

Chapter 4

Structuring the Scope of Work—Tax Issues

*William W. Chip**

Research References

West's Key Number Digest
Taxation ¶73 to 77

Westlaw Databases
American Law Reports (ALR)
Going Global: A Guide to Building an International Business
(GOGLOBAL)
Laws of International Trade (INTLTRADE)

A.L.R. Library
West's A.L.R. Digest, Taxation ¶73 to 77
State Corporate Income Taxation of Foreign Dividends, 17 A.L.R. 6th
623

*William (Bill) W. Chip is a partner at the law firm Covington & Burling LLP. He is the firm's senior international tax partner and resides in the firm's Washington office. Mr. Chip has 27 years of tax experience, including 10 years as a law firm tax partner and 10 years as a global audit firm tax partner. Over the course of his career, Mr. Chip has represented and advised many of the largest multinational companies headquartered in the United States and European Union, including oil companies, banking and security firms, and other specialized industries. He advises tax directors, general counsels, and CFOs on the international tax aspects of business globalization, strategic acquisitions and joint ventures, integration of acquired and pre-existing businesses, and the use of complex financial instruments for corporate finance and risk management. He has achieved favorable settlements of complex international tax controversies with the IRS, in the courtroom, and in Competent Authority proceedings. A preeminent transfer pricing expert, Mr. Chip regularly manages global transfer pricing projects that cover planning, documentation, audit defense, and negotiation of Advance Pricing Agreements. In matters involving tax jurisdictions outside the United States and United Kingdom, Mr. Chip relies on a well-established network of eminent foreign tax attorneys and often collaborates with one or more of the Big Four accounting firms. Prior to entering law school, Mr. Chip served as an officer in the U.S. Marine Corps, attaining the rank of Captain.

Treatises and Practice Aids

Gutterman and Brown, *Going Global: A Guide to Building an International Business* §§ 25:33, 29:28, 29:34, 30:63, 30:65, 31:63
Laws of International Trade §§ 58:2, 86:44

KeyCite®: Cases and other legal materials listed in KeyCite Scope can be researched through the KeyCite service on Westlaw®. Use KeyCite to check citations for form, parallel references, prior and later history, and comprehensive citator information, including citations to other decisions and secondary materials.

§ 4:1 Checklist

- Systems for taxing cross-border income
- Source of income
- Tax arbitrage
- Taxable presence (nexus)
- Calculating taxable income
- Outsourcing services
- Substance over form
- Tax treaties
 - “Permanent establishment”
 - “Business profits”
 - Withholding tax relief
 - “Treaty shopping”
 - Use of affiliates
- Guide to structuring contracts
 - Extent of local activities
 - Local incentives and provisions
 - Segregation of the contract
 - Separate contracts
 - Assignment of local activities
 - Subcontracting of local activities
 - Negotiating and signing the contract
 - Performance of the contract

§ 4:2 In general

The taxation of income arising from international contracts will vary considerably depending on how the contract is characterized (turnkey, sales of goods, transfer of know-how, provision of services, license of intellectual property etc.),

special-contract requirements (warranties, etc.), and ancillary transactions (installation services, software updates, etc.). In addition to these business considerations that may impact the taxation of income from the contract, the parties to the contract may have specific tax objectives that may lead to writing the contract and structuring the transaction in a very particular way. For all of these reasons, a basic understanding of U.S. and international tax rules is important.

§ 4:3 Systems for taxing cross-border income

As many as three countries may claim a right to tax the profits from a cross-border contract: the home country (where the seller makes his or her home or is legally organized); the host country (where contract activity is performed); and the source country (where the income from the contract originates). Although few transactions would actually give rise to tax claims from three countries, transactions that expose a contracting party to double taxation are not at all uncommon. Double taxation could absorb virtually all of the profits from a contract.

All developed countries have instituted one of two systems (or some combination thereof) for minimizing double taxation with respect to local income that is derived by nonresidents and foreign income that is derived by local residents—the exemption system and the credit system. Many European countries take a “territorial” approach whereby income associated with a foreign taxable presence is exempt from taxation in the home country. The U.S. and some other countries follow the credit system whereby worldwide income of a resident taxpayer is taxable with a credit allowed for taxes paid in the host or source country. The credit is allowable, however, only against income from sources without the U.S.

