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IRS Issues a Warning to Canadian Law Firms with U.S. Branch Offices

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For over ten years, the position of the Internal Revenue Service ("IRS"), as reflected in a 1993 private letter ruling, has been that nonresident alien partners of a service partnership with a US branch office will not be subject to US tax on their share of the partnership's effectively connected income, provided that they themselves perform no services in the US and provided that they are eligible for the benefits of a qualifying US tax treaty. The IRS recently issued a published ruling reversing this position, effectively warning Canadian and other non-US law firms with US branch offices that they can no longer rely on the old ruling. Consequently, nonresident alien partners of such firms generally will need to file US tax returns. Nonresident alien partners may be able to avoid the filing requirement, however, by amending their partnership agreements to allocate the profits of the US branch office solely to the US resident partners.

BACKGROUND

In general, a nonresident alien who is engaged in a US trade or business is subject to US tax on his or her income that is "effectively connected" with such US trade or business ("effectively connected income").[1] If the nonresident alien is a partner in a partnership that is engaged in a US trade or business, then the nonresident alien partner is deemed to be so engaged, regardless of whether he or she conducts any activities in the US.[2]

Under these general principles of the Code, it is quite clear that the nonresident alien partners of a law firm with a US branch office are subject to US tax on their distributive shares of the firm's effectively connected income, even if they have never even seen the firm's US branch office. The tax rules under the Code, however, may be overridden by an applicable US tax treaty.[3] A taxpayer who claims the benefits of a US tax treaty is required to file a US

[1] Section 871(b) of the Internal Revenue Code of 1986, as amended (herein referred to as "the Code"). Unless otherwise stated, statutory references in this article are to the Code or the regulations thereunder.
[2] *See* Code section 875(1).
[3] Code section 894.

federal income tax return and attach IRS Form 8833 (Treaty Based Return Position Disclosure Under Section 6114 or 7701(b)).[4]

Many U.S. tax treaties, including the U.S.-Canada income tax treaty,[5] contain an "Independent Personal Services" provision similar or identical to the following:[6]

> "1. Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State, unless such services are performed in the other Contracting State and the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his activities.
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> 2. The term 'personal services in an independent capacity' includes but is not limited to independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, economists, architects, dentists, and accountants."

Pursuant to the definition set forth in paragraph (2) above, it is clear that the above-quoted Independent Personal Services provision applies to partners of law firms.[7] Thus, in the case of a nonresident alien entitled to the benefits of a U.S. tax treaty containing such a provision, the nonresident's distributive share of the partnership's effectively connected income may be subject to U.S. tax only if (i) the personal services giving rise to such income are performed in the US, and (ii) the income is attributable to a fixed base in the US that is regularly available to the nonresident for the purpose of performing his or her activities.

THE 1993 PLR

In a well known private letter ruling issued in 1993[8] (the "1993 PLR"), the IRS interpreted Article 14 of the U.S.-Germany income tax treaty,[9] which was (and still is) identical to the Independent Personal Services provision set forth above. The 1993 PLR addressed a fact pattern in which a German law firm had a New York office with a single US resident partner.

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[4] *See* Code section 6114. A taxpayer who fails to file IRS Form 8833 is subject to penalties for failure to file but is not barred from claiming treaty benefits.

[5] The Convention Between the United States of American and Canada with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (herein referred to as "the US-Canada income tax treaty").

[6] Note that the corresponding provision of the OECD model treaty was removed in 2000. See Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, January 2003).

[7] The US-Canadian income tax treaty has no counterpart to paragraph (2) quoted in the text above, but it seems unlikely that the independent activities of lawyers would be excluded. The US Treasury department technical explanation to the United States Model Income Tax Convention of September 20, 1996 expressly provides that the term "personal services of an independent character" includes the independent activities of lawyers.

[8] PLR 9331012, May 5, 1993 (herein referred to as "the 1993 PLR").

[9] The Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, signed at Bonn on August 29, 1989 (herein referred to as "the US-Germany income tax treaty").

The US resident partner performed services only in the US and consequently was informed by the German tax authorities that he would not be taxable in Germany on any portion of the partnership's income. The nonresident partners performed no services in the US.

