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# U.S. Ruling Could Affect Italian Partnerships With U.S. Branch Offices

by Alessandro Adelchi Rossi

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# Practitioners' Corner

## U.S. Ruling Could Affect Italian Partnerships With U.S. Branch Offices

*by Alessandro Adelchi Rossi*

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Generally, Italian — and other non-U.S. — professional partnerships that wish to expand their operations in the United States must make specific determinations — for example, how to allocate the partnerships' profits; whether the allocation method adopted has substantial economic effect; the source of the U.S.-resident partner's distributive share of the partnership income; and whether a U.S.-resident partner is a resident of the United States under the applicable income tax treaty.

Following a revenue ruling issued earlier this year by the U.S. Internal Revenue Service in connection with the Germany-U.S. tax treaty,[1] a professional firm organized as a partnership under Italian law with a branch office in the United States now also must determine the U.S. tax ramifications for its Italian-resident partners of the partnership's allocable share of income attributable to that U.S. office, even though the Italian residents do not perform any services in the United States. The ruling represents a sharp change in the IRS's view on this matter, as discussed below.

### Taxation of Foreign Partners Under U.S. Law

The income derived by non-U.S.-resident individuals from the performance of personal services in the United States is generally treated as U.S.-source income[2] effectively connected with the conduct of a trade or business in the United States by the nonresident alien individual,[3] and as such

[1]Rev. Rul. 2004-3, 2004-7 IRB 486, *2004 WTD 20-11 or Doc 2004-1818.*

[2]*See* section 861(a)(3) of the Internal Revenue Code. However, in very limited circumstances (namely, when the Italian individual is not in the United States for over 90 days during the taxable year, the compensation does not exceed US $3,000, and the services are performed as an employee of or under a contract with an Italian or other foreign person not engaged in a trade or business in the United States, or are performed for an Italian or other foreign office or place of business of a U.S. person), the income of an Italian individual from the performance of personal services in the United States is excluded from U.S.-source income. *See* IRC section 861(a)(3)(A), (B), (C).

[3]*See* IRC sections 864(b)(1) and 864(c)(3).



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it is taxed at the regular graduated rates. However, gross personal services income of nonresident alien individuals is also subject to withholding at source at a rate of 30 percent.[4] In most cases this will result in overwithholding because the 30 percent rate is almost as high as the top marginal rate due on effectively connected income and is imposed without allowance for deductions.

IRC section 701 provides that a partnership is not subject to income tax. Rather, the persons carrying on the business of the partnership as partners are liable for income tax in their separate or individual capacities. A partner must determine its income tax by separately taking into account its distributive share of the partnership's income.[5]

***The requirement of a fixed base permits independent contractors to extend their operations into other countries without multiplying their burdens of tax compliance.***

Under IRC section 875(1), a nonresident alien individual who is a partner in a partnership engaged in a U.S. trade or business is himself considered to be so engaged. IRC section 871(b)(1) provides that a nonresident alien individual may be taxed on taxable income that is effectively connected with the conduct of a U.S. trade or business.

Also, under the so-called limited force of attraction rule, all U.S.-source income of a non-U.S. partner engaged in a U.S. trade or business (with the exception of categories of periodic income — for example, dividends, interest, and royalties — and capital gains that are unrelated to the U.S. trade or business of the foreign partner) is "attracted" to the U.S. trade or business[6] and is subject to U.S. tax.[7]

However, the domestic provisions must be applied with due regard to any U.S. treaty obligation that applies to a taxpayer.[8] For Italian residents, in most cases, article 14 of the Italy-U.S. tax treaty in force[9] provides relief from U.S. tax, as discussed in the following paragraph.

## Article 14 of the Treaty

Article 14 sets forth the general rule for the tax treatment of income derived from the performance of services in an independent capacity by an individual or a group of individuals (for example, a partnership). Under the general rule, an individual who is a resident of Italy and who derives income from performing personal services is taxed in his country of residence only, unless (1) the services are performed in the United States and (2) the services are attributable to a "fixed base" maintained by the individual in the United States,[10] or the individual is present in the United States for a period or periods aggregating more than 183 days in the fiscal year concerned.

It should be observed that under the new income tax treaty and protocol, which the two countries signed on August 25, 1999, but that has not yet entered into force,[11] the 183-day rule has been eliminated. Therefore, independent personal services would be taxed in the United States only if the individual is operating from a fixed base.

