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In this article, McCormick analyzes the United States' attempts to adjust the permanent establishment standard to an increasingly digital economy.

Nonresident businesses entering the U.S. market will make determinations of whether a U.S.-based entity is required to facilitate the nonresident's domestic activities. When a nonresident establishes a U.S. subsidiary taxed as a C corporation, income earned by the subsidiary from worldwide sources becomes subject to U.S. tax.

To replicate this result, nonresidents engaged in U.S. commerce that do not separately incorporate — whether conducting U.S. activities directly or through a U.S.-based flow-through entity (such as a partnership or limited liability company) — are taxable by the United States on income associated with their U.S. activities (regardless of whether income is U.S.-source). Under statutory U.S. rules, a nonresident is taxable on income effectively connected to a U.S. trade or business. More often, the standard for evaluating a nonresident's level of U.S. tax exposure is the income tax treaty standard: whether business profits are attributable to a U.S. permanent establishment.[1]

Ramifications of maintaining a U.S. PE are significant. Business profits attributable to the U.S. PE are subject to U.S. tax, no matter the profits' source or character. Nonresidents normally are not taxed by the United States on foreign-source income or capital gains when either income type is attributable to a U.S. PE; however, the PE becomes subject to U.S. tax.

Historically, the United States has required some elevated level of physical connection or presence for the creation of a PE. Income earned without real physical presence was viewed as more passive, and PE creation typically did not result. In a growingly digitized economy, however, this view clearly is antiquated; foreign businesses can actively access the U.S. market's benefits and customers without a traditional physical presence. Concerns regarding nonresident creation of PEs have noticeably increased with COVID-19's upheaval of working conditions.

An evolving economy necessitates an evolving PE standard. This article details U.S. attempts to adjust the PE standard to a growingly digital economy.

Background: Taxation of Nonresident Businesses

A nonresident business with U.S. activities must consider a multitude of U.S. tax issues. The threshold issue is how the business will be classified for U.S. tax purposes. Like domestic entities, foreign businesses can be classified either as corporate entities (separately taxable on income earned in the company's name) or as flow-

[1] The United States has income tax treaties in force with 63 countries, including most heavily populated European, North American, and Asian countries.

throughs (with income passing through to the entity's owners).[2] Foreign entities are usually able to elect their classification for U.S. tax purposes. If no election is made, default rules dictate classification. Critically, default classifications are determined not by reference to home-country classification but by whether stakeholders in the business have limited liability. If all the stakeholders have limited liability, the entity is classified as a corporation.[3]

Under statutory rules, nonresidents are subject to U.S. tax on (1) fixed or determinable annual or periodic income sourced to the United States and (2) income effectively connected to the nonresident's U.S. trade or business.[4] FDAP income includes noncapital gains income sourced to the United States. Tax is collected through withholding by the U.S. payer (without deductions or credits for costs associated with income generation), with a 30 percent withholding rate (often lowered by treaty provisions) applicable.[5]

Nonresident aliens are taxed on income effectively connected with a U.S. trade or business at graduated rates, with deductions allowed.[6] Determinations of whether income fits within the effectively connected income category hinge on whether a U.S. trade or business is found. Case law provides that a U.S. trade or business exists when profit-oriented activities are carried on in the United States and are regular, substantial, and continuous.[7] Passive asset ownership (that is, a securities portfolio of U.S.-domiciled companies) does not create a U.S. trade or business outside special statutory inclusion.[8] What is instead required is some level of profit-oriented activity using the United States beyond as merely a customer locale. When this exists, classification of activities as a trade or business is likely. Income is effectively connected with a U.S. trade or business if it meets either an asset use test (looking to whether income was derived from an asset used in conducting a U.S. trade or business) or a business purpose test (focusing on whether U.S. trade or business activities were a material factor in income generation).[9]

When a U.S. trade or business is found, the scope of U.S. tax expands significantly. Nonresidents not engaged in a U.S. trade or business are subject to U.S. tax only on FDAP income, leaving significant gaps in U.S.-source income items (most notably, non-real property capital gains, but also most U.S.-source interest).[10] If a nonresident is engaged in a U.S. trade or business, it is taxed on all income effectively connected to that trade or business — not just FDAP income, but also capital gains, inventory sales, and some foreign-source income items connected to a U.S. office.[11] The ramifications of maintaining a trade or business are thus nonresident-specific: For those solely generating income that would be subject to U.S. tax regardless of the existence of a trade or business, trade or business classification can be preferred (given the ability to be taxed on a net basis). For businesses with more expansive operations, however, the creation of a U.S. trade or business can carry significant tax consequences.

