Model Income Tax Convention* art. 16 (15 Nov. 2006), Models IBFD.
69. Art. 15 *US Model* (2006).
70. Art. 17 *US Model* (2006).
71. Art. 20 *US Model* (2006).
72. T.D. 9456, 74 Fed. Reg. 38830 (4 Aug. 2009). The 2009 final regulations are generally applied to taxable years beginning after 31 July 2009, but contain an election that allows taxpayers to apply the regulations to earlier years.
73. Treas. Reg. sec. 1.482-9(l)(1).
74. Treas. Reg. sec. 1.482-9(l)(2).

For these purposes, "[i]ntangible property" is defined as any:[75]

- patent, invention, formula, process, design, pattern, or know-how;
- copyright, literary, musical, or artistic composition;
- trademark, trade name, or brand name;
- franchise, license, or contract;
- method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
- any similar item,

which has substantial value independent of the services of any individual.

The definition of intangible property has spurred controversy. For instance, is goodwill and going concern value a "similar item"? Is "workforce in place" also a "similar item" or is its value attributable to the services of individuals? The Obama Administration has proposed to "clarify" that such items are intangible property.[76]

The application of the transfer pricing rules to "embedded intangibles" may give rise to disputes.[77] For instance, business may provide specialized services to affiliates and disputes may arise as to whether the income from such activities should be considered attributable to services, intangibles or both. In the recent case of *Veritas Software Corp. v. Commissioner* (2009),[78] the US Tax Court considered a cost-sharing agreement entered into between Veritas US, a US company, and its wholly-owned foreign subsidiary, Veritas Ireland. The Court determined that the buy-in required under the cost sharing regulations should be limited to the value of pre-existing intangibles at the time they are contributed to the cost-sharing pool. The Court also rejected certain of the IRS's valuation techniques.

In a footnote, the Tax Court also rejected the IRS's argument that "access to [a] research and development team" and "access to [a] marketing team" are intangibles under section 936(h)(3)(B) of the IRC or Treas. Reg. section 1.482-4(b). The Court stated that, to be considered intangible property, "each item [not specifically listed as an intangible] must meet the definition of a 'similar item' and have 'substantial value independent on the services of an individual", and that "the value of Veritas US's [research and development] and marketing teams is based primarily on the services of individuals (i.e., the work, knowledge, and skills of team members)". In an Action on Decision stating that the IRS does not acquiesce in the result or reasoning of the Tax Court's decision, the IRS argued that the court failed to recognize that:[79]

> depending on the facts and circumstances, an experienced and successful team's contribution to value may substantially exceed the total compensation expense to employ the individual team members, and similarly may be independent of the services of any individual team member who may be replaced without materially affecting the team as a whole. This is especially true where the relevant value stems not merely from the R&D and marketing teams in isolation, but from their interrelationship in combination with other important elements in an intangibles and services package such as in this case.

The regulations governing the pricing of controlled services transactions, discussed in section 3.2., contain rules addressing services transactions that include other types of transactions, including a transfer of intangible property. According to the regulations:[80]

> [w]hether such an integrated transaction is evaluated as a controlled services transaction under this section or whether one or more elements should be evaluated separately under other sections of the section 482 regulations depends on which approach will provide the most reliable measure of an arm's length result.

The regulations state that "ordinarily" the separate elements of an integrated transaction need not be considered separately and can be evaluated under the services regulations, provided that each component of the transaction is adequately taken into account in evaluating comparability.

