The Archaic Subpart F Services Rules: Ill-Fitting and Disruptive for Modern Services Businesses

By Lowell D. Yoder, David G. Noren, and Elizabeth C. Lu

This article[1] analyzes the Subpart F services rules and demonstrates how these antiquated rules—which have not been updated since the 1960s—are ill-fitting and disruptive for modern services businesses. The authors urge Treasury and IRS to eliminate or at least rationalize certain overbroad rules in the regulations that cause many modern business-driven structures to have Subpart F income by deeming the existence of related-person services transactions—these regulatory rules, lacking any basis in the statute, exacerbate the burden of the out-of-date Subpart F services provisions. Treasury and IRS also should clarify regulatory rules for determining the location of services to address important new issues raised by today's services businesses. The authors also recommend that Congress repeal, or, as recent legislative proposals have suggested, significantly narrow the scope of the Subpart F services provisions, which would reduce complexity and increase competitiveness for U.S.-based multinationals.

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LOWELL D. YODER is a Partner in the Chicago office of McDermott Will & Emery LLP. **DAVID G. NOREN** is a Partner in the Washington D.C. office of McDermott Will & Emery LLP. **ELIZABETH C. LU** is a Partner in the Chicago office of McDermott Will & Emery LLP.

I. Introduction

Service businesses make up over half of today's U.S. economy—including consulting, financial, transportation, technology, e-commerce, and software services.[2] U.S.-based multinational groups perform services for customers globally through multiple entities in numerous countries, often with substantial operations carried on outside the United States as a market necessity.

At the time the Subpart F rules were enacted, foreign subsidiaries of U.S. companies generally were not subject to direct U.S. taxation on their services income. Under Subpart F, however, services income of a controlled foreign corporation ("CFC") could be included currently in the income of its U.S. parent. Subpart F applies to income derived by a CFC from performing services outside its country of organization for, or on behalf of, a related person.

The Subpart F services rules in the Code have remained unchanged since they were enacted in 1962, and most of the regulations have not been updated in almost 50 years. Congress focused at the time on relatively limited situations involving the separation of supporting services from sales of industrial machines. The drafters of the regulations expanded the focus to target income derived from building dams, constructing highways, and drilling oil wells, promulgating broad rules deeming services performed for unrelated persons as being performed for related persons with certain kinds of financial or functional involvement in the arrangements.

Today's services economy is much larger and more multifaceted than the services economy of 50 years ago. Modern services businesses that inherently require substantial overseas operations in multiple countries often are forced to adopt burdensome terms and disruptive arrangements in order to conform ordinary business deals to antiquated and ill-fitting rules, and to live with substantial tax uncertainties in many cases. At the same time, technological advances permit high-value services to be provided remotely, causing some to express concerns that the current rules may facilitate low-tax structures that could not have been anticipated 50 years ago.

In addition, following the Tax Cuts and Jobs Act of 2017 (the "TCJA"), the tax landscape has changed. Now, under the rules for global intangible low-taxed income ("GILTI"), services income of a CFC generally is included currently in the income of its U.S. parent and subject to a 10.5% effective U.S. corporate tax rate.[3] When the CFC's services income is Subpart F income, it is subject to the full 21% U.S. corporate tax.[4]

This article addresses the rules for determining whether services income earned by a CFC falls within the definition of Subpart F income. The focus is on income derived by foreign subsidiaries of U.S. corporations from operating services businesses outside the United States. This article discusses common global structures used by U.S.-based companies for the performance of services, and the complexities and uncertainties encountered in applying the Subpart F rules to modern services businesses.

The article recommends actions that Treasury and the IRS might (and could) take to clarify and update certain rules in the regulations, and discusses legislative options in the context of recently proposed tax reform proposals. We advocate modifying the regulations to limit the scope of the deemed related person rules and to clarify that the determination of the location of services should be based on where the CFC's employees perform the contracted-for services. The article also recommends that Congress significantly narrow or repeal the foreign base company services income rules and ensure that the key characteristics of the modern services economy are taken into account in designing any new generally applicable subpart F or minimum tax rule.

II. Taxation of Services Income Earned by Foreign Subsidiaries

A. Foreign Corporation Generally Not Subject to U.S. Taxation

A foreign corporation[5] as a general rule is not subject to U.S. taxation. Foreign corporations are subject to U.S. income taxation only on income derived from the conduct of a business in the United States and on certain types of U.S.-source income.[6] This treatment applies equally to a foreign based corporation and to a foreign subsidiary of a U.S. corporation.[7]

A foreign corporation that derives income from performing services in the United States is subject to U.S. taxation on that income. Such income generally is considered as U.S. source income[8] attributable to carrying on a trade or business in the United States.[9] On the other hand, a foreign corporation that derives services income only from foreign operations is not subject to U.S. taxation on that income.[10]

B. Subpart F

Subpart F of Subtitle A, Chapter 1, Subchapter N, Part III of the Internal Revenue Code (Code Secs. 951-965), which was enacted in its original form in 1962, provides that certain income ("Subpart F income") of a CFC is subject to current U.S. taxation at the U.S. statutory tax rate.[11] The CFC itself is not subject to U.S. tax, but the net amount of an item of Subpart F income is included in the gross income of the U.S. shareholders of the CFC (essentially like an accelerated dividend).[12]

U.S. shareholders are U.S. persons[13] who own 10% or more of the value or voting stock of a foreign corporation.[14] A CFC is a foreign corporation more than 50% of the stock of which is owned, by vote or value, by U.S. shareholders.[15]

Subpart F income includes certain categories of: insurance income, passive income, sales income, services income and oil-related income.[16] This article analyzes the Subpart F income category for services income (foreign base company services income, which is a component of foreign base company income, which in turn is a component of Subpart F income). An item of income that does not fall within any of the taxable categories of income under Subpart F is not subject to current taxation under the Subpart F rules—there is no miscellaneous or "catch-all" category, nor is there any provision requiring that an item of income be "analogized" into a Subpart-F-relevant kind of income even if the item does not fit within the four corners of any Subpart F definition.[17] Exceptions may apply to cause what would otherwise be Subpart F income not to be taxable under Subpart F.[18]

U.S. shareholders that are corporations generally are eligible to claim a deemed-paid foreign tax credit for foreign income taxes paid or accrued by a CFC on the earnings of the CFC that are deemed distributed under Subpart F.[19] Earnings of a CFC that have been included in the gross income of a U.S. shareholder under Subpart F are then excluded from income when actually distributed to the shareholder.[20]

Subpart F was first proposed by the Kennedy Administration, which recommended that tax deferral practices be eliminated by legislation which "would tax each year American corporations on their current share of the undistributed profits realized in that year by subsidiary corporations in economically advanced countries."[21] Under that proposal, all income of foreign subsidiaries would be subject to current U.S. taxation.

A bill was introduced in the House in 1962 addressing the concerns of the Kennedy Administration.[22] The resulting legislation adopted by both the House and the Senate in the Revenue Act of 1962 included Subpart F, providing for the current taxation of U.S. shareholders of CFCs on certain undistributed earnings of CFCs.[23]

The legislation as enacted, however, fell short of the President's recommendations. It did not eliminate tax deferral generally.[24] In this regard, the House Report states:

> Your committee's bill does not go as far as the President's recommendations. It does not eliminate tax deferral in the case of operating businesses owned by Americans which are located in the economically developed countries of the world. Testimony in hearings before your committee suggested that the location of investments in these countries is an important factor in stimulating American exports to the same areas. Moreover, it appeared that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax.[25]

Therefore, services income earned by a CFC is subject to current full-rate U.S. taxation only if it falls within the definition of a specific category of Subpart F income. Services income from conducting operations outside the United States that is not Subpart F income is not subject to current U.S. taxation, except under the GILTI regime (described below).[26]

C. GILTI

The TCJA did not repeal or revise the foreign base company services income rules. However, it introduced several

new provisions into the Code, including Code Sec. 951A regarding global intangible low-taxed income (GILTI). Under the GILTI regime, U.S. shareholders of a CFC must include in income currently their GILTI, where GILTI is the excess of U.S. shareholder's net CFC tested income over a deemed tangible income return.[27]

Net CFC tested income generally includes all of a CFC's income, other than amounts received as dividends and amounts that are Subpart F income.[28] Unlike Subpart F, the GILTI regime applies to income the same, regardless of how it is characterized for U.S. federal income tax purposes. U.S. shareholders may deduct fifty percent of their GILTI, such that GILTI generally is taxed at a 10.5% rate (50% of the 21% U.S. corporate tax rate).[29] U.S. shareholders that are corporations generally are eligible to claim a deemed-paid foreign tax credit for up to 80 percent of foreign income taxes paid or accrued by a CFC with respect to net CFC tested income.[30]

Like Subpart F, GILTI applies regardless of whether earnings are repatriated to the United States. Nearly all foreign earnings can repatriated without further U.S. taxation, thereby eliminating the "lock-out effect." Earnings of a CFC that have been included in the gross income of a U.S. shareholder, whether under Subpart F or GILTI, are excluded from income when actually distributed to the shareholder.[31] This exclusion would not apply to the extent that a CFC's income has not been included in its U.S. parent's gross income, perhaps because of the deemed tangible income return or because tested income was offset by tested losses in other CFCs.

There have been recent legislative proposals to revise the GILTI regime. Though specifics of the proposals have varied, they would generally apply GILTI on a country-by-country basis and subject GILTI to tax at a rate of 15%.[32] These proposals would bring the GILTI regime more in line with principles set forth under the Organisation for Economic Cooperation & Development's ("OECD's") Pillar Two.[33]

Post-TCJA, services income of a foreign subsidiary of a U.S. corporation generally is subject to current U.S. taxation, either at a 10.5% rate under the GILTI regime, or at the 21% U.S. corporate tax rate if such income is Subpart F income. The stakes of whether services income is foreign base company services income are lower than they were before the TCJA: now the question is whether the income will be taxed currently at a 21% versus 10.5% rate, whereas pre-TCJA, the question was whether such income was taxed currently at a 35% rate versus a 0% rate (subject to further repatriation tax). However, the rules for determining whether income is foreign base company services income have not changed and are just as complex as they were before the TCJA.

III. Foreign Base Company Services Income

As discussed above, a foreign subsidiary of a U.S. corporation is not subject to direct U.S. taxation on income it derives from performing services outside the United States. Under Subpart F, however, the U.S. corporate shareholder includes in its gross income the foreign subsidiary's services income to the extent it falls within the definition of foreign base company services income.[34] And any amounts that are not Subpart F income generally are included under the GILTI regime.

Code Sec. 954(e) provides that an item of income is foreign base company services income if the income is derived by a CFC from performing services (i) outside the country under the laws of which the CFC is created or organized (ii) for or on behalf of a related person. Services income derived by a CFC must satisfy *both* of these requirements in order to be foreign base company services income.[35]

Therefore, services performed for persons unrelated to the CFC generally do not give rise to foreign base company services income. This is the case even if the services are performed outside the CFC's country of organization. Thus, services may be performed anywhere in the world for unrelated persons, including in the United States.[36] As discussed below, the Subpart F regulations provide that services performed by a CFC for an unrelated person under certain enumerated circumstances can be *deemed* to be performed for or on behalf of a related person, in which case this prerequisite of the definition of foreign base company services income would be satisfied, thereby rendering the locational prerequisite determinative.

If a CFC does earn income from performing services for or on behalf of a related person (actually or by way of deeming), such income is still not foreign base company services income to the extent the income is derived from performing services within the CFC's country of organization. Only to the extent the income is attributed to services performed outside the CFC's country of organization is the income foreign base company services income.

The following sections analyze the definition of "services" for purposes of Code Sec. 954(e), when services are considered as performed for or on behalf of a related person, and when services are considered as performed outside the CFC's country of organization. In addition, coordination rules with other categories of Subpart F income and exceptions for certain types of services income are discussed.[37]

IV. Definition of "Services" Income for Subpart F Purposes

A. General

Code Sec. 954(e) applies only to income derived in connection with the performance of services. Therefore, an item of income earned by a CFC must first be characterized as *services* income before it is subject to analysis under the foreign base company services income rules. An item of income that is not properly characterized as services income cannot be foreign base company services income.

Code Sec. 954(e) contains a list of specific types of services that are subject to analysis under the foreign base company services income rules and ends with "or like services." The list was drafted over 50 years ago, with a very different set of activities in mind from those now common in the modern services economy. The legislative history indicates that Congress was targeting services that taxpayers might separate from the manufacture and sale of industrial machines. Nevertheless, the kinds of services listed are broad enough to include most types of services income derived by modern services businesses.

Subpart F does not contain a definition of services income for purposes of Code Sec. 954(e). The regulations state that the substance of an arrangement is analyzed to determine whether a particular item of income is characterized as income from the performance of services.[38]

B. Types of Services

1. List of Services

Code Sec. 954(e) provides that income from the following list of services can give rise to foreign base company services income: "technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services."[39] Neither the legislative history nor the regulations provide any further detail or description of the types of services within the scope of Code Sec. 954(e). There have been no amendments since 1962 to the Code modifying the list of the types of services subject to analysis under Code Sec. 954(e).

Under the *expressio unius est exclusio alterius* canon of construction, the express mention of certain items generally should be interpreted as an exclusion of other items.[40] Congress's use of a list of types of services rather than simply referring to "services" suggests that certain types of services are not intended to be included within the scope of Code Sec. 954(e). There has been no guidance identifying any services that may be excluded from analysis under the foreign base company services income provision.

That being said, the list also ends with "or like services," indicating that there are types of services not expressly listed that can be subject to analysis under Code Sec. 954(e). Under the *ejusdem generis* canon of construction, such a general phrase should be restricted to the same kind or class of things as the items preceding it.[41] Indeed, even without resorting to Latin maxims, the use of the word "like" here gets the same idea across in plain English—"like" services must describe something less than "all" services.

The drafting of the statute thus suggests an intent to exclude some services from the conceptual scope of the statute, but the enumerated items such as "technical," "skilled," "commercial" and "industrial" services are so broad that they would seem to include essentially any type of arrangement for the provision of services. Therefore, it would seem appropriate to subject to analysis under Code Sec. 954(e) most or all types of services income derived by modern services businesses. For example, while e-commerce did not exist as a global services business in 1962, services income derived by a CFC from engaging in such a business generally will be subject to analysis under Code Sec. 954(e).[42]

The IRS apparently has adopted a broad interpretation of the list of services, viewing all types of business-related services as being subject to analysis under Code Sec. 954(e). The IRS addressed the application of Code Sec. 954(e) to income from factoring,[43] as well as to film production services performed for a studio (as technical, managerial and skilled services).[44] Congress has indicated that insurance and financing income may be considered as services for purposes of Code Sec. 954(e).[45]

Still, the list of services should be interpreted as imposing *some* limit on the nature of the services—otherwise the statute's enumerated items and limitation of covered non-enumerated items to "like services" would be superfluous (*i.e.*, the Congress could have just said "services"). Applying Code Sec. 954(e) to all services without limitation would conflict with the principle of construction that statutory language should not be construed as mere surplusage.[46]

One possible limiting effect of the enumerated list in this regard is that it appears to contemplate only relatively complex activities, such that relatively unskilled or clerical/ministerial activities might fall outside the definition. However, various provisions of the regulations appear to assume that the performance of routine, ministerial services may be relevant to the application of the foreign base company services income rules. For example, the regulation addressing the location where services are performed takes into account income apportioned to

clerical work.[47] Taking into account this kind of activity in applying Code Sec. 954(e) is in some tension with the language of the Code and the legislative history, although the inclusion of this activity arguably may be permitted to the extent incidental to or in support of enumerated (or "like") services—"income derived in connection with the performance of" such services arguably may capture all services necessary to generate income from the listed (or "like") services, including incidental or supporting activities.

Whether to take into account relatively low-skill, routine activities may not be a significant issue for most modern services businesses. It is unlikely that a material portion of services income derived by a CFC would be attributed to this kind of activity, or that taking this activity into account in applying the various rules of Code Sec. 954(e) would provide a materially different result. If the result were materially different, then it may be defensible to take a position excluding low-skill, routine activity from consideration (although in some situations such a position might be inconsistent with the regulations).[48]

Another possible solution to the "mere surplusage" problem could be that the enumerated services are all things that businesses commonly do for each other. In other words, the list seems to envision "B2B" activities, as opposed to, say, dance lessons, lawn-mowing, or babysitting services marketed to individual consumers. This kind of activity typically would not be provided by a CFC to a related person, but treatment as such is entirely possible under the broad "for or on behalf of" concepts addressed in detail below, thus arguably requiring an exclusion from the conceptual scope of relevant services. So perhaps the limiting principle is that foreign base company services income does not include relatively simple retail-type services that could otherwise be caught up due to the "for or on behalf of" rule. Thus, under this view, relatively simple or clerical B2B activity is included, as those services may be industrial or commercial (even if not skilled). And more complex activities (*e.g.*, architectural) are caught up even if provided on a retail basis to household consumers, because the nature of the services is such that they are commonly provided on a B2B basis.

2. Services Income Separated from Manufacturing Activities

The legislative history indicates that Code Sec. 954(e) was principally directed at situations where a CFC organized in a low-tax jurisdiction performs services which have been separated from manufacturing activities of a related person to obtain a lower rate of tax for the services income. The 1962 Senate Report explained the intent underlying Code Sec. 954(e) as follows:

> Foreign base company services income is income derived from the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or similar services, but only where they are performed for a related person and are performed outside the country in which the controlled foreign corporation is organized.
>
> As is the case of sales income, the purpose here is to deny tax deferral where a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax for the service income.[49]

Thus, the legislative history shows that Congress had a rather narrow view of the purpose of Code Sec. 954(e) as denying tax deferral where services income is earned in a subsidiary and separated from functionally connected manufacturing or similar activities of a related corporation.

The only example in the initial proposed regulations issued under Code Sec. 954(e) in 1962 reflects a similar description of the types of services intended to be covered by the provision.

> **Example.** Foreign corporation A, incorporated under the laws of foreign country X, and foreign corporation B, incorporated under the laws of foreign country Y, are both wholly-owned subsidiaries of domestic corporation M. Corporation A, a manufacturer of industrial machinery sells products which it manufactures to C Corporation, not a related person, for use by C Corporation in foreign country Z. B Corporation, by contract with C Corporation, not a related person, agrees to render technical advice to C Corporation in connection with the installation, maintenance, and operation of the machines C Corporation purchases from A Corporation. The services performed for C Corporation by B Corporation are considered to be performed on behalf of A Corporation.[50]

The services income derived by B Corporation would be foreign base company services income to the extent the services are performed outside Country Y.

Examples similar to the above example are contained in the final regulations.[51] The examples analyze the application of Code Sec. 954(e) to income derived by a CFC from the installation and maintenance of machines sold by a related

person to an unrelated customer,[52] and address warranty and maintenance services provided by a CFC for equipment sold by a related person to an unrelated customer.[53]

While the legislative history reveals that Congress was targeting income from services that is separated from manufacturing income, the Code does not so limit the scope of Code Sec. 954(e). Thus, the legislative history explained much less than the full scope of what the Congress was doing, and the reference to services being separated from the manufacture and sale of machines in the legislative history does not operate as a limit on the types of services that are subject to analysis under Code Sec. 954(e).

3. Building Dams, Drilling Oil Wells, and Constructing Superhighways

Shortly after Subpart F was enacted, the Treasury apparently became concerned with services income derived by a CFC from major foreign construction projects. Regulations were issued with a specific focus on such services businesses.

The majority of the examples contained in the final regulations analyze the application of the foreign base company services income rules to income derived from:

- Contract oil well drilling;[54]
- Building a dam;[55] and
- Construction of a superhighway.[56]

There is substantial informal guidance from decades ago discussing how the foreign base company services income regulations apply to such items of income.[57]

4. Interpretative Guidelines

Income arising from most types of services performed by modern global services companies appears to be subject to analysis under Code Sec. 954(e), even though the legislation was focused on the separation of services from manufacturing. Such services generally would seem to fall within the meaning of "technical," "skilled," "commercial" or "industrial" services. For example, services income from e-commerce businesses, even though not a global business in 1962 or likely even imaginable by that Congress, would be subject to analysis under Code Sec. 954(e). Nevertheless, it would appear that consideration of low-skilled, routine labor in applying the rules of Code Sec. 954(e) may not be required by the language of the Code (although again the regulations do reference unskilled labor for certain purposes), and arguments may be made for excluding certain other kinds of services that seem to have been far from the Congress's mind (*e.g.*, services of a kind that typically are not provided on a B2B basis).

The inclusion of a specific list of the types of services intended to be subject to analysis under Code Sec. 954(e), along with the limited focus of Congress in enacting that provision, counsels that some restraint be exercised in extending these rules to new kinds of services—although the statute is indeed broad, some consideration should be given to the threshold question whether a new kind of service is conceptually within the scope of services covered by the statute.

C. Services Income Distinguished From Other Types of Income

1. Substance of Transaction

An item of income is analyzed under Code Sec. 954(e) only if the item in substance is services income. The regulations state that: "For purposes of Code Sec. 954, income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction."[58]

The regulations further state that the determination of whether an item of income is characterized as services income is based on all facts and circumstances.[59] Local law is not controlling in characterizing income for purposes of Subpart F.[60]

As mentioned above, Subpart F does not provide a definition of transactions that give rise to services income. The regulations only provide examples of activities giving rise to services income analyzed under Code Sec. 954(e), such as maintenance and installation of machines, drilling oil wells, building dams and constructing superhighways.

In the absence of a definition of services income in the Subpart F rules, generally accepted definitions of services provide guidance. Courts generally define services as the deployment of labor and capital for the benefit of another person, with the provider not retaining an ownership interest in the fruits of the activities performed.[61]

A 2010 Tax Court opinion provides helpful analysis concerning the definition of services. In *Container Corporation v. Commissioner*,[62] the Tax Court considered whether a guarantee fee paid by a U.S. subsidiary to its Mexican parent company should be treated like a service fee or interest for purposes of determining the source of the fee in applying the withholding tax rules. The Tax Court referenced the general notion that labor or personal services generally employ the use of human capital as opposed to the salable product of the person's skill. The Tax Court concluded that a guarantee fee is not actually a payment for services. However, the Court found that a guarantee fee most closely analogized to a service because it represents a promise to possibly perform a future act.[63]

Applying the source rules to items of income characterized on the basis of analogy is necessary and well accepted, as every item of income must have a source for tax purposes.[64] Subpart F, in contrast, does not characterize income by analogy—rather, if an item of income falls outside a particular Subpart F definition, the item simply is not subject to the Subpart F rules applicable to that category of income.[65] Not every kind of income is "Subpart F relevant" in the first place.

The regulations illustrate the rule that substance controls and not the label stating that an amount that is designated as *rent* but actually constitutes income from *services* is not characterized as rent, but as income from services.[66]

In TAM 9527010, the IRS concluded for Subpart F purposes that income received *via* a purported sales agreement for a film was services income and not sales income because the other contracting party held the benefits and burdens of ownership of the film throughout the period of production. In the TAM, the IRS states:

> "The economic substance, rather than the form, will control in determining whether to characterize the agreement between Studio and [the CFC] as a purchase and sale agreement or instead as a contract to provide services. *Bailey v. Commissioner*, 90 T.C. 558, 607 (1988), *aff'd, vacated and remanded* 912 F.2d 44 (2d Cir. 1990). The use of purchase and sale language in the agreement will not determine whether the agreement is in fact a sale. *Tolwinsky v. Commissioner*, 86 T.C. 1009, 1043 (1986). For tax purposes, a sale occurs when the benefits and burdens of ownership have been transferred rather than when the technical requirements of title passage have occurred. *Bailey*, 90 T.C. at 607."[67]

The income was foreign base company services income because it was attributed to services performed for, or on behalf of, a related person outside the CFC's country of organization.

Similarly, in GCM 33455,[68] income that a CFC received from assembling television tuners for its U.S. parent was found to be services rather than sales income for purposes of applying Subpart F. The CFC received the parts on consignment from the parent, which retained title to the components throughout the assembly process. Although the taxpayer assumed the income would be sales income, the IRS determined that the "parent's express retention of title to the component parts indicated that the CFC was performing services of a manufacturing nature for its parent and not manufacturing and selling its own product."[69] Because the services were performed within the country of organization of the CFC, the income arising from performing the services was not foreign base company income.[70]

The regulatory requirement that a transaction is characterized by reference to its substance for Subpart F purposes should apply equally to the taxpayer and the IRS. That is, both the taxpayer and the IRS should be permitted to (and, in fact are required to) characterize income for Subpart F purposes based on substance, and the label applied to a transaction should not control. This is different from other areas of tax law where no specific substance-based characterization rules are set forth in the regulations.[71] In the absence of such substance-based characterization rules, a taxpayer is often bound by the form of its transaction.[72]

Differences between substance and form are not likely to be a normal occurrence, as a well-advised taxpayer generally will use a transactional arrangement that aligns with the taxpayer's desired tax positions. Difficult situations may arise, however, with cross border transactions where a different form provides a more favorable tax result in a foreign country, the form follows industry classification standards, or the income is inadvertently mislabeled by the taxpayer. If the treatment under Subpart F of an arrangement is challenged by the IRS during an audit, the taxpayer should be able to argue that the income in substance is subject to analysis under another category that provides a better Subpart F result if the income in substance falls within the type of income subject to analysis under the other category.

The form of remuneration should not bear on the determination of whether an item of income is characterized as services income. The Code and regulations expressly provide that income from services can be in the form of compensation, commissions, fees or otherwise.[73]

As discussed below, in some cases it is possible that an item of income characterized as services income based on its substance also might be treated as sales income for purposes of Code Sec. 954. Code Sec. 954(d) expressly provides that commissions or fees received for purchasing or selling property on behalf of a related person is subject to analysis under Code Sec. 954(d). Income treated as sales income should not also be analyzed as services income under Code Sec. 954(e).[74]

2. Separately Determined Items of Income from Single Transaction

The regulations address situations where a single transaction gives rise to income in more than one category of Subpart F income. As a general rule, the separate categories of income are to be separately analyzed under Code Sec. 954.[75] If the income cannot be separately determined, than

the single item of income is classified in accordance with the predominant character of the transaction.[76]

The regulations illustrate an arrangement where services income and sales income can be separately identified. A CFC, in its business of purchasing personal property and selling it to related persons outside its country of organization, also performs services outside its country of organization with respect to the property it sells. The regulations state that the sales income will be treated as foreign base company sales income, and the services income will be treated as foreign base company services income for purposes of these rules.[77]

The regulations state that the portion of income or gain derived from a transaction that is included in the computation of foreign personal holding company income is always separately determinable and thus must always be segregated from other income and separately classified.[78] For example, where income is derived by a CFC from a services arrangement and includes an amount for interest, the interest component would be required to be analyzed under the foreign personal holding company income rules, and the services component under the foreign base company services income rules.[79]

3. Predominant Character

As noted above, the regulations acknowledge that "the portion of income or gain derived from a transaction that would meet a particular definitional provision under Code Sec. 954 or 953 (other than the definition of foreign personal holding company income) in unusual circumstances may not be separately determinable."[80] If such portion is not separately determinable, then the income from the transaction must be classified in accordance with the predominant character of the transaction.[81]

The regulations provide the following example. A CFC engineers, fabricates, and installs a fixed offshore drilling platform as part of an integrated transaction. The portion of income that relates to services is not accounted for separately from the portion that relates to sales, and is otherwise not separately determinable. Therefore, the classification of income from the transaction shall be made in accordance with the predominant character of the arrangement.[82]

The IRS analyzed the application of the predominant character test to income derived by a CFC from providing food and beverages aboard cruise ships operating in international waters.[83] If the income were classified as sales income, it would not be subject to Subpart F, but if classified as services income, it would have been subject to Subpart F (under the former foreign base company shipping income provision). The IRS in two Technical Advice Memoranda concluded that the income derived by the CFCs from the food and beverage concessions was services income rather than sales income under the predominant character test:[84]

> "A restaurant's income is attributable more to the labor of its chef, the services of the wait staff, and the ambiance of the surroundings than to the sale of the ingredients that the chef uses. Similarly, the operation of a lounge entails more services than sales. In addition to the liquor, a customer is paying a bartender to mix his drink, pour it into a glass, serve it hot or cold, as the case may be, and for the ambiance of the surroundings ... the predominant character of these activities is the performance of services rather than the sale of personal property …."