Given the combination of the low threshold for a U.S. trade or business and the expansion in tax consequences that can result when maintaining one, nonresidents have an incentive to avoid trade or business tax exposure. Income tax treaties present an opportunity here — elevating the ECI standard to "business profits attributable to a United States permanent establishment."

PEs

Income tax treaties permit qualified residents of a treaty party country to remove application of the U.S. trade or business standard and replace it (usually) with analysis of whether business

[2] Reg. section 301.7701-3(b)(2).

[3] *See* reg. section 301.7701-3(a).

[4] *See* sections 871 and 881.

[5] Sections 871 and 881.

[6] Section 871(b).

[7] *See United States v. Balanovski*, 236 F.2d 298 (2d Cir. 1956); and *United States v. Northumberland Insurance Co. Ltd.*, 521 F. Supp. 70 (D.N.J. 1981).

[8] *See Higgins v. Commissioner*, 312 U.S. 212 (1941). The primary statutory inclusion is the 1980 Foreign Investment in Real Property Tax Act, which automatically classifies gains from the disposition of U.S. real property interests as effectively connected to a U.S. trade or business. *See* section 897(a).

[9] Section 864(c)(2).

[10] *See* section 881(a).

[11] Section 864(c).

profits are attributable to a U.S. PE. Specifically, treaties apply when a taxpayer resides in one country and has income taxable by another country under that country's default rules (the source country). When (1) the residence country and the source country have in place an income tax treaty between them and (2) the applicable taxpayer can establish valid residence in the former, the source country's default tax rules can (by election) be overridden by treaty terms. While each treaty between two countries has its own distinct articles, most all share general concepts and terms (with the overarching goal of any income tax treaty being the minimization of double taxation).

For nonresident taxpayers with U.S. activities, standards for overarching tax imposition are dictated by whether the nonresident qualifies for tax treaty benefits.

Tax Treaty Availability

Treaty benefits are available when the beneficial owner of an income item is a person qualified under a treaty for benefits. For treaty purposes, the term "person" generally includes individuals, estates, trusts, partnerships, companies, and any other bodies of persons.[12] The term "company" means any corporate body or any entity taxed as a corporation.[13]

A resident of a treaty party country is any person that, under the laws of either treaty party jurisdiction, is liable for tax because of domicile or residence (but not when subject to tax only on income sourced to that country).[14] When a taxpayer is classified as a resident of both treaty party countries under each country's default rules, tiebreaker provisions apply.[15]

Neither the term "beneficial owner" nor any version thereof is defined within income tax treaties. However, technical explanations (which accompany tax treaties to more fully explain the treaty's provisions) provide that the beneficial owner "is the person to [whom] . . . income is attributable for tax purposes under the laws of the source [country]."[16] Generally, the beneficial owner of an income item for treaty benefit purposes is the person liable to pay tax on the income (that is, a corporate taxable entity can be classified as a beneficial owner; a flow-through entity, like a partnership, will not itself be eligible for treaty benefits).[17]

PE Standard

As noted, nonresidents eligible for treaty benefits alter the U.S. business tax scope from income effectively connected with a U.S. trade or business to profits attributable to the carrying on of a business through a U.S. PE.[18] The existence of a PE generally permits a source country to tax the nonresident as if it had separately incorporated within the jurisdiction — further replicating the trade or business statutory standard.[19] Functionally, treaties provide that a business enterprise is taxable only in its country of residence, unless it takes steps of enough significance to create a PE in the other country. Given that the United States has executed tax treaties with the significant majority of other countries with prominent global economies, the PE standard is more likely to determine a nonresident business's U.S. tax exposure.

A PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on.[20] Although the PE standard is higher than the U.S. trade or business standard, it can still be low. For an extreme example, the maintenance of a small office in the United States solely to solicit orders for work done outside the United States has constituted a PE.[21]

Offices, places of management, and branches all are included within the PE concept.[22] However, maintenance of a fixed place of business solely for

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[12] *See* U.K.-U.S. income tax treaty, article 3(1).

[13] *Id.*

[14] *See id.* at article 4(1).

[15] *See id.* at article 4(5).

[16] *See* U.K.-U.S. income tax treaty technical explanation, article 10 (2003).

[17] *Id.*

[18] *See* Canada-U.S. income tax treaty, article 7(1).

[19] *See id.* at article 7(3).

[20] *See* U.S. model income tax convention, article 5(1).

[21] *See* Rev. Rul. 65-263, 1965-2 C.B. 561.

[22] U.S. model income tax convention, article 5(2).

auxiliary or preparatory activities does not cause a PE to be created.[23] Agent activities within the United States create a PE for a nonresident business if the agent has and habitually exercises an ability to conclude contracts in the name of the business within the United States.[24] When a nonresident business forms a U.S. subsidiary, the subsidiary's acts are not attributed to the parent for purposes of PE creation; rather, the subsidiary is taxed separately on its own activities.[25]

Whether a fixed place of business exists for a nonresident business is ultimately determined under U.S. standards. To constitute a fixed place of business, an establishment need not be immovable or perpetual.[26] A PE does, however, need an element of permanence. Whether a place of business is sufficiently permanent is fact-specific, with connection to the United States over a multiyear period often sufficient.[27] A facility need not be actually attached to the ground, so long as it remains at a given site.[28]

For a PE to create U.S. tax consequences, mere existence of a PE is insufficient; business profits must be attributable to the PE. The term "business profits" is not specifically defined under tax treaties. Technical explanations clarify that business profits include any income generated by a trade or business, thereby incorporating capital gains and other income that would be treated as effectively connected to a U.S. statutory trade or business.[29]

PEs in a Digital Economy

Historically, a foundational element of whether a nonresident maintains a U.S. business has been the nonresident's level of physical presence within the United States. PEs by definition use a fixed place standard, typically necessitating some level of physical connection. This requirement traditionally has been sensible — for a nonresident to actively access benefits of the U.S. market (thereby making an elevated level of tax appropriate), some U.S. footprint has been needed.

Difficulty with the traditional PE/trade or business standard arises when applied to a digitized economy. Substantial physical connection with the United States is now required to be engaged in active U.S. operations. By necessity, the standards for evaluating nonresident business have begun to be adapted.

What specifically constitutes a PE in the digital context is unsettled, both in the United States and in other jurisdictions.[30] Given both the infancy and significance of the issue, it has generated continuous attempts to define a scope.[31] Two areas in which questions often arise are (1) services physically performed outside the United States for the benefit of end-users in the United States, and (2) employees working remotely from the United States for an employer that does not otherwise maintain a U.S. PE.

Services Performed Outside the United States

Traditionally, personal services have been both performed and consumed within the same jurisdiction. Personal services are statutorily taxed in the country where they are physically performed.[32] Separately, performance of digital services outside the United States but for U.S. customers generates some level of PE creation risk for a nonresident business.

Many treaties were enacted decades before digital commerce was a significant consideration and have never been updated.[33] Treaties not addressing digital activities have been left to interpretation about what constitutes a PE. When a U.S. treaty doesn't specifically address the issue, a nonresident is subject to the U.S. interpretation of PE in the digital context.

[23] *Id.* at article 5(4).

[24] *Id.* at article 5(5).

[25] *Id.* at article 5(7).

[26] *See* Rev. Rul. 67-322, 1967-2 C.B. 469.

[27] *See id.*

[28] *See* OECD model treaty commentary on article 5 (2014).

[29] *See* U.K.-U.S. income tax treaty technical explanation, article 7 (2003).

[30] As one would suspect, tax treaty provisions apply jointly to each treaty party; a U.S. taxpayer operating in Mexico is subject to Mexico's PE rules in the same fashion as a Mexican taxpayer is subject to the U.S. PE standard.

[31] *See* OECD, "Clarification on the Application of the Permanent Establishment Definition in E-Commerce" (2000).