A special rule, however, is provided for certain services transactions involving intangibles. If the transaction "include[s] an element that constitutes the transfer of intangible property or may result in a transfer, in whole or in part, of intangible property" and the element relating to intangible property is material to the pricing, the arm's length result for the intangible element of the transaction "must be corroborated or determined by an analysis under § 1.482-4" (the regulations governing the pricing of intangibles).[81] The regulations provide an example of a US and a related foreign company that perform research and development (R&D) activities related to integrated circuits.[82] The foreign company also manufactures integrated circuits. In years 1 through 3, the US company "engages in substantial research and development activities, gains significant know-how regarding the development of a particular high-temperature resistant integrated circuit, and memorializes that research in a written report". At the beginning of year 4, Company X enters into a technical assistance agreement with the foreign affiliate. As part of that agreement, researchers from the US company meet with the researchers from the affiliate and provide them with a copy of the written report. Three months later, the researchers from the foreign company apply for a patent for a high-temperature resistant integrated circuit based in large part upon the know-how obtained from the researches from the US company. The example provides that the controlled services transaction

75. Sec. 936(h)(3)(B) IRC. *See* also Treas. Reg. sec. 1.482-4(b). ("For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual - (1) Patents, inventions, formulae, processes, designs, patterns, or know-how; (2) Copyrights and literary, musical, or artistic compositions; (3) Trademarks, trade names, or brand names; (4) Franchises, licenses, or contracts; (5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and (6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b) (1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.")
76. US Department of Treasury, General Explanations of the Administration's FY 2012 Revenue Proposals 45 (2011).
77. Issues pertaining to embedded intangibles in tangible property are out of the scope of this article and are not discussed herein. *See* Treas. Reg. sec. 1.482-3(f).
78. US: TC, 10 Dec. 2009, *Veritas Software Corp. v. Commissioner*, 133 T.C. 14.
79. Action on Decision, I.R.B. 201-49.
80. Treas. Reg. sec. 1.482-9(m)(1).
81. Treas. Reg. sec. 1.482-9(m)(2).
82. Treas. Reg. sec. 1.482-9(m)(5), Ex. 4.

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includes an element that constitutes the transfer of intangible property, for example, know-how. The regulation concludes that "[b]ecause the element relating to the intangible property is material to the arm's length evaluation, the arm's length result for that element must be corroborated or determined by an analysis under § 1.482-4".

The special rule for bundled transactions involving intangibles was broader in earlier versions of Treas. Reg. section 1.482-9. In contrast to the final regulations, which apply to transactions that include an element that "constitutes the transfer of intangible property or may result in a transfer, in whole or in part, of intangible property", earlier proposed regulations applied the special rule in the case of transactions that "may result in a transfer... of intangible property, *or may have an effect similar to the transfer of intangible property*, or may include an element that constitutes the transfer of intangible property" (emphasis added).[83] This version of the regulations was criticized as "an unnecessarily broad remedy" that "deni[ed] aggregation to the vast majority of non-abusive services transactions that happen to include a material intangibles element, regardless of whether intangibles are in fact 'transferred' in the transaction (as distinguished from merely being 'embedded')".[84]

4. Conclusions

The increasing importance of cross-border services to the global economy, as well as the changing nature of services, presents challenges to the historic paradigm of services taxation. For instance, the proper characterization of financial functions is often uncertain, while transactions with an electronic element put pressure on the place of performance aspect of the services source rule. In the treaty context, whether or not the United States should make exceptions to its desired threshold for source taxation of income from enterprise services continues to be a question as the US treaty network is updated and expanded.

Despite these challenges, no major change in direction appears imminent. Rather, with regard to characterization issues, it is likely that some uncertainty in respect of novel questions will continue to persist as the law develops through court decisions and administrative guidance. On treaty issues, it appears to be likely that the United States will continue its normal treaty policy, including general opposition to services PEs and technical services provisions, with possibilities for exceptions where they are perceived to be in the United States' overall interest.

83. 68 Fed. Reg. 53447 (10 Sept. 2003) (Prop. Reg. sec. 1.482-9(m)(2)).
84. L.B. Terr, *The Proposed Transfer Pricing Services Regulations*, 101 Tax Notes, p. 1439 (22 Dec. 2003).

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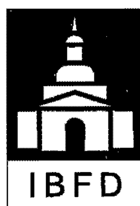

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