Therefore, the IRS concluded that the income derived therefrom was foreign base company shipping income.[85]

The issue addressed in the above TAMs was subject to litigation.[86] The IRS ultimately reversed its position, conceding that the income derived by the food-and-beverage concessionaires was not foreign base company shipping income.[87]

4. Intangible Property Used or Developed in Performing Services

A significant portion of income derived by various modern global services businesses can be attributed to valuable intangible property used by the service provider in the performance of the services. For example, a substantial portion of income from providing computer software as a service may be attributed to the value of the underlying copyrights and patents. A material portion of income from providing consulting services may be attributable to proprietary know-how or other intangible property necessary to provide the services at the necessary level of quality or the necessary speed. A CFC also may perform research and development services resulting in valuable intangible property for the customer—in this case intangible property may or may not be a major contributor to the performance of the services, but at a minimum it is clear that the performance of the services results in the development of valuable intangible property for the customer.

It would be unusual for an arrangement for the performance of services to contain a separate charge for the intangible value underlying the provision of the service. Rather, a single charge generally would be invoiced for the services provided. This concept of course is not unique to services transactions—the value of a pill sold by a

pharmaceutical company may be largely attributable to the intangible property that the pill embodies, but the sale of the pill is still simply a sales transaction, and the tax law does not attempt to pull apart different elements of value in the sales consideration into different tax transactions.

The long-established approach of the U.S. federal income tax rules is that the consideration received for the provision of services (just like that received for the sale of tangible property) that uses valuable intangibles is not disaggregated and reconstructed into separate tax transactions. Thus, the foreign personal holding company income rules are not applied to some portion of the service fees representing intangible value as if the CFC had received royalties on a license of the intangibles. Rather, if the transaction is characterized as a services transaction in substance, the entire amount is treated as services income for Subpart F purposes.[88]

Under the Subpart F rules for characterizing income, the fundamental question is whether the income is derived for providing services or for transferring intangible property, or both. If the customer does not receive any rights to use the intangible property but instead receives only the services, then the income stream should be characterized only as services income.[89] It is the service provider, as opposed to the customer, that is actually using the intangible property (just as the pharmaceutical company uses its intangible property to develop, manufacture, market, and sell a medicine, but the patient does not actually use intangible property by purchasing and using the medicine). Even if there is substantial intangible value underlying the provision of the services, without a transfer of intangible rights there can be no element of a license, lease or sale of the intangible property.[90]

This embedded-value principle is illustrated in the Code Sec. 482 services regulations. The services regulations expressly apply to a services transaction where intangible property is an element used in rendering the services.[91] The regulations generally do not bifurcate the transaction and analyze the intangible element separately, although they may consider the transfer pricing rules that apply to intangibles in arriving at the proper transfer price for the services arrangement.[92]

The IRS addressed this specific question in the context of the source of income upon the sale of property. In Rev. Rul. 75-254,[93] the IRS ruled that income from a trademarked product should not be disaggregated for sourcing purposes on a sale of the products to a distributor. The IRS reasoned that the sale of a trademarked product carries with it the right to use the trademark on resale. Because there was no specific grant of trademark rights by the seller to the distributor, no imputed royalty was appropriate.

The Code Sec. 482 rules that apply to income from the sale of products adopt the approach articulated in the revenue ruling. The regulations confirm that a transfer of tangible property is not considered a transfer of an embedded intangible "if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices."[94]

This treatment can significantly affect the results under Subpart F. Assume in the above example that the CFC earned $50 million, and $20 million was attributable to services income and $30 million to computer software intangibles used in providing the services. If the income is characterized as services income and it is derived from performing services for unrelated persons, then none of the income is foreign base company services income, even if the CFC acquired or licensed the intangibles from a related person. On the other hand, if $30 million were considered as royalty income, the CFC would have to demonstrate that it derived the income in the active conduct of a trade or business, either through development of the intangible or through actively marketing the product.[95] Accordingly, this determination can be of great importance in applying Code Sec. 954(e) to income derived by modern services businesses.

In other situations, for example R&D services arrangements, a CFC's services may result in valuable intangibles that are owned ab initio by the customer, as a work for hire.[96] Here, although the customer ends up with intangible property as a result of the arrangement, this property was never owned by the service provider. Instead, the customer owns every bit of intangible property generated, from the moment of its creation. As the bearer of the costs and risks of development, the customer has full benefits and burdens of ownership in the intangible property all along. In such a case there is no sale or license of intangible property to the service recipient. If there *is* some element of a transfer of existing intangible property rights from provider to recipient, but the portion of the payments cannot be separately determinable, the transaction may be considered as giving rise entirely to services income based on its predominant character, subject to the caveat that any amount attributable to foreign personal holding company income (*e.g.*, royalties) is always separately determinable.[97] This caveat may not be relevant in a great many R&D services situations, as the services recipient typically would obtain an interest in the intangible property that is not time-limited or field-of-use-limited as between the two contracting parties—the customer simply owns the intangible property ab initio. Thus, if anything the more likely overlap would be with sales income, which does not

necessarily prevent the application of the predominant character analysis. And if the service provider indeed reserves to itself substantial ownership rights to the intangible property which are subsequently transferred to the customer, then it might be difficult to conclude that the arrangement indeed had the predominant character of a services arrangement.

In sum, the IRS has not expressly addressed the question of how Subpart F should apply to services arrangements that include substantial value relating to the use of intangible property in performing the services or the development of intangible property through the performance of the services. Absent a legislative change, there would seem to be no basis for the IRS to adopt any position other than the general rules for characterizing transactions based on their substance and predominant character, and without disaggregation for elements of value in the transaction that might reflect the value of intangibles used in providing the services or arising from the services provided.

V. Services Performed for or on Behalf of a Related Person

Once a determination is made that a CFC derives an item of income from performing services within the meaning of Code Sec. 954(e), it must be determined whether the item of income falls within the definition of foreign base company services income.

A fundamental initial prerequisite for an item of services income to be foreign base company services income is that the income must be derived from services performed for, or on behalf of, a related person. Income derived from services performed for a related person will be foreign base company services income to the extent the income is derived from services performed outside the CFC's country of organization.

The requirement that the services income have some related-person connection in order to fall within Subpart F is fundamental to Subpart F's approach to active income in general. Whereas generally passive income covered by the Subpart F foreign personal holding company income rules (dividends, interest, rents, royalties, *etc.*) was thought to be inherently mobile and thus of potential concern even when earned directly from unrelated persons, the Subpart F rules dealing with sales and services income are specifically concerned with the "separation" (sometimes referred to as "deflection") of active income from one related person to another.[98] The construct is that some other (presumably higher-tax) related person naturally "should" have earned the income, but the taxpayer has attempted to "deflect" the income to the lower-tax related person. Where there is no such deflection, under this approach, there should be nothing for Subpart F to worry about even in a low-tax structure.

This section discusses generally when services are performed for, or on behalf of, a related person. The next section describes rules provided in the regulations that *deem* a CFC as performing services for, or on behalf of, a related person even when the CFC performs the services for unrelated persons.

A. Definition of Related Person

The definition of a *related person* for purposes of the foreign base company services income rules is a person with respect to a CFC if:

- Such person is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the CFC; or
- Such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the CFC.[99]

A related person may be domestic or foreign.

For purposes of this definition, "control" means, with respect to a corporation, the ownership (directly or indirectly) of stock possessing more than 50% of the total voting power *or* more than 50% of the total value of the corporation.[100] In the case of a partnership, trust, or estate, control means the ownership (directly or indirectly) of more than 50% (by value) of the capital or profits interests in such partnership, or the beneficial interests in such trust or estate. Rules similar to the rules of Code Sec. 958 (including the indirect and constructive ownership rules) apply in determining whether the 50% ownership test is satisfied.[101]

This article discusses the foreign base company services income rules in the context of a CFC performing services for other members of a multinational group or for unrelated customers. Thus, the application of the definition of a related person is generally straightforward. However, difficult issues concerning whether a person is related to a CFC for purposes of Code Sec. 954(e) can arise in connection with joint ventures, and the broad constructive ownership rules can sometimes lead to surprising results.[102]

B. Performing Services for a Related Person

A CFC will satisfy the requirement that services are performed for, or on behalf of, a related person when the CFC enters into an arrangement with a related person to provide services for compensation.

Example. CFC is hired by USP, its domestic parent, to provide data processing services. Income derived by CFC from this activity would be considered as income from services performed for a related person.

CFC's services also would be considered as performed for a related person if the services were provided to another corporation wholly owned by USP.

Example. CFC is hired by FS, a foreign subsidiary of USP, and USP is CFC's domestic parent. CFC provides technical services to FS for a fee. FS is a related person with respect to CFC.

Income earned by the CFC from performing services for FS would be foreign base company services income to the extent the income arises from services performed outside the CFC's country of organization.

C. Related Person Services for Unrelated Persons

Services performed by a CFC may be considered as performed for a related person, even if the recipient of the services is an unrelated person.

Example. Both CFC and FS are owned by USP, a domestic corporation. An unrelated customer hires FS to provide data processing services. FS hires CFC to perform a portion of the data processing services for the unrelated person. CFC is considered as performing the services for a related person.

Where the recipient of the services is an unrelated person, a CFC may consider entering the contract to perform the services directly with the unrelated person.

Example. In the above example, CFC and FS may instead separately enter into services contracts with an unrelated customer to provide data processing services. Thus, CFC is considered as performing the services for an unrelated person, and generally the foreign base company services income rules would not apply.

As discussed in the next section, however, under certain circumstances services performed by a CFC for an unrelated person—even with direct contracting between the CFC and the unrelated customer—can be deemed to be performed for, or on behalf of, a related person.

D. Disregarded Entity Structure Eliminates Related Foreign Person Transactions

Global services companies often provide services to customers from multiple countries. One CFC may hire another CFC to assist in providing services to unrelated customers, or may hire a U.S. affiliate. Accordingly, with modern services businesses, it is common for there to be related-person services arrangements, even when the recipient of the services is an unrelated person.

As discussed above, to minimize related-person services arrangements, each CFC might consider entering a services contract directly with the unrelated customer. This can be burdensome and may not be acceptable to a customer.

A disregarded entity structure may be used to minimize related person services arrangements. A U.S. company may structure its foreign services operations by having a foreign holding company own all or most of the foreign operating companies, which would be electively disregarded for U.S. tax purposes.[103] One or more of the foreign disregarded entities contracts directly with unrelated customers for the performance of the services by various companies within the group. Any service arrangements between these disregarded foreign entities would be ignored for U.S. tax purposes and thus would not give rise to related-person services transactions. The foreign holding company would be viewed as the only CFC, and the income of all the disregarded entities would be treated as its income. The services income generally would not be foreign base company services income, because the services are performed for unrelated customers.[104]

The ability to elect to classify entities as disregarded is unavailable to eliminate related person transactions involving a U.S. affiliate.[105] Thus, if a U.S. affiliate enters the services agreement with the unrelated person and subcontracts foreign services to related CFCs, the CFCs would be considered as providing services for a related person.[106]

A significant consideration in deciding whether to implement a disregarded entity structure concerns the rules that deem a CFC as performing services on behalf of a related person. As discussed in the next section, under certain circumstances services performed for unrelated customers will be deemed to be performed for related persons. If one of those rules applies, then typically most or all of the services income derived in a disregarded entity structure would become foreign base company services income, as typically most or all of the services will have been performed outside the holding company's country

of organization. Therefore, if there is a meaningful risk of the deemed related person rules applying, a disregarded entity structure should not be used. Instead, operating with regarded CFCs would reduce the amount of foreign base company services income to the extent each CFC performs the services in its country of organization.[107]

VI. Services Deemed Performed for a Related Person

A. General

Income derived by a CFC from performing services for an unrelated person generally is not subject to Code Sec. 954(e) because it does not satisfy the definition of foreign base company services income. The regulations, however, provide rules that deem a CFC as performing services for, or on behalf of, a related person under certain circumstances. In such cases, the services income would be foreign base company services income to the extent attributable to the performance of services outside the CFC's country of organization.

The regulations set forth four specific situations where a CFC will be considered as performing services for, or on behalf of, a related person when the services are not directly performed for a related person, but a related person is involved in a particular way with the services arrangement.[108] The four situations are as follows:

- A CFC is paid or reimbursed by, is released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing services;
- A CFC performs services which a related person is, or has been, obligated to perform;
- A CFC performs services in relation to property sold by a related person and the performance of such services constitutes a condition or material term of such sale; and
- A CFC receives substantial assistance furnished by a related person in the performance of the services.

Under the regulations, if services are performed under any of these conditions, income derived by a CFC from performing services for an unrelated person will be deemed to be performed for, or on behalf of, a related person.

The regulations also state that services performed for, or on behalf of, a related person include but are not limited to the enumerated cases contained in the regulations. Therefore, the IRS might assert that a services arrangement that does not literally satisfy any of the above four arrangements but falls within the spirit of the above four cases should be considered as a related person services arrangement. However, in the 50-year history of the relevant regulations, we are not aware of any situation in which the IRS has applied the deemed-related services concept to any arrangement not listed in the regulations.

There is no express provision in the Code for deeming a CFC to be performing services for a related person when the CFC is actually performing services for an unrelated person. There also is no discussion in the legislative history of treating services provided to an unrelated person as performed for a related person. The regulations apparently base the rules deeming a CFC as performing services for a related person on the statutory language that treats a CFC as deriving income from related person services when it performs the services "on behalf of" a related person. The arrangements described in the regulations, however, represent a significant expansion beyond the language of the Code and do not appear to have been contemplated by the Congress in enacting Code Sec. 954(e).

It is noteworthy that the initial proposed regulations did not include the above deemed related person arrangements.[109] They contained only the third situation above, involving services income separated from manufacturing income, as discussed in the legislative history. The final regulations promulgated in 1964[110] and modified in 1968[111] adopted an expansive view of when a CFC would be deemed to perform services for, or on behalf of, a related person. While the regulations have not been substantively amended since 1968, the IRS and Treasury have issued Notice 2007-13,[112] announcing regulations that would materially limit the scope of application of the substantial assistance rule contained in the regulations.

Each of the above listed four arrangements is discussed below.

B. Related Person Pays a CFC for Performing the Services

Under the first deemed services arrangement in the regulations, services will be considered as performed for, on behalf of, a related person if the CFC is paid by a related person for performing the services.[113] For purposes of this rule, a CFC will be viewed as paid by a related person if it is paid directly, reimbursed, released from an obligation to a related person, or otherwise receives substantial financial benefit from a related person.

The regulations provide the following example illustrating the application of this rule when a CFC performs services for an unrelated person.

Example. CFC performs installation and maintenance of industrial machines for an unrelated person.

CFC is paid by a related person for the installation and maintenance of the machines which the related person manufactures and sells to a customer. The installation and maintenance services performed by CFC for the unrelated person are treated as performed for, or on behalf of, a related person because the CFC is paid by a related person for performing the services for the customer.[114]

The income earned by the CFC will be foreign base company services income to the extent attributable to the services that are performed outside of the CFC's country of organization.

For modern global services businesses, this rule generally does not appear overly restrictive.[115] When services are rendered by a CFC to an unrelated person, agreements generally provide that the unrelated person will compensate the CFC directly.[116]

C. Related Person Obligated to Perform the Services

1. General Rule

Services performed by a CFC for an unrelated person which a related person is (or has been) obligated to perform generally will be considered as services performed for, on behalf of, a related person.[117] This rule applies whether or not the services are provided with respect to property sold by the related person.

This rule can apply, for example, when a person related to a CFC enters a contract to provide services to an unrelated person, and assigns the contract to the CFC for performance. This provision also would apply where a CFC acts as a subcontractor for a related person who is the general contractor on a services project. Under this provision, a CFC may be deemed to perform services for a related person where a related person in the past was obligated to perform the services, and was released from such obligation before the CFC enters an agreement to provide the services.

The application of this provision is illustrated in the regulations by the following example.

> **Example.** M Corporation is obligated under a contract with an unrelated person to construct a superhighway in a foreign country. M Corporation later assigns the entire contract to its wholly owned subsidiary, CFC, and the unrelated person releases M Corporation from any obligation under the contract. CFC's services rendered in connection with the construction of the superhighway under the contract are considered to be performed for, or on behalf of, a related person because a related person had been obligated to perform such services.[118]

This rule also would apply if M Corporation assigned only a portion of the contract to CFC. However, this rule should not apply if the contract did not obligate M Corporation to perform any specific services for the unrelated person, and merely provided a framework pursuant to which the unrelated person could request services from M Corporation. In that case, if CFC enters into a similar framework-type contract with the unrelated person, the services that CFC performs for the unrelated person that the unrelated person requested under the new framework-type contract with CFC, would not be services that M Corporation is, or has been, obligated to perform.

2. Related Person Guaranty of Performance

The regulations provide that this deemed-related rule applies generally when a related person guarantees the performance by the CFC of services for an unrelated person. The performance guarantee may be provided by a U.S. related person or a foreign related person.

> **Example.** IndianCo enters a contract with an unrelated person to provide software development services. The U.S. parent of IndianCo guarantees performance of the services contract. A U.K. company provides certain services to the unrelated customer for which it receives a service fee from IndianCo. Under the regulations, IndianCo would be considered as performing the services for, or on behalf of, a related person.

The result would be the same even if a foreign related person provided the performance guarantee.

An exception to this rule applies under limited circumstances. If certain requirements are satisfied, a CFC will *not* be considered to have performed services which a related person is, or has been, obligated to perform pursuant to a services contract where the related person's obligation arose only in connection with its guarantee of the performance of the services by the CFC.[119]

For this exception to apply, the circumstances of the performance guarantee must meet each of the following requirements:

- The related person's sole obligation with respect to the contract is to guarantee performance of the services;
- The CFC is fully obligated to perform the services under the contract; and

- The related person (or any other person related to the CFC) does not in fact: (i) pay for performance of, or perform, any of the guaranteed services, or (ii) pay for performance of, or perform, any significant services related to the guaranteed services.

If the related person giving the guarantee (or any other person related to the CFC) does in fact pay for performance of, or perform, any of the guaranteed services, or any significant services related to such services, the services performed by the CFC will be deemed services which a related person is, or has been, obligated to perform.

For purposes of this exception, a related person will be considered to guarantee performance of the services by a CFC if the related person guarantees performance of such services by a separate contract of guarantee. This exception also is available when the related person enters into a services contract solely for purposes of guaranteeing performance of such services and immediately thereafter assigns the entire contract to the CFC for execution.

The regulations provide an example of the application of this exception to a situation involving a related person separately guaranteeing performance of services by a CFC.

> **Example.** CFC procures and enters into a contract with an unrelated person to construct a superhighway and CFC is capable of performing the contract, but the unrelated person enters into the contract on the condition that a related person agrees to perform, or to pay for performance, if CFC fails to perform under the contract. CFC completes its performance under the contract and no related person pays for, or performs, any services called for by the contract or any significant services related to such services. The CFC's services are not treated as performed for, or on behalf of, a related person.[120]

Therefore, the services income earned by the CFC is not foreign base company services income, even if the services are performed outside of the CFC's country of organization.

The regulations provide the following example of the application of this exception to a situation where the related person enters into a service contract for the sole purpose of guaranteeing a CFC's performance of services.

> **Example.** M Corporation enters into a contract with an unrelated person to construct a superhighway in a foreign country. M Corporation immediately assigns the contract to its wholly owned subsidiary, CFC. M Corporation is not released by the unrelated person upon the assignment of the contract to CFC. The sole purpose of having M Corporation on the contract, however, is to have it guaranty performance of the contract by CFC. CFC is capable of performing the construction contract. No related person pays for, or performs, any services called for by the contract or any significant services related to such services. The construction of the superhighway by CFC is not considered the performance of services for, or on behalf of, related person.[121]

On the other hand, a guarantee will be considered as giving rise to income for services performed for, or on behalf of, a related person if a related person performs significant services related to the services the performance of which it has guaranteed. This is illustrated by the following example from the regulations.

> **Example.** Assuming the same facts as in the previous example, except M Corporation, preparatory to entering the superhighway construction contract, prepares plans and specifications which enable the submission of bids. The regulations provide that M Corporation will have performed significant services related to services which it has guaranteed. Therefore, CFC's construction services under the superhighway construction contract will be considered performed for, or on behalf of, a related person.[122]

Therefore, any income derived by the CFC from performing the highway construction services outside of its country of organization would be foreign base company services income.

As described below, under the fourth deemed related person services arrangement provided in the regulations a CFC will be viewed as performing services for, or on behalf of, a related person if the related person provides "substantial assistance" to the CFC in the performance of the services. The regulations state that the standards for determining the application of the exception for services involving related person performance guarantees is different from the substantial assistance standard.[123] Therefore, if a related person, with respect to guaranteed services, pays for or performs the guaranteed services, or performs any significant services related to such services, the guarantee exception will not apply even though the payment or performance by the related person does not rise to the level of being considered substantial assistance to the CFC under the fourth category.[124] On the other hand, if a related person performance guarantee does not fall within this rule and qualifies for the guarantee exception, it must still be tested under the substantial assistance

rule, because the two rules are applied independently. As discussed below, Notice 2007-13 has materially limited the scope of the substantial assistance rule, and therefore this coordination rule has less importance as a result of that Notice.

3. Updating the Regulations

The deemed related person rules treating a CFC as performing services for, or on behalf of, a related person when the performance of the services are guaranteed by a related person, or when a CFC performs a portion of a global services contract entered by a related person, are overly broad in the context of today's global services businesses. We recommend that these rules be repealed, or significantly curtailed.[125]

In today's global economy, services arrangements are often entered with unrelated persons, requiring the performance of a wide range of different functions in multiple countries. Unlike in the scenarios the Congress had in mind in 1962, the use of personnel based in different locations is not necessarily a contrivance meant to "separate" functions to reduce taxes, but instead is absolutely inherent in the nature of the business and critical to meeting market demands. Thus a U.S. based company may need to have numerous affiliates performing various services in different locations around the world, based on considerations of cost, expertise, or other functional factors affecting the ability to deliver what the customer demands. The third party often desires to contract with one person rather than many, and it is not uncommon for a customer to request a performance guarantee from a U.S. parent. Accordingly, many or most global services arrangements by definition would cause a CFC under this deemed related person rule to be considered as performing its services for, or on behalf of, a related person, and there is no threshold of materiality for this rule to apply.[126] This effectively causes the second statutory requirement for services income to be foreign base company services income to be superfluous, calling these deemed related person rules into question as applied to modern services businesses, particularly when there is no express support in the Code or legislative history for such rules.

The apparent purpose of this rule when added to the regulations in the 1960s is found in the context of major construction projects where a CFC does not have the ability to build a dam, construct a highway, or drill an oil well, and requires critical and substantial assistance from its U.S. parent. This same concern would not apply to many modern-day services arrangements where numerous entities perform particular services from multiple locations with substantial employees and expertise, because this is what the marketplace demands.

For example, a U.S. company may enter into a global services contract and assign a portion of the contract to an Indian subsidiary that has hundreds of employees, including senior management. Because the Indian CFC was assigned a portion of the contract, it will be considered as performing its services for or on behalf of a related person. The same result would apply if the CFC enters the contract directly with the unrelated person, and performance of the services is guaranteed by the U.S. company, if a U.S. affiliate or a foreign affiliate performs even a very small amount of the guaranteed services, or performs significant related services. The application of this rule is overly broad in today's global services economy, and the impact is far beyond what could have been intended by the writers of the regulations.

The IRS and Treasury acknowledged several years ago that the performance guarantee rule may be overbroad in its application in today's global services businesses, and should be updated. As part of Notice 2007-13, limiting the scope of the substantial assistance rule, the IRS also stated that it understands that taxpayers are also concerned with the rule concerning a guaranty of performance and requested comments.

As discussed below, Notice 2007-13 provides that the substantial assistance rule no longer applies when a CFC receives assistance from a related foreign person. In addition, that deemed related person rule applies only when the cost of assistance provided by a related U.S. person is 80 percent of the CFC's costs of performing the service for the unrelated person.

Our primary recommendation on this issue is simply to eliminate the guarantee and assignment rules, and rely on the substantial assistance rule to deem a related-person transaction where too much assistance is received from related U.S. persons. As an alternative, certain specific circumstances might be delineated to substantially narrow the scope of the application of this rule.

For example, a showing of unusually heavy reliance on a guarantee (or on contractual obligations remaining after an assignment), along the lines of that required under *Plantation Patterns* to treat a financial guarantor of a debt as the borrower in substance, might be required before attaching such potentially significant consequences to a guarantee or to an assignment.

Alternatively, or in addition, exceptions to related-party treatment should apply where the CFC earning the services income in question engages in substantial activities to generate the income, relative to any activities performed by the guarantor or assignor. Such a

narrowing of the rules would be consistent with the policy goals discussed above, to target situations in which there has been a "separation" or "deflection" of services income from an entity that was the natural candidate to earn the income to an entity with a less obvious functional basis for serving in that role. Where a CFC performs key value-driving activities through its own employees, it is hard to justify treating that CFC as an unworthy recipient of the resulting income, even if its performance is guaranteed by an affiliate, or the contract was assigned by an affiliate. Whatever sense this treatment may have made in the historically prevalent fact patterns involving services in support of major construction projects, it makes little sense in the modern services economy, in which customers demand services that by their nature are best performed by a variety of different affiliates in a multinational group, working together.

The IRS and Treasury clearly have the authority to make such changes, as they created the current rule in the regulations in the first place, and there is no indication that Congress even contemplated such rules when enacting Code Sec. 954(e).

D. Services Are a Condition or Material Term of a Sale of Property by a Related Person

Under the third enumerated deemed related person arrangement in the regulations, services will be considered as performed for, or on behalf of, a related person if a CFC performs the services for an unrelated person with respect to property sold by a related person and the performance of such services constitutes a condition or material term of the sale.[127] The examples illustrating this rule involve sales of industrial machines. As discussed above, this reflects the situation contemplated by Congress when enacting Code Sec. 954(e).

The regulations provide the following example illustrating the application of this rule when a related person provides a reduced price to a customer on the sale of property conditioned on the customer hiring the CFC for specified services.

> **Example.** Domestic corporation M manufactures an industrial machine that requires special installation. M sells the machine for a basic price if the sales contract contains no provision for the machine's installation. If, however, the customer agrees to employ and pay CFC (a wholly-owned subsidiary of M) a specified installation charge, M sells the machine at a price less than the basic price. The CFC's installation services furnished to the customers who purchased the machine at a price below the basic price (on the condition that they agreed to employ and pay CFC a specified installation charge) are performed for, or on behalf of, the related person.[128]

The regulations provide the following example illustrating the application of this rule when a related person provides a warranty on the condition that the customer hires the CFC for specified services.

> **Example.** A related person provides a warranty on a machine sold to a customer conditioned upon installation and maintenance of the machine by a factory-authorized services agency and CFC is the only authorized services agency. CFC's services income from installation and maintenance work performed on the machines is from services performed for, or on behalf of, a related person.[129]

Not all income received for the performance of services for an unrelated person with respect to property purchased from a person related to the CFC is considered as income from services performed for, or on behalf of, a related person. Where a related person is not involved in the purchaser's selection of a service provider, income received by a CFC for providing such services is not considered as received for services performed for, or on behalf of, a related person. The regulations provide the following example illustrating this situation.

> **Example.** A company manufactures and sells machines without any provision for, or understanding as to, maintenance of the machines. The machines require constant maintenance that can be performed by the manufacturer, the manufacturer's CFC, or certain other unrelated persons throughout the world. The customer selects CFC to perform maintenance services. CFC's services are not performed for, or on behalf of, a related person.[130]

This rule would seem to target situations in which a related person that sells products may essentially shift a portion of the *sales* income to a CFC performing supporting services, through special arrangements with the person acquiring the products. The focus is on services performed with respect to the property sold, *e.g.*, to install a machine or maintain it. At a minimum, it would seem that regulations should clarify that services that extend significantly beyond ensuring that the property

originally sold is functioning should fall outside the scope of this rule. This issue may prove challenging in the computer software context, for example—if software is sold as a copyrighted article and then is continuously updated over time, is it really appropriate to taint services performed by a CFC many years later based on the fact that a different affiliate made the initial sale of the copyrighted article, regardless of the degree of relevant substance in the CFC? Again it would seem appropriate that a CFC be treated as a worthy recipient of the income it earns from third parties through the efforts of its own staff of highly skilled employees, regardless of the history of how the relationship with the relevant customer was first initiated.