[32] *See* section 861(a)(3).

[33] *See* Israel-U.S. income tax convention.

Direct IRS guidance on what constitutes a PE in the context of digital services is lacking. Inferences are thus sought from existing guidance and from non-U.S. interpretations of the PE standard. As to the latter, the OECD, a forthright authority on treaty interpretation, has issued guidance on the topic.

Under OECD guidance, the location of servers through which services are provided is a relevant consideration and can contribute to the finding of a PE.[34] However, when a company does not own or control a server and merely pays for space on the server of another, it is unlikely to constitute a PE.[35] Traditional factors regarding whether the United States is used as a business market are also important.[36]

The date on which a treaty's PE provisions have been updated is often critical. A primary example of treaty evolution in this context is the Canada-U.S. income tax convention. A 2007 protocol to the Canada-U.S. treaty added article 5(9), covering personal services rendered by a Canadian-based business enterprise to U.S. customers (or vice versa). Under the protocol, when a Canadian company provides services in the United States, the Canadian company will be deemed to provide the services through a PE if and only if (1) services are performed by an individual present in the United States more than 183 days in a 12-month period and, during that period, more than 50 percent of the gross active business revenue of the Canadian company consists of income from those services; or (2) services are provided in the United States for an aggregate of 183 days in a 12-month period for the same or a connected project for customers who are residents of the United States.[37]

The technical explanation to the Canada-U.S. treaty provides that article 5(9)(b) is applicable only to services performed *or* provided within Canada; services do not count for this requirement merely because they are furnished to U.S. end-users.[38] Additional clarification of "provided" is not given.

As for remote services, the treaty states that when a Canadian company provides "customer support *or other services* by telephone or computer" to customers in the United States, the activities are not classified as performed or provided within the United States.[39] The technical explanation also provides an example of an architect residing in Canada who is hired by a company based in the United States. As part of the work, she surveys a planning site in the United States and does blueprint work in Canada. Days physically present in the United States for surveying are counted; however, days spent working at home are not counted (even though those services will ultimately be performed for the benefit of U.S. customers).[40]

Remote Work by Employees

Employees of a nonresident business enterprise working remotely in the United States are an especially timely consideration given the implications of COVID-19. Existing trends toward remote work — and often, work outside a business enterprise's country of domicile — combined with expected post-COVID-19 workplace (and societal) shifts give this area increased importance.

As noted, PEs normally must have distinct physical aspects; offices are explicitly included within the PE concept.[41] Mere availability of physical space in a jurisdiction is normally insufficient for a PE. However, when physical space is used (either directly or indirectly) to generate significant income for a business enterprise, a PE can result from that physical space.[42]

The risk of PE creation from work by U.S. employees most often centers on the use of office space within the United States. Whether office space is sufficient to constitute a PE is fact-

[34] *See* OECD, *supra* note 31.

[35] *Id.*

[36] *See* U.S. Treasury, "Selected Tax Policy Implications of Global Electronic Commerce" (Nov. 1996).

[37] Canada-U.S. income tax treaty, article 5(9).

[38] Canada-U.S. income tax treaty technical explanation, at 11 (2008).

[39] *Id.*

[40] *Id.*

[41] *See* U.S. model income tax convention, article 5; and OECD model treaty commentary.

[42] *Id.*

specific. Focus is on the extent to which the employee's activities directly relate to business profit (although this standard inherently is extremely subjective). An office does not automatically create overarching PE tax repercussions; a U.S. office of a nonresident business enterprise does not create a PE when only auxiliary or preparatory activities occur there.

In the COVID-19 context, juxtaposing the PE standard with the trade or business standard applied to businesses not resident in a treaty party country is noteworthy. The former inherently requires an element of permanence; treaties and their technical explanations have consistently emphasized the requirement that PEs be non-temporary.[43] Permanence of an office is not the same type of prerequisite in the trade or business context; instead, focus is fact-specific, and generally on whether U.S. activities are regular and continuous (and whether income is effectively connected to any trade or business established).[44] ■

[43] *See* OECD model income tax convention technical explanation, article 5.

[44] *See Northumberland Insurance*, 521 F. Supp. 70.