Curiously, the 1993 PLR first addressed the tax treatment of the US resident partner. Because the US resident partner only performed services for the partnership in the US, the 1993 PLR concluded that he was exempt from German tax on his partnership income under the Independent Personal Services provision set forth in Article 14 of the US-Germany income tax treaty. Similarly, because the nonresident partners only performed services for the partnership outside the US, the 1993 PLR concluded that they were exempt from US tax pursuant to article 14.[10] Finally, based upon an exemption in the treasury regulations, the 1993 PLR held that if the partnership disclosed on its partnership information return[11] the position taken in reliance on the US-Germany income tax treaty, the nonresident partners would then be excused from disclosing that position on a return.[12]

The 1993 PLR provided little in the way of analysis, and its conclusions have long been considered suspect by international tax practitioners in the US. Regardless of whether the nonresident partners perform services in the US, the IRS reasonably could have concluded that Article 14 of the US-Germany income tax treaty did not apply, because (i) the services giving rise to the income at issue were performed in the US (albeit by other persons) and (ii) the income was attributable to a fixed base (the New York branch) regularly available to the nonresident partners for purposes of performing their activities (or regularly available to the partnership and thus attributed to the nonresident partners).

The IRS may possibly have considered it implicit in requirement (i) above that US tax could be imposed in such situations only if the services performed in the US were performed by the nonresident alien partner himself. Alternatively, with respect to requirement (ii) above, the IRS may possibly have believed that a one-man US branch office could not realistically be considered "regularly available" to numerous nonresident partners, and for reasons known only to the IRS, may have concluded that attribution principles did not apply.

Alternatively, the IRS's rationale may have had nothing whatsoever to do with its interpretation of the Independent Personal Services article of the US-Germany income tax treaty. The IRS may simply have decided that, so long as Germany was willing to exempt the US resident partners of multinational service partnerships from German tax on their German source income, the US ought to reciprocate.[13] In this regard, 1993 PLR's focus on the German tax

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[10] The 1993 PLR stated that "Partnership and Resident Partner have executed an agreement allocating all the profits of the New York office to Resident Partner." The significance of this statement is not entirely clear. If it means that the nonresident partners were not entitled to share in the partnership's effectively connected income (because all such income was allocated to the US resident partner), then the subject matter of the ruling would appear to have been moot. It seems likely that some other arrangement created at least a substantial risk that the purported allocation of the profits of the New York office solely to the US resident partner lacked economic effect.

[11] IRS form 1065, "U.S. Return of Partnership Income."

[12] Treas. reg. section 301.6114-1(c)(4). In 1993, this exemption was set forth in Treas. reg. section 301.6114-1(c)(7).

[13] Such a reciprocal exemption is not without precedent, *see*, *e.g.*, Code section 883, but it is considered bad form for the IRS to take such matters into its own hands in the absence of an exemption provided under the Code or an applicable US tax treaty.

treatment of the US resident partner is notable. Indeed, only after concluding that the US resident partner was exempt from German tax did the 1993 PLR address the US tax treatment of the nonresident partners.

In addition to the questionable basis for the 1993 PLR's conclusions, it must be emphasized that the 1993 PLR was only a private letter ruling, not a published ruling, A private letter ruling may not be cited as authority and is binding on the IRS only with respect to the taxpayer to which it is issued.

THE 2004 RULING

Whatever the technical merits of the 1993 PLR (and notwithstanding its lack of precedential value), Canadian and other non-US law firms have been more than happy to rely on it for many years.[14] In February 2004, however, the IRS issued Revenue Ruling 2004-3,[15] which reverses the position of the 1993 PLR. The 2004 Ruling presents virtually the same fact pattern as 1993 PLR, although it deals with a "service partnership" rather than a law firm specifically. Also, in the 2004 Ruling, the partnership has only two partners and they divide the profits of the partnership equally.[16]