E. Substantial Assistance Furnished by a Related U.S. Person

1. General

The fourth situation in the regulations where services performed by a CFC for an unrelated person will be deemed to be performed for, or on behalf of, a related person is where a related person (or related persons) "substantially assists" the CFC in the performance of the services.[131] The regulations take into account services furnished by related U.S. persons as well as related foreign persons, and provide expansive rules for determining when the services substantially assist the CFC in performing the services for the unrelated person.

This rule apparently is premised on the notion that a CFC should be considered as performing services for, or on behalf of, a related person if the CFC requires substantial assistance from a related person in order to perform the underlying services. The American Law Institute notes that "[t]hese rules appear designed to prevent an enterprise from reducing the U.S. tax base by 'hiving off' a service activity into a controlled foreign corporation that is not in fact economically capable of performing the services itself but is a mere appendage of the U.S. parent or other related party."[132]

The substantial assistance rule, however, has been widely criticized as outside the scope of both the language of the Code and the Congressional intent. There is no express language in the Code supporting this deemed related person rule, nor does the legislative history suggest that a CFC receiving services from related persons could thereby be treated as performing its services for related persons.[133] As one commentator stated around the time that the rule was issued, "[i]t is difficult to understand how the CFC as a recipient is then performing services for or on behalf of a related person."[134]

In Notice 2007-13, the IRS and Treasury announced that the regulations would be amended to narrow the substantial assistance rule.[135] The regulations, when revised, will limit substantial assistance to assistance furnished directly or indirectly by a U.S. person or persons that are related to the CFC, and will provide an 80 percent cost test for determining when the substantiality threshold has been crossed. Taxpayers may rely on Notice 2007-13 for taxable years of CFCs beginning on or after January 1, 2007, and for taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end. The announced regulations have not yet been issued.

If a CFC is considered as receiving substantial assistance from one or more related U.S. persons, then income earned from performing services for unrelated persons will be deemed to be received for performing services for related persons. Thus, income derived by a CFC for such services would be foreign base company services income to the extent derived from the performance of services outside the CFC's country of organization.

The broad substantial assistance concept as set forth in the regulations is summarized below as background for a discussion of the narrower rule now in effect under Notice 2007-13. Several of the rules in the regulations remain relevant for purposes of applying Notice 2007-13, and inform the interpretation of that Notice.

2. The Regulations

a. History of Regulations. The original proposed regulations issued pursuant to Code Sec. 954(e) on December 27, 1962,[136] did not include any fourth category of deemed related person services arrangements. They merely addressed a situation described in the legislative history where a CFC performs services for unrelated persons in connection with products manufactured and sold by a related person, and a related person pays the CFC for performing the services.

The original final regulations adopted on May 13, 1964[137] also did not contain a substantial assistance test. They did contain a fourth deemed related person arrangement based on an assistance concept, but with a different test. Under that test, services performed by a CFC would be considered as performed for, or on behalf of, a related person where:

> The controlled foreign corporation is not capable of performing the services without direction, supervision, equipment, know-how, services of personnel,

> financial assistance (other than contributions to capital), or other assistance contributing to the ultimate completion of such services, made available to it by a related person.[138]

This standard was referred to as the "necessity of assistance test."

The original final regulations contained the following example of the application of the necessity of assistance test.

> **Example.** CFC1 enters into a contract with an unrelated person to drill an oil well outside of CFC1's country of incorporation. CFC1 is fully obligated to perform the services under the contract. However, CFC1 is not capable of performing the services under the contract without the services of personnel from CFC2, a related person. CFC2 furnishes CFC1 with the services of its personnel. The services of CFC1 are considered as performed for, or on behalf of CFC2.[139]

Comments submitted to Treasury after the original final regulations were adopted raised objections to this rule. Treasury acknowledged these objections, and responded by issuing proposed regulations on February 22, 1967,[140] which replaced the necessity of assistance test with a new substantial assistance test. The proposed regulations were adopted in revised form (as they appear currently) as final regulations on November 5, 1968.[141]

The modified final regulations represented a substantial refinement to the original necessity of assistance test. The Technical Memorandum states that the assistance test as originally adopted may have imposed too harsh a burden on taxpayers to prove that the CFC was in fact capable of performing the services without the assistance actually furnished by the related person. Moreover, the rule could have been construed to require only a minimal amount of related person assistance in relation to the project (assistance could be relatively minor in the overall context of the services provided, and yet necessary).[142]

b. Assistance Furnished by a Related Person.

(i) General. Under the 1968 regulations, assistance is taken into account if provided by a related person, as defined in Code Sec. 954(d)(3). Assistance received from unrelated persons and from the CFC's own employees is not counted for purposes of applying the substantial assistance rule.

The definition of related person for this purpose is the same as the definition for purposes of determining whether services are provided to a related person. Thus, as discussed above, a person is related to a CFC if there is an overlap of more than 50% of ownership by vote or value.

(ii) Use of Personnel of a Related Person. Under the regulations, a CFC generally will be considered as receiving assistance from another person when the person provides assistance through its own employees. An example in the regulations treats a related person as providing assistance to a CFC where the CFC temporarily employed technical and supervisory personnel of its parent corporation to assist in performing an oil well-drilling contract. Since the services of the technical and supervisory personnel constituted substantial assistance, the CFC was considered as performing the services on behalf of a related person.[143]

On the other hand, employees who are full-time employees of the CFC on an indefinite basis apparently are not considered as employees of a related person providing services to a CFC. In an example in the regulations, where a CFC was not viewed as receiving substantial assistance from a related person, the statement is made that technical and supervisory personnel "are regular full-time employees of [the CFC] who are not on loan from any related person."[144]

(iii) Joint Officers and Directors. The IRS has taken the position in informal guidance that the use by a CFC and a related person of joint officers and directors who directly supervise the underlying services agreement constitutes substantial assistance furnished to a CFC by a related person. For example, in a Technical Advice Memorandum,[145] a domestic parent, a domestic affiliate and CFCs owned by the parent were engaged in contract drilling of oil and gas wells. Officers and/or directors of the domestic corporations were also officers and/or directors of the CFCs (the "joint officers"). The joint officers were engaged in the CFCs' operations, and performed a number of activities for the CFCs, including contract acquisition, contract arbitration, execution of letters of intent, drilling rig and employee contracting, marketing to solicit drilling contracts, top level policy decision making, capital equipment maintenance advice, and drilling operations monitoring. The IRS ruled that the services performed by the joint officers were direct assistance furnished by a related person which constituted a principal element in producing the income from services performed by the CFC, and therefore amounted to substantial assistance received from a related person.[146]

A General Counsel Memorandum provides a more detailed analysis in support of the above position. It

was written in response to a proposed Technical Advice Memorandum that had determined that since the officers of a CFC's parent ("P") were also the officers of the CFC ("S"), the services rendered by such officers in obtaining, supervising, and managing the oil contracts were performed for S and not for P. The GCM disagreed with that position, stating:[147]

> We think such services should be considered as supplied by P, the related person for purposes of Treas. Regs. §1.954-4(b)(2)(ii). Treas. Regs. §1.954-4(b)(3), Example 2 indicates that the temporary services of personnel of the related corporation on behalf of, and on loan to, the CFC are considered services rendered by a related person. Likewise in this case, when the officers of P perform activities for S, they are effectively "on loan" from P to S. The activities of such joint or "loaned" officers should, in the absence of evidence to the contrary, be presumed to be services rendered by the related corporation, P, on behalf of S. *See* the memorandum dated February 3, 1966, from Mr. Achstetter to Mr. Lazerrow, found in LR File No. 790, which states under these regulations that if the president of the parent corporation is also an officer of the CFC, his services would be personal services supplied by a related person.

The GCM went on to find that the services of the joint officers rose to the level of substantial assistance since they provided the overall direction of the performance of the drilling contracts.

c. Types of Assistance Taken into Account. Under the regulations, the substantial assistance rule applies only if a CFC receives assistance from related persons in the performance of services for unrelated customers. For this purpose, the regulations define two categories of "assistance": (1) direction, supervision, services, and know-how; and (2) financial assistance (other than contributions to capital), equipment, material, or supplies.[148] The regulations also state that *assistance* for this purpose is not limited to these identified items.[149]

(i) Direction, Supervision, Services and Know-How. The first category of assistance is direction, supervision, services and know-how. The regulations state that such assistance furnished to a CFC is not taken into account unless the assistance so furnished assists the CFC *directly* in the performance of its services.[150]

The Technical Memorandum accompanying the final regulations provides guidance concerning when a person will be considered as providing direct assistance to a CFC. That Memorandum states that assistance in the form of direction, supervision, services and know-how will *not* be considered to assist the CFC directly in the performance of the services unless such assistance provides the CFC with essential facilities necessary to its performance of such services and without which such services cannot be performed.

The Technical Memorandum further explains that services furnished to a CFC will be considered to assist directly in performing the services to be performed by the CFC where the performance of such services by the CFC necessarily requires the exercise of services of the type furnished by the person providing the assistance. If the essential service to be performed by the CFC is like in kind to the assistance, then, regardless of the skill required in performing the essential service, the person providing the assistance may be considered to assist directly in the performance of the essential service.[151]

The regulations provide the following example of services provided to a CFC that were *not* considered as directly assisting the CFC in the performance of its services.

> **Example.** CFC enters into a contract with an unrelated person to construct a dam in a foreign country. CFC is owned by M Corporation. CFC leases or buys from M Corporation, on an arm's-length basis, the equipment necessary for the construction of the dam. CFC's technical and advisory personnel who design and oversee the dam's construction are CFC's regular full-time employees (who are not on loan from any related person). M Corporation performs the principal clerical work and the financial accounting required in connection with the construction of the dam on a remunerated basis. All other assistance required by CFC in completing the construction of the dam is paid for by CFC and furnished by unrelated persons. The services performed by CFC under the contract for the construction of the dam are not performed for, or on behalf of, a related person because the clerical and accounting services furnished by M Corporation do not assist CFC directly in the performance of the contract.[152]

Therefore, clerical and accounting services provided to a CFC should not cause the CFC's services income to be considered as derived from performing services for, or on behalf of, a related person.

Another example in the regulations treats a related person as providing assistance to a CFC where personnel of

its parent corporation assisted in performing an oil well-drilling contract. Since the services of the technical and supervisory personnel constituted substantial assistance, the CFC was considered as performing the services on behalf of a related person.[153]

(ii) Financial Assistance, Equipment, Material, or Supplies. The second category of assistance in the regulations is assistance provided to a CFC in the form of financial assistance, equipment, material or supplies. Contributions to capital are excluded from consideration. Unlike the first type of assistance, there is no requirement that this assistance directly assist the CFC in performing the services.

The regulations provide that financial assistance (other than contributions to capital), equipment, material, or supplies furnished to a CFC are considered assistance *only* in that amount by which the consideration actually paid by the CFC for the purchase or use of such item is less than an arm's length charge.[154] Assistance is considered provided only to the extent of the difference between the fair market value of the assistance received and the price paid by the CFC for the assistance.[155] Thus, a CFC is not treated as receiving assistance by virtue of financial assistance, equipment, material, or supplies that are furnished for an arm's length charge.[156] The fact that this category of assistance applies only to situations in which there has been a failure to provide arm's length compensation perhaps explains why there is no further "direct assistance" requirement for this category.

For purposes of determining whether an arm's length charge was made for financial assistance, equipment, material, or supplies, any adjustments actually made by the IRS under Code Sec. 482 are taken into account and the phrase "consideration actually paid" includes any amount which is deemed paid by the CFC pursuant to any such adjustment. Thus, if the IRS adjusts any non-arm's length amounts to arm's length amounts under Code Sec. 482, the CFC would not be treated as receiving such forms of assistance. On the other hand, if the Service does not make any Code Sec. 482 adjustment, any less-than-arm's-length amount will be considered assistance provided to the CFC.[157]

d. "Substantial" Assistance. Assistance as defined under the above-described rules also must be "substantial" for it to cause income earned by a CFC for the performance of services for unrelated customers to be considered as income from services performed for, or on behalf of, a related person.

Under the regulations, the determination of whether assistance furnished to a CFC was substantial generally was determined from the facts and circumstances of each case.[158] The rules differ, however, depending on the type of assistance provided by the related person or persons. If the substantial assistance standards were satisfied under either set of rules, the CFC's services income was treated as derived from services performed for, or on behalf of, a related person. In addition, even if the separate tests were not met, if the assistance taken together, along with other assistance, amounted to substantial assistance, the CFC's services were considered as performed for, or on behalf of, a related person.[159]

(i) Direction, Supervision, Services or Know-How. Under the regulations, assistance furnished by related persons to a CFC in the form of direction, supervision, services or know-how is *not* considered substantial unless the assistance satisfies either one of two tests:

- The assistance furnished provides the CFC with skills that are *a principal element* in producing the income from the performance of the services by the CFC; or
- The cost to the CFC for the related person's assistance equals 50% or more of the total cost[160] to the CFC of performing the underlying services.[161]

If either one of these tests is satisfied, under the regulations the services income derived by the CFC will be considered as income received from the performance of services for, or on behalf of, a related person.

Based on the Technical Memorandum accompanying the final regulations, the first category above applies only to services provided by a related person which constitute skilled services.[162] On the other hand, the second category above applies to both skilled and unskilled services provided by a related person. As described above, all services, both unskilled and skilled, must *directly* contribute to the performance of the essential service by the CFC to be taken into account in applying these tests.[163]

The IRS in a GCM refers to a November 10, 1966 memorandum to then Assistant Secretary of the Treasury Stanley Surrey from then Deputy Legislative Tax Counsel and Special Assistant for International Tax Affairs Richard Loengard, explaining these tests as contained in the proposed regulations:[164]

> In drafting this rule, two cases were kept in mind in which it was thought to be desirable to treat the income of the controlled foreign corporation as being foreign base company service income. The first of these cases is one in which the U.S. parent renders so much assistance to the foreign company that the foreign company

may be treated as not being an independent entity. [This rule] provides that the foreign company's income will not be tainted merely because of the quantity of assistance provided to the controlled foreign corporation if the cost of that assistance is less than 25 percent of the total cost of the services being rendered by the foreign corporation to third parties ….

The second case which was kept in mind in drafting the regulations involves the situation in which the vast bulk of the costs incurred by the controlled foreign corporation in rendering services to an unrelated party are not on account of assistance rendered it by its affiliate but that assistance is a *sine qua non* to the ability of the foreign subsidiary to earn its services income. For example, a famous architect might set up a European company to render architectural services abroad. While any jobs obtained by the controlled foreign corporation would be the result of the reputation of the architect, most of the work on the job would be done by local employees. However, in all cases, the architect would take personal responsibility for the job and it would be the contribution of his services which would be the major factor in the ability of the foreign company to earn income ….[165]

The final regulations modified the proposed regulations by substituting the phrase "principal element" for "major factor," and increasing the percentage test from 25% to 50%.

The regulations provide the following example illustrating the application of the principal element test.

Example. M Corporation owns all the stock of CFC. CFC enters into a contract with an unrelated person to drill an oil well in a foreign country. CFC employs a small clerical and administrative staff and owns the necessary well-drilling equipment. Most of the technical and supervisory personnel who oversee the drilling of the oil well are regular employees of M Corporation who are temporarily employed by CFC. CFC hires on the open market unskilled and semiskilled laborers to work on the drilling project. CFC's oil well drilling services are performed for, or on behalf of, a related person because the services of the technical and supervisory personnel which are provided by M corporation are of substantial assistance in the performance of the contract in that they assist CFC directly in the execution of the contract and provide CFC with skills which are a principal element in producing the income from the performance of the contract.[166]

The example treats services provided by regular employees of a related person as assistance provided by the related person, even though such persons are temporarily employed by the CFC.

The principal element test is a subjective test and uncertain in application. As discussed below, this subjective test is no longer relevant in applying the substantial assistance rule under Notice 2007-13.

(ii) Financial Assistance, Equipment, Materials and Supplies. In determining whether the financial assistance, equipment, materials, and supplies prong of the substantial assistance test has been met, the regulations compare the total of the amount considered to be assistance under this prong (*i.e.*, the non-arm's-length amount)[167] furnished by all related persons with the profits derived by the CFC for performance of the underlying services.[168] The Technical Memorandum accompanying the final regulations states that whether there has been substantial assistance by a related person or persons for this purpose is a question of fact.[169] Again, to the extent the CFC pays an arm's length amount for such items, they will not be considered as assistance received from a related person.

(iii) Aggregation of Assistance. In testing for substantiality, the regulations require aggregation of assistance provided by multiple related persons. Thus, although assistance furnished to a CFC by one related person in the form of direction, supervision, services, or know-how might not be considered substantial, and assistance furnished by another related person in the form of financial assistance (other than contributions to capital), equipment, material, or supplies also might not be considered substantial, such assistance may nevertheless in the aggregate, or in combination with other assistance furnished by related persons, be considered substantial.[170] It is only necessary under the regulations to apply this test if substantial assistance is not found under either of the two separate tests above.[171] There has been no guidance illustrating when or how this aggregation rule would apply to particular circumstances.

3. Notice 2007-13: Updated Substantial Assistance Rule

a. General. The IRS issued Notice 2007-13, announcing that Treasury and the IRS would issue regulations materially limiting the scope of the substantial assistance rule contained in the regulations. Several of the key changes include the following:

- Substantial assistance is determined based only on an objective cost test;
- The cost threshold for substantial assistance is increased from 50% to 80%; and
- Only assistance furnished by related *U.S.* persons is taken into account.

The Notice states that for purposes of the objective cost test, "assistance" will include, but not be limited to, the two categories listed in the regulations. The Notice does not say that the total cost of an item of assistance defined by the second category is taken into account (the regulations provide that items in the second category are assistance only to the extent the amount paid is less than the arm's length amount).

The Notice states that the reason for narrowing the substantial assistance rule is that the rules in the regulations were inconsistent with the way in which modern services businesses are conducted. The Notice recognizes that since the regulations were published in 1968, there has been a substantial expansion in the provision of global services. It acknowledges that many U.S. multinationals have globally integrated services businesses with support capabilities for customer projects in different geographic locations, largely based on factors such as expertise and cost efficiencies. Thus, the IRS and Treasury determined that it would be inappropriate to continue to treat a CFC as performing services for or on behalf of a related person merely because other related foreign entities are involved in the provision of services. If the substantial assistance regulations are not amended to deal with these types of business structures, the Notice states that the regulations may cause taxpayer to change the way they do business or structure their operations in light of the substantial assistance rules, even if such a structure would be less efficient from a business perspective, for example, requiring a taxpayer to duplicate infrastructure in each country.

However, the IRS and Treasury were concerned that services arrangements still could be used to shift services income that otherwise would be derived in the United States to CFCs organized in low-tax jurisdictions in cases where related United States persons provide so much assistance to the CFC that the CFC cannot be said to be providing the services on its own account and thus acting as an independent entity. The IRS and Treasury thus decided to modify, rather than eliminate, the substantial assistance rule.[172]

The Notice states that the amended regulations will be effective for taxable years of foreign corporations beginning on or after January 1, 2007. The Notice further provides that taxpayers may rely upon the Notice until the regulations are amended (which has not yet happened).[173]

b. Assistance Provided by Related U.S. Persons.

(i) General. Under Notice 2007-13, only assistance provided by U.S. related persons is taken into account for purposes of determining whether a CFC receives substantial assistance in performing the services for an unrelated person. Thus, any assistance received from a foreign related person is not counted against the CFC. Indeed, as discussed below, such services are counted favorably in applying the 80% substantial assistance cost test.

For example, CFC1 may subcontract various services to CFC2 and CFC3 in providing services to an unrelated customer. Unlike the rules in the regulations, under Notice 2007-13 the substantial assistance rule would not apply to treat CFC1 as providing services for, or on behalf of, a related person, even if the assistance CFC1 receives from CFC2 and CFC3 is substantial. Accordingly, CFC1's income from performing services for the unrelated client should not be foreign base company services income, regardless of where the services are performed.[174]

For this purpose, the definition of related person is the same as that discussed above. A U.S. person will be related to a CFC if there is an overlap of more than 50% ownership by vote or value.

(ii) Indirect Assistance. Generally, under Notice 2007-13 assistance provided by a related CFC is not counted as assistance for purposes of applying the substantial assistance rules. The Notice provides, however, that assistance furnished *indirectly* by a related U.S. person through a related CFC is taken into account. This new rule was not necessary under the regulations, because assistance furnished by a related CFC was itself taken into account in applying the substantial assistance test.

The Notice provides that where CFC1 pays a fee to CFC2 for assistance, and CFC2 pays a fee to a U.S. related person to provide some of the assistance, the cost of the U.S. related person's assistance is taken into account in the numerator and denominator of the 80 percent cost test. For this purpose, services provided by a CFC itself are not services provided "indirectly" by a related U.S. person (or persons).

The application of this indirect assistance rule is illustrated in the following example from the Notice.

Example. USP, a U.S. corporation, wholly owns CFC1 and CFC2, each a foreign corporation. CFC2 enters into a contract with FP, an unrelated person, to design a bridge in Country Y, a foreign country that is not CFC2's country of organization. With respect to the contract with FP, USP performs services in Country Y for CFC1 in the form of design and technical services for which CFC1 pays USP $85x. CFC1 contracts with CFC2 to provide those services and others to CFC2 for $90x. CFC2 uses those services together with services it performs itself that cost CFC2 $10x to design the bridge for FP. Pursuant to the cost test, USP provides substantial assistance to CFC2 in the performance of its contract for FP because USP indirectly furnishes assistance to CFC2 (through CFC1) the cost of which exceeds 80 percent of the total costs to CFC2 for performing the contract.[175]

The Notice also makes clear that if instead the amount CFC1 paid to USP were $60, the substantial assistance rule would not apply, because the cost of assistance indirectly provided by USP to CFC2 would not exceed 80 percent of the total costs to CFC2 for performing the services contract.[176]

The Notice does not address a situation where USP hires a CFC to provide indirect assistance to another CFC. Consistent with the above indirect assistance rule—which looks through an intermediary to determine which person ultimately provides the assistance—the eventual regulations should exclude amounts the CFC pays to USP to the extent USP pays an amount to another related CFC to provide the assistance. That is, the conduit-type approach under the Notice should be a two-way street and thus should always look through an intermediary, whether such treatment helps or hurts the taxpayer. Otherwise, the rules could require a global company to structure or restructure its arrangements to have the CFC hire all other CFCs directly for assistance. It may also be appropriate to apply a similar rule to the cost of third-party services paid by USP to assist the CFC with the performance of its services, as the CFC could just as well have hired the third parties directly (and is bearing the costs of the third parties' activities), arguably making it inappropriate to consider these costs as costs of related U.S. assistance. Of course, to the extent that USP is entitled to an arm's length mark-up on the third-party services (reflecting value added by USP in supervising the third party, for example), it would be appropriate to treat that mark-up as a cost of related U.S. assistance.

(iii) Use of Personnel of Related Person. The Notice states that employees, officers, or directors of a CFC who are concurrently employees, officers, or directors of a related U.S. person during a taxable year of the CFC will be considered employees, officers or directors solely of the related U.S. person for such taxable year. This is similar to the approach taken in applying the substantial assistance rule in the regulations, as discussed above. Accordingly, the cost of their services apparently will need to be taken into account as costs of a U.S. related person in applying the 80 percent test.[177] It would seem appropriate that seconded employees (employees on loan to the CFC, which bears the costs) should not fall within this rule.[178]

The guidance issued under the regulations discussed above should inform the application of Notice 2007-13 in analyzing assistance received from a related U.S. person. Of course, unlike the regulations, employees, officers and directors of related foreign person are not counted against the CFC in calculating the 80 percent cost test (*i.e.*, such costs are only included in the denominator).

c. Types of Assistance Taken into Account.

(i) General. The Notice appears to contemplate that both categories of assistance described in the regulations are taken into account for purposes of calculating the 80 percent cost test. Thus, assistance for this purpose includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material or supplies provided directly or indirectly by a related U.S. person to the CFC.

With respect to the first category of assistance—direction, supervision, services and know-how—the regulations applied only if such services *directly* related to the performance of the services. The Notice does not expressly state whether the "directly related" limitation applies for purposes of the 80 percent test. The examples in the Notice illustrate the application of the cost test with respect to services that contribute to the performance of the essential service by the CFC.[179] Limiting such assistance to include only assistance that directly contributes to the performance of the services is an appropriate standard, and should be clarified in regulations.

The second category of assistance in the regulations—financial assistance, equipment, material or supplies—covers items that were counted as assistance only to the extent the price paid by the CFC was not arm's length. The Notice does not expressly state whether the same rule applies for purposes of the 80 percent test. If anything, the Notice seems to indicate that such costs are counted

even if the CFC pays an arm's length price, although it is odd that such a major departure from the underlying regulations was not discussed in detail in the Notice. This issue should be clarified in the regulations. It is not clear what policy purpose would be served by expanding the concept of assistance in financial or tangible form to include situations in which arm's length compensation has been provided. This category of assistance is best thought of as a backstop to international transfer pricing rules—certainly financial and tangible contributions should be captured if not properly compensated, but the core of the substantial assistance concept is really assistance in the form of activities directly relating to the services provided to the customer (which constitutes relevant assistance even if properly compensated, based on the concept—reiterated in the Notice—that a certain level of activity of this nature calls into question whether the CFC can be said to be providing services on its own account in the first place).

The Notice illustrates the application of the 80 percent cost test when a related U.S. person provides supervisory services and a related CFC provides support services.

> **Example.** USP, a U.S. corporation, wholly owns CFC1 and CFC2, each a foreign corporation. CFC1 enters into a contract with FP, an unrelated foreign person, to design a bridge for FP in Country Y, a foreign country that is not CFC1's country of organization. CFC1 incurs a total of $100x of costs to design the bridge for FP. USP performs supervisory services in Country Y for CFC1 with respect to the contract for which CFC1 pays USP a fee. CFC1 directly performs services related to the performance of that contract that cost CFC1 $15x. CFC2 performs centralized support services related to the performance of that contract in Country X, its country of organization, for which CFC1 pays CFC2 $10x. CFC1 is not treated as receiving substantial assistance in the performance of that contract because more than 20% of the cost of that contract is attributable to services furnished directly by CFC1 and/or a related CFC (CFC2). This conclusion applies without regard to the significance of the supervisory activities provided by USP in generating the services income.[180]

For purposes of the objective cost test, the term "cost" is determined after taking into account adjustments under Code Sec. 482. This is the same approach as provided in the regulations for the first category of assistance, but different from the approach in the regulations for the second category of assistance, which gave the IRS flexibility as to whether to apply Code Sec. 482 (although under the regulations only the non-arm's length amount was taken into account).

The Notice does not provide any guidance concerning potential types of assistance beyond the assistance expressly mentioned in the regulations. The IRS and Treasury, however, have suggested that the assistance taken into account under the Notice may be broadly defined. In many cases it may be unclear whether a particular activity is taken into account as assistance. For example, the costs of marketing and selling the services to prospective customers arguably may be insufficiently linked to the actual *performance* of the services to be taken into account as assistance, although such activities may play a significant role in generating the services *income*. What if the marketing or selling activities also play some role in educating or training the customer to use the services?

It should be noted that a broad approach to defining costs can cut either for or against the taxpayer, depending on the circumstances. In some cases, a broad interpretation may cause the 80 percent test not to be satisfied, by increasing the denominator in a situation in which the relevant costs do not involve a related U.S. person. If the costs relate to activities performed by the CFC, related CFCs or unrelated persons, they would be included in the denominator but not the numerator. On the other hand, if the broadly defined costs relate to assistance provided by related U.S. persons, the costs would also be included in the numerator, making it more likely that the 80 percent test would be satisfied.

(ii) Services Involving Intangibles. The 80 percent cost test generally should achieve its objective of subjecting to the substantial assistance rule only those arrangements where U.S. related persons are clearly the main engine behind the performance of the essential services. Nevertheless, this test might raise issues where the CFC performs services using valuable intangibles provided by a related U.S. person.