A company that resides in a country that employs an exemption system will almost always benefit from reducing taxes in the host or source country. A company that resides in a country that employs a credit system may not realize such benefits since income not taxed abroad will be taxed at home. However, even companies that reside in credit-system countries may benefit from foreign tax reduction if they are effectively exempt from current taxation at home because of tax loss carryovers or if the rate of foreign tax exceeds the rate of domestic tax.

§ 4:4 Source of income

A maxim of international law is that a country has the right

§ 4:4

to tax income arising from sources within that country. In addition, the U.S. does not tax foreign persons on certain categories of income from sources without the U.S., and the U.S. foreign tax credit applies only to the portion of total U.S. tax that is allocable to income from sources without the U.S. Accordingly, understanding the source-of-income rules is very important. Although there may be variations from country to country, the basic rules are as follows:

- Interest is sourced to the country of the obligor.
- Dividends are sourced to the country of incorporation of the payor.
- Royalties and license fees are normally sourced to the country where the licensee is resident. However, for U.S. foreign tax credit purposes, royalties are sourced to the country where the license agreement allows the rights to be used.
- Rents are sourced to the country where the property is located.
- Services are sourced to the country where the services are performed. However, services may sometimes involve transfers of technology, and to that extent, the payment may be taxed as a license fee.
- Sales of personal property are normally sourced where title (risk of loss) passes from the seller to the purchaser. However, for U.S. tax purposes, even when title passes outside the U.S., a portion of the income from property manufactured by the seller in the U.S. as well as income from selling into the U.S. through a fixed place of business in the U.S. may be deemed to be from U.S. sources.
- Sales of real property are sourced where the real property is situated.

§ 4:5 Tax arbitrage

It is possible that payments under a given contract may be treated differently under U.S. law and the law of the host or source country and become subject to double taxation notwithstanding that a credit or territorial system is in place. The laws may ascribe different sources to the payments or may characterize them differently (e.g. as payments for services versus payments for technology). The result may be double taxation, i.e., taxation in both countries with no relief in either country for the other country's tax.

Most developed countries have entered into tax treaties with

each other and have done so with a number of developing countries as well. A principal purpose of these treaties is to prevent double taxation of income from cross-border contracts. A tax treaty may settle the source of income from a specific type of transaction, may define the tax character of a specific transaction, or may simply cede taxation of a specific income item to one of the treaty countries. Tax treaties also ordinarily provide a mechanism whereby the “competent authorities” of the treaty countries may agree to provide full or partial relief from double taxation in cases where the treaty does not do so automatically.

Different tax treatment of a transaction by two countries may also present opportunities for “tax arbitrage,” i.e., avoiding taxation in either country by structuring the transaction so that each country treats it as being taxable only by the other. Transactions, financial instrument, or legal entities that are structured to be treated differently in different countries are referred to as “hybrids.” An example of a “hybrid instrument” would be a financial instrument that is treated as debt in one country and equity in the other. An example of a “hybrid entity” would be one that is classified as a corporation in one country and a partnership or other fiscally transparent entity in the other.

§ 4:6 Taxable presence (nexus)

Dividends, interest, license fees, and other categories of income can be sourced from a given country and taxed by the source country even if the recipient has little or no actual presence in that country. However, while having a taxable presence in a source country is not always a necessary condition for the imposition of local tax, local presence is often a sufficient condition for taxation by the host country, since most countries reserve the right to tax income associated with a local taxable presence (known in tax parlance as nexus) regardless of the residence of the taxpayer or the source of the income.

The determination of what constitutes nexus is always a question of fact and requires careful attention to the manner of doing business in the host country.

The following activities generate increasing exposure to taxation based on nexus:

- Registering (qualifying) to do business
- Using “missionaries” to call on customers to generate business

§ 4:6

- Soliciting orders (either by drummers or by telephone)
- Delivering goods in the jurisdiction, e.g., by repackaging goods for on-delivery to customers
- Carrying out training seminars in the host country, e.g., as to how to use the products
- Closing transactions in the host country, i.e., by accepting (vs. merely taking) orders
- Performing services of virtually any nature (unless ancillary to the sale of goods or transfer of technology)
- Having a local office or other fixed place of business

As discussed below, the risk that nexus in a country other than the resident country may give rise to double taxation is often mitigated by tax treaties.