Citing Code section 875 and several authorities holding that the permanent establishment of a partnership is attributed to its partners,[17] the 2004 Ruling holds that the fixed base of the partnership is also attributed to its partners for purposes of Article 14 of the US-German income tax treaty. Accordingly, the 2004 Ruling concludes that the nonresident partner is treated as having a fixed base regularly available to him in the US and therefore is subject to US tax on his share of the income attributable to such fixed base, regardless of whether the nonresident partner performs any services in the US. The 2004 Ruling does not overtly refer to the 1993 PLR. Nevertheless, the 2004 Ruling clearly was intended as a very public warning: any law firm (or other service partnership) that continues to rely on the 1993 PLR does so at its own peril.[18]

IMPLICATIONS FOR THE FUTURE

Canadian law firms with US branch offices can no longer afford to rely on the 1993 PLR.[19] For those that do, the potential risks for nonresident partners include penalties, interest, and, if no US income tax returns are filed, denial of deductions.

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14 As noted above, a private letter ruling may not be cited as authority and is binding on the IRS only with respect to the taxpayer to which it is issued. Private letter rulings tend to be reflective of the views of the IRS, however, and taxpayers often feel emboldened to take any favorable position that is supported by a private letter ruling.

15 Rev. rul. 2004-3, 2004-7 IRB 486 (herein referred to as "the 2004 ruling"). See also PLR 2004-20012, January 30, 2004, revoking PLR 9331012, May 5, 1003.

16 In contrast, the 1993 PLR stated that "Partnership and Resident Partner have executed an agreement allocating all the profits of the New York office to Resident Partner." As noted above, however, it seems likely that there was at least a substantial risk that the purported allocation of the profits of the New York office solely to the US resident partner lacked economic effect (else the subject matter of the ruling apparently would have been moot).

17 *See Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); *Unger v. Commissioner*, 936 F.2d 1316,1319 (D.C. Cir. 1991); *Johnston v. Commissioner*, 24 T.C. 920 (1955); Rev. Rul. 90-80, 1990-2 C.B. 170.

18 The 2004 Ruling expressly states: "This holding also is applicable in interpreting other U.S. income tax treaties that contain provisions that are the same or similar to Article 14 of the Treaty."

19 Indeed, as indicated above, whether they ever should have relied on the 1993 PLR is debatable.

The Code prescribes a variety of penalties for failure to file US tax returns and failure to pay US income tax. For example, Code section 6651(a)(1) generally imposes a failure to file penalty equal to 5 percent of the amount of tax required to be shown on the return for each month (or portion of a month) in which the return is not filed, up to a limit of 25%. Code Sections 6651(a)(2) and (3) generally impose a penalty for failure to pay any tax that is shown (or that should have been shown) on a return equal to 0.5 percent of such tax for each month (or portion of a month) in which the tax is not paid, up to a limit of 25%.[20] Although these penalties (and others) may be avoided where the failure is "due to reasonable cause and not due to willful neglect," in light of the 2004 Ruling, the IRS likely would consider any failure to file and pay US tax in similar circumstances to be unreasonable.

Pursuant to Code section 874(a), a nonresident alien of the US who fails to file a "true and accurate return" within a prescribed time period is not entitled to claim any deductions.[21] Thus, a nonresident alien who is not exempt from US tax under an applicable US tax treaty will be subject to US tax on his or her effectively connected income on a gross basis if he or she fails to file a US federal income tax return by the prescribed deadline.

This draconian and punitive rule arguably is inconsistent with Article 14, since it would permit the US to tax something more than a nonresident's distributive share of the net income attributable to the fixed base. However, the IRS has issued a Technical Advice Memorandum specifically holding that the deduction-disallowance rule does not violate the Business Profits article US-Canada income tax treaty (which expressly provides for the allowance of deductions); and the IRS is unlikely to view the Independent Personal Services article (which does not expressly provide for the allowance of deductions) more favorably.[22] A court might possibly disagree with the IRS, but it hardly seems prudent to plan on this basis.

One possible response to the 2004 Ruling is for the Canadian (and other non-US) partners of firms with US branch offices to simply file US tax returns, pay their US tax and claim a credit against their Canadian (or other non-US) taxes.[23] Pursuant to Article XXIV(2) of the US-Canada income tax treaty (and similar provisions of other US income tax treaties), such credit generally should be allowable, subject to applicable limitations. Filing returns in multiple jurisdictions may be somewhat inconvenient, but given the ability to avoid double taxation through the availability of foreign tax credits, this result would hardly be a disaster.