The Notice does not expressly address the treatment of payments made by a CFC to a related person to obtain or develop intangibles.[181] Such payments may take the form of royalties or consideration for a purchase of intangible property. Also, a CFC may make payments for research and development services or cost sharing payments pursuant to a cost sharing arrangement.

Payments to obtain or develop intangibles under certain circumstances may implicate the 80 percent test, even where the CFC's own employees perform the majority of the activities in providing the services under the arrangement. It is not clear that such payments should be counted

at all. Costs of intangibles relied on to generate services income do not necessarily directly relate to the actual provision of the services (*e.g.*, a trade name, trademark, or service mark). In addition, apportioning such costs in a situation in which there is no such direct relationship would be somewhat arbitrary.

Moreover, there is some basis in both the regulations and the Notice for not including intangibles (other than know-how) as relevant assistance in the first place. Intangible property (other than know-how) is nowhere mentioned in the regulations or the Notice as a kind of relevant assistance, and it is arguably unlike all of the enumerated items on the list, thus making it a poor candidate for inclusion as an unenumerated item, under the *ejusdem generis* canon of construction. In addition, the fact that know-how (a well-recognized item of intangible property under the various definitions of intangible property in the Code and regulations) is included, while all other intangible property is not included perhaps suggests that the exclusion of other intangible property was intentional (under the *expressio unius est exclusio alterius* canon).

Some commentators indeed have expressed the view that intangibles should not be included in the 80 percent cost calculation. Some note that the intangibles may not directly assist in the performance of the specific services under a contract, or that the putative assistance in this form may not be contemporaneous with the performance of the services (*e.g.*, a payment relating to the development of intangible property that may not be ready for commercialization for some time, if ever).[182] In cost-sharing arrangements, cost sharing payments relate to the development of new intangible property, and at any rate are generally treated as intangible development costs *of the paying participant* and not as services received from a related person.

At a minimum, it is clear that if payments to develop intangibles are to be taken into account, detailed new rules would be needed to match those costs with services revenue streams (*e.g.*, through some sort of amortization concept). Detailed rules also would be required to allocate intangible-related costs across the many different service lines and service contracts that may be supported in some way by the particular intangible property. The fact that such a detailed framework would be required in order to apply this broader concept of assistance in a rational manner perhaps further reinforces that the rules as currently articulated should not be interpreted as requiring these costs to be taken into account.

d. "Substantial" Assistance. Under Notice 2007-13, assistance furnished by a related U.S. person or persons is regarded as substantial only if the cost to the CFC of the assistance equals or exceeds 80 percent of the total cost to the CFC of performing the services. The Notice states that taxpayers may show that the substantial assistance rule does not apply by demonstrating that the cost of the services provided by the CFC itself (and/or by related CFCs) is more than 20 percent of the total cost to the CFC of performing the services.

The term "cost" will be determined after taking into account adjustments, if any, made under Code Sec. 482. As discussed above, the Notice does not address whether the entire cost of the second category of assistance is taken into account, or only the unadjusted non-arm's-length amount as provided in the regulations.

The costs of the CFC's own employees as well as the costs of services provided by related foreign entities are included in the denominator when calculating the 80 percent test. Also, amounts paid to third parties for assistance in performing the services are included in the denominator. Only costs paid to related U.S. persons are included in the numerator of the 80 percent fraction. As discussed above, any amounts paid to a related CFC that the related CFC pays to a related U.S. person are counted as costs for assistance provided by a related U.S. person.

The Notice does not elaborate on the calculation of costs taken into account. It would seem appropriate that the test be applied based on annual costs, although this is not expressly stated in the Notice. As noted above in connection with intangible property costs, if costs for items useful beyond the taxable year are included, guidance would be needed to match the annual services revenues with the appropriate costs. For example, the cost of property acquired should not be taken into account in the year of acquisition, but spread over the useful life of the property. Another question is whether non-cash expenses might be counted, such as depreciation and amortization deductions.

And as noted above, rules may be needed to allocate and apportion costs among various service lines and arrangements, as neither the regulations nor Notice 2007-13 provides any guidance on that point. Directly related costs likely should be allocated to the particular services contract, and it may be appropriate to apply the expense allocation rules in the Code Sec. 861 regulations for purposes of allocating expenses that are not directly related (to the extent such expenses are counted). In general, in the absence of specific guidance, taxpayers should be able to use any reasonable method, consistently applied, to allocate expenses to multiple service lines.[183]

The subjective portion of the substantial assistance test that applied to certain assistance has been eliminated.

Whether assistance is a "principal element" in producing the income from the services is no longer relevant. Rather, the new regulations will find substantial assistance only where the objective cost test is met. For example, a U.S. related person may provide important services to a CFC in the form of supervision and technical assistance, and such services will not be considered as substantial assistance unless the objective cost test is satisfied. This is an important simplification to the application of the substantial assistance test.

It is important to reiterate that, where a CFC receives substantial assistance from related U.S. persons, that does not necessarily mean that the CFC has foreign base company services income. Such determination only means that the CFC will be considered as providing the services on behalf of a related person (even though the actual customer is an unrelated person). Income from the provision of such services results in foreign base company services income only to the extent the services are performed outside the CFC's country of organization.

Notice 2007-13 was welcome relief for modern services businesses. In today's global business environment, the provision of services has become more specialized, making it impractical if not impossible to duplicate an entire services infrastructure in each country, such that services are often contracted for and supervised from a central location, and clients are serviced from multiple countries by affiliated subcontractors, each providing its own particular expertise. As a result, it is common for CFCs that provide services to unrelated clients to receive some form of assistance from related persons, including shared personnel, direction, and know-how. The new substantial assistance rules go a long way toward accommodating such global services business operations, although many important interpretative issues remain to be addressed, as noted above.

VII. Services Performed Outside the CFC's Country of Organization

As discussed above, a CFC's income from the performance of services is foreign base company services income only to the extent the income is attributable to services performed outside the CFC's country of organization.[184] Income from services performed within a CFC's country of organization does not constitute foreign base company services income even if the income is derived from the performance of services for, or on behalf of, a related person. The determination of the location of performance of services is unnecessary if the services are not performed for, or on behalf of, a related person, because income from such services falls outside the definition of foreign base company services income regardless of where the services are performed.

The requirement that the services income be attributable to activities performed outside the CFC's country of organization in order to fall within Subpart F is fundamental to Subpart F's approach to active income in general. The Subpart F rules dealing with sales and services income are specifically concerned with the possibility that such income, although active, may nevertheless be geographically mobile, thus permitting the "separation" (sometimes referred to as "deflection") of active income from one related person to another.[185] The construct is that some other (presumably higher-tax) related person naturally "should" have earned the income through activities occurring in its own location, but the taxpayer has attempted to "deflect" the income to the lower-tax CFC organized in a country other than the one where the activities generating the income are actually carried out. To the extent that the CFC's country of organization, the income-generating service activities, and the resulting income are all aligned in the same place, there should be nothing for Subpart F to worry about even in a low-tax structure (and indeed even if a related person is involved).

As a general rule the place where services are performed is where the persons performing such services are physically located at the time of performance.[186] The location of a customer or the place where the services are used is not relevant.

A. CFC's Country of Organization

1. General

To determine whether a CFC derives income from performing services outside its country of organization, the country "under the laws of which the controlled foreign corporation is created or organized" must first be determined.[187] Neither the Code nor the regulations elaborate on the meaning of that phrase.

The plain meaning of the country under the laws of which the CFC is created or organized is the country from which an entity derives its existence or legal personality. For example, a German GmbH which derives its legal existence under the laws of Germany would be considered as organized under the laws of Germany.

2. Companies Not Subject to Taxation in Their Country of Organization

For purposes of determining a CFC's country of organization, it is not relevant whether the CFC is subject to taxation in the putative country of organization (or in any

other country). While the presumption might have been that a company organized under the laws of a country would be subject to taxation in such country, no such requirement appears in the Code or regulations, and thus the foreign tax treatment of a CFC is simply not a factor in determining where the CFC is created or organized.

For example, a company formed under the laws of some countries may not necessarily be considered as tax resident in the country of incorporation. A non-tax resident company generally is not subject to tax in its country of organization on income that is not attributed to such country. One example is a company formed under the laws of Ireland that is managed and controlled in a different country, which would be considered as not tax resident in Ireland.[188] The nonresident Irish company would be considered as created or organized in Ireland for purposes of Code Sec. 954(e), even though it is not taxed as a resident of Ireland.[189]

Another nonresident entity is a reverse hybrid entity, which is classified as a partnership for foreign tax purposes and by election classified as a corporation for U.S. tax purposes.[190] An example is a Dutch CV with non-Dutch partners, which would not be subject to tax in the Netherlands on income that is not attributed to carrying on business in the Netherlands. Since the entity is organized under the laws of the Netherlands, it is treated as created or organized under the laws of that country for purposes of applying the Subpart F rules. Thus, again a CFC that is not subject to local country taxation on a residence basis can be treated as formed under the laws of such country for purposes of Code Sec. 954(e).

The use of non-tax resident companies to earn services income may not fundamentally undermine the intended application of Code Sec. 954(e). For example, any income derived by a nonresident Irish company from performing services for a related person outside Ireland would be foreign base company services income. If the services are performed in Ireland, the income generally would be subject to Irish taxation. Therefore, as a general matter, a nonresident CFC would be subject to tax on its services income either in its country of organization or pursuant to Code Sec. 954(e).

3. Disregarded Entities

An entity for which a valid disregarded-entity election has been filed is treated as a branch or division of its owner for purposes of applying the Subpart F rules.[191] Accordingly, the country of organization of a disregarded entity is not relevant in applying Code Sec. 954(e). All of the income of the disregarded entity is treated as derived by its CFC owner, and the country of organization of the CFC that owns the disregarded entity is the relevant country of organization for purposes of Code Sec. 954(e).

Whether an entity that performs services for a related person is a CFC or disregarded can be determinative of whether or not the services income is foreign base company services income.

> **Example.** A Luxembourg CFC owns all of the stock of an Indian CFC. The Indian CFC has hundreds of employees who perform software services for the ultimate U.S. parent and other related CFCs. The services are performed in India. Therefore, the services income would not be foreign base company services income. However, if an election were filed to disregard the Indian CFC into its Luxemburg parent, all of the Indian CFC's services income derived from performing services for related persons would become foreign base company services income, because the services are performed outside Luxembourg.

This result, self-imposed though it may be, seems artificial, and the application of Code Sec. 954(e) when the Indian entity is disregarded seems unwarranted given the hundreds of employees performing the services in India. Nevertheless, the rules clearly require this conclusion, and thus it is important to consider the application of Code Sec. 954(e) before filing an election to disregard a CFC deriving services income.[192]

An election to disregard the Indian CFC might have been made to permit dividends, interest, rents or royalties to be paid to the Luxembourg CFC. Under the general rules, such payments typically would give rise to foreign personal holding company income if paid by an Indian CFC to a Luxembourg CFC.[193] By electing to disregard the Indian CFC, the payments are ignored for Subpart F purposes. Nevertheless, such an election would result in all of the Indian entity's services income becoming foreign base company services income.

In 2006 Congress enacted Code Sec. 954(c)(6) as an exception for dividends, interest, rents and royalties that are received by a CFC from a related CFC.[194] Under that provision, payments of dividends, interest, rents and royalties made by an Indian CFC to its Luxembourg CFC parent would not be foreign personal holding company income to the extent such payments do not reduce any Subpart F income of the Indian CFC. This exception allows the Indian entity to avoid making a disregarded entity election, and thus its services income would not become foreign base company services income.[195]

B. Where Services Are Performed

Income from the performance of services for, or on behalf of, a related person falls within the definition of foreign base company services income only to the extent the income is from services performed outside the CFC's country of organization. If all services that give rise to the income are performed within the CFC's country of organization, then none of the income is foreign base company services income.

The regulations provide guidance for determining a CFC's income derived in connection with services performed outside the CFC's country. The rules in the regulations were promulgated in 1964, and have not been updated since then.[196]

The regulations state that the place where services are performed is to be determined based upon the facts and circumstances of each case.[197] The regulations go on to provide that under the facts and circumstances test, as a general rule services will be considered performed where the "persons" performing the services for the CFC which derives the services income are *physically located* when they perform their duties in the execution of the underlying service activity resulting in such income.

Customer location, and the place where the services are used or consumed, are not relevant factors for purposes of determining whether income is derived from the performance of services outside the CFC's country of organization.[198] For example, when services are performed by a Swiss CFC through its employees physically located in Switzerland, for customers who are located in Germany, the U.K. and Spain, no portion of the income should be considered as arising from services performed outside Switzerland.

The ALI Report illustrates the point that the location of customers is not relevant. It observes that data processing and financial services performed in a low-tax country by a CFC organized under the laws of such country is not foreign base company services income, regardless of where the services are used.[199]

The ability of modern services businesses to provide services remotely has made much more prevalent situations in which services are performed in countries other than where the customers/users are located. The rule treating services performed outside the CFC's country as foreign base company services income generally ensures that income derived from services performed in the CFC's country of organization would be subject to local country taxation (as the employee presence necessary to perform the services presumably would create a permanent establishment or other taxable presence in the country where the employees are located).

The covid-19 pandemic has accelerated the trend towards remote work. This trend poses a challenge for CFCs to the extent that employees desire to work outside the country of organization of the CFC that employs them.

Congress may not have been concerned with the location of the customers, although it might have assumed that users generally would be in the country where the CFC performs the services. Although the *Piedras Negras*[200] case demonstrates that this was not always true even prior to the enactment of Subpart F, the dawn of the Internet era and associated computing and telecommunications capabilities certainly have made the remote-services fact pattern much less exceptional than it was several decades ago. Congress may not have anticipated the ease of providing services through telecommunications and over the Internet from low-tax remote countries, often using high-value intangibles, across a wide swath of industries that decades ago would have required greater physical proximity between provider and customer.[201]

C. Apportionment of Services Income

1. General Rules

Under certain circumstances services may be performed both within and without a CFC's country of organization. In such cases, the CFC must determine the amount of income from the underlying services activities that is attributable to the services performed outside the CFC's country of organization.

The regulations provide that income generally is apportioned on the basis of employee time spent within and without the CFC's country of organization.[202] This determination is required with respect to each services contract or arrangement performed for, or on behalf of, a related person.

In allocating time spent within and without the CFC's foreign country of organization, the regulations require that relative weight be given to the value of the various functions performed by persons in fulfillment of the service contract or arrangement. For example, clerical work will ordinarily be assigned little value, while services performed by technical, highly skilled, and managerial personnel will be assigned greater value in relation to the type of function performed by each individual.[203] No additional guidance is provided to make this determination. As discussed above, unskilled services arguably should not be taken into account, as income associated with such services may be outside the scope of Code Sec. 954(e) and generally are not the services giving rise to material income under the contract. Thus, for example, an employee-time

spent allocation of income may not take into account every hour of an employee's time if that employee performed ancillary and incidental services that did not give rise to the services income.[204]

An issue unaddressed by the regulations or any other guidance is whether activities of employees that are not directly performing the services contracted for by the customer are taken into account in determining the location of the performance of services (*e.g.*, marketing of the services to the customers). Marketing might not be an element of the services that the customer purchases, but from the service provider's perspective marketing may be important to the generation of the services income. In addition, several commentators have discussed two possible additional issues in determining the location of the performance of services. One issue is whether activities of companies hired by a CFC to assist in providing the services can be taken into account in determining where services are performed, or whether instead only the activities of the CFC's own employees are taken into account.[205] A second issue concerns whether services can be treated as performed at locations where machines are used (*e.g.*, servers) to assist with providing the services giving rise to the CFC's income.

2. Activities Incidental to Performing the Contracted Services

A question that arises when determining the location of the provision of services is whether activities other than the direct performance of the services contracted for by the customer should be taken into account. Such activities might include marketing or advertising, research and development, financing, or accounting.[206] A CFC's employees may travel to other countries to market services to potential customers, or the CFC may have a branch in another country performing incidental services. There are no authorities that address whether such activities are relevant in determining the location of the services income derived from the performance of the services for the customer for purposes of Code Sec. 954(e).

The foreign base company services income provisions treat only income derived from performing certain listed services (*e.g.*, technical, engineering, supervisory services) as subject to analysis under Code Sec. 954(e). The enumerated services are those which give rise to the services income earned by the CFC from performing the services requested by the customer. The list does not include incidental services, such as marketing, clerical, administrative, research, and similar support type services.

Consistent with limiting the location determination to enumerated services, the language of the regulations provides that the determination of the location of the performance of services is based on where persons are physically located "when they perform their duties in the execution of the services activity resulting in the income." This would seem to exclude ancillary activities other than the services contracted for by the customer. Possibly pointing in the other direction is a reference to clerical services as relevant in allocating income to services performed within and without a CFC's country of organization, but as mentioned above, this may be outside the scope of the language of the statute.[207]

Another reason for disregarding ancillary activities is the lack of any rules for apportioning the services income to such activities. For example, it would be difficult to determine how much of the services income should be allocated to marketing or financing activities, since they do not directly contribute to generating the services income in any reliably measurable way. Accounting for these activities in the apportionment of services income would entail considerable complexity in order to track what may be a minor contributor to the true value provided in the relevant transactions. In addition, it may often be the case that these ancillary activities are more mobile than the more complex activities for which customers actually contract—in such situations, inviting taxpayers to attribute income to these activities in location determinations may open up new avenues for taxpayers to shelter more income from Subpart F than would be appropriate, thus creating new issues for taxpayers and the IRS to fight about, again for no real apparent upside.

Therefore, the better interpretation of the regulations—particularly in light of the regulations' instruction to weigh activities by value in apportioning services income based on location—is to allocate income only on the basis of activities constituting the performance of the services directly requested under the services contract. This fits well with the language of the Code and follows from the language of the regulations. Allocating the income to incidental activities would require complex valuation determinations and would not seem to advance any significant policy objective.[208]

3. Activities of Persons Other than the CFC's Employees

In today's global economy, it is common for a CFC to contract with other entities to assist with the performance of services for a customer. For example, a Singapore CFC may function as a center of excellence and provide services

to customers throughout Asia. The Singapore CFC hires a related Indian entity to assist with certain services. A U.S. affiliate and unrelated companies may also contribute to the services provided to the Asian customers. It is expected that these companies would be paid an arm's length amount by the Singapore CFC for the services they perform (or the amount paid would be subject to transfer pricing adjustments).

If the Singapore CFC performs the services for unrelated customers, then the location of where the services are performed generally would not be relevant. As discussed above, the foreign base company services income rules generally do not apply to services performed for unrelated persons, regardless of where the services are performed. However, under certain circumstances the Singapore CFC can be deemed to perform the services on behalf of a related person. This can be the case where the CFC receives substantial assistance from related U.S. persons, performs the services under a contract that was assigned by a related person, or a related person provides a performance guarantee. These circumstances may present the question whether the location of the activities of the other entities assisting the Singapore CFC in the performance of the services is relevant to the determination of the location of where the CFC's income-generating services are performed.

The most straightforward reading of the regulations is that only the activities of the CFC's own employees are taken into account in determining whether any income is derived from services performed outside the CFC's country of organization. The activities of other entities hired by the CFC to assist with providing the services are not referenced in the regulations as being relevant in determining where services are performed.

This interpretation follows from the language in the regulations, which determines the location of the performance of services by reference to individuals and employees. The regulations state that as a general rule, "services will be considered performed where the *persons* performing the services for the CFC … are *physically located* when they perform their duties in the execution of the services activity resulting in the income."[209] While persons can include entities,[210] the reference to the physical location of the person would seem to exclude a reference to an entity. Among "persons," only individuals can have a physical location, as a company or other entity does not have a physical location (it may have a country of organization, or a permanent establishment or a branch, and it may own physical things with physical locations, but it does not, as an entity, have a physical location—it is instead a purely legal construct). Thus, the regulations appear to limit the analysis for the determination of where services are performed based on the location where individuals perform the services giving rise to the CFC's income.

Limiting the location determination to an analysis of individuals is reinforced by the sentences in the regulations following the above sentence. The regulations state:

> "*Therefore*, in many cases, total gross income of a controlled foreign corporation derived in connection with each service contract or arrangement performed for or on behalf of a related person must be apportioned between income which is not foreign base company income and that which is foreign base company income on a basis of *employee*-time spent within the foreign country under the laws of which the controlled foreign corporation is organized and employee-time spent without the foreign country under the laws of which such corporation is created or organized. In allocating time spent within and without the foreign country under the laws of which the controlled foreign corporation is created or organized, relative weight must also be given to the value of the various functions performed by *persons* in fulfillment of the service contract or arrangement. For example, clerical work will ordinarily be assigned little value, while services performed by technical, highly skilled, and managerial *personnel* will be assigned greater values in relation to the type of function performed by each *individual*."[211]

The interchangeable use of persons, personnel, employees and individuals seems to rather clearly demonstrate that the regulations should take into account only the performance of services by individuals, not by entities.[212]

While the regulations do not expressly refer to the employees of the CFC, that is the context in which the regulations are written. The determination is to be made on the basis of the location of where the CFC derives its income from performing the services, which would seem to be a reference to the CFC's own employees which perform the services that give rise to the CFC's services income. The employees of other entities engage in activities that result in income derived by such other entities.

The location rule in the regulation does not include any express reference to other entities assisting the CFC. This absence is particularly significant because immediately before the location provision the regulations provide detailed rules addressing when assistance provided by persons related to the CFC in performing services would constitute substantial assistance causing the CFC's services to be deemed performed on behalf of a related person. If the regulation writers believed that the location of employees

of other entities providing assistance to the CFC was relevant in determining the location of services giving rise to the CFC's income, it would seem that some reference would have been included in the regulations addressing the location of the performance of the services.[213]

Furthermore, the lack of any rules for allocating income to services performed by employees of other entities assisting the CFC strongly suggests that the location of such services was not intended to be taken into account. How would a CFC determine what portion of its income is allocated to services performed by another entity? How would a CFC obtain the information concerning the location of employees of unrelated service providers? It may be that the regulation writers viewed the other entity as receiving an arm's length fee for performing the services in the other country, so the income attributable to the activities occurring in the other country is already attributed to such country and is not considered as income of the CFC.[214]

In 1986 the American Law Institute published a major study on International Aspects of United States Income Taxation (the "ALI Report"). The ALI Report discusses at length the foreign base company services income rules, and in particular the rules that deem a CFC as performing its services on behalf of a related person under certain circumstances where the CFC receives substantial assistance in the performance of the services from a related person. The ALI Report takes as the law that a CFC that meets the substantial assistance rule but which performs all of the services through its employees in its country of organization does not have foreign base company services income. [215] The ALI Report recommends a change to the law to provide generally that income derived from services in which the substantial assistance played a significant role will be foreign base company services income.[216]

Since the regulations appear to be drafted to consider only the activities of the CFC's own employees in determining the locations of services, and don't provide rules to address how to determine the location of activities of employees of other parties or how to apportion income to such activities, the better view is that only activities of employees of the CFC should be considered in apportioning a CFC's income to countries other than the CFC's country of organization.[217] If the IRS and Treasury believe that the determination of the location of services giving rise to a CFC's income should take into account activities of employees of other entities, it would be appropriate to propose such a change through the normal regulation process, allowing a period for comments due to the long existence of the current regulations, the complexity of such new rules, and the likely controversy of expanding the rules.

4. Location of Machines

Another question that commentators have discussed concerns whether machines used in providing services should be a factor in determining where a CFC performs its services. For example, a CFC may provide software services through a server located in a country other than the country under the laws of which the CFC is organized. Another example is a CFC that earns advertising income over websites that are hosted on servers located in multiple countries.

Neither the Code nor the regulations explicitly address whether the location of equipment used in providing services should be taken into account when determining the location of where services are performed. As discussed above, while the regulations provide that the location of the performance of services generally will be determined based on the relevant facts and circumstances, they state as a general rule that the location of the performance of services will be determined based on where persons are physically located when rendering the services. There is no mention of the location of equipment as relevant, and the IRS has not issued any guidance specifically addressing this question.[218]

In the absence of any specific guidance, it would seem that the location of machines in and of itself should not be taken into account in determining the location of where a CFC performs its services. No such incorporation of machine location (separate from employee location) was contemplated by Congress or by the writers of the regulations. In addition, no rules are provided for determining how to allocate income to equipment located outside a CFC's country of organization.

If the CFC pays another party for access to equipment (for example, servers, under web hosting services arrangements) necessary to the performance of the CFC's services, the location where the other party maintains its equipment and performs its activities does not appear relevant under the language or intent of the current regulations. As discussed above, the other entity receives payment for the services performed in the other country, and there are no rules for determining what portion of the CFC's income, if any, could be allocated to the activities of the other entity.

While consideration may be given to modifying the regulations to address the use of equipment in another country, it would seem counter-productive to add machines as factor to be taken into account. Rules would have to be provided concerning the amount of income to be allocated to the country where a machine is located. In

addition, it might be difficult to determine the location of servers used to provide the services, particularly if the servers are owned by unrelated parties. Indeed, the location of equipment providing a commodity-type service, like servers in most business models, may be both low-value and readily manipulable by taxpayers, and thus not a factor that the government would wish to emphasize in any important tax analysis.[219] Exceptions to this proposition may be provided, for example where the CFC's cost of use of the relevant equipment is very high relative to its overall costs (suggesting the equipment is not low-value in the overall context of the services performed), or where the CFC has only a relatively insubstantial employee team performing services in the CFC's country of organization (also suggesting that the equipment is much of what the customer is paying for, as opposed to high-value human activities in the country of organization).

VIII. Coordination with Other Categories of Subpart F Income

A. Priority of Other Categories

1. General Rules

An item of income that is characterized as services income and subject to analysis under Code Sec. 954(e) may also be subject to analysis under another category of Subpart F income. The regulations provide coordination rules addressing this overlap.

An item of services income that also is a type of income subject to analysis under any of the following categories of Subpart F income is first subject to analysis under the other category:

- Insurance income (Code Sec. 953);
- Oil related income (Code Sec. 954(f)) ; and
- Foreign personal holding company income (Code Sec. 954(c)).[220]

The above categories of Subpart F income take priority over the category for foreign base company services income.[221] As discussed below, the regulations do not provide a priority rule as between services income and sales income.

For example, Code Sec. 954(c)(1)(H) treats as foreign personal holding company income certain income received from personal services contracts. Such items of income are first analyzed under the foreign personal holding company income rules before applying the foreign base company services income rules. Similarly, Code Sec. 954(g) may treat certain services income as foreign base company oil-related income.[222] Oil-related services income would be first analyzed under the foreign base company oil-related income rules before applying the foreign base company services income rules.[223]

2. Retesting Under Code Sec. 954(e)

If an item of services income that is first analyzed as foreign personal holding company income or foreign base company oil-related income qualifies for an exception under such a category, generally it will then be subject to analysis under the foreign base company services income category. For example, if income that is initially analyzed under Code Sec. 954(c)(1)(H) as income from a personal services contract qualifies for an exception, or if oil-related services income qualifies for the same-country exception under Code Sec. 954(g)(1), such item of income must then be analyzed under Code Sec. 954(e), and may be treated as foreign base company services income. The services income may ultimately avoid foreign base company income treatment if it does not fall within the definition of the foreign base company services income category. For example, satisfying the same-country exception under the foreign base company oil-related income rules would seem to render it likely that the same-country exception under the foreign base company services income rules (although not necessarily, due to differences between the two same-country rules).

As discussed below, income derived in the active conduct of a banking, financing, securities, insurance, or similar business and by securities dealers may qualify for an exception under those provisions. Such income is not subject to retesting under Code Sec. 954(e).[224]

B. Coordination of Services and Sales Income

1. Mutually Exclusive

There is no rule in the regulations for coordinating the application of the foreign base company services income category with the foreign base company sales income category. The absence of a coordination rule suggests that the Congress viewed services income and sales income as non-overlapping categories for purposes of the foreign base company income rules. As discussed below, this conclusion is supported by guidance from the IRS that applies either the foreign base company *sales* income rules or foreign base company *services* income rules to an item of income, but does not analyze the same item of income under both provisions.