§ 4:7 Calculating taxable income

Under the force-of-attraction principle applicable under the internal laws of most countries, once a foreign company has established a nexus under local law, all income arising from sources within that country may be taxed to that company. This means that creation of a taxable presence can cause seemingly unrelated income (for example, interest or dividends) to be taxable at the same rates as income directly arising from the assets or activities that gave rise to nexus. U.S. tax law applies a limited force-of-attraction principle that treats certain categories of income such as dividends, interest, and royalties as exempt from standard income taxation (although potentially subject to withholding tax) unless the income is effectively connected with U.S. business activity. In addition, certain types of income arising from foreign sources may also be taxed if effectively connected with the local taxable presence (for example, income from the import and local sale of goods through a local office, even where title passes outside of the jurisdiction).

§ 4:8 Outsourcing services

For decades, U.S. and other companies in the industrialized world have been entering into contracts with offshore manufacturers to make or assemble components or even final products for sale and home and abroad. With the emergence of China as a manufacturing center, the number and magnitude of these contract-manufacturing arrangements have increased explosively. More recently, coincident with the emergence of India as a source of inexpensive labor that is relatively well-educated

and English-proficient, companies in the developed countries have been outsourcing the performance of services that were customarily provided by employees in the home country. Software companies have outsourced computer programming, global accountancies have outsourced routine compliance work, financial services firms have outsourced processing, and offshore call centers have been established for everything from the sale of newspapers to the answering of customer service inquiries.

India and other countries to which services are outsourced may have tax systems not well adapted to cross-border commerce and limited treaty networks. Consequently, the structuring of cross-border contractual arrangements and the drafting of the contracts themselves must be customized to suit the local situation. Evolving rules mean that forms of contract must be periodically updated and contracts in force must be periodically reviewed for tax effect.

Among the “tax traps” that need to be avoided are treatment of a contract with a local company to perform services as creating a local tax nexus or permanent establishment for the service recipient, thereby subjecting to local income tax not only the profits of the local company from rendering the services but also any profits earned by the recipient as a result of receiving the services.

When the company providing the service is an affiliate, assertions that the fees paid for the local services are less than an arm’s-length price resulting in an upward adjustment to the affiliate’s taxable income and possible imposition of penalties and interest. Because developing countries may not have access to information about market prices for comparable services, they sometimes apply arbitrary formulas, including cost-plus formulas, to establish the “arm’s-length” price.

§ 4:9 Substance over form

It is common practice to involve an additional company in a contract structure to isolate taxable activities from nontaxable activities so that the latter are not “tainted” by the former. It is important to keep in mind that the participation of a party to an international contract may not be recognized by local tax authorities if the party does not have “substance” in the form of employees and capabilities; does actively participate in the negotiation and performance of the contract; or is unable to demonstrate by documentation that it has a real existence, re-

§ 4:9

ally transacts business, and actually communicates in its own name and on its own letterhead within and without the corporate group of which it is a part.

§ 4:10 Tax treaties

Double taxation of profits from a contract is most readily avoided when a tax treaty is in effect between the home country and the host or source country. Although tax treaties tend to use certain standard terms and concepts, often based on the Model Tax Convention of the Organization for Economic Cooperation and Development, there are many variations in the utilization and interpretation of these terms and concepts, making it essential to read the applicable treaty carefully to be sure that the benefits anticipated are in fact available.

§ 4:11 Tax treaties—“Permanent establishment”

Tax treaties almost always establish a higher threshold for taxing business profits than can be found under the internal law of the host or source country. For example, whereas any local economic presence or activity usually creates a taxable nexus under local tax law, tax treaties usually preclude taxation by the host country unless the nexus constitutes a permanent establishment. A permanent establishment normally involves a place of business the location of which is fixed by something physical and permanent, such as:

- a place of management
- a branch
- an office
- a factory
- a workshop
- a mine, oil or gas well, quarry, or other place of extraction of natural resources

In addition, a building site or construction, assembly, or installation project is almost always a permanent establishment, but only if it lasts more than a certain period of time, usually 12 or 18 months in the case of developed countries (but typically only six months in the case of developing countries).