## The 'Fixed Base' Concept

A fixed base has the same purpose as a permanent establishment, namely to determine which country has primary taxing jurisdiction.[12] As a practical matter, the requirement of a fixed base permits independent contractors to extend their operations into other countries without multiplying their burdens of tax compliance.

Its significance is perhaps best explored through the following example.

*Example 1*

Consider the steps an Italian lawyer would go through to expand his business in the United

[4]*See* IRC section 1441(a).

[5]*See* IRC section 702. Under IRC section 702(b), the character of an item of income, gain, loss, deduction, or credit is determined as if that item was realized directly from the source from which it was realized by the partnership or incurred in the same manner as incurred by the partnership.

[6]IRC section 864(c)(2).

[7]IRC section 864(c)(3).

[8]*See* IRC section 894(a)(1).

[9]That treaty and protocol between the United States and Italy entered into force on December 20, 1985.

[10]Exceptions to this rule are provided for specific categories of income under articles 16 (directors' fees), 17 (performance income of artists and athletes), 20 (particular income of professors and teachers), and 21 (particular income of students and trainees).

[11]On November 5, 1999, the U.S. Senate approved the new treaty subject to a reservation requiring the removal of the "main purpose" test and subject to an understanding that the competent authorities would have the authority to obtain and provide information held by financial institutions and others. President Clinton signed the U.S. Instruments of Ratification on December 28, 1999. However, the new treaty has not yet been ratified by Italy, and will enter into force once the instruments of ratification are exchanged.

[12]*See* E. Michaud, *Intertax* 68, 72 (1987).

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States. The Italian lawyer is likely to approach the U.S. market through meetings with potential clients, seminars, the intermediation of local professionals (lawyers, accountants, and so forth), and similar means. These transactions could cause the Italian lawyer to be "doing business" in the United States. If the performance of services in the United States was exposed to taxation by that country, the Italian lawyer could easily find himself subject to the burdens of complying with the U.S. tax requirements. Although the actual amount of that tax might not be intolerable (particularly if it were offset by appropriate credits in Italy), the mere fact of becoming a taxpayer in another country could add up to significant administrative burdens and obstacles to overseas transactions.

With article 14 setting the existence of a "fixed base" as a threshold of taxation by the country of source, the Italian lawyer in the example could render his services in the United States free of U.S. tax. This protection extends, however, only to a limited extent. If the Italian lawyer in example 1 above finds a particularly favorable reception for his services in the United States, he might also find it convenient, in order to pursue his U.S. business more effectively, to open his own U.S. office. However, an Italian independent contractor with a more extensive presence in the United States is plausibly also in a better position to comply with U.S. income taxation requirements.

Article 14 incorporates this view by elevating this type of presence to the status of fixed base. When the Italian lawyer establishes a protracted presence in the United States, he is treated as having accepted the same terms of participation in the U.S. economy as are imposed on U.S. lawyers.

Whether a fixed base is regularly available to a person is determined based on all the facts and circumstances. In general, the term encompasses situations when a fixed base is at the disposal of the individual whenever he performs services in that country.[13]

*Example 2*

An Italian resident partner in a law firm that has offices in the United States is considered to have a fixed base regularly available to him in the United States if work space in those offices (whether or not the same space) is made available to him whenever he wishes to conduct business in the United States, regardless of how frequently.

On the other hand, an Italian professional who has no office in the United States and occasionally rents a hotel room to serve as a temporary office is not considered to have a fixed base regularly available to him.

## Computation of the Profits Attributable to a Fixed Base

In general, the provision of article 7 (business profits) of the treaty could be used as guidance for interpreting and applying article 14. Thus, for example, similar to a permanent establishment, expenses incurred for the purposes of a fixed base, including general and administrative expenses, are deductible in computing the income attributable to that fixed base.[14]

However, unlike article 7, in article 14 the income of the Italian lawyer in example 2 above would have to be attributable not only to his U.S. fixed base, but also to services performed in the United States. By way of comparison, article 7 does not contain a similar source rule requiring that all of the income-generating activities be performed in the country where the permanent establishment is located.

The application of this source rule is illustrated by the following example involving a partnership.