As discussed above, an item of income is characterized as services income or as sales income based on the substance of the arrangement. If a single transaction gives rise to

some services and some sales income, then the regulations require that the income generally be apportioned between sales and services income for purposes of separately applying the foreign base company income rules to each portion of income.[225] Where the sales and services components are so integrated that the portion of income derived from the transaction that would be attributable to sales and services is indeterminable, all income from the transaction will be classified in accordance with the predominant character of the transaction for purposes of applying the foreign base company income rules.[226]

2. Certain Services Income Treated as Sales Income

Certain income that may generally be characterized as services income is analyzed under the foreign base company *sales* income rules rather than under the foreign base company *services* income rules. Specifically, Code Sec. 954(d) requires analysis under the foreign base company sales income rules of income in the form of commissions or fees derived by a CFC in connection with the "sale of personal property to any person on behalf of a related person," or the "purchase of personal property from any person on behalf of a related person."

This characterization rule can be consequential. For example, assume a Swiss CFC receives fees for the performance of services in Switzerland identifying suppliers, arranging shipping, and performing quality control with respect to products purchased from a German supplier by its U.S. parent. The Swiss CFC performs all of its activities in Switzerland, and the products are manufactured in Germany. If the fee income is analyzed under the foreign base company services income rules, it would not be Subpart F income, because the services are performed in the Swiss CFC's country of organization.[227] On the other hand, if the fee income is analyzed under the foreign base company sales income rules (by reason of being derived from purchasing products on behalf of the U.S. parent), it would be Subpart F income, because the products are both manufactured, and sold for use, outside the Swiss CFC's country of organization.[228]

The treatment of certain services income as sales income is a concept unique to Subpart F. Commissions and fees received for purchasing or selling property on behalf of another person are characterized as services income for other purposes of the Code. Outside of Subpart F, income is analyzed as sales income only when ownership is taken to the property that is purchased or sold.[229] Thus, Code Sec. 954(d) requires a determination of whether income that in substance is services income should instead be analyzed as sales income. The guidance for making this determination is limited to the relevant Subpart F rules, legislative history and other Subpart F authorities, because whether an item of income in substance is services income is obviously not determinative.

The legislative history states that foreign base company sales income "is income from the purchase and sale of personal property if the property is either purchased from a related person or sold to a related person"[230] or income from "*similar cases* where the controlled foreign corporation does not take title to the property but acts on a fee or commission basis."[231] In explaining the scope of the foreign base company sales income provisions, the Senate Report states: "The sales income with which your committee is primarily concerned is income of a selling subsidiary (*whether acting as principal or agent*)."[232] Thus, the legislative history explains the intended scope of applying Code Sec. 954(d) to commission or fee income as a transaction where a CFC sells or purchases property, not in its own name, but in the name of a related person.

The language used in the Code to describe the four factual scenarios that are analyzed under Code Sec. 954(d) comports with the above explanation of when certain fees or commissions should be analyzed as sales income for purposes of the foreign base company income rules:

1) *The purchase of personal property from a related person and its sale to any person,*
2) The *sale of personal property to any person* on behalf of a related person,
3) The *purchase of personal property from any person* and its sale to a related person, or
4) The *purchase of personal property from any person* on behalf of a related person.

The regulations list the same four transactions and use the same descriptive language.[233]

The transactions described by scenarios 1) and 3) are transactions that give rise to sales income for general U.S. income tax purposes where the CFC takes ownership of the property by purchase and then transfers ownership of the property through a sale. Such transactions would not be viewed generally as giving rise to services income. Under the transactions described by scenarios 2) and 4), the CFC engages in the same "selling" or "purchasing" activities in connection with the personal property as in scenarios 1) and 3) but does not take ownership of the property, and thus the resulting income would normally be considered as services income. For Subpart F purposes, however, commission and fee income derived from such purchasing or selling activities is treated as sales income subject to analysis under Code Sec. 954(d).

From the above language of the Code and the legislative history, it follows that for services income to be treated as

sales income, the CFC must engage in the activities that it would engage in if it had actually purchased property, or had actually sold property. When comparing scenarios 1) and 2), the CFC in both cases must engage in "the sale of personal property to any person," and the only difference is that in scenario 1) the CFC takes ownership of the property from a related person, and in scenario 2) the CFC does not take ownership of the property from a related person. Similarly, when comparing scenarios 3) and 4), the CFC in both cases must engage in "the purchase of personal property from any person," and the only difference is that in scenario 3) the CFC takes ownership of the property from the person and transfers it to a related person, and in scenario 4) the CFC does not transfer ownership to the property to a related person. Thus, for fees or commissions to be treated as sales income, the CFC ordinarily would be expected to solicit sales or contact suppliers, negotiate the terms of the sales or purchase transaction, and enter into the contract on behalf of a related person. The only essential difference should be that ownership of the property does not transfer through the CFC, but transfers directly between the related person and the other party.[234]

The limited authority considering this distinction supports the above interpretation. The regulations provide the following example illustrating the rule that commission income derived by a CFC for soliciting sales orders on behalf of a related person constitutes foreign base company sales income.

> **Example.** CFC, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. By contract, N agrees to pay CFC, a related person, a commission equal to 6% of the gross selling price of all personal property shipped by N as the result of orders solicited by CFC in foreign countries Y and Z. In fulfillment of such orders, N ships products manufactured by it in the United States. CFC does not assume title to the property sold. Gross commissions received by CFC from N in connection with the sale of such property for use in countries Y and Z constitute foreign base company sales income.

The example illustrates that commissions received by the CFC for selling property as an agent for its parent was characterized as sales income for purposes of the foreign base company income rules.[235]

In a private letter ruling, the IRS addressed the application of Code Sec. 954 to fees received by a CFC for activities related to the sale of products.[236] Under the facts of the ruling, income was derived in a CFC-owned structure through a branch that operated as a principal. The branch provided overall support to the manufacturing, marketing and selling of the products. The branch received a percentage of the sales proceeds from a related CFC to compensate it for its services. Although the branch was significantly involved in the manufacturing, marketing and selling activities, it did not take title to the raw materials, work-in-process or the finished products. Without discussion, the ruling treated the payments received by the branch from the related CFC as sales income to be analyzed under Code Sec. 954(d).[237] The IRS ruled that the payments qualified for the manufacturing exception.

The IRS has also concluded in a technical advice memorandum that fees received by a CFC for arranging for the purchase of products on behalf of a related person were subject to analysis under Code Sec. 954(d).[238] Under the facts of the TAM, a U.S. parent entered into a contract with its foreign subsidiary ("CFC") for the CFC to serve as the parent's nonexclusive buying agent for the purchase of apparel and other merchandise. CFC was organized under the laws of Country S. The goods were manufactured outside of CFC's country of organization. CFC, as agent for the parent, negotiated purchase contracts and entered into contracts with manufacturers outside Country S, supervised manufacturers, expedited the implementation of contracts, and arranged for documentation and shipping of purchased goods. The parent sold the imported merchandise under its own name. The parent paid the entire cost and expenses of CFC's services performed on behalf of the parent and paid CFC a 2% commission based on the price of the goods purchased on behalf of the parent.

The IRS ruled that the substance of the transaction required CFC's commission income to be analyzed as sales income rather than as services income, finding that all of the activities of the CFC were in connection with the purchase and sale of apparel products by the parent.[239] As a result of classifying the commissions as sales income, the TAM holds that such income constituted foreign base company sales income to the extent the property purchased was manufactured outside the CFC's country of incorporation, and sold for use outside such country.[240]

In a private letter ruling, the IRS addressed the application of Code Sec. 954 to commissions received by a CFC for activities related to the purchase of products.[241] Under the facts of the ruling, a CFC entered into a buying arrangement with various related persons to perform procurement related activities. The CFC was responsible for ensuring that the products purchased by the related persons from vendors met specified standards of design, image, quality, vendor compliance, and brand. The related persons paid the CFC a commission for its procurement

services based on a percentage of the price of ordered merchandise received by the buyer. Without discussion, the commissions were analyzed as sales income subject to analysis under Code Sec. 954(d).[242] The IRS ruled that the income qualified for the manufacturing exception because the CFC substantially contributed to the manufacture of the products.

Not all activities related to the purchase or sale of property fall within the scope of Code Sec. 954(d)(1). The regulations defining services income for purposes of Code Sec. 954(e) specifically include "services (whether or not with respect to property sold by a related person)" and "services with respect to property sold by a related person."[243] An exception is provided for income from services that directly relate to the sale (or offer to sell) of personal property by a corporation which was manufactured by the corporation and were performed prior to sale.[244] These provisions contemplate Code Sec. 954(e)(1) as covering services that are derived in connection with the purchase or sale of property, and therefore establish that not all services related to purchasing or selling property are within the scope of Code Sec. 954(d).[245]

The foreign base company services income regulations provide several examples which classify income connected with property sold by a related person as services income. For example, income from the installation and maintenance of industrial machines sold by a related person is classified as services income, not sales income.[246] Also, income from warranty services provided with respect to machines sold by a related person is treated as services income.[247]

In TAM 8509004, the IRS ruled that a CFC did not perform "sales or selling activities" for purposes of Code Sec. 954(d) where the CFC's staff supervised independent sales agents, performed market research, and prepared demand forecasts. The CFC contracted out selling activities to related and unrelated parties.[248] In concluding that the CFC's home office performed "no selling or sales activities," the IRS specifically rejected the position that the CFC was engaged in "selling activities" by virtue of having entered into third-party and intercompany agreements for the performance of these functions. Rather, the CFC home office's supervision, market research, and demand forecast activities were in the nature of services, rather than sales.

In sum, the foreign base company rules require a unique determination of whether certain income from services performed in connection with the purchase or sale of property on behalf of a related person is analyzed as sales income or service income. Such fees or commissions can be analyzed as purchasing or selling income even if the income would be characterized in substance as services income and treated as services income for other purposes of the Code. The essential criteria for treating commissions and fees as purchasing or selling income is that the CFC engages in the activities it would engage in if were actually purchasing a product (*e.g.*, contacting suppliers, negotiating terms of contracts, and entering into contracts), only on behalf of another person, or the activities it would engage in if it were actually selling a product (*e.g.*, soliciting a sale, negotiating the terms of contracts, and entering into a contract), only on behalf of another person. The fundamental concept is the CFC acting as a buying agent or a selling agent. There will be uncertainty as to whether certain commissions and fees should be analyzed as services or sales income depending on the level of purchasing or selling activities engaged in by a CFC, and the fact that not all income from activities related to the purchase or sale of products is analyzed as sales income.[249] For example, the regulations identify several purchasing-related activities as indicia of manufacturing taken into account in determining whether a CFC has made a substantial contribution to the manufacture of a product[250]; it would be counterintuitive for income from performing these types of manufacturing-related activities to be analyzed as sales income.

A 2015 IRS field attorney advice memorandum unfortunately only adds to the uncertainty in this area. In FAA 20153301F (released 8/14/15), the IRS rejected the taxpayer's attempt to characterize certain intercompany referral fee income as services income under Code Sec. 954(e). The taxpayer owned several CFCs, some of which sold products to related and unrelated parties. Simplifying the facts somewhat, the taxpayer designed a uniform sales process that generally required the participation of two separate CFCs, CFC1 and CFC2, to consummate a sale. CFC1, through "Customer Brokers," managed the relationship with the customer (whether related or unrelated) and would negotiate the sale; CFC2, through "Supply Brokers," performed the logistics (*e.g.*, ensuring that the customer received the goods and collecting payment). CFC2 would record the sales revenue and pay CFC1 an intercompany referral fee based on a percentage of the sale's gross margin.[251]

The taxpayer argued that CFC1 above should be able to bifurcate its intercompany referral fee income between sales and services income based on a 70/30 split. The taxpayer supported its position by distinguishing between the portion of the fees received for pre-sale services (which the taxpayer conceded—perhaps unnecessarily—was sales income) and the portion of the fees received for post-sale services (which the taxpayer treated as services income

subject to analysis under the foreign base company services income rules). According to the taxpayer, services necessary for the sale to occur should be treated as a sales function, but "if the sale can be made whether or not the service is provided to the seller (*e.g.*, if the service is provided only after the sale), compensation for that service should not be considered sales income because it constitutes compensation for services that is distinct from the sales process."[252]

The IRS rejected this distinction and held that no portion of the intercompany referral fees should be characterized as services income. The IRS's conclusions were based on a mix of primarily factual arguments (relating to the taxpayer's lack of documentation and other evidentiary support for the bifurcation) and also more general legal assertions. It would be troubling if these assertions actually represent the IRS's views outside the context of the FAA's particular facts, as the assertions are completely conclusory and unsupported by actual legal analysis or precedent.

In rejecting the taxpayer's bifurcation between pre and post-sale services and concluding that all such services must be treated as sales income for Code Sec. 954(d) purposes, the IRS made the following general assertions: (1) The fact that the referral fees were computed based on the gross margins of CFC2 (which in turn were determined entirely based on sales income rather than services) supports the position that the referral fees were in the nature of sales income, (2) because CFC1 received referral fees "solely as a result of successful sales activities with no contingency for the completion or efficacy of the purported non-sale," the fees were predominantly sales income, and (3) the regulatory examples illustrating foreign base company services income[253] connected to a property sale are all distinguishable because in each example the service fee was separately stated from the sales price.[254] Based on these general assertions, and additional factual arguments described below, the FAA concludes that the referral fees must be taken into account under the predominant character test, and that the predominant character of the fees was sales income.

The FAA provides no citations or further legal analysis for these general assertions, and we would give them very little weight in analyzing the services versus sales issue under current law. For example, there is no regulatory requirement that a service fee must be separately stated from the sales function in order to be respected as services-type income, and there is no concept that any service fee not so separately stated must "default" into sales-type income. Nor does the statute provide that income determined by reference to gross margin or sales defaults to sales income (and indeed, the definition of foreign base company services income specifically contemplates income in the form of commissions). To the contrary, the regulation explicitly directs that all such fees must be characterized in accordance with their substance,[255] and that a separate determination of the amounts attributable to different categories be made if at all possible.[256]

In addition, in the FAA the IRS held that the intercompany referral fee received by the Customer Broker was foreign base company sales income because it was "derived solely in connection with the purchase and sale of personal property on behalf of a related person (*i.e.* the purchase and sale by the [related person] on behalf of the Customer Broker")." The IRS's treatment of Customer Broker's referral fee as sales income because it is in connection with the purchase and sale of property by a related person (not by Customer Broker), is unfounded. is evident that Code Sec. 954(e)'s definition of foreign base company sales income includes the implicit reference to a purchase or sale ***by the CFC*** (not by another party) because the analysis of whether the purchase is from, or the sale is to, or the purchase or sale is made on behalf of, a related person, is based on whether the purchase is from, the sale is to, or the purchase or sale is made on behalf of, a person that is a related person ***to the CFC***. A CFC performing services that contribute to a sale of property by another person should not cause the CFC's income to be characterized as sales income, rather than services income.

Notwithstanding the IRS's apparent preference for treating all commission income as sales-type income in situations in which there is some connection to products purchased or sold by a CFC on behalf of a related person, taxpayers (and the IRS) should not hesitate in appropriate cases to pursue a more fine-grained analysis based on separate determinations of the income attributable to each category in these situations, consistent with the regulations cited immediately above. The law does not support a "force of attraction" approach here, allowing the IRS (or a "taxpayer) to sweep all income into the sales category simply because there exists some connection to products purchased or sold by a CFC on behalf of a related person.

In sum, sales vs. services questions come up with increasing frequency these days, and guidance is badly needed. It should be noted that both taxpayers and the IRS have an interest in reducing uncertainty in this area. Due to the various substantive differences between the foreign base company sales and services rules, these characterization issues do not predictably cut either in the government's favor or in the taxpayer's favor. Sometimes a taxpayer may prefer services characterization, sometimes sales characterization. But everyone would benefit from greater

certainty on these issues. Two LTRs apparently suggest an IRS openness to allowing a certain degree of electivity on these questions—respecting the taxpayer's judgment that a particular kind of income is either services or sales income, provided the taxpayer consistently adheres to its characterization over time.[257]

3. Tested Once

As discussed above, income generally is characterized in substance as either services income or as sales income—notwithstanding the breadth of both the services and sales definitions under the foreign base company income rules, the structure of the Code and regulations (for example, the lack of a sales-services priority rule) supports the conclusion that the two categories do not overlap. Thus, once an item of income is properly characterized as services income or as sales income, it is analyzed only under the relevant Subpart F income category, *i.e.*, Code Sec. 954(e) or Code Sec. 954(d), respectively. The character determination is an exclusive one.

Rev. Rul. 86-155[258] confirms this conclusion:

> Foreign base company services income does not include any item of income which is appropriately classified as sales income, including income derived from the manufacture and sale of property. Furthermore, foreign base company sales income does not include any item of income which is appropriate [sic] classified as services income. In determining whether income from the engineering, fabrication, and installation of offshore drilling platforms potentially constitutes either foreign base company services income or foreign base company sales income, it is necessary as an initial matter to characterize such income as either services income or as sales income.

This revenue ruling confirms what is already clear from the structure of the Code, that an item of income must first be classified as sales income or as services income for purposes of Subpart F, and once the character of income is determined to be sales or services income, only the specific Code Sec. 954 rule applicable to such type of income is analyzed.

As discussed above, certain commission or fee income derived in connection with the purchase or sale of property that in substance is services income is instead analyzed under Code Sec. 954(d) as purchasing or selling income. In these situations, once fees and commissions are appropriately classified as sales income, they are analyzed only under Code Sec. 954(d), and not under Code Sec. 954(e). This is the result even if the income qualifies for an exception to the foreign base company sales income rules. This conclusion finds further support in the examples in the regulations and private rulings issued by the IRS that analyzed only under Code Sec. 954(d) commissions and fees treated as purchasing or selling income. If commission and fee income qualified for an exception to Code Sec. 954(d), the IRS did not reanalyze the item of income as services income.[259] Again, notwithstanding the breadth of the sales and services concepts under Subpart F, and the uncertainties encountered in making these character determinations, a key premise of statutory Subpart F is that these two categories do not overlap. Thus, however difficult it may be in certain situations, an exclusive characterization must be determined based on substance, and the applicability or inapplicability of various exceptions under Code Sec. 954(d) and (e) has nothing to do with the character determination.

IX. Exceptions from Foreign Base Company Services Income

Several exceptions are provided for income from services that may otherwise fall within the definition of foreign base company services income.[260] Two exceptions apply to services income related to property manufactured by a CFC. Also, exceptions are provided for services income derived in the active conduct of a banking, financing, securities, insurance, or similar business and for services income derived by securities dealers.[261]

A. Services Income Related to the Sale of Property

Foreign base company services income does not include income derived in connection with the performance of services by a CFC if the following three conditions are satisfied:

- The services directly relate to the sale or exchange of personal property by the CFC;
- The property sold or exchanged was manufactured, produced, grown, or extracted by the CFC; and
- The services were performed before the sale or exchange of such property by the CFC.[262]

The type of services that qualify for this exception apparently would include marketing services.

> **Example.** CFC manufactures products in Ireland for sale throughout the world. The products are sold to related CFCs for sale in the distributor's local countries. The manufacturing CFC engages in marketing and advertising activities outside Ireland targeting the

ultimate customers, for which it receives a service fee from the affiliated CFCs. Such services income qualifies for this exception, even though performed outside Ireland on behalf of related persons.

In addition, foreign base company services income does not include services furnished by a CFC that directly relate to an offer or effort to sell or exchange personal property which was, or would have been, manufactured, produced, grown, or extracted by the CFC. This rule applies whether or not a sale or exchange of the property is in fact consummated.[263]

B. Securities, Finance and Insurance Related Income[264]

Code Sec. 954(c)(2)(C)(ii) provides an exception for dealers in securities. Certain income that would otherwise be foreign personal holding company income is excepted if derived by such dealers in the ordinary course of their business, and attributed to the country in which the dealer is organized. Income that qualifies for this exception would also be excluded from the definition of foreign base company services income.

Code Sec. 954(h) provides an exception to the definition of foreign personal holding company income for certain income derived in the conduct of an active banking, financing or securities business.[265] Any services income that is analyzed under Code Sec. 954(h) and qualifies for the active banking, financing or securities exception is also excluded from the definition of foreign base company services income.[266]

Code Sec. 954(i) provides an exception to the definition of foreign personal holding income for income derived in the conduct of an active insurance business by a qualifying insurance company. Any services income that is analyzed under Code Sec. 954(i) and qualifies for the active insurance business exception will also be excluded from the definition of foreign base company services income.[267]

X. Low-Taxed Foreign Services Structures

U.S.-based companies conducting services operations outside the United States often use organizational and operational structures designed in part with a view to minimizing foreign taxes on the services income. Taxes are a cost of operating a business, and properly managing all costs, including taxes, is necessary to remain competitive. The importance of tax costs to a company's competitive position was recognized by Congress when it enacted Subpart F—Congress rejected President Kennedy's proposal to tax all earnings of foreign subsidiaries, in order to avoid placing U.S.-based companies at a competitive disadvantage with foreign-based companies.

A U.S.-based company might set up services operations through foreign subsidiaries organized in the countries where the services are performed. The foreign subsidiaries deriving services income typically would be subject to foreign taxes in their respective countries. The foreign base company services income rules generally would not subject such income to current U.S. taxation, because the services would be performed in the country where each CFC is organized.

Such country-locus structures often are not feasible for modern services businesses. Today many types of services are provided remotely, and it often would be inefficient to perform all services in the country where the relevant customers are located. In addition, service businesses often face business imperatives to centralize various functions, establish centers of excellence, or set up operations in countries with low labor costs. It is now easier than it was in the early 1960s to have employees based in one location travel to multiple other locations to provide specialized services. To further reduce costs, a U.S. multinational company may establish certain operations in low-tax countries or implement structures that minimize foreign taxes.[268]

Structures used to efficiently provide services and achieve lower foreign taxes on foreign services income can involve earning a portion of the income from a services business in a country other than the physical location of the CFC's employees when carrying out the services, as well as the use of transactions with related persons, given the need to bring different CFCs' capabilities to bear on a particular services project. When establishing such operational structures, a U.S.-based company must consider the possible application of the foreign base company services income rules. The tax objective of U.S. multinationals is to achieve a low foreign tax rate while not triggering the application of the Subpart F rules.

A. Providing Services Remotely

Many services businesses today perform their services in locations remote from their customers. For example, a company organized in Singapore may provide e-commerce-related services from Singapore to unrelated customers throughout Asia. The Singapore tax authorities often grant rulings providing a relatively low tax rate on income derived in Singapore, provided the taxpayer commits to maintaining a certain level of operational substance in Singapore.

Without a taxable presence in the countries where customers are located, the Singapore company typically should pay minimal foreign taxes on its services income. In addition, generally the income should not be foreign base company services income if the CFC performs the services for unrelated persons.

This structure raises several of the issues discussed above concerning the application of the foreign base company services income rules. For example, the Singapore entity might be deemed to perform the services on behalf of a related person (*e.g.*, the entity receives substantial assistance from related U.S. persons or the U.S. parent guarantees the performance of the services). Even under such circumstances, the services income would not be foreign base company services income provided the Singapore entity is regarded as a separate entity for U.S. purposes, to the extent the income is not allocated to the performance of services outside of Singapore.[269] It is likely that the employees of the Singapore entity will travel periodically to the various countries where its customers are located, and to the extent income is allocated to activities performed outside Singapore, the income would be foreign base company services income (the better position is that only contract-fulfilling services should be taken into account in apportioning the services income, as opposed to ancillary activities). Furthermore, as discussed above, some uncertainty exists concerning the location of performance of services if the Singapore entity receives assistance from other entities outside Singapore or uses machines located outside of Singapore in the performance of the services. The better position is that such activities are not taken into account in determining where the Singapore CFC performs the services giving rise to its income.

B. Services Principal Structure

Service businesses often involve the provision of some services in the countries where a customer is located, as well as providing some services remotely. Centers of excellence may be established to provide certain specialized and high-value services. Also, services operations may be organized in other countries with low labor costs. It is often possible to develop a structure under these circumstances that reduces the foreign tax costs of providing the services to foreign customers.

Consider the following structure under a U.S. corporation that provides services to customers in multiple countries. The U.S. company owns a Dutch holding company ("Dutch HoldCo"). Dutch HoldCo in turn owns a Singapore entity and an Irish entity that function as regional centers of excellence. Dutch HoldCo also owns an Indian entity and a Chinese entity, each with hundreds of employees that assist in performing services for customers. In addition, Dutch HoldCo owns a number of entities organized in countries in Europe and Asia that market the services to local customers and perform some services in the countries where the customers are located. Dutch HoldCo is a CFC for U.S. tax purposes, and all other foreign entities are electively disregarded under Dutch HoldCo.

IrishCo and SingaporeCo function as principals, providing oversight and performing certain valuable services, assuming risks, and coordinating the provision of services by various related and unrelated providers. Either the principals or the companies in the countries where customers are located enter into services contracts with local customers. The principals earn the residual profits and are subject to a low tax rate in their respective countries. The other entities earn a cost-plus return.

For purposes of applying the Subpart F rules, Dutch HoldCo is the only CFC. The separate existence of all other entities is ignored, and all transactions between the entities under Dutch HoldCo are ignored for U.S. tax purposes.[270] Accordingly, Dutch HoldCo is considered as earning service fees from performing the services for the unrelated customers. Under the general rules of Code Sec. 954(e), the services income would not be foreign base company services income because the services are not performed for related persons.[271]

With a global services arrangement, it is important that a U.S. related person (or any other related regarded entity) not enter the services contract and then subcontract the foreign services to DutchHoldCo (or to one of its disregarded entities). Under those circumstances, Dutch HoldCo would be considered as performing the services for a related person, and its income would be Subpart F income to the extent attributable to services performed outside the Netherlands (which would be most of the services in our example). Rather, Dutch HoldCo (or one of its disregarded entities) should directly contract with the customer for the foreign services, and if necessary, subcontract to the U.S. related person (or other related, regarded entities) to assist with the performance of certain services.[272]

Dutch HoldCo will be deemed to perform services on behalf of a related person if assistance provided by U.S. related persons is substantial in the performance of the services for an unrelated customer. A CFC is considered as receiving substantial assistance if the costs of the assistance received directly or indirectly from related U.S. persons equals or exceeds 80% of the total costs to the CFC of providing the services.[273] As discussed above, there is some uncertainty concerning whether payments for intangibles

are taken into account in this determination.[274] Also, it is not clear whether costs for assistance that does not directly assist in providing the contracted-for services are counted (*e.g.*, marketing costs). This test often should not be burdensome, although for certain high-margin businesses, uncertainties surrounding the costs of intangibles and indirect costs might present risks.

A performance guarantee by a CFC's U.S. parent (or another related person) would also cause Dutch HoldCo to be treated as deriving income from performing services on behalf of a related person if any related person performs any of the guaranteed services or performs significant related services.[275] This rule can be problematic where customers request the U.S. parent to guarantee performance of the services, because it is likely that some related person will assist with providing the services.[276]

If a deemed related person rule applies, most of income in the above structure would be Subpart F services income, because the Dutch HoldCo would derive income from performing services outside the Netherlands. Where there is a meaningful risk of a CFC being treated as performing services on behalf of a related person, consideration should be given to using a regarded CFC structure, which would avoid Subpart F services income to the extent each CFC performs its services in its country of organization. Nevertheless, CFCs receiving payments from related persons would need to analyze and document where the services are performed, as it would be common for employees to travel to different countries to provide their particular expertise.

With a regarded entity structure, additional issues would need to be addressed in determining the location of the performance of the services. As discussed above, some uncertainty exists concerning the location of performance of services if the Singapore or Irish entity receives assistance from other entities outside Singapore and Ireland, respectively, or uses equipment located outside its country in the performance of the services, and whether activities other than those carrying out the contracted-for services are taken into account. The better position is that activities of other entities and machines, as well as support activities, are not taken into account in determining where a CFC performs the services giving rise to its own income. Rather, the location of the performance of the services by a CFC should be based on the location of the CFC's employees when performing the contracted-for services.

C. Intangible Property Holding Company

Intangible property often is a major contributor to income derived by various types of businesses, including services businesses. For example, companies providing services may use valuable software, or exploit a highly recognized brand name or special expertise.

