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Art and cultural assets news – autumn: International art dealers selling in the US — Tax considerations

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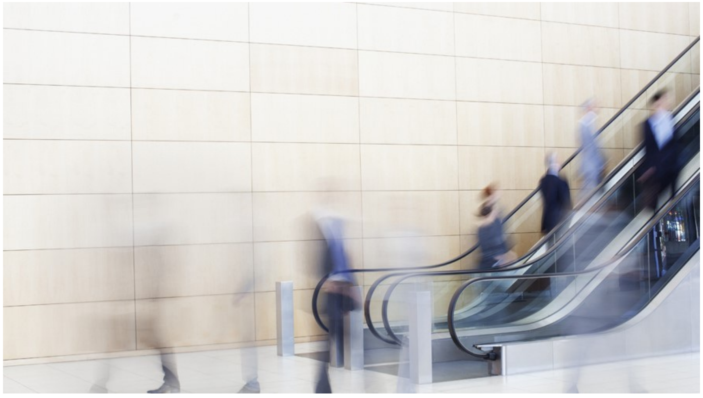

International art dealers operating outside the United States should consider various tax issues when selling works in the US through US-based dealers and galleries. A key tax consideration is whether there is a sufficient US income tax nexus that would cause the offshore dealer's profits to be subject to US federal, state, and local level income taxation. Another key tax consideration is compliance with transfer pricing rules to the extent that the offshore dealer is transacting business with a US-based related party.

US Tax Nexus

Selling in the US through a US-based exclusive distributor could result in a US tax nexus for the offshore dealer. To the extent that the selling agent devotes its primary efforts to acting for the offshore dealer and is compensated on a commission basis, the activity of the US agent will be attributed to the offshore dealer and the latter will be deemed to be engaged in a US trade or business potentially resulting in a US income tax charge.

The risk of US trade or business status would arise even though the US seller is a separate legal and tax entity, despite the US agent's ‘independent' status. This will be the case even if the offshore seller is in a jurisdiction with which the US has an income tax treaty since the US agent will typically constitute a ‘permanent establishment' of the offshore seller causing the latter's profits attributable thereto to be subject to US income taxation.

By contrast, the activity of the US agent should not be attributed to the offshore dealer where the former acts as a purchaser for resale with correlative inventory, profit margin and risk of loss typical of a wholesaler or distributor. In order for the offshore seller to be insulated from US tax nexus, it should also negotiate, approve and execute sales contracts outside of the US.

One exception to the above principles is set forth in two public rulings of the Internal Revenue Service (IRS) involving offshore sellers in treaty jurisdictions. In these rulings, the IRS does not attribute the US business activity of the US selling agent where the US seller takes possession of goods under a bailment relationship and, upon locating a retail customer but prior to the retail sale, purchases the goods from the offshore seller. In this context, the US party must agree in advance to pay the wholesale price, determine its own retail price and otherwise bear profit margin and inventory risk.

The risk of US tax nexus also arises where one or more offshore sellers enter into a joint venture agreement involving an unrelated party either located in the US or offshore but doing business in the US In this situation, the joint venture or partnership may be deemed to be doing business in the US which would then cause each venture member to be treated as doing business in the US, thereby giving rise to potential tax liability on income attributable to the venture.

Lastly, an activity that is not entirely clear is the warehousing of goods with an independent warehouser in the US before transfer to a US reseller or before a retail buyer is found for the goods. Typically US income tax treaties protect this physical presence of goods from permanent establishment status and income taxation provided there is no on-site agent filling orders. Where the offshore seller is not in a treaty jurisdiction, this scenario is not automatically insulated from US taxation.

State and Local Income Tax Considerations

State and city income tax laws may apply different nexus standards for filing returns and taxation than those under US Federal tax law.

New York corporate franchise tax as well as New York City corporate tax could apply if a foreign corporation in New York either (i) employs capital, (ii) owns or leases property or (iii) maintains an office even if its activities do not otherwise constitute ‘doing business' under the Federal tax standard. Thus, artworks warehoused in New York through an independent agent could trigger state and local tax nexus. However, to the extent the offshore seller's activities are limited to the acceptance of orders outside New York and the filling of such orders from a delivery point outside the State, sales into New York would fall under the protection of a federally-mandated exemption from state and city level income taxation.

US Transfer Pricing Requirements

In the event that the US selling agent and the offshore seller are ‘related parties' for US income tax purposes, the transfer pricing rules under US Federal income tax law will apply, whether the sales relationship is purchase for resale or commission-based, to ensure that the US seller is earning an appropriate share of income for its role and transaction risk. The transfer pricing rules aim to construct pricing that would give rise to profit similar to what would be earned in the case of transactions between unrelated parties.