Section 894.—Income Affected by Treaty

26 CFR 1.894–1: Income affected by treaty.

Service partnerships. This ruling provides guidance concerning the application of the U.S.-Germany income tax treaty to a nonresident partner in a service partnership that conducts activities in the United States. It makes clear that a nonresident partner is subject to U.S. income tax on his share of income from the partnership to the extent that such income is attributable to the partnership's activities in the United States, without regard to whether the partner performs services in the United States. This ruling also applies to other U.S. income tax treaties that have the same or similar provisions as those in the U.S.-Germany treaty.

Rev. Rul. 2004–3

ISSUE

Whether a nonresident partner in a service partnership that has a fixed base in the United States is subject to U.S. tax on income attributable to that fixed base

under Article 14, Independent Personal Services, of 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 on August 29, 1989, as amended by the Protocol signed on the same date (the "Treaty").

FACTS

P is a service partnership that is organized under the laws of Germany. P has offices in Germany and the United States. Its U.S. office is a fixed base under Article 14 of the Treaty. P is comprised of two partners: A, a nonresident alien individual who is a resident of Germany under Article 4 of the Treaty, and B, a U.S. resident. A performs services solely at P's office in Germany and B performs services solely at P's office in the United States. A and B agree to divide the profits of the partnership equally.

LAW AND ANALYSIS

Under section 701 of the Internal Revenue Code (the "Code"), 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. Code section 702 requires a partner to determine its income tax by separately taking into account its distributive share of the partnership's income. Under section 702(b), the character of an item of income, gain, loss, deduction, or credit is determined as if such item were realized directly from the source from which it was realized by the partnership, or incurred in the same manner as incurred by the partnership. Under Code section 704, a partner's distributive share generally is determined by the partnership agreement unless an allocation under the agreement does not have substantial economic effect.

Under section 875(1) of the Code, 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. Section 871(b)(1) of the Code provides that a nonresident alien individual is taxable under Code sections 1 or 55 on his taxable income that is effectively connected with the conduct of a U.S. trade or business.

Section 894(a)(1) states that the provisions of the Code shall be applied to any taxpayer with due regard to any U.S. treaty obligation that applies to such taxpayer. In *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962), 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 U.S.-Canada income tax treaty. In *Unger v. Commissioner*, 936 F.2d 1316,1319 (D.C. Cir. 1991), 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. *See also 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); Rev. Rul. 90–80, 1990–2 C.B. 170 (same).

Article 14 of the Treaty provides:

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.

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.

Applying Article 14 in the partnership context requires a determination of whether an individual partner in a service partnership who derives income attributable to the fixed base of the service partnership in the other Contracting State is taxable on that income even though the partner does not perform any services in the other Contracting State. Consistent with section 875 and the case law discussed above, the fixed base of a partnership is attributed to its partners for purposes of applying Article 14 of the Treaty. Accordingly, A is treated as having a fixed base regularly available to him in the United States. A is subject to U.S. net income taxation on his allocable share of income from P to the extent that such income is attributable to the fixed base in the United States without regard to whether A performs services in the United States.

HOLDING

A is treated as having a fixed base regularly available to him in the United States and is subject to U.S. net income taxation on his allocable share of income from P to the extent that such income is attributable to P's fixed base in the United States, without regard to whether A performs services in the United 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.

DRAFTING INFORMATION

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