As discussed above, income that is in substance services income is analyzed under the Subpart F rules as services income, even if a significant portion of the income is attributable to the use of intangibles (just as sales income may include a significant return on intangibles). Accordingly, such income generally is not Subpart F income when the customers are unrelated to the CFC.[277] If the income instead were characterized as royalty income from licensing intangibles to unrelated persons, the CFC would have to demonstrate that it derived the income in the active conduct of a trade or business, either through development of the intangible or through actively marketing the product.[278]

When the services are performed in a country with a relatively high tax rate, a separate company organized in a lower-tax country may own or in-license intangibles and then license the intangibles to entities providing the services (or to an entity functioning as a principal).[279] The operating entity would pay a royalty to the intangibles holding company and deduct the payments against its higher-taxed income.[280]

Congress has provided an exception to Subpart F for such structures.[281] Royalties received by a CFC from a related CFC that derives services income generally are excluded from the definition of Subpart F income. There is no requirement that the CFC receiving the royalties engage in an active business.[282] The royalties would be Subpart F income only to the extent the expense reduces Subpart F income of the licensee.[283]

For example, a U.S. corporation forms a Dutch CV, which is classified as a corporation for U.S. purposes and as a partnership for Dutch purposes. The Dutch CV owns intangible property and licenses the intangibles to its wholly owned Dutch BV operating company. The Dutch BV derives services income from providing services to unrelated persons. The Dutch BV pays a royalty to the Dutch CV, and the expense reduces the Dutch BV's taxable income.[284] The royalty income is not subject to income taxation in the Netherlands because the Dutch CV is a transparent entity and its owners do not have a taxable presence in the Netherlands. The royalty income of the Dutch CV should not be Subpart F income under Code Sec. 954(c)(6) provided the Dutch BV's income is not Subpart F income.

The same result can be achieved if the services entity and the intangibles company are part of a disregarded entity structure. Assume instead in the above example that Dutch BV is disregarded for U.S. tax purposes. Payments

of a royalty from the services company to the intangibles company are disregarded for U.S. tax purposes. The Dutch CV is considered as earning services income subject to analysis under Code Sec. 954(e).[285] The tax results in the Netherlands would be the same as in the above example.

It should be noted, however, that if the holding company is in a country different from the country where the operating entity is organized, a disregarded entity structure forfeits the ability to claim that services are performed in the CFC's country of organization.[286] This can be important if there is a material risk that the disregarded entity may be deemed to perform services on behalf of a related person. In such a case, a regarded entity structure should be used. As discussed above, royalties received by an intangibles holding company generally should be excluded from foreign personal holding company income.[287]

XI. Recommendations for Updating the Regulations

As discussed above, the Subpart F services regulations have not been revised since they were issued as final regulations in 1968 (Notice 2007-13 announced that regulations would be issued modifying the substantial assistance rule in the regulations). The guidance, special rules and examples in the regulations focus on income from services supporting sales of industrial machines by related persons, and income derived from building dams, constructing highways, and drilling oil wells with financial and functional assistance from related persons.

Today's services economy is much larger and more multifaceted than the services economy of 50 years ago. The types of services are fundamentally different, including technology, e-commerce, and software services, as well as new modes of delivering consulting, financial, and transportation services. Modern services businesses inherently require substantial overseas operations in multiple countries, and collaboration among many different affiliates in order to deliver what the customer demands. U.S. services companies often are forced to adopt burdensome terms and disruptive arrangements in order to conform ordinary business deals to arcane and ill-fitting rules, and to live with substantial tax uncertainties in many cases.

In prior sections we described a number of specific recommendations for updating the regulations, particularly the deemed related person services rules and the rules for determining the location of the performance of services. We also recommend necessary guidance for determining when the unique rule applies to treat certain services income as sales income for purposes of applying the foreign base company income rules. The previously described proposals are summarized in this section. This section focuses on issues that may properly be addressed *via* regulation. This section also argues that the IRS and Treasury should not seek to use the regulatory process to broaden the foreign base company services income rules to apply to low-tax structures based on policy concerns, but instead should leave any expansion of the foreign base company services rules to legislative action by Congress. The next section in turn will take up that topic.

A. Clarify and Limit the Scope of Deemed Related Person Services Rules

As a business necessity, services companies today typically fulfill a global contract using multiple entities within a group located in various geographic regions, with employees with specialized skills traveling to different locations as needed. This modern business model tends to result in related-person services income (assuming more than one regarded entity is involved). The old rules in the Code focusing on services provided by a CFC to customers in its own country are burdensome and disruptive to modern service businesses.

The regulations exacerbate this situation by containing expansive rules deeming a CFC to be performing services for a related person in certain circumstances when the services are actually performed for unrelated persons. These regulations appear to have been primarily directed at large offshore construction projects, such as building dams, drilling oil wells, and constructing highways, and support services provided by a CFC to a related person that sells industrial machines to customers. The regulations, which did not contemplate the modern services economy as it exists today, can have broad application to current business models, leading to inappropriate accelerated U.S. taxation of foreign services income.

As discussed above, related person transactions can be minimized among supporting foreign affiliates providing services to unrelated persons by conducting the services operation under a foreign holding company in multiple branches or disregarded entities. Nevertheless, the deemed related person services rules in the regulations in many situations can have the effect of treating most or all the income derived in such structures as Subpart F services income.

The broad deemed related services rules in the regulations do not find support in the language of the Code or in the legislative history, and should be significantly limited or eliminated. Specific recommendations for updating the regulations were described above, and are summarized below.

1. Clarify Application of Substantial Assistance Test

The regulations contain a rule that treats a CFC as performing services for a related person if it receives substantial assistance from related persons (U.S. or foreign) in the performance of services for unrelated persons. For this purpose, the regulations define two categories of "assistance": (1) direction, supervision, services, know-how, and (2) financial assistance (other than contributions to capital), equipment, material, or supplies.[288] The regulations also state that assistance for this purpose is not limited to these identified items.[289]

The regulations provide that assistance in the first category furnished to a CFC is not taken into account unless the assistance so furnished assists the CFC *directly* in the performance of its services.[290] The regulations also provide that financial assistance (other than contributions to capital), equipment, material, or supplies furnished to a CFC are considered assistance only in that amount by which the consideration actually paid by the CFC for the purchase or use of such item is less than an arm's length charge.[291]

Under the regulations, the determination of whether assistance furnished to a CFC was substantial generally was determined from the facts and circumstances of each case.[292] Assistance furnished by related persons to a CFC in the form of direction, supervision, services or know-how is substantial if the assistance furnished provides the CFC with skills that are a principal element in producing the income from the performance of the services by the CFC, or the cost to the CFC for the related person's assistance equals 50% or more of the total cost to the CFC of performing the underlying services.

The IRS and Treasury announced in Notice 2007-13 that regulations will be issued to provide that only assistance furnished by U.S. related persons is taken into account for purposes of determining whether a CFC receives substantial assistance in performing the services for an unrelated person. Thus, any assistance received from a foreign related person is not counted. The regulations will provide that assistance furnished by a related U.S. person or persons is regarded as substantial only if the cost to the CFC of the assistance equals or exceeds 80 percent of the total cost to the CFC of performing the services. Thus, the "principal element" subjective test for determining substantial assistance is no longer relevant.

The Notice acknowledges that many U.S. multinationals have globally integrated services businesses with support capabilities for unrelated projects in different geographic locations, largely based on factors unrelated to tax. Thus, the IRS and Treasury determined that it would be inappropriate to continue to treat a CFC as performing services for or on behalf of a related person merely because other related foreign entities are involved in the provision of services. The Notice states that if the regulations are not amended to deal with these types of business structures, the regulations may cause taxpayers to change the way they do business or structure their operations in light of the substantial assistance rules, even if such a structure would be less efficient from a business perspective. However, the IRS and Treasury were concerned that services arrangements still could be used to shift services income that otherwise would be derived in the United States to CFCs organized in low-tax jurisdictions, and thus provided a limited application of the substantial assistance rule where U.S. persons provide so much assistance a CFC cannot be said to provide the services on its own.

Modifying the regulations to limit the assistance taken into account to assistance furnished by U.S. related persons, providing an 80% cost test, and eliminating the subjective test is a major advance from the overly broad rules in the regulations.[293] We recommend that regulations be issued to provide necessary guidance concerning the application of the objective cost test, and in particular, what costs should be counted as assistance.

We recommend that only costs directly related to providing the contracted-for services be taken into account, in keeping with the policy of the regulation and the Notice to target situations in which the level of assistance furnished calls into question which entity should have been facing the customer and earning the services income in the first place. Thus, for example, the regulations should exclude marketing and advertising costs, unless those costs are functionally intertwined with the provision of the services themselves (*e.g.*, by providing the customer significant education and training in the use of the services).

If expenditures relate to more than one year, we recommend they be allocated to the years to which they relate, and not be taken into account entirely in the year incurred (*e.g.*, equipment). The straight line method of depreciation or amortization might be used to reflect costs for a particular year. This properly matches costs with the income generated from incurring the costs.

We further recommend that rules be provided for allocating costs incurred to support multiple services arrangements. Rules similar to the rules contained in Reg. §1.861-8 might be referenced for guidance. Such rules should favor being administrable rather than precise, as the 80-percent calculation is not a computation of income or tax.

Finally, the regulations should specifically address the costs of acquiring or developing intangibles. For the

reasons discussed above, we recommend confirming that cost sharing payments are not counted, as they are characterized under the cost-sharing regulations as intangible development costs of the participant bearing the costs. If royalties and buy-in (or PCT) payments are to be counted, this should be specified clearly in the regulations, and these costs should be spread over the life of the intangibles. Costs for marketing intangibles generally should not be included because they are not supportive of the actual performance of the contracted-for services. In addition, rules should be provided for allocating costs of any intangibles among various services contracts.

2. Eliminate the Performance Guarantee Rule

A guarantee by a related person of the performance of services by a CFC causes a CFC to be treated as performing services for a related person if any related person performs any of the guaranteed services, or any related person performs any significant services related to the guaranteed services. This rule applies whether the guarantor is a domestic or a foreign related person, and without regard to the relative value of the provision of the guarantee.

In today's modern global services businesses, it is not uncommon for customers to request a guarantee with respect to global services contracts. Also, it is common for several entities to assist with the performance of services for a customer, and for skilled employees to travel among various locations. Thus, in many situations this rule will effectively cause the first requirement of the definition of foreign base company services income to be met. This is not an appropriate application of the Code, because it sets the relatedness bar extremely low as applied to standard operating structures, and the rule is not provided by the Code nor even suggested by the legislative history.

We recommend that the guarantee rule be eliminated (except possibly for limited circumstances in which the reliance on the guarantee is so heavy as to call into question whether the service-providing CFC should have been the contracting party in the first place). Any concerns with substance and support from U.S. related persons can be sufficiently addressed with the substantial assistance rules.[294] This is necessary to avoid imposing inappropriate burdens on modern services businesses.

3. Eliminate the Assignment-of-Contracts Rule

As discussed above, if a related person enters a services contract and assigns all or a portion of the contract to a CFC to fulfill, except in specific situations such as a framework-type contract (rather than a contract that obligates the related person to perform a specific service for the unrelated person), generally that CFC will be deemed to perform the services on behalf of a related person. It is common for a single contract to be entered with a customer for global services, and the portions performed by affiliates assigned to them.

We recommend that this rule be eliminated for the same reasons stated above for eliminating the guarantee rule. It is unnecessary to impose burdens on services businesses to require, in order to avoid subpart F risk, that each CFC enter its own contract to perform services outside the U.S. with the customer, and will be disruptive to the client relationship. This burdensome rule is not provided in the Code nor suggested in the legislative history, and thus should be removed.

4. Clarify the Rule Concerning Services Performed in Connection with the Sale of Property

Code Sec. 954(e) applies to income derived by a CFC that provides services "on behalf of" a related person to the extent the services are performed outside the CFC's country of organization. The legislative history indicates that Congress was targeting support services provided by a CFC to an unrelated customer that purchased machinery and equipment from a related person. The regulations provide examples of installation and maintenance services.

A CFC would be considered as providing services for, or on behalf of a related person, if a related person hires the CFC to install or maintain the equipment. The regulations expand this to apply in a situation where the unrelated customer hires the CFC directly and pays the CFC for the services. A CFC is deemed to provide services for, or on behalf of, a related person, however, only if a CFC performs the services for an unrelated person with respect to property sold by a related person and the performance of such services constitutes a condition or material term of the sale.[295]

We recommend that, for the reasons set forth in Notice 2007-13, this rule should not apply when a foreign related person sells the property with respect to which a CFC then provides the support services. While special U.S. base erosion concerns may be present where a related U.S. person sells the property (or, in the substantial assistance context, provides a great deal of assistance), it no longer makes sense to burden modern services businesses with this rule in situations in which various foreign affiliates are effectively going to market together,

and any tax planning motivations relate to foreign as opposed to U.S. taxes.

In addition, with modern services business it is common for separate services to be provided in a transaction that involves the sale of machines and equipment, but that are not actually supporting the machines and equipment. The services may even be the most significant element of the transaction. For example, a company may sell hardware to a customer and separately negotiate a software services contract. We recommend that it be clarified that the regulations' deemed related services rule applies only to services supporting the machines or equipment sold by a related person, and not to services that may be purchased in conjunction with the purchase of the tangible personal property. To apply the rule more broadly would be to elevate form over substance, focusing on the mechanics of contracting instead of the substance of the services being provided and whether those services really are of any direct benefit to the related person selling the tangible personal property.

B. Clarify that the Location of Services is Determined Based on Activities of a CFC's Employees When Performing the Contracted Services

The rules in the regulations for determining the location of services have not been updated since the 1960s. They did not contemplate the operational models of modern services businesses, such as multiple entities necessarily involved with fulfilling global services contracts, the routine provision of services remotely, and the increasing use of machines in providing a wide range of services. We recommend that the regulations be amended to provide additional guidance concerning the determination of the location where services are performed.

Only the location where the contracted-for services are performed should be taken into account in determining the location of services. For example, generally the location of employees engaged in soliciting, marketing or advertising should not be relevant to the determination of location. Also, support services should not be taken into account. This is consistent with the language of the statute, which focuses on the actual services provided to the customer.

The regulations should clarify that generally the determination of the location where services are provided is based solely on where employees of the CFC are located when performing the services.[296] The activities of other entities (related or unrelated) assisting the CFC in the performance of the services should not be taken into account, because those entities receive arm's length compensation for furnishing such assistance. This approach seems consistent with what Congress contemplated in 1962 and represents a reasonable reading of the rules in the current regulations.[297]

In addition, the location of machines which might be used in the provision of services generally should not be taken into account in determining the location of the performance of services. Taking pure machine activity into account for these purposes would not seem to have a basis in the statute. It could also lead to arbitrary results. For example, a type of equipment commonly used in connection with performing services is a computer server. In most e-commerce businesses, servers are necessary, but serve a commodity-type function in the overall context of the business, and can be located anywhere in the world without affecting the customer experience in any noticeable way. Attaching importance to server location in making various tax determinations thus could place weight on what may be a highly manipulable factor, which ultimately seems likely to hurt the fisc, while posing a potential trap for the unwary taxpayer.[298] Furthermore, this determination could be complex to apply, as it often is not even clear in a particular case which server location has been used in connection with a particular services arrangement—multinationals often have (or have access to) servers in several locations around the world, with processes flowing automatically to whichever servers in the system have capacity at the moment, which would make it difficult to track how much various server locations were used in servicing a particular customer. There may be exceptions to these general observations, for example where machines represent the primary value of the services offered, such as where a CFC operates a server farm and sells web hosting services to its customers.[299]

C. Clarify That Commission and Fee Income is Analyzed as Sales Income Only When a CFC Functions as a Purchasing or Selling Agent

Certain income that is characterized in substance as services income is analyzed under the foreign base company *sales* income rules rather than under the foreign base company *services* income rules. Code Sec. 954(d) requires analysis under the foreign base company sales income rules of income in the form of commissions or fees derived by a CFC in connection with the "sale of personal property to any person on behalf of a related person," or the "purchase of personal property from any person on behalf of a related person."

The treatment of certain services income as sales income is a concept unique to Subpart F. Commissions and fees received for purchasing or selling property on behalf of another person are characterized as services income for other purposes of the Code. The guidance for making this determination is limited to the relevant Subpart F rules, legislative history and other Subpart F authorities, because whether an item of income in substance is services income is not determinative.

There is uncertainty concerning the circumstances under which fees or commissions should be analyzed as sales income. There has been limited guidance, and this is an area of confusion and differences of view. Clarification is needed focusing on situations where commissions are for purchasing or selling products in a manner economically and functionally equivalent to a purchase and sale transaction.

The language of the Code and the legislative history indicate that income earned by a CFC that functions as a purchasing agent or a sales agent should be analyzed as sales income. Such a CFC would engage in contacting suppliers and customers, negotiating contracts, and entering into contracts on behalf of related persons. The CFC would engage in essentially the same activities as if it were purchasing or selling property for its own account, except that it does not take title to and beneficial ownership of the property.

Guidance is required for determining whether and when a CFC that does not engage in all activities necessary to purchase or sell a product would nevertheless be analyzed as earning sales income. At a minimum it would seem that certain activities should be necessary, such as interacting with the third-party supplier or customer, and negotiating terms of the transactions. Other related activities, such as quality control or vendor certification, presumably should not result in purchasing/selling characterization, without more. In addition, a predominance test may be appropriate, such that if the majority of functions based on value represented purchasing or selling activities (an illustrative list could be provided in regulations), the income is analyzed as sales income. Otherwise, the income should be analyzed as services income. A CFC that only interacts with related persons should not trigger an application of this unique characterization rule.

The rules should also confirm that the treatment of a CFC as being engaged in purchasing or selling on behalf of a related person extends only to the purchasing or selling income, and to income not separately determinable as a practical matter. Income such as rents, royalties, interest and dividends should not be brought within the sales category, nor should services income unconnected with the purchasing or selling of the property.

The guidance should clarify that any income that is in substance services income but is treated as sales income for Subpart F purposes should only be analyzed as sales income under Code Sec. 954. If the income qualifies for an exception to foreign base company sales income treatment (*e.g.*, same-country manufacturing), the income should be excluded from foreign base company income, and not be reanalyzed as foreign base company services income. This appears consistent with current law and the approach of the IRS as discussed above.

D. The IRS and Treasury Should Not Issue Guidance Targeting Services Structures Solely on the Basis of Low Effective Tax Rates

Some have expressed concern that the current foreign base company services income rules, in conjunction with other international tax rules, inappropriately allow U.S. companies to shift services income to low-tax countries.[300] Certain structures that minimize foreign taxes on income derived in providing services to foreign customers are described above. Low-taxed foreign income is currently the subject of various international tax reform proposals advanced by President Obama and members of Congress, as discussed in the next section.

We do not believe that the IRS and Treasury should develop new rules attempting to limit the ability of companies to achieve low foreign taxes on their foreign services income on the basis of policy considerations, except to the extent that a structure or transaction can fairly be said to abuse or avoid the clear purpose of an existing provision of Code Sec. 954(e). Rules addressing possible policy concerns beyond those embodied in the statute should be the prerogative of Congress.

An important reason for not issuing regulations targeting low-tax foreign structures simply because they are low-tax is that the rules of the Code in many ways reflect Congressional decisions to permit such structures under certain conditions. As discussed above, Congress enacted and has consistently extended an exception that allows operating companies to pay royalties to intangibles holding companies even if the income is subject to minimal taxes.[301] In addition, the foreign base company services income rules do not contain a foreign branch rule, and thus facilitate low-tax structures using disregarded entities or branches under a foreign holding company.[302] Policy makers have been considering whether and how to further address these structures, and it is widely expected that

international tax reform, when it eventually happens, will include some sort of broadening of Subpart F or enactment of a minimum tax on foreign income.

Another reason to refrain from broadly addressing low-tax structures through guidance is that it is impossible to discern any clear policies underlying the existing rules to guide the IRS and Treasury in developing rules further addressing low-tax structures. Congress made it clear when enacting Subpart F that certain low-tax structures would not be subject to Subpart F, in order to avoid placing U.S. companies at a competitive disadvantage with foreign based companies, and that other low-tax structures would be subject to Subpart F based on concerns about income shifting. The legislative history does not identify criteria for determining when services income should be subject to Subpart F or not subject to Subpart F, and thus the best guidance for making these judgments is the plain language of the statute. Any regulations expanding Subpart F to apply to low-tax structures beyond the language of the Code may impose tax on the very income Congress intended not to subject to Subpart F.

The courts have pointed out that Congress's intent is difficult to ascertain in the Subpart F area, noting that the Subpart F rules represent a compromise among competing policy considerations.[303] This has caused courts to reject IRS positions that seek to impose Subpart F beyond the language in the Code. For example, in one of the early Subpart F cases, the Tax Court rejected the government's assertions of intent as the basis for deciding against the taxpayer, stating:

> Even assuming that the existence of a clear "statutory scheme" would be sufficient to allow this Court to rewrite the language of the statute, we are unable to agree with respondent's premise that such a consistent "statutory scheme" exists. While we do not doubt that Congress sought to achieve the general purposes quoted above in the Senate committee report … it appears that Subpart F, as finally enacted, embodies numerous exceptions to those general purposes. A review of the events leading to the enactment of Subpart F is sufficient to show that respondent's ideal of a "statutory scheme" is elusive indeed …. But the point to be observed is that the existence of these many exceptions makes it hard to glean from Subpart F the precise 'statutory scheme' to which respondent alludes. In summary, we are not prepared to say that the purposes and goals of Subpart F have been so obviously revealed as to preclude the possibility that Congress intended in certain cases that section 951(d) would provide favorable treatment for the taxpayer.[304]
>
> The courts have consistently refused to fill in any "gaps" in Subpart F, pointing out that this should be left to Congress.
>
> The point to be made, however, is that invariably the fertile imaginations of tax attorneys – both those representing taxpayers and those representing the Government – are able to generate hypothetical cases in which the Code provision in issue yields apparently anomalous results ... Be that as it may, "neither we nor the Commissioner may rewrite the statute simply because we may feel that the scheme it creates could be improved upon."[305]

While the IRS has not litigated any cases involving significant questions arising under the foreign base company services income rules, the IRS has challenged positions of taxpayers concerning the application of the foreign base company sales income rules and the foreign personal holding company income rules. The government's arguments have been based primarily on policy considerations, and the IRS has lost nearly every case.[306] The courts consistently have rejected policy arguments in favor of the plain language of the Code or regulations, explaining that Congress must close any perceived loopholes.

In *Ashland Oil Inc. v. Commissioner,*[307] a U.S. corporation organized a wholly owned subsidiary in Liberia, which purchased and sold marine chemical products. In order to establish a source of supply for those products, the Liberian CFC entered into a manufacturing, license and supply agreement with an unrelated Belgian corporation. Under the agreement, the CFC purchased finished products from the unrelated Belgian corporation. The CFC then sold the products to unrelated customers. Although the CFC was organized in Liberia "in large part to save income taxes," the Tax Court held that the income derived by the CFC was not foreign base company sales income.[308]

The IRS acknowledged that the purchase transactions were made with an unrelated supplier and did not dispute that the sales transactions were made with unrelated customers, and therefore the income fell outside the general definition of foreign base company sales income. The IRS, however, argued that, based on general policy statements in the legislative history, the branch rule contained in Code Sec. 954(d)(2) should apply to create a deemed related-person transaction, thereby causing the Liberian CFC's income to be foreign base company sales income.

The IRS referred to the legislative history as describing that the foreign base company sales income rules are intended to end tax deferral in certain situations where the income from sales activities is separated from

manufacturing activities of a related person and is thereby subject to a lower rate of tax. Based on the legislative history, the IRS contended that the branch rule should apply in any situation where sales income is subject to a significantly lower rate of tax than manufacturing income.

The IRS argued that the definition of "branch or similar establishment" should be broadly defined to include a contract manufacturer, which would cause the CFC's income to be foreign base company sales income under the manufacturing branch rule. The Tax Court rejected the IRS's argument, finding (among other things) that a separate corporation, such as the Belgian corporation, could not be treated as a branch to create a related-party transaction. The Tax Court determined that Congress did not grant Treasury specific regulatory authority to define "branch or similar establishment." The Tax Court rejected the Service's argument that the branch rule should be viewed as a broad "loophole closing" provision, to be applied whenever an arrangement separates the manufacturing and sales functions so as to avoid or limit tax on the sales income. Accordingly, the branch rule was not applicable, and the CFC's income was not foreign base company sales income, despite the fact that the CFC's sales income was subject to a lower rate of tax.

In *Vetco, Inc. v. Commissioner*,[309] the Tax Court similarly rejected the IRS's attempt to broadly define the term "branch" for purposes of applying the Code Sec. 954(d)(2) branch rule. In this case, Vetco International A.G. ("VIAG"), a Swiss CFC, entered into a contract manufacturing arrangement with its wholly owned UK subsidiary, Vetco Offshore, Ltd. ("VOL"). Under the arrangement, VOL assembled oil and gas drilling equipment from parts and designs provided by VIAG. The assembly activities took place in Aberdeen, Scotland. At all relevant times, title to the materials was held by VIAG, which bore the full risk of loss. VIAG did not have its own employees, but contracted with various affiliates to handle certain functions. VOL earned a fixed fee for its manufacturing services. VIAG sold the finished products to unrelated purchasers.

The IRS argued that although VOL was a subsidiary of VIAG, it was really no different from a branch within the meaning of Code Sec. 954(d)(2). The IRS contended that the taxpayer used VIAG and VOL to avoid U.S. tax by splitting their sales and manufacturing operations in order to take advantage of Switzerland's lower tax rate and urged the court to look past petitioner's "contractual wizardry" and to apply the branch rule as a loophole-closing device.

The Tax Court rejected the IRS's argument and agreed with the taxpayer, who argued that a subsidiary by definition could not be a branch under Code Sec. 954(d)(2). The Court noted that "branches or similar establishments could be established in a foreign country without the stock ownership required of a separately incorporated subsidiary. Accordingly, the branch rule was intended to prevent CFCs from avoiding Code Sec. 954(d)(1) because there would be no transaction with a related person within the meaning of Code Sec. 954(d)(3)."[310] The court again rejected the loophole-closing argument, finding that the legislative history did not support a broad interpretation of the term "branch," and that the provision lacked the "broad language necessary to support [the IRS's] position."[311] Accordingly, the term "branch" for purposes of Code Sec. 954(d) must be interpreted according to its ordinary usage to mean a physical location where activities are conducted separate from the main office.[312]

In *Brown Group, Inc.* v. *Commissioner*,[313] the government sought to treat a CFC partner's distributive share of sales income derived by a partnership as foreign base company sales income, notwithstanding the fact that the statute in effect at the time failed to so provide. The Eighth Circuit addressed the IRS's argument that Subpart F is a broad anti-deferral provision. The IRS sought to apply Subpart F to Brinco, a partnership that was majority-owned by a CFC. At the time, Subpart F did not include partnerships in the definition of "related person" under Code Sec. 954(d)(3)(B) or (C).[314] As a result, Brinco's income was not included in the statutory definition of foreign base company sales income because its income was technically not earned on behalf of a related person as so defined.[315] The IRS argued that the aggregate theory of partnerships should be used to further the purposes of Subpart F and treat Brinco's income as foreign base company sales income. Although the Tax Court held that the partnership's income was Subpart F income, the Eighth Circuit reversed, noting that "[a]lthough our holding may result in a tax windfall to the Brown Group due to the particularized definition of 'related person' under the pre-1987 version of Code Sec. 954(d)(3), such a tax loophole is not ours to close but must rather be closed or cured by Congress."[316]

In *MCA, Inc. v. United States,*[317] a case similar to *Brown Group*, the Ninth Circuit found in favor of the taxpayer, holding that royalties received by a CFC partner from a partnership of which the CFC was a 95-percent partner were not Subpart F income because a partnership controlled by a CFC was not a related person. The court summarized the government's arguments as follows:

> The government suggests that even if the distributorships technically satisfy the partnership test of §301.7701-2, we should construe the regulations broadly to classify the distributorships as corporations, thereby eliminating an abusive tax shelter. The government reasons that Congress enacted Subpart F to eliminate the tax deferral advantage of doing business through controlled foreign corporations, by taxing currently to United States shareholders all income that is deemed earned by those shareholders. The government asserts that in enacting Subpart F Congress was more concerned with the nature of the income than the form of the entity generating the income, and that CIC's distributorship income is precisely the kind that Congress intended to tax currently under I.R.C. §951(a).