*Example 3*

An Italian partnership has 10 partners, nine of whom are resident and perform personal services only in Italy and one of whom performs personal services from a U.S. office that constitutes a fixed base under article 14.

Under the partnership agreement, the 10 partners share profits equally. The nine Italian partners are taxable only in their country of residence (that is, Italy) because they performed all of their activities there,[15] but they have to comply with the U.S. reporting requirements of IRC section 6114(a).[16]

[13]*See* the Treasury technical explanation to article 14 of the 1996 U.S. model treaty.

[14]*See* OECD commentary to article 14, par. 3.

[15]Therefore, under article 14, the normal U.S. domestic rules do not apply. Those rules require treating each partner of a partnership that derives U.S. effectively connected income as having a U.S. permanent establishment (or fixed base).

[16]IRC section 6114(a) provides that a taxpayer who takes a position that a tax treaty overrules or modifies the domestic law must disclose that position on the tax return or other prescribed form. IRC section 6114(b) permits the secretary of the treasury to waive the requirements of IRC section 6114(a) if the waiver does not impede assessment and collection of tax. Treas. reg. section 301.6114-1(c) lists the circumstances in which that reporting requirement is waived. Under Treas. reg. section 301.6114-1(c)(4),

*(Footnote continued on next page.)*



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However, if one of the nine Italian partners worked in the United States on a matter involving the U.S. office, his share of the income attributable to the fixed base is taxable in the United States.

It should be observed that on April 29, 2000, the OECD Council deleted article 14 from the OECD model treaty on the assumption that there were no intended differences between the concept of "permanent establishment" and "fixed base," that is, between articles 5 and 14, including the computation of profits under articles 7 and 14.

## IRS's Prior Position

In a 1993 private letter ruling,[17] the IRS confirmed the source rule of article 14 requiring that, for a foreign partner to be subject to U.S. tax, his activities must be performed in the United States through a fixed base. The ruling involved a law firm organized as a partnership under German law. The partnership had a branch office in New eYork City.

The one U.S.-resident partner performed services only in the United States and, according to the German tax authorities, was taxable only in the United States while residing there. The partnership and the U.S.-resident partner had executed an agreement allocating all of the New York office's profits to the U.S.-resident partner.

***The U.S. tax authorities have grown uncomfortable, from a policy standpoint, with the position adopted in the 1993 letter ruling.***

Citing the technical explanation of paragraph 1 of article 14 of the Germany-U.S. treaty, the IRS ruled that, because the U.S. resident partner only performed the services for the partnership in the United States, he was only taxable in the United States on his distributive share of partnership income under article 14 of the Germany-U.S. income tax treaty.

By the same token, the income derived by the non-U.S. resident partners in Germany was only taxable to them in Germany because they did not perform any services in the United States.

## IRS's View

Over the years, the U.S. tax authorities have grown uncomfortable, from a policy standpoint, with the position adopted in the 1993 letter ruling. To satisfy inquiries from both agents and the taxpayers, on January 29, 2004, the IRS issued Rev. Rul. 2004-3.

The ruling was issued in connection with a German service partnership with offices in both Germany and the United States. The U.S. office was a fixed base under article 14 of the Germany-U.S. tax treaty. The partnership had two partners: a nonresident alien individual who was a resident of Germany under article 4 of the Germany-U.S. treaty and a U.S. resident. The German-resident partner performed services solely at the partnership's office in Germany and the U.S.-resident partner performed services solely at the partnership's office in the United States. The two partners agreed to divide the profits of the partnership equally.

The IRS determined that the fixed base of a partnership was attributed to its partners for applying article 14 of the relevant treaty. In reaching its conclusions, the IRS relied on IRC section 875 (under which a nonresident alien individual who is a partner in a partnership that is engaged in a U.S. trade or business is himself considered to be so engaged) and some case law. Namely, the IRS cited *Donroy*,[18] in which the court held that the U.S. permanent establishment of a partnership was attributable to a foreign person that was a limited partner under the 1942 Canada-U.S. income tax treaty. Also, the IRS cited *Unger*,[19] in which the court followed the holding in *Donroy*, noting that it stood for the proposition that the office or permanent establishment of a partnership is, as a matter of law, the office of each of the partners — whether general or limited.