Finally, a local agent can constitute a permanent establishment if it has and habitually exercises the power to conclude contracts on behalf of the foreign enterprise unless the agent is independent of the foreign enterprise, e.g., by having its own base of customers.

§ 4:12 Tax treaties—“Business profits”

Under most treaties, the business profits attributable to a permanent establishment may be taxable by the host country, regardless of the source of the income. Items of income dealt with in other articles in the treaty, such as dividends, interest, and royalties are usually unaffected by this provision.

§ 4:13 Tax treaties—Withholding tax relief

Most countries have provisions dealing with taxation of certain kinds of income that are normally taxed at source, such as dividends, interest, and royalties. This tax is usually collected from the payee by requiring the payer to withhold a tax from the gross payment at rates that typically run between 15% and 35%, with 30% being typical and also the standard U.S. withholding tax rate. Under most treaties, this withholding rate is reduced to a lower rate (usually 5%, 10%, or 15%) and is sometimes eliminated altogether (especially for interest and royalties but sometimes also for dividends).

§ 4:14 Tax treaties—“Treaty shopping”

Led by the U.S., many countries are scrutinizing the interposition of an intermediary between two contracting parties merely to take advantage of a favorable treaty with the intermediary’s home country. In particular, the benefits of a U.S. tax treaty can be denied under the Limitation on Benefits article that is found in most such treaties. To qualify for treaty benefits under this article, the taxpayer must fall within one of several objective categories or must secure an exemption from the source or host country. Some of the typical objective categories are being engaged in a substantial and active trade or business in the resident country, being publicly traded on a stock exchange in the resident country, or being majority-owned by persons that otherwise qualify as treaty residents (unless more than 50% of the company’s profits are paid out to nonresidents in the form of deductible payments). These anti-treaty-shopping rules are becoming extremely complex, and parties hoping to “shop” for a beneficial treaty must be extremely wary.

§ 4:15 Tax treaties—Use of affiliates

The fact that a company, resident in a given country with a tax treaty, is controlled by a company resident in another

§ 4:15

treaty country will not normally cause the controlling company to be deemed to have a permanent establishment in the country where the controlled company resides unless the controlled company in fact executes contracts on behalf of the parent as its agent. This treaty protection does not extend, however, to controlling companies resident in non-treaty countries. Although as a matter of practice, tax authorities commonly respect the juridical existence of affiliated companies, nothing prevents them from challenging the substance of the related company, particularly if the company was recently formed for a specific purpose (e.g., to perform services in respect of a single large contract). Moreover, whether or not a treaty applies, any transaction carried out with an affiliate must be at arm's-length prices or else the local tax authority may adjust the locally reported profits to the amount of profits that would have been realized in a contract between unrelated persons. The U.S. and, increasingly, other countries expect the parties to maintain contemporaneous documentation showing that prices meet this arm's-length standard and impose penalties on companies that do not.

§ 4:16 Tax treaties—Tax treaty checklist

Not all countries have tax treaties, and those that do (including the U.S.) sometimes have not updated them for decades. Even recently negotiated treaties may vary considerably in key areas. The following areas warrant special attention:

- *Applicable treaties.* Identify the treaties that the host country has currently in effect with other countries and narrow the list to those countries where the prime contractor has affiliates that may perform with respect to the contract (particularly with respect to required local operations such as installation or erection and construction activities)
- *Permanent establishment article.* Review the permanent establishment article for the treaties identified above, with particular emphasis on the clause pertaining to building sites or construction, installation or assembly projects, or supervisory activities in connection therewith. Identify those treaties that provide maximum protection
- *Limitation of benefits article.* If contemplating using an associated company to perform with respect to clearly taxable activities, confirm that the treaty benefits will in fact apply for that company under this article

- *Business profits article.* Review this article to determine the calculation of profit that might be associated with a permanent establishment in the host country. Check the type of expenses that may be charged to and deducted by the permanent establishment (e.g., a reasonable allocation of executive and general administrative expenses, interest, and similar expenses, whether incurred in the country of the permanent establishment or elsewhere)
- *Withholding tax articles.* Review the other articles in the treaty covering, for example, royalties and services. Determine whether all or part of the contract may be re-characterized as a know-how transfer, perhaps thereby benefiting from a zero withholding tax provision.