The Ninth Circuit rejected the government's arguments, stating:

> We find this argument unpersuasive. Although we agree that CIC's distributorship income is apparently the kind that Congress intended to tax currently if received from a controlled corporation, we decline the government's invitation to depart from the plain language of the statute. Congress wrote the statute unambiguously to apply to Subpart F income received from controlled "corporations" only. If the omission of income received from controlled partnerships has indeed created an unjustified loophole in the tax laws, the remedy lies in new legislation, not in judicial improvisation.[318]

The Tax Court also rejected the IRS's Subpart F policy arguments in *Dover Corp. v. Commissioner*,[319] a case involving a "check-and-sell" transaction, in which a taxpayer elected to disregard a CFC as a separate entity prior to selling it, in order to treat the sale as a sale of operating assets (not subject to Subpart F) instead of a sale of stock (subject to Subpart F). The court concluded that, to the extent that policy concerns were raised by the intersection of the check-the-box regulations and the rules of Subpart F, Treasury and the IRS should address them by amending the regulations, rather than aggressively interpreting the existing regulations in audit and litigation, in pursuit of a particular policy result:

> Finally, we note that, consistent with his admonition in the preamble to the final check-the-box regulations, T.D. 8697, 1997-1 C.B. at 216, that "Treasury and the IRS will continue to monitor carefully the uses of partnerships [and, by extension, disregarded entities] in the international context and will take appropriate action when … [such entities] are used to achieve results that are inconsistent with the policies and rules of particular Code provisions," respondent was, of course, free to amend his regulations to require a minimum period of continuous operation of a foreign disregarded entity's business, prior to the disposition of that business, as a condition precedent to treating the owner as having been engaged in the trade or business for purposes of characterizing the gain or loss. But, in the absence of respondent's exercise of that authority, we must apply the regulation as written.[320]

The IRS and Treasury issued proposed regulations to cause such transactions to be subject to Subpart F, but the regulations were subsequently withdrawn as a result of comments criticizing the proposed approach as overly broad.[321]

For the reasons set forth above, we do not believe that the IRS and Treasury should develop new rules attempting to limit the ability of companies to achieve low foreign taxes on their foreign services income on the basis of policy considerations, except to the extent that a structure or transaction can fairly be said to abuse or avoid the clear purpose of an existing provision of Code Sec. 954(e). Rules addressing possible policy concerns beyond those embodied in the existing statutory language should be the prerogative of Congress. In view of Subpart F's balancing of competing policy goals (protecting U.S. multinationals' competitiveness vs. placing limits on income shifting), it is impossible to determine in a particular scenario on which side of the line the Congress would have placed a particular structure. Congress clearly intended that some but not all low-taxed income derived by CFCs should be subject to Subpart F, and the only reliable guide for determining what the Congress thought should be subject to Subpart F is the language of the statute itself. Thus, as the courts have stated consistently, any expansion of the rules beyond the plain meaning of the Code should be the responsibility of Congress, and not the IRS and Treasury. And, as the next section discusses, there currently seems to be bipartisan interest in tightening Subpart F (or taking other measures) to further address low-tax structures. That work should be allowed to run its course.

XII. Recommendations for Repealing or Revising Code Sec. 954(e)

The U.S. tax landscape is very different now than it was when Subpart F was added to the Code in 1962. In particular, under the GILTI regime, income of foreign subsidiaries of U.S. corporation generally is subject to current U.S. taxation, regardless of whether such income is Subpart F income. U.S. multinationals cannot indefinitely defer paying U.S. tax on the earnings of foreign subsidiaries by keeping such earnings offshore.

In this new environment, much of the rationale for the Subpart F rules, including the foreign base company services rules, no longer applies. The complexity of the foreign base company services rules is harder to justify in an environment where nearly all income of CFCs is subject to current U.S. taxation. Therefore, we recommend that, in light of the GILTI regime, the foreign base company services income rules in Code Sec. 954(e) be repealed. If such rules are not repealed, we recommend that they be revised and significantly narrowed in scope, as was proposed in various versions of the recent Build Back Better Act legislation.

A. Repeal the Foreign Base Company Services Rules Because They Are Unnecessary Post-TCJA

As noted above, the TCJA did not repeal or make any changes to the definition of foreign base company services income. However, it did shift certain factors relevant to a U.S. corporation's decision regarding whether services for foreign customers should be performed by a U.S. corporation or by a foreign subsidiary.

Before the TCJA, a U.S. corporation would be subject to 35% tax on its income for performing services for a person located outside the United States. It would not be subject to any current U.S. tax on earnings of a foreign subsidiary for performing services for an unrelated person located outside the United States, as long as such earnings were not foreign base company services income and were not repatriated to the United States.

The TCJA shifted the treatment of services income of foreign subsidiaries of a U.S. corporation by providing that, even if such services income was not foreign base company services income, the U.S. corporation generally is subject to current U.S. taxation on that income at a rate of 10.5 percent (13.125 percent when taking into account the ability to credit 80% of GILTI foreign taxes). The TCJA reduced the U.S. corporate income tax rate so that foreign base company services income now is subject to a 21%, rather than 35%, rate.

The TCJA also introduced the deduction for foreign derived intangible income ("FDII").[322] As a result of this deduction, services provided by a U.S. person to a person located outside the United States, or with respect to property located outside the United States, are subject to a 13.125 percent rate of tax. Because the FDII rate and GILTI rate are so close, the TCJA has reduced the incentive for U.S. corporations to provide services to foreign customers *via* foreign subsidiaries, rather than directly.

The TCJA has narrowed the difference between the tax rate that applies when services are performed by a U.S. corporation versus a foreign subsidiary of a U.S. corporation, as well as the difference between the tax rate that applies when services income of a foreign subsidiary is Subpart F income versus not Subpart F income. Following the TCJA, nearly all services income of a foreign corporation is subject to current U.S. tax. Thus, like other kinds of income, services income of CFCs generally is burdened with substantially greater U.S. tax under the GILTI regime than it was before the TCJA was enacted. Even substantial alignment of functionality with income in the various relevant countries is no defense, because GILTI applies to quite a lot of ordinary business structures that do not involve any particularly exotic or aggressive tax planning.

In this environment, it is difficult to justify the continued existence of the foreign base company services income rules. As discussed throughout this article, the rules involve significant levels of complexity. This complexity may not be necessary where essentially all income of foreign subsidiaries of U.S. shareholders is subject to current U.S. tax.

One central element in the reasoning behind the GILTI regime is a conclusion that the "legacy" Subpart F rules have inadequately controlled income shifting. If that is a key operating assumption, then it would seem to make sense to craft new rules better-suited to the problem, and to discard the old rules.[323] Why continue to apply rules that both the business community and the government have concluded are unfit for their purpose, as unduly burdensome on business, too leaky in containing income shifting, or both? If the Subpart F services rules are thought to permit too much income shifting, and GILTI is meant to better target the problem, then why force taxpayers and the government to continue to apply the legacy rules, at great complexity cost, when the result of such application will be only to produce results that would now have to be seen as arbitrary (as a key premise of the GILTI regime would be that the status of services income as Subpart F income or not does not actually tell us much about whether the structure presents a real policy concern).

There may be a concern that repealing the legacy Subpart F rules may significantly reduce the revenue raised by the GILTI regime, thus leading to a preference to keep both regimes in place side-by-side (especially since policy makers may have concluded that "businesses have learned to live with" the legacy rules). But this approach misses an important point of tax reform: to make an entire range of changes deemed meritorious, both taxpayer-favorable and fisc-favorable, and particularly ones that reduce pointless complexity. The exercise certainly should not be about pure revenue maximization, even if curtailing income shifting is a major focus.

B. Limit Application of Code Sec. 954(e) to Services Provided to Related U.S. Persons (as Recently Proposed in the Build Back Better Act)

Certain members of Congress recently proposed significant changes to the foreign base company services income rules as part of the Build Back Better Act (the "BBBA"). The BBBA would have drastically limited the application of Subpart F. It would have done this by revising the definition of a related person, so that definition would generally only have included a U.S. taxable unit (including a branch). Therefore, under the BBBA, a CFC would have foreign base company services income (or foreign base company sales income) only if it provided services (or sells property) to or on behalf of a related U.S. person, but not if it provided services (or sells) to or on behalf of a related foreign person.

The general concept behind the foreign base company services income rules is that if there is a business reason for the CFC to be organized in its jurisdiction and earning services income, the services income is not subpart F income. This policy limits foreign-to-foreign base erosion, by discouraging US companies from earning services income in low-tax jurisdictions, like Bermuda or the Cayman Islands, when the services are, for example, provided in Switzerland to German customers. This policy was not motivated by direct revenue-raising concerns, as from the standpoint of the U.S. fisc, the United States actually collect more taxes when CFCs operate in low-tax countries than in high-tax countries, because of the foreign tax credit system. Rather, the policy was motivated by a more indirect concern that the easier it is for companies to base erode Germany, the more likely they would be to move operations out of the United States and into Germany.

The BBBA's proposed change to the foreign base company services income rules was expected to raise revenue. This may have been because the BBBA would have made it harder for taxpayers to engage in affirmative subpart F planning by taking advantage of the benefits of subpart F income over GILTI in certain circumstances (*e.g.*, the use of foreign tax credits). Affirmative subpart F planning would potentially have been even more important under the BBBA, as GILTI would have moved to a country-by-country system, whereas subpart F would not have. The revenue impact also presumably reflects the fact that many companies have effectively planned their way out of having large current subpart F inclusions, so there is limited subpart F revenue being picked up under current law.

However, another way to look at the BBBA proposal is that it signaled a significant policy shift away from using Subpart F as a tool to prevent foreign-to-foreign base erosion, and limiting it to situations in which CFCs are being used to base erode the United States.[324] With ongoing OECD Pillar 2 developments and movements towards a 15% global minimum tax, there's less need to use Subpart F to limit to foreign-to-foreign base erosion. It also makes sense to limit the Subpart F income rules to reduce complexity and controversy.

The BBBA's proposal would have significantly reduced the application of the foreign base company services income rules. Now that the BBBA seems unlikely to pass in its current form, it remains to be seen whether its proposal to limit the application of foreign base company services income to services provided to related U.S. persons will be incorporated into future legislative tax proposals.

XIII. Conclusion

This article has analyzed the Subpart F services rules in detail and has demonstrated how these antiquated rules are ill-fitting and disruptive to modern services businesses. We urge the Treasury and IRS to eliminate or at least rationalize certain overbroad provisions of the regulations that lack any basis in the statute and exacerbate the burden of out-of-date rules by deeming the existence of related-person services transactions in many modern business-driven structures. Treasury and IRS also should clarify regulatory rules for determining the location of services to address important new issues raised by today's services businesses. We also recommend that the Subpart F services rules be repealed, or at least significantly narrowed in scope, and that any broad new current-taxation approaches to foreign earnings be carefully designed with the modern services economy in mind.

ENDNOTES

[1] This article is an updated version of an article by Lowell D. Yoder and David G. Noren that was published in the March 2016 issue of TAXES.

[2] Commerce Department statistics indicate that private service-producing industries accounted for 67.5% of U.S. GDP in 2014. *See* Bureau of Economic Analysis, U.S. Commerce Department, *Value Added by Industry as a Percentage of Gross Domestic Product* (Apr. 23, 2015), available at *www.bea.gov/iTable/index_industry_gdpIndy.cfm* (last accessed Oct. 5, 2015). Although the operative definition of "services" for purposes of this economic analysis may not always align with transactional characterization for tax purposes (such that there could be some "services" companies earning sales income for tax purposes, and some "manufacturing" companies earning services income for tax purposes), there is substantial overlap.

[3] Code Secs. 951A, 250(a)(1)(B).

[4] *See* Code Sec. 951.

[5] A foreign corporation is an entity classified as a corporation for U.S. tax purposes (Reg. §§301.7701-1, -2 and -3) and not formed under the law of the United States or of any state. Code Sec. 7701(a)(4) and (5); Reg. §301.7701-5. All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise indicated.

[6] Code Secs. 881 and 882.

[7] *See E.I. du Pont de Nemours & Co.*, CtCls, 79-2 USTC ¶9633, 608 F2d 445, 221 CtCls 333 (1979), *cert. denied*, 445 US 962, 100 SCt 1648 (1980); S. Rep. No. 1881, 87th Cong., 2d Sess. 78 (1962); H.R. Conf. Rep. No. 2508, 87th Cong., 2d Sess. 29 (1962).

[8] Code Sec. 861(a)(3); Reg. §1.861-4; *Yardley & Co.*, BTA Memo 12,823-Q.

[9] Code Sec. 864(b), (c)(3); Reg. §1.864-2(a), -4(b). *See* section VII, *infra*, for a discussion of how the location of services is determined for sourcing and Subpart F purposes.

[10] Code Secs. 862(a)(3) and 864(c)(4). The general exclusion from U.S. taxation of business income earned by a foreign corporation from foreign operations has a long history. *See Barclay & Co. v. Edwards*, SCt, 1 USTC ¶120, 267 US 442, 448, 45 SCt 135 (1925); *Nat'l Paper & Type Co. v. Bowers*, SCt, 1 USTC ¶106, 266 US 373, 45 SCt 133 (1924).

[11] Code Sec. 951(a)(1)(A); Reg. §1.951-1(a). In addition, the amount of certain investments in U.S. property held by the CFC triggers an inclusion in the gross income of a U.S. shareholder. Code Secs. 951(a)(1)(B) and 956.

[12] *See also* Code Secs. 1291–1298 (passive foreign investment company rules, which also may impose pre-distribution taxation on shareholders with respect to certain income of a foreign company). These rules generally do not apply to CFCs, which are the subject of this article. Code Sec. 1297(d).

[13] A U.S. person is defined as a citizen or resident of the United States, a domestic partnership, a domestic corporation, or a domestic trust. Code Secs. 957(c) and 7701(a)(30).

[14] Code Sec. 951(b); Reg. §1.951-1(g).

[15] Code Sec. 957(a). For purposes of determining U.S. shareholder and CFC status, stock owned directly, indirectly and constructively is taken into account. *See* Code Sec. 958. However, U.S. shareholders are subject to taxation under Subpart F only to the extent of their direct and indirect ownership in the CFC. Code Sec. 951(a).

[16] Code Secs. 953 and 954. Only the net amount is included in the income of the U.S. shareholders. Code Sec. 954(b)(5).

[17] In contrast, under the source rules, items must be "sourced by analogy" to that category of income under the source rules that the item most nearly resembles. *See, e.g.*, *Container Corp.*, CA-5, 2011-1 USTC ¶50,351, 107 AFTR 2d 2011-1831 (2011) (noting sourcing-by-analogy approach and citing prior case law establishing this principle).

[18] Two general exceptions to the definition of foreign base company income can apply to exclude income that is otherwise Subpart F income: (1) the *de minimis* exception (Code Sec. 954(b)(3)(A)); and (2) the high-tax exception (Code Sec. 954(b)(4)). *See also* Code Sec. 952(c) (earnings and profits limitations).

[19] Code Sec. 960.

[20] Code Sec. 959. Also, the basis of the stock held in the CFC by U.S. shareholders is increased for amounts taxable under Code Sec. 951 to the U.S. shareholders, and decreased when such previously taxed amounts are distributed. Code Sec. 961.

[21] *See* Hearings on the President's 1961 Tax Recommendations before House Committee on Ways and Means, Doc. No. 140, 87th Cong., 1st Sess. 8-10 (1961).

[22] H.R. 10650, 87th Cong., 2d Sess. (1962).

[23] P.L. 87-834, 76 Stat. 960 (1962). H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. (1962); H.R. Conf. Rep. No. 2508, 87th Cong., 2d Sess. (1962). For additional discussion of the legislative background, *see* Yoder, Lyon & Noren, 926-3rd T.M., *CFCs—General Overview* (2010); Yoder, *Subpart F in Turmoil: Low-Taxed Active Income Under Siege*, 77 TAXES 142 (1999).

[24] *See* H.R. Conf. Rep. No. 2508, 87th Cong., 2d Sess. (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 78 (1962). *See also* Dissenting Views of Senators Frank Carlson, Wallace F. Bennett, John Marshall Butler, Carl T. Curtis and Thruston B. Morton in Section 11—Foreign Source Income, H.R. 10650, As Amended by the Senate Finance Committee, 1962-3 CB 1059; Additional Views of Senator Eugene J. McCarthy on H.R. 10650, 1962-3 CB 1054; Supplemental and Minority Views of Senators Paul Douglas and Albert Gore, 1962-3 CB 1092.

[25] H. Rep. No. 1447, 87 Cong., 2d Sess., at 461-62. *See also* S. Rep. No. 1881, at 785. For a detailed compilation of the legislative history and hearings, *see* Legislative History of H.R. 10650, 87th Cong., The Revenue Act of 1962, Committee on Ways and Means, U.S. House of Representatives, Prepared by the Staff of the Committee on Ways and Means, 90th Cong., 1st Sess. (1967) (four volumes); President's 1961 Tax Recommendations, Hearings Before the Committee on Ways and Means, House of Representatives, 87th Cong., 1st Sess. (1961) (four volumes).

[26] The Subpart F rules enacted in 1962 also included a general exception for income derived by a CFC if the taxpayer established that the CFC was not availed of to reduce taxes, which applied to exclude income otherwise within the definition of Subpart F income. Former §954(b)(4). In 1986 Congress replaced this exception with a high-tax exception. Code Sec. 954(b)(4).

[27] Code Sec. 951A(b)(1).

[28] Code Sec. 951A(c).

[29] Code Sec. 250(a)(1)(B).

[30] Code Sec. 960(d)(1).

[31] Code Sec. 959. Also, the basis of the stock held in the CFC by U.S. shareholders is increased for amounts taxable under Code Sec. 951 to the U.S. shareholders, and decreased when such previously taxed amounts are distributed. Code Sec. 961.

[32] *See* H.R. 5376 (passed Nov. 19, 2021); Senate draft version of BBBA (released Dec. 11, 2021).

[33] OECD, "Tax Challenges Arising from the Digitalisation of the Economy—Global Anti-Base Erosion Model Rules (Pillar Two)" (Dec. 2021), available at *www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf*.

[34] Code Sec. 954(a)(3); Reg. §1.954-1(a)(2)(iii). The amount included in the income of the U.S. corporate parent is the net amount of services income after reduction for expenses allocated and apportioned to such income, including income taxes. Code Sec. 954(d)(5). For commentary discussing the foreign base company services income rules, *see* Laity, *The United States' Response to Tax Havens: The Foreign Base Company Services Income of Controlled Foreign Corporations*, 18 NW. J. INT'L L. & BUS. 1 (1997); Toon, *Foreign Base Company Services Income*, 3 INT'L TAX J. 229 (1997); Holleman, *U.S. Taxation of Foreign Income: The Overseas Construction Industry*, 23 TAX L. REV. 155 (1968); Yoder, Lyon & Noren, 6240 T.M., *CFCs—Foreign Base Company Income (Other than FPHCI)*.

[35] Code Sec. 954(e); Reg. §1.954-4(a). Each item of services income is separately analyzed to determine whether it falls within the definition of foreign base company services income.

[36] However, as discussed above, a CFC that derives income from performing services in the United States generally would be subject to direct U.S. taxation on such income. *See* Code Sec. 864; Code Sec. 881. A CFC's U.S. source income that is effectively connected with a U.S. trade or business is excluded from Subpart F income. Code Sec. 952(b).

[37] The application of Code Sec. 954(e) to income derived by partnerships that are owned by CFCs raises additional issues, a discussion of which is beyond the scope of this article. *See* Yoder, Lyon, &

Noren, 6240 T.M., *CFCs—Foreign Base Company Income (Other than FPHCI)*, at part XII.F.

[38] Reg. §1.954-1(e)(1).

[39] Code Sec. 954(e)(1). The identical list is contained in the regulations. Reg. §1.954-4(a).

[40] *See, e.g., Andrus v. Glover Const. Co.*, SCt, 446 US 608, 616-17, 100 SCt 1905 (1980) (*citing Continental Casualty Co.*, SCt, 314 US 527, 533, 62 SCt 393, 86 L.Ed. 426 (1942)).

[41] *See, e.g., Harrison v. PPG Industries, Inc.*, SCt, 446 US 578, 588, 100 SCt 1889 (1980); *Circuit City Stores, Inc. v. Adams*, SCt, 532 US 105, 114-15, 121 SCt 1302 (2001).

[42] *See* Tillinghast, *Taxation of Electronic Commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven*, 4 FLORIDA TAX REV. 339 (1999) (discussing the application of the foreign base company income rules to the provision of software over the Internet); Maguire & Anolik, *Subpart F and Source of Income Issues in E-Commerce*, TAX NOTES, Dec. 25, 2000; Cicconi, *U.S. Tax Issues for Foreign Mobile Application Companies*, 134 TAX NOTES 715 (2/6/12); Sprague, Chesler, Reid, Cohen & Hubbard, 555 Tax Mgmt. Portfolio, *Federal Taxation of Software and E-Commerce*.

[43] GCM 39220 (Apr. 24, 1984) (concluding that factoring income consists of a commission, which "is a charge for the services of passing on credits, assuming all credit risks, and keeping accounts"), *revoked by* GCM 39652 (Aug. 10, 1987) (Code Sec. 864(d) was later enacted to address factoring). The GCM was issued with respect to LTR 8338043 (Jun. 17, 1983), *revoked by* LTR 8748030 (Aug. 31, 1987).

[44] TAM 9527010 (Apr. 7, 1995); FSA 1998-233 (Mar. 18, 1992), *reprinted at* 98 TNI 183-35 (Sep. 22, 1998).

[45] Congress amended the definition of Code Sec. 954(e) to provide an exception for income derived from banking, financing, insurance and securities services that qualify for exceptions from the definition of foreign personal holding company income provided in Code Sec. 954(c)(2)(C)(ii), (h) and (i). Thus, apparently Congress was of the view that it is possible that such services might otherwise have been subject to Code Sec. 954(e).

[46] *See, e.g., Astoria Federal Savings & Loan Ass'n v. Solimino*, SCt, 501 US 104, 112, 111 SCt 2166 (1991); *Sprietsma v. Mercury Marine*, SCt, 537 US 51, 63 (2003); *Bailey*, 516 US 137, 146, 116 SCt 501 (1995).

[47] Reg. §1.954-4(c). Also, in applying one of the rules that deems a CFC to be performing services for, or on behalf of, a related person, the regulations take into account unskilled labor as a factor. Reg. §§1.954-4(b)(2)(ii)(b)(2) and 1.954-4(b)(2)(ii)(e), which has been modified by Notice 2007-13, 2007-1 CB 410.

[48] For other purposes, the regulations distinguish "skilled" and "unskilled" labor. Reg. §§1.954-4(b)(2)(ii)(b)(2) and 1.954-4(b)(2)(ii)(e).

[49] S. Rep. No. 1881, 87th Cong., 2d Sess. 84, 1962-3 CB 703, 790 (1962).

[50] Proposed Reg. §1.954-4(b)(1), 27 FR 12,759 (Dec. 27, 1962).

[51] T.D. 6734, 1964-1 CB (Part 1) 237, 275.

[52] Reg. §1.954-4(b)(3), *Exs.* 1 & 8.

[53] *Id., Exs.* 9 & 10.

[54] *Id., Ex.* 2.

[55] Reg. §1.954-4(b)(3), *Ex.* 3.

[56] *Id., Exs.* 4, 5, 6 and 7.

[57] *See* TAM 8127017 (Mar. 26, 1981) (contract drilling of oil and gas wells); TAM 8114015 (Dec. 18, 1980) (contract drilling of oil and gas wells); GCM 38065 (Aug. 24, 1979) (oil drilling rig contracts); Rev. Rul. 86-155, 1986-2 CB 134 (engineering, fabrication, and installation of offshore drilling platforms); Rev. Rul. 82-226, 1982-2 CB 156 (construction services), *obsoleted*, Rev. Rul. 2003-99, 2003-2 CB 388.

[58] Reg. §1.954-1(e).

[59] Reg. §1.954-1(e)(1).

[60] *Id.*

[61] *See P. Boulez*, 83 TC 584, Dec. 41,557 (1984). *See also R. Goosen*, 136 TC 547, Dec. 58,655 (2011); *S. Garcia*, 140 TC 141, Dec. 59,484 (2013).

[62] CA-5, 134 TC 122, Dec. 58,131 (2010) *aff'd*, 107 A.F.T.R.2d 2011-1831 (2011).

[63] Treating the guarantee fee like a service fee, it was foreign source income based on the location of the guarantor in Mexico (if it were analogized to interest, it would be U.S. source based on the residence of the payor of the amount). The sourcing result under the *Container* case was reversed prospectively by legislation. Code Sec. 861(a)(9).

[64] *See Bank of America*, CtCls, 82-1 USTC ¶9415, 680 F2d 142, 147, 230 ClsCt 679 (1982); W.A. *Hawkins*, 49 TC 689, 693-94, Dec. 28,889 (1968) (sourcing alimony income based on the residence of the obligor by analogy to interest income).

[65] *See* LTR 9729011 (Apr. 11, 1997) (ruling that cancellation of indebtedness income fell outside the categories of Subpart F income and therefore was not subject to analysis under Subpart F); Yoder, *COD Income Slips Through the Subpart F Net*, 26 TAX MGMT. INT'L J. 624 (12/12/97). In addition, the 1986 enactment of a separate Subpart F foreign personal holding company income category for "income equivalent to interest" under Code Sec. 954(c)(1)(E), when interest itself had long since been covered, further illustrates that Subpart F does not apply to items outside the four corners of the relevant definitions. *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, at 967 (May 4, 1987).

[66] *See* Reg. §1.954-1(e)(1). *See also* Code Sec. 7701(e) (distinguishes leasing from services income); *Tidewater Inc.*, CA-5, 2009-1 USTC ¶50,337, 565 F3d 299 (2009) (controversially finding that income from a vessel time charter was properly characterized as rental income and not services income under Code Sec. 7701(e), based on a novel "constructive control" theory essentially attributing activities of ship's crew to the customer); *nonacq.*, AOD 2010-001 (May 14, 2010).

[67] *See also* FSA 1998-233 (Mar. 18, 1992), *reprinted at* 98 TNI 183-35 (Sep. 22, 1998) (similarly finding that there must be "an ownership interest in the motion picture" on the part of the creator if the transaction is to be characterized as a sale of property. Because there was no such ownership interest in the film, the contract was characterized as a contract for services, since the CFC had nothing to convey).

[68] Jun. 15, 1967. Income received by a CFC for producing a product on behalf of another person pursuant to a consignment manufacturing arrangement should be considered as services income for purposes of §954(e). *See Hawaiian Philippine Co.*, CA-9, 39-1 USTC ¶9263, 100 F2d 988, 991 (1939); Rev. Rul. 74-331, 1974-2 CB 282 (*Ex.* 3).

[69] GCM 33455 (Mar. 9, 1967) *modified* GCM 33178 (Jan. 27, 1966), which had analyzed the income as sales income based on the assumption of the taxpayer.

[70] *See* Reg. §1.861-18(d), (h), *Ex.* 15 (U.S. corporation providing services for the development of computer software treated as deriving services income where a foreign corporation bore the risk of developing the software and is the owner of the copyrights). Reg. §1.861-18 is expressly applicable for purposes of the Subpart F rules, although it applies only to computer software and thus does not cover the waterfront of e-commerce or other modern service economy activities.

[71] A common example is a "shrink-wrap license" of computer software, which is labeled a license, but generally is characterized as a sale of a copyrighted article under Reg. §1.861-17, and thus for Subpart F purposes. For further background on e-commerce characterization issues, *see* Sprague & Reid, *A Break in the Clouds: A Proposed Framework for Analyzing Cloud Computing Transactions*, 92 TAXES, No. 3 (Mar. 2014).