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if a partnership that has the taxpayer as a partner discloses on its information return a position for which reporting is otherwise required by the taxpayer, the taxpayer is then excused from disclosing that position on a return. Therefore, if an Italian partnership discloses on its Form 1065 its position that the Italy-U.S. income tax treaty overrides or modifies the application of IRC section 875 and other domestic provisions to the non-U.S. resident partners of that partnership, those partners do not have to file U.S. federal income tax returns to disclose that position.

[17]LTR 9331012.

[18]*Donroy, Ltd. v. United States*, 301 F.2d 200 [9 AFTR 2d 1129] (9th Cir. 1962).

[19]*Unger v. Commissioner*, 936 F.2d 1316, 1319 [68 AFTR 2d 91-5204] (D.C. Cir. 1991). The IRS also cited *Johnston v. Commissioner*, 24 T.C. 920 (1955) (holding that a partnership's permanent establishment is deemed to be a permanent establishment of its partners) and Rev. Rul. 90-80, 1990-2 C.B. 170 (same).



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The IRS, without regard to whether the German-resident partner performs services in the United States, held that he is subject to U.S. net income tax on his allocable share of income from the partnership to the extent that that income is attributable to the fixed base regularly available to him in the United States.

As a result of the IRS's holding in Rev. Rul. 2004-3, LTR 9331012 was no longer in accord with the IRS's views, and it was revoked.[20]

Because article 14 of the Italy-U.S. treaty is similar to article 14 of the Germany-U.S. treaty,[21] Rev. Rul. 2004-3 is also applicable in interpreting the Italy-U.S. treaty.

## Interpretation of the Italy-U.S. Treaty

According to the IRS, income from the performance of personal services includes all income attributable to the fixed base for personal services carried on by the partnership (whether by the partner himself, other partners in the partnership, or by employees assisting the partners). The IRS was probably unhappy with an interpretation of a treaty that would limit its jurisdiction over non-U.S. partners of partnerships engaged in a U.S. trade or business, even though it is a generally accepted principle that a treaty cannot amplify, but can limit, a country's tax jurisdiction.

With a narrow reading of article 14 of the treaty, it may be argued that to be subject to U.S. tax, an Italian member of a partnership with a fixed base in the United States should directly perform his activities in the United States. In that case, the IRS interpretation might be contrary to the spirit of the treaty.

Generally, the interpretation of a treaty is a question of law, with the treaty language itself as the starting point.[22] The clear language controls unless the "application of the words of the treaty according to their obvious meaning effects a result that is inconsistent with the intent or expectations of the signatories."[23]

Thus, to ensure its fair operation, the Italy-U.S. treaty must be interpreted in a manner that gives effect to the intent of the parties, as ascertained from the text, context, and history of the treaty, including the course of conduct of both countries.[24]

However, U.S. courts have held that when examining a provision of a tax treaty, its purpose and role within the U.S. tax structure must be examined, not just its literal language.[25] The legislative, judicial, and administrative agencies of the United States tend to interpret tax treaties more as statutes than contracts, giving undue weight to unilateral interpretive materials and underemphasizing materials that reflect the mutual views of both contracting states.[26] This U.S. practice of treaty interpretation diverges greatly from the Italian and international practice and seems to be confirmed by the ruling under review.

## Conclusion

The language of the Italy-U.S. treaty appears to be sufficient to make an argument that, to be subject to U.S. tax, an Italian resident with a fixed base in the United States must directly perform his activities in the United States. However, Rev. Rul. 2004-3 clearly indicates that the IRS has taken a precise position on the issue that would adversely affect non-U.S. resident members of professional partnerships with branch offices in the United States. As a result, the ruling might generate controversy in this area, making it more difficult for Italian, as well as other non-U.S., professional partnerships to decide on a course of action to expand their operations in the United States.

[20]LTR 200420012.

[21]The Italian treaty also includes a minimum-presence (more than 183 days) test as an alternative to the fixed base test.

[22]*See Eastern Air Line Inc. v. Floyd*, 499 U.S. 530, 534 (1991).

[23]*See* TAM 199941007.

[24]*See, for example*, *Air France v. Saks*, 470 U.S. 392 (1985).

[25]*See, for example*, *Great-West Life Assurance Company v. United States*, 678 F.2d 180 (Ct. Cl. 1982).

[26]*See* American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation II* (1992).

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