§ 4:17 Guide to structuring contracts

With the foregoing general considerations in mind, there are several areas where knowledge of local laws, careful review of the contract structure, and attention to documentation can reduce or eliminate local taxation. There are three stages of increasing exposure where tax considerations should be addressed:

- *Bid Stage.* At this stage, there is considerable pressure to submit an accurate bid on a timely basis with a potential competitor down the hall. Nevertheless, prudence is warranted as documents submitted at this time will taint all later stages.
- *Contract-Negotiation Stage.* The customer may have its own agenda for contract structure and language. A balance will have to be struck to achieve tax objectives in the context of agreeing on the overall contract. Keep in mind that, in case of audit, the local tax authorities will carefully review the contract documentation, including minutes of negotiations and names of parties (and companies) present and represented at such negotiations.
- *Contract-Performance Stage.* Regardless of the terms of the contract, if the actual work is performed by the wrong company, visas are entered in the wrong name, or intercompany documentation is insufficient to show substance, the project may nevertheless be found to be fully taxable in the host country. Fastidious attention to the documentation and manner of performance is essential to assure that the tax results originally anticipated are in fact delivered.

§ 4:18

§ 4:18 Guide to structuring contracts—Determine extent of local activities

Contracts for the sale of big-ticket items such as boiler islands for power plants, turbines, desulpherization equipment, etc. often involve significant amounts of local erection and construction activity. Under the internal laws of most countries, this activity will cause a taxable presence and, if integral to the total contract, can cause the entire income from the contract to be taxable. Even if a treaty is in place, the time limit for such activities is often only six months. In addition, there may be post-installation warranty activities that require a local presence over an extended period. It is thus essential to understand the conditions of the project to be aware of any such local presence in order to properly structure the contract.

§ 4:19 Guide to structuring contracts—Local incentives and provisions

Some countries provide incentives in the form of reduced taxation or even outright grants for providing equipment or carrying out activities in a certain geographic area of the country, in certain targeted economic areas, or to modernize or upgrade plants in certain industries. It is important to review the laws of the target country to be generally aware of these provisions so as to take advantage of them.

§ 4:20 Guide to structuring contracts—Segregation of the contract

If it is clear that performing a contract will involve a local presence to install the equipment, erect and construct a facility to house the equipment, or to handle warranty obligations, then consideration should be given to segregation of the contract so that the “tainted” local work can be carried out and taxed separately from the nontaxable supply of equipment or goods. There are several alternatives for accomplishing this, discussed below in descending order of tax security.

§ 4:21 Guide to structuring contracts—Separate contracts

The highest security comes from entering into separate contracts with the customer for supply of goods and equipment and any services or activities for which a local presence will be required. The local work can be contracted for by a local

company (either related or unrelated) or by a company in another country (again, either related or unrelated) that is willing to qualify itself to perform in the host country. If the company performing the local activities is affiliated with the seller, and especially if this company is domiciled in the same country as the seller or their common parent, particular attention must be given to ensure that this company has the means to perform (failing which, it may be deemed to lack substance and thus be viewed as an extension of the prime contractor).

In dividing the scope of work between the contract for sale of goods and that for local activities, the price allocated to the latter must be calculated to allow for a reasonable “arm’s-length” profit to reduce the likelihood of a challenge to the overall structure.

Note that in a number of countries, the customer may be reluctant to enter into separate contracts for what to them appears to be a single transaction. In such case, a performance guarantee from the supplier of the goods may be sufficient to overcome their resistance.

§ 4:22 Guide to structuring contracts—Assignment of local activities

In the event that separate contracts are not possible, the next-best alternative is for the contract to clearly identify the separate scope and price for the equipment vs. the local activities and to provide that the local work may be assigned to a separate company for completion. It will strengthen the position of the taxpayer if the other company is identified in the contract. After assignment, the assignee and the customer should behave as if they contracted separately for this scope of the project. The comments made above regarding capability and reasonableness of the price allocation apply here also.

§ 4:23 Guide to structuring contracts—Subcontracting of local activities

In some jurisdictions, a subcontractor (including an independent local company) is an agent of the prime contractor with respect to a project and thus can be deemed to constitute a local presence on behalf of the prime contractor. It may nevertheless prove a workable approach for the main contract to provide for the possibility of subcontracting the local activities to another party. As with the assignment alternative, it is better for the other party to be identified in the contract, for sepa-

§ 4:23

rate scope and price to be specified, and for the parties to behave after the assignment as if the contract were separate ab initio (with payments going directly from the customer to the sub-contractor).

