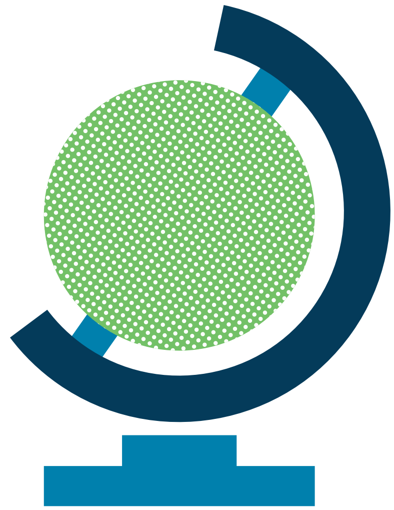

INTERNATIONAL TIDBIT:

Shop 'Til You Drop with an Attractive U.S. Tax Break

With Houston as the world's energy capital and a leading exporter of equipment for use around the world, our foreign-based clients have been surprised to learn that they can set up a purchasing office here in Texas and not be subject to U.S. federal income tax on subsequent sales outside the U.S. of products procured with the help of a U.S. purchasing office. The reason lies in a key provision in double taxation treaties that defines what is a "permanent establishment" in the U.S. of a company resident in another country.

PLACE OF BUSINESS FOR PURCHASING PRODUCTS

Under tax treaties negotiated by the U.S., as well as under the Model Treaty published by the Organization for Economic Cooperation and Development, a permanent establishment does not include an office, branch, or other fixed place in the U.S. through which business of a foreign company is carried on, provided the activity is solely for the purpose of purchasing. The reasoning behind this is that purchasing, without a sale, is a preparatory or auxiliary type of activity and doesn't give rise to income. This is reminiscent of the rule in many countries that in the absence of a completed commercial cycle within the country – such as the sale of a purchased or manufactured product – there is not sufficient economic activity or profit to be taxed.

In the typical scenario, a foreign trading company sets up a U.S. branch office (or limited liability company disregarded for federal income tax purposes). Its employees deal with suppliers and arrange for the items purchased to be drop-shipped from the supplier to the foreign country. A subsequent sale of the products is made by the foreign trading company to its foreign customer with title to the products passing to a foreign customer outside the United States. In the alternative the foreign company may be buying equipment for use in its own business, such as a foreign oil company acquiring equipment for use in drilling activities outside the U.S. In both cases, the significant profit-generating activity is outside the U.S.

STAYING WITHIN THE LIMITS

In seeking to benefit from this provision of U.S. treaties, foreign companies must be vigilant that the activities of the U.S. office are limited to purchasing and any other activities described as "preparatory or auxiliary" in the treaty, such as warehousing or advertising. It could be tempting for employees of the purchasing office to help with sales to foreign customers, undertake services such as modifying equipment for a particular use, or engaging in other activities more closely connected with the generation of profits that could be attributable to the U.S. office. These other activities could cause the office to lose its protected status and become a permanent establishment whose business profits would be taxable in the U.S. As a result, it is important for employees of the purchasing office to understand the limitations on their activities, whether embodied in an employment contract or company policy. It is also important for anyone acting on behalf of the foreign company to respect the limitations in the treaty and refrain from negotiating sales contracts at the U.S. office with foreign customers who may come to the U.S. for industry trade fairs such as the Offshore Technology Conference.

WHAT IF NO TREATY IS AVAILABLE?

All is not lost if the foreign company is resident in a country that lacks a double taxation treaty with the U.S. and on which the foreign company can rely. A very narrow exception exists under sections 864 and 865 of the Internal Revenue Code for the sale of inventory property. Generally, the U.S. taxes income of a foreign company that is effectively connected with a U.S. trade or business, such as a purchasing office. However, if inventory is sold by the foreign company through material participation in the sale by a foreign office, for use or consumption of the inventory outside the U.S., and title passes to the foreign customer outside the U.S., then the income from the sale is treated as foreign source income. Generally, foreign source income is not treated as effectively connected with a U.S. trade or business. Therefore, if the narrower exception under the Code is met, benefits similar to those under a double taxation treaty are available to a foreign company with a U.S. purchasing office.

OTHER TAX OBLIGATIONS

Finally, foreign companies using a U.S. limited liability company to set up a purchasing office and hire employees should keep in mind that even if the U.S. company is treated as a disregarded entity for U.S. federal income tax purposes, it still has obligations for payroll taxes and withholding with respect to the employees. It may also have to register for state taxes such as income and franchise tax as well as sales and use tax, depending on the rules of the state in which the office is located or employees are resident. However, fulfilling the requirements for an exemption from federal income tax may still make the use of a purchasing company an attractive way to accomplish a business objective to provide U.S.-made products to foreign customers.