[72] *See C.L. Danielson*, CA-3, 67-1 USTC ¶9423, 378 F2d 771, 775 (1967), *vacating and remanding* 44 TC 549, Dec. 27,476 (1965) (holding that the taxpayers were not allowed to disavow their allocations of purchase price as stated in the purchase contract under the following rule of law: "a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, *etc.*"); *National Alfalfa Dehydrating & Milling Co.*, SCt, 74-1 USTC ¶9456, 417 US 134, 149, 94 SCt 2129 (1974) (citations omitted). However, even in such circumstances, case law does not squarely address how to determine the "form" of a transaction. *See e.g., Rochester Development Corp.*, 36 TCM 1213, Dec. 34,630(M), (P-H) ¶ 77,307 (1977) (considering whether a transaction was properly characterized as a lease or a sale and noting that "[t]he issue before us does not involve an attempt by petitioner to vary the undertakings set forth in the written agreements. Rather, our task is to determine the tax consequences of the agreements, keeping in mind that we are not bound by the descriptive terminology used by the parties ..."). Thus, even in the absence of substance-based characterization regulations, *Rochester Development* suggests both that taxpayers may invoke the substance of their transaction for tax purposes, and that "form"

refers not to the labels or terminology used but rather to the entirety of the documentary rights and obligations surrounding the transaction.

[73] Code Sec. 954(e)(1); Reg. §1.954-4(a).

[74] *See infra*, sec. VIII.B.

[75] Reg. §1.954-1(e)(2).

[76] Reg. §1.954-1(e)(3).

[77] Reg. §1.954-1(e)(2).

[78] Reg. §1.954-1(e)(3).

[79] Reg. §1.954-1(e)(2). *See also* Reg. §1.954-2(h)(5) (treats a portion of income from services receivables outstanding for more than 120 days as income equivalent to interest).

[80] Reg. §1.954-1(e)(3).

[81] *Cf.*, *Tidewater Inc.*, CA-5, 2009-1 USTC ¶50,337, 565 F3d 299 (2009) (the Circuit Court held that income from time charters was characterized as rental income and not services income under Code Sec. 7701(e) based on the predominant character of the transaction, and did not follow the District Court's approach of bifurcating the transaction); *nonacq.* AOD 2010-001 (May 14, 2010) (IRS agreed transaction should not be unbundled but disagreed that the predominant character was rents rather than services).

[82] Reg. §1.954-1(e)(3). The regulations do not provide further guidance concerning how to determine the predominant character, nor do they indicate whether the income in the example would be classified as sales or services income. *See also* Rev. Rul. 86-155, 1986-2 CB 134 ("In general, income derived by a CFC from the performance of each integrated business transaction is considered a single item of income and will be classified in accordance with the predominant character of the transaction, even though an incidental part of the income could be characterized as a different class of income. However, in situations in which a CFC is engaged in performing separate business transactions, even though pursuant to the same contract or arrangement, the income from each such transaction shall be separately considered for purposes of classification under the predominant character test.").

[83] TAM 9327003 (Feb. 25, 1993) and TAM 9327004 (Feb. 25, 1993). *See also* TAM 9327001 (Feb. 12, 1993) (income from the operation of gambling concessions aboard a cruise ship operated by unrelated persons in international waters treated as foreign base company shipping income). For a criticism of these TAMs, *see* Stankee, *IRS Overloads Space or Ocean Activities Basket*, 5 J. INT'L TAX'N 24 (1/94); Turro, "*Space and Ocean Activities Under Subpart F*," 95 TNT 45-3 (Mar. 7, 1995).

[84] The IRS applied the predominant character test of former Temp. Reg. §4.954-1(e)(3), which is substantially the same as the test in final Reg. §1.954-1(e)(3).

[85] Code Sec. 954(f) was repealed by the American Jobs Creation Act of 2004, P.L. 108-357.

[86] *Pietro*, Doc. No. 11722-97; *Stein*, Doc. No. 11809-97; *Rahn*, Doc. No. 11815-97.

[87] *See L.A. Pietro*, 78 TCM 825, Dec. 53,632(M), TC Memo. 1999-383 (1999); *L. Stein*, 78 TCM 827, Dec. 53,633(M), TC Memo. 1999-384 (1999). *See also* Stankee, *IRS Concedes that Concessionaires Profits Were Not Subpart F Income*, 11 J. INT'L TAX'N 18 (3/00).

[88] For a discussion of the tax treatment of transactions with embedded intangible property, *see* Doernberg, *Taxation Silos: Embedded Intangibles and Embedded Services*, TAX NOTES, Mar. 13, 2006; Angus & Zollo, *Revisiting the U.S. Taxation of Intangible Property Income of Controlled Foreign Corporations*," 84 TAXES 75 (2006); Yoder & Lyon, *Intangible Property Used Outside the U.S.: Active vs. Passive Treatment of Royalties and Gain*, 5 J. TAX'N GLOBAL TRANS. 39, 46–47 (Winter 2006).

[89] *See* Code Sec. 7701(e) (distinguishes leasing from services income, based on whether the customer in substance is using the subject property or instead receiving services in which the service provider uses the subject property); *Tidewater Inc.*, CA-5, 2009-1 USTC ¶50,337, 565 F3d 299 (2009) (the Circuit Court held that income from time charters was characterized as rental income and not services income under Code Sec. 7701(e) based on the predominant character of the transaction, and did not follow the District Court's approach of bifurcating the transaction); *nonacq.* AOD 2010-001 (May 14, 2010) (IRS agreed transaction should not be unbundled but disagreed that the predominant character was services rather than rents); Reg. §1.861-18(d) (computer software regulations distinguishing a services arrangement from another transaction taking into account which party owns the copyright rights in the computer program and how the risks of loss are allocated among the parties); Reg. §1.861-18(b)(2) (providing for separate treatment of a transaction involving computer programs only where the transaction in substance consists of more than one transaction).

[90] *See, e.g., P.G. Wodehouse*, SCt, 49-1 USTC ¶9310, 337 US 369, 69 SCt 1120 (1949) (income for an exclusive copyright to the American market for stories to be written were royalties); Rev. Rul. 74-555, 1974-2 CB 202 (income for the privilege of using copyrights for written works were royalties and not compensation for services because the taxpayer did not give up control over what the taxpayer was to write or when it was to be written, but provided only the right to publish); *State National Bank of El Paso*, CA-5, 75-1 USTC ¶9307, 509 F2d 832 (1975) ("In black letter law, a lease is a transfer of an interest in and possession of property for a prescribed period of time in exchange for an agreed consideration, called 'rent.'"). If the agreements provide for a sale or license of intangible property, then the income stream from the single transaction generally must be allocated between sales or royalty income and services income, and subject to analysis under Code Sec. 954(d) or 954(c) and Code Sec. 954(e), respectively.

[91] Reg. §1.482-9(c)(2)(ii)(B)(3), (c)(4), *Ex.* 4; (d)(3)(ii),

[92] Reg. §1.482-9(m)(1) ("Ordinarily, an integrated transaction of this type may be evaluated under this section and its separate elements need not be evaluated separately ...."). *Cf.*, Reg. §1.482-9(m)(2) (analyzing services transactions that include a material element involving the transfer of intangible property as including a separate analysis for the intangibles); Reg. §1.199-3(h)(4) (indicating that some transactions involving the transfer of intangible property also might contain an embedded service element the income attributable to which would not qualify for Code Sec. 199 benefits).

[93] 1975-1 CB 243. This ruling was considered in GCM 36194 (Mar. 17, 1975).

[94] Reg. §1.482-3(f).

[95] Code Sec. 954(c)(2)(A). There are certain situations where deriving royalty income rather than services income may be more beneficial under Subpart F. For example, this may occur where a CFC with a significant marketing organization is deemed to provide services on behalf of a related person outside of its country of organization, such that any services income would be foreign base company services income, but any royalty income would qualify for the active trade or business exception.

[96] *See, e.g., P. Boulez*, 83 TC 584, Dec. 41,557 (1984) (income for producing recordings was services income rather than royalty income, because the taxpayer never held a property right in the recordings); *Ingram v. Bowers*, CA-2, 3 USTC ¶915, 57 F2d 65 (1932) (contract to create copyrighted musical work gave rise to services income); *P. Karrer*, CtCls, 57-1 USTC ¶9649,152 FSupp 66, 138 CtCls 385 (1957) (services income generated by taxpayer hired to create a patented invention).

[97] Reg. §1.954-1(e)(3).

[98] *See* H.R. Rep. No. 1447, 87th Cong., 2d Sess. 62 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962); *see also* U.S. Treasury Department, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* (Dec. 2000), at xii–xiv.

[99] Code Sec. 954(d)(3); Reg. §1.954-1(f).

[100] When enacted, "control" was defined solely by reference to voting power. The definition was expanded with the Tax Reform Act of 1986 to add an alternative value test. P.L. 99-514, 100 Stat. 2085 (1986).

[101] Code Sec. 954(d)(3).

[102] For a discussion of the Subpart F constructive ownership rules, *see* Yoder, Lyon & Noren, *CFCs—General Overview*, 926-3rd T.M. Portfolio, at part VI.D.

[103] Regulations provide that eligible foreign entities that are wholly owned may by election be disregarded for U.S. tax purposes. Reg. §301.7701-2, -3.

[104] The foreign base company services income rules do not contain a branch rule like the foreign base company sales income rules do. *See* Code Sec. 954(d)(2); Reg. §1.954-3(b). Thus, the fact the holding company conducts its business for unrelated persons through multiple entities working together across multiple countries does not create the related-person transactions necessary to trigger application of the foreign base company services income rules (although, as discussed further below, if there is a related-person element to the arrangement

based on other facts and circumstances, such an arrangement could be problematic, because the holding company will be treated as performing activities outside its country of organization).

[105] Disregarded entity structures may also be unavailable with CFCs that are *per se* entities, in separate ownership chains, or joint ventures.

[106] A possible alternative is for the CFC to enter the contract with the customer and contract with the U.S. affiliate to assist with providing the services. Thus, the CFC would not be considered as performing services for a related persons. However, as discussed in the next section, under certain circumstances the CFC can be deemed to perform services on behalf of a related person (*e.g.*, where U.S. related persons "substantially assist" with the performance of the services).

[107] Using a regarded entity structure may also be beneficial if services are provided to U.S. affiliates or to regarded related foreign affiliates, because a disregarded entity structure will not cause payments for such services to be ignored for U.S. tax purposes anyway.

[108] Reg. §1.954-4(b).

[109] 27 FR 12759, 12768 (Dec. 27, 1962).

[110] T.D. 6734, 1964-1 CB (Part 1) 237, 275.

[111] T.D. 6981, 1968-2 CB 314.

[112] 2007-1 CB 410.

[113] Reg. §1.954-4(b)(1)(i).

[114] Reg. §1.954-4(b)(3), *Ex.* 1.

[115] This deemed-related rule should not apply when a related person merely collects fees from unrelated persons on behalf of a CFC under an administrative services arrangement, and remits the amounts collected to the CFC within a reasonable period. In such a case, the related person should not be considered as "paying" the CFC, as the related person is not a party in interest with respect to the payment but rather is merely forwarding or remitting someone else's payment for administrative convenience.

[116] This deemed-related rule generally would apply if one CFC pays another CFC to perform services for an unrelated person. As discussed elsewhere in this article, this rule would not apply if the two entities instead were part of the same disregarded entity structure (both being disregarded into the same CFC, or one being disregarded into the other).

[117] Reg. §1.954-4(b)(1)(ii).

[118] Reg. §1.954-4(b)(3), *Ex.* 5. This rule applies whether M Corporation is a U.S. corporation or a foreign corporation.

[119] Reg. §1.954-4(b)(2)(i).

[120] Reg. §1.954-4(b)(3), *Ex.* 4.

[121] Reg. §1.954-4(b)(3), *Ex.* 6.

[122] Reg. §1.954-4(b)(3), *Ex.* 7.

[123] Reg. §1.954-4(b)(2).

[124] The Technical Memorandum attached to Treasury Decision 6981, 1968 TM Lexis 11, specifically addresses this point: "Proposed subparagraph (2)(i) of the accompanying proposed Treasury decision has been amended to make clear that, if the related person (or any other person related to the controlled foreign corporation) does in fact pay for performance of, or perform, any of the guaranteed services or any significant services related to such services, the services performed by the controlled foreign corporation pursuant to the contract will be services performed for, or on behalf of, a related person within the meaning of subparagraph (1)(ii) even though the payment or performance by the related person, or by any other person related to the controlled foreign corporation, is not considered to be substantial assistance for purposes of subparagraph (1)(iv)."

[125] For prior recommendations along these lines, *see* Sotos, Stenger & Stevenson, *Following Through on Notice 2007-13: Suggestions for Updating the Subpart F Services Regulations*, 37 Int'l Tax J., No. 6, 35 (Nov.–Dec. 2011); O'Neill & Shulman, "Modernization Required for Treatment of Performance Guarantees Under IRS's Pending Foreign Base Company Services Regulations," 245 BNA DTR J-1 (12/22/08).

[126] Contrast this treatment of a performance guarantee with the treatment of financial guarantees under the case law, which generally respects a borrower as the true borrower for tax purposes notwithstanding a guarantee by a related party, absent facts and circumstances demonstrating that the lender was relying very heavily on the guarantee as opposed to the borrower's own creditworthiness in deciding to make the advance. *See Plantation Patterns*, CA-5, 72-2 USTC ¶9494, 462 F2d 712 (1972).

[127] Reg. §1.954-4(b)(1)(iii).

[128] Reg. §1.954-4(b)(3), *Ex.* 8.

[129] Reg. §1.954-4(b)(3), *Ex.* 9.

[130] Reg. §1.954-4(b)(3), *Ex.* 10.

[131] Reg. §1.954-4(b)(1)(iv); *see also* Reg. §1.954-4(b)(2)(iii) (special rule for applying the substantial assistance rule to services income derived by partnerships). A discussion of the application of the foreign base company services income rules to partnerships is beyond the scope of this article. *See* Yoder, Lyon, & Noren, 6240 T.M., *CFCs—Foreign Base Company Income (Other than FPHCI)*, at part XII.F.; Sotos, *Applying the Substantial Assistance Rules to a CFC Partner After Notice 2007-13*, 41 Int'l Tax J. 29 (May–Jun. 2015).

[132] ALI, *supra*, at 272. *See also* Notice 2007-13 ("The purpose of the substantial assistance rules is to treat as foreign base company services income, income received by a CFC from rendering services to an unrelated person where in rendering those services a related person substantially contributes to the CFC's performance of such services in a manner that suggests that the CFC, rather than the related party, entered into the contract to obtain a lower rate of tax on the services income.").

[133] Whether Reg. §1.954-4(b)(1)(iv) constitutes a valid exercise of the IRS's rulemaking authority has not been challenged in court. *Cf., W. Lovett Est.*, CtCls, 80-1 USTC ¶9432, 621 F2d 1130 (1980) (the Court found Subpart F regulations invalid as unsupported by the language of the Code); *Altera Corp.*, 145 TC No. 3, Dec. 60,354, 145 TC 91 (2015) (unanimous reviewed Tax Court opinion held that Reg. §1.482-7(d)(2) (2003) was invalid because the Treasury failed to demonstrate that it engaged in reasoned decision-making as required by the Administrative Procedure Act).

[134] Holleman, *U.S. Taxation of Foreign Income: The Overseas Construction Industry*, 23 Tax L. Rev. 155, 179 (1968); *see also* Saltzman, *Undistributed Income Subject to 'Taint' of Subpart F is Spelled Out by Final Regs*, 21 J. Tax'n 110, 112 (8/64).

[135] Notice 2007-13, 2007-1 CB 410.

[136] 27 FR 12759, 12768 (Dec. 27, 1962).

[137] T.D. 6734, 1964-1 CB (Part 1) 237, 275.

[138] *Id.*, at 276.

[139] Former Reg. §1.954-4(b)(2), *Ex.* 2 (1964), 1964-1 CB (Part 1), at 277.

[140] 32 FR 3155 (Feb. 22, 1967).

[141] T.D. 6981, 1968-2 CB 314. The revisions to the regulations are discussed at length in the Technical Memorandum accompanying T.D. 6981, *reprinted at* 1968 TM Lexis 11.

[142] Technical Memorandum accompanying T.D. 6981, 1968-2 CB 314, 1968 TM Lexis 11.

[143] Reg. §1.954-4(b)(3), *Ex.* 2.

[144] Reg. §1.954-4(b)(3), *Ex.* 3; *see also* GCM 38065 (Aug. 24, 1979) (indicates that the efforts of full-time staff employees permanently transferred by a related person to the CFC may not be treated as assistance provided by a related person to the CFC).

[145] TAM 8127017 (Mar. 26, 1981).

[146] *See also* TAM 8114015 (Dec. 18, 1980) (similar analysis and conclusion).

[147] GCM 38065 (Aug. 24, 1979).

[148] Reg §1.954-4(b)(2)(ii)(a).

[149] *Id*.

[150] Reg. §1.954-4(b)(2)(ii)(e).

[151] Technical Memorandum Accompanying T.D. 6981, 1968-2 CB 314, *supra*.

[152] Reg. §1.954-4(b)(3), *Ex.* 3.

[153] Reg. §1.954-4(b)(3), *Ex.* 2.

[154] Reg. §1.954-4(b)(2)(ii)(c).

[155] Technical Memorandum accompanying T.D. 6981, 1968-2 CB 314, *supra*.

[156] *See* Reg. §1.954-4(b)(3), *Ex.* 3 (no assistance from a related person where a CFC leases and buys from its parent, on an arm's-length basis, equipment and material necessary for the construction of a dam).

[157] *Id*.

[158] Technical Memorandum accompanying T.D. 6981, 1968-2 CB 314, *supra*.

[159] For purposes of determining whether a CFC received substantial assistance under the regulations, apparently services provided to the CFC by all related persons is aggregated (*i.e.*, the substantial assistance test does not have to be independently satisfied with respect to each related person providing assistance).

[160] The term "cost" is determined after taking into account any adjustments made under Code Sec. 482. Reg. §1.954-4(b)(2)(ii)(b).

[161] Reg. §1.954-4(b)(2)(ii)(b). Presumably, amounts paid to unrelated persons by the CFC for assistance in performing the services were taken into account as a cost of the CFC in performing the services for purposes of calculating the 50% test.

[162] Technical Memorandum accompanying T.D. 6981, *supra*.

[163] Reg. §1.954-4(b)(2)(ii)(e).

[164] GCM 38065 (Aug. 24, 1979).

[165] *See* GCM 38065 (Aug. 24, 1979) ("Further, we do not believe that this situation is distinguishable in substance from the above-quoted example in the underlying regulations file concerning a famous architect who sets up a European company to render services abroad. In the subject case S could not earn its income without the related corporation's activities. The assistance rendered by P in the subject case, and P's president, A, seems to be a *sine qua non* to the ability of the CFC to earn its services income. In both situations, although certain technical operations are conducted by the CFC, it is the related corporation which provides the overall direction of the performance of the contracts, without which the CFC could not earn its services income.").

[166] Reg. §1.954-4(b)(3), *Ex.* 2. For similar conclusions, *see* TAM 8114015, (Dec. 18, 1980); TAM 8127017, (Mar. 26, 1981); GCM 38065 (Aug. 24, 1979). *See also* LTR 9527010 (Apr. 7, 1995) (where a related person's responsibilities for casting, supervising the filming and supervising the editing were held to provide CFC with skills that were a principal element in producing the income CFC received under an agreement to produce a film).

[167] As described above, this determination is made after taking into account any adjustments made under Code Sec. 482.

[168] Technical Memorandum accompanying T.D. 6981, 1968-2 CB 314, 1968 TM Lexis 11. As noted above, unlike the direction, supervision, services, and know-how prong of the substantial assistance test, the assistance furnished by a related person to the CFC under the financial assistance, equipment, materials, and supplies prong of the substantial assistance test need not directly assist the CFC in the performance of the CFC's services.

[169] *See also* GCM 38065 (Aug. 24, 1979) ("Whether direct, substantial assistance is rendered by a related corporation to a controlled foreign corporation depends on the facts and circumstances of each case.").

[170] Reg. §1.954-4(b)(2)(ii)(d). Direction, supervision, services, and know-how are not taken into account for this purpose unless such assistance directly assists the CFC in the performance of the CFC's services. This is the same rule discussed above, applicable in determining whether such assistance alone constitutes substantial assistance. Reg. §1.954-4(b)(2)(ii)(e).

[171] *See* GCM 38065 (8/24/79). *See also L.D. Barnette*, 63 TCM 3201, 3201-15, Dec. 48,319(M), TC Memo. 1992-371 (1992) (Tax Court rejected IRS's assertion that a CFC had foreign base company services income, finding that the income was not the CFC's income).

[172] Similar reasons were given for regulations expanding the manufacturing exception for Subpart F sales income. The Preamble to Proposed Reg. §1.954-3(a)(1)(i), (4)(i), 73 FR 10,716 (Feb. 28, 2008), at p 10, 718 states: "Final regulations addressing FBCSI were first published in 1964 (T.D. 6734, 29 FR 6392). Since then, global economic expansion and globalization have led to significant changes in manufacturing. Many multinational groups have extensive manufacturing networks that straddle geographic borders. These cross-border manufacturing networks are created primarily to leverage expertise and cost efficiencies. In addition, the use of contract manufacturing arrangements has become a common way of manufacturing products because of the flexibility and efficiencies it affords. Accordingly, updated rules in this area are important to the continued competitiveness of U.S. businesses operating abroad .... In response to the growing importance of contract manufacturing and other manufacturing arrangements, the Treasury Department and the IRS propose to modernize the FBCSI regulations in light of current business structures and practices that are inadequately addressed by the current regulations."

[173] For commentary on Notice 2007-13, 2007-1 CB 410, *see* Anson, Dubert & Chen, *The Substantial Assistance Rules: An Evolution in Subpart F Planning*, 48 Tax Notes Int'l 695 (Nov. 12, 2007); Cornett & McHenry, *Government Provides "Substantial Assistance" to U.S. Multinationals*, 33 Int'l Tax J. 19 (May–Jun. 2007); Glicklich & Miller, *Notice 2007-13 Dramatically Limits the "Substantial Assistance" Trap Under Subpart F*, 33 Int'l Tax J. 5 (Mar.–Apr. 2007); Lemein, Lipeles & McDonald, *Substantial Assistance Substantially Eliminated*, 85 Taxes 5 (May 2007); Miller, *Notice 2007-13 Announces New and Improved Substantial Assistance Rules*, 36 Tax Mgmt. Int'l J. 168 (2007); O'Neill & Siler, *U.S. Substantial Assistance Rules: Help for Global Services Companies*, 48 Tax Notes Int'l 303 (Oct. 15, 2007); Rollinson, O'Connor, Gordon & Kilthau, *Notice 2007-13 and the Substantial Assistance Rules—A Good Start, But More Clarification Required*, 19 J. Int'l Tax'n 18 (Jan. 2008); Yoder, *Notice 2007-13: New Subpart F Substantial Assistance Rule*, 36 Tax Mgmt. Int'l J. 230 (2007); Sotos, Stenger & Stevenson, *Following Through on Notice 2007-13: Suggestions for Updating the Services Regulations*, 37 Int'l Tax J. 35 (Nov.–Dec. 2011).

[174] Of course, CFC2 and CFC3 will be considered as deriving income from performing services for, or on behalf of, a related person (*i.e.*, CFC1), and their income would be foreign base company services income to the extent attributable to services performed outside their respective countries of organization. As discussed above, if CFC1, CFC2 and CFC3 were all part of a disregarded entity structure, service fees paid by CFC1 to CFC2 and CFC3 would be disregarded, and therefore not subject to Code Sec. 954(e).

[175] Notice 2007-13, 2007-1 CB 410, ¶2, C, *Ex.* 2.

[176] *Id.*, *Ex.* 3.

[177] *See* TAM 811405 (Dec. 18, 1980) and TAM 8127017 (Mar. 26, 1981) (services performed by joint officers and directors of a related person and a CFC were considered as direct assistance furnished by a related person).

[178] *Cf.* Reg. §1.954-3(a)(4)(i) and T.D. 9438 (Dec. 24, 2008) (seconded employees treated as employees of the CFC for purposes of applying the manufacturing exception).

[179] Reg. §1.954-4(b)(2)(ii)(e).

[180] Notice 2007-13, 2007-1 CB 410, ¶2, C, *Ex.* 1.

[181] *See* Lisa M. Nadal, "Cost of Intangibles Included in Subpart F Calculation Hicks Says," 2007 TNT 14-8 (1/22/07) (reporting remarks of Hal Hicks, then International Tax Counsel for the U.S. Treasury Department, to the effect that "intangibles should be included in the pool of costs used to determine what constitutes 'substantial assistance'" under Notice 2007-13); Morrison, *Cost Sharing Intangibles in a Services Business—A Foreign Base Company Services Income Issue That Shouldn't Be*, 32 Tax Mgmt. Int'l J. 143 (2012) (discussing the meaning of "know-how" used in the regulations).

[182] *See* Rollinson, O'Connor, Gordon & Kilthau, *Notice 2007-13, 2007-1 CB 410 and the Substantial Assistance Rules—A Good Start, But More Clarification Required*, 19 J. Int'l Tax'n 18 (Jan. 2008); Hoerner, Yan & Galin, *PCT Payments Should Not be Included in the Numerator of the 80% Cost Test for Purposes of the Substantial Assistance Rule*, 42 Tax Mgmt. Int'l J. 547 (9/13/13).

[183] Gottesman v. Comm'r, 77 T.C. 1149 (1981).

[184] Code Sec. 954(e)(1)(B); Reg. §1.954-4(a)(2).

[185] *See* H.R. Rep. No. 1447, 87th Cong., 2d Sess. 62 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962); *see also* U.S. Treasury Department, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* (Dec. 2000), at xii–xiv.

[186] Reg. §1.954-4(c).

[187] Reg. §1.954-4(a)(2).

[188] In response to international pressure and public attention to "Double Irish" and other structures, Ireland amended its laws effective as of Jan. 1, 2015 to prevent the formation of new nonresident companies lacking a tax residence in any other jurisdiction, and to grandfather existing nonresident companies through 2020, treating them as tax residents as of Jan. 1, 2021. *See* Irish Finance Bill 2014, sec. 38 (Oct. 23, 2014); *see also* Irish Department of Finance, *Competing in a Changing World: A Road Map for Ireland's Tax Competitiveness*, at 8 (Oct. 2014), available at *www.budget.gov.ie/Budgets/2015/Documents/Competing_Changing_World_Tax_Road_Map_finalrev.pdf*.

[189] *See* Treasury Subpart F Study, at pp. 66–67.

[190] Reg. §301.7701-2(a).

[191] Reg. §301.7701-2(a), (c)(2). An organization's status as an entity separate from its owners for U.S. tax purposes does not depend on whether the organization is recognized as an entity under local law. Reg. §301.7701-1(a)(1). Following an election to be disregarded, the disregarded entity's owner is deemed to be the owner of the entity's assets and liabilities for all U.S. tax purposes. Reg. §301.7701-3(g)(1)(iii); *Dover Corp. & Subsidiaries*, 122 TC 324, Dec. 55,630 (2004).

[192] The relevant country for purposes of applying Code Sec. 954(e) to a CFC's distributive share of services income derived by a partnership in which it is a partner is the CFC's country of organization (not the partnership's country of organization). Reg. §1.954-1(g).

[193] Code Sec. 954(c)(1)(A).

[194] Code Sec. 954(c)(6) was enacted as a temporary exception, although Congress has extended Code Sec. 954(c)(6) every year through 2025, as part of the "tax extenders" package that the Congress generally has taken up every year or two.

[195] *See* Yoder, *Code Sec. 954(c)(6) and The Same Country Rules for Sales and Services Income*, 6 J. Tax'n Global Trans. 3 (Fall 2006).

[196] T.D. 6734, 1964-1 CB (Part 1) 237.

[197] Reg. §1.954-4(c).

[198] Under the source rules, in determining whether services are performed within the United States, the residence of the taxpayer, the place where the contract for services was made and the place or time of payments are not relevant factors in determining the source of services income. Reg. §1.861-4(a)(1). *See also Piedras Negras Broadcasting Co.*, 43 BTA 297, Dec. 11,616 (1941), *aff'd*, CA-5, 42-1 USTC ¶9384, 127 F2d 260 (1942), *nonacq.*, 1941-1 CB 18 (radio station broadcasting from Mexico, but almost exclusively targeting U.S. consumers and advertisers, derived foreign-source advertising income).