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[20] The maximum aggregate penalty that may be imposed for failure to file and failure to pay is 47.5 percent. The two penalties generally are independent, but the failure to file penalty for any month is reduced by the amount of the failure to pay penalty for that month. *See* Code section 6651(c).

[21] The deadline is set forth in applicable Treasury regulations. *See* Treas. reg. section 1.874-1(b)(1). In limited circumstances, the deadline may be waived in the case of a nonresident who establishes to the satisfaction of the IRS that he or she acted reasonably and in good faith. *See* Peter A. Glicklich & Michael J. Miller, "US Export Taxation, Treaty Challenges, and Filing Leniency Bear Watching," (2002) vol. 50, no. 2 *Canadian Tax Journal* 791. However, it seems unlikely that this standard would be viewed as met in the case of a nonresident who chooses to disregard the 2004 Ruling.

[22] TAM 199941007 (June 25, 1999).

[23] Partners who essentially receive a fixed salary, rather than a distributive share of the partnership's income, however, may not be required to file US tax returns and pay US tax. The US Tax Court has held that "guaranteed payments" (*i.e.*, payments determined without regard to the income of the partnership) received by a partner for services performed wholly outside the US may be characterized in their entirety as foreign-source income, *Miller v. Commissioner*, 52 T.C. 752 (1969).

Firms that take this route will need to become acquainted with the US withholding rules applicable to partnerships that conduct a trade or business in the US and have foreign partners. In the absence of a treaty override, a partnership must withhold at the maximum marginal rate (presently 35%) on the share of its effectively connected income that is allocable to Canadian and other nonresident partners.[24] Such withholding is required (generally on a quarterly basis) regardless of when or whether the partnership makes distributions to its partners.

Another possible way of dealing with the 2004 Ruling is for Canadian (and other non-US) firms with US branch offices to amend their partnership agreements, so that the profits generated by the US branch office are allocated *solely* to the US resident partners. If properly drafted, such an amendment should prevent the nonresident partners from having any effectively connected income that could be subject to US tax.

In order for such an amendment to achieve the desired objective, there could be no arrangement (written or unwritten) to shift the profits of the US branch office back to the nonresident partners. In other words, the amendment would need to be drafted so that it could potentially have an adverse economic impact on the nonresident partners of the firm.[25] Therefore, partners of Canadian (and other non-US) firms with US branch offices must carefully consider whether they are willing to forego a share of the profits of the US branch office in order to avoid US tax; and it should come as no surprise if some partners are willing to do so and others are not. It should be possible for firms to accommodate the wishes of both sets of partners, but at the cost of increased complexity.

Canadian (and other non-US) firms that perform services in the US but do not have a US branch office, and therefore are not affected by the 2004 Ruling, should nevertheless make note of the filing obligations that must be satisfied to claim treaty benefits. As indicated above, a taxpayer generally claims treaty benefits by filing a US income tax return and attaching IRS Form 8833. Firms that file US partnership information returns[26] may wish to consider disclosing their treaty positions on such information returns so that their nonresident partners (presumably all partners) will then be excused from the US filing obligations that otherwise would apply.

Canadian (and other non-US) firms that perform services in the US should also be mindful that any exemption available under an applicable US tax treaty does not necessarily protect their partners from state and local income tax. US tax treaties are *not* binding on states and localities. In certain states, a treaty exemption may have the indirect effect of reducing or avoiding state or local tax (since many states use federal income as a starting point for determining the state tax base), but the tax laws of the applicable state must be examined on a case-by-case basis.

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[24] Code section 1446.

[25] Thus, for example, a provision purporting merely to allocate all foreign-source income to the nonresident partners without affecting the actual allocation of economic profit among the partners would not be given effect for US tax purposes. The Tax Court has held that the portion of a partner's distributive share that qualifies as foreign-source is based on the ratio of the partnership's foreign-source income to the total income of the partnership. *E.g., Miller v. Commissioner,* 52 T.C. 752 (1969). A putative allocation provision with no economic significance would not change this result. An allocation with economic significance, however, should be respected.

[26] IRS form 1065, supra note 11.