Caveat: Under no circumstances should the subcontractor be allowed to negotiate with the customer to change the terms of the main contract, failing which the subcontractor may be deemed to be the agent of the prime contractor and thus to constitute a nexus or permanent establishment of the prime contractor in the host country.

§ 4:24 **Guide to structuring contracts—Negotiating and signing the contract**

Actions taken from the start of negotiations may taint the outcome of the project from the tax point of view. The following areas of exposure should be controlled to maximize the chances of a favorable outcome:

- To the extent possible, make sure that representatives of the company that will perform with local activities participate in discussions and negotiations with respect to scope and pricing of the contract. These individuals should be identified on the meeting log and referred to in the minutes.
- If the prime contractor already has a presence in the country, make sure that the contract is nevertheless signed by an officer or authorized individual who is located outside of the country. Particularly, avoid having the contract signed by a local agent.
- If the country has no tax treaty with the country of the prime contractor, verify that under local law the mere signing of the contract is not sufficient to create a tax presence. Otherwise, try to arrange the signing outside of the country. This applies for stamp duties also, which are occasionally imposed with respect to the value of contracts signed within the country.

If the country has no tax treaty with the country of the prime contractor, verify that under local law the mere passage of title (risk of loss) within the country does not create a tax nexus. Otherwise, try to include a clause specifying that passage of title and risk of loss will occur outside of the country. If the prime contractor is a U.S. company, check with your tax advisor as to the impact of a U.S. title passage on the foreign tax credit limitation of the company.

§ 4:25 Guide to structuring contracts—Performance of the contract

The execution of the contract does not toll further exposure to taxation in the host country. The best intentions at time of signing are often forgotten in the heat of performing the contract. Areas of attention to post-signing activities include:

- *Registration to do business.* Make sure that the correct company registers to do business and in the proper manner. Some companies have registered as nontaxable “representative offices” yet have nevertheless found themselves exposed to taxes, interest, and penalties when performing with respect to service contracts.
- *Employee visas/business cards.* Make sure that the employees entering the company with respect to the local activities are employees of the correct company and have business cards and obtain visas in the name of that company.
- *Intercompany correspondence.* Make sure that communications between the company performing local activities and other companies associated with the contract are formal and via company letterhead to show substance and “arm’s-length” dealings.
- *Subcontracts.* Make sure that contracts and subcontracts are in place stating scope, price, terms, etc. for all intercompany transactions, and that these terms are complied with. This is extremely important in the case of the subcontracting alternative discussed above.
- *Relations/communications with customer.* Make sure that the parties to the contract or contracts communicate with the customer properly and on appropriate stationery. The company performing the local activities should communicate and behave as if it had a separate contract, even if the subcontracting alternative is chosen. For example, all payments for local activities should go directly from the customer to the company performing that work.

§ 4:26 Selected bibliography

There are a number of good reference materials for those wishing to study this area in greater depth. These include:

- Model Income Tax Treaty and Commentary, Organization for Economic Cooperation and Development (O.E.C.D.)
- “U.S. International Taxation,” J. Kuntz & R. Peroni (Warren, Gorham & Lamont)

§ 4:26

- “Analysis of U.S. Income Tax Treaties,” Andersen (Warren, Gorham & Lamont)

Guides to the proper structuring of cross-border transactions to avoid double taxation for a variety of countries are also included in the Country Handbooks presented within the International Contract Manual. Tax issues and refinements can be complex. Moreover, taxation is an area in which treaties, local laws, regulations, and interpretations of those authorities change—often more frequently than in other fields. Accordingly, none of the guides to the avoidance of double taxation presented in the Manual should be regarded as a “do it yourself kit.” The general guide presented in this chapter as well as the tailored guides contained in the Country Handbooks are submitted simply as aids to the conduct of the requisite dialogues with knowledgeable counsel. U.S. taxpayers in particular should understand that under U.S. professional practice standards, certain tax advice must meet requirements as to form and substance. This Manual is not intended or written to be used and cannot be used for the purpose of avoiding tax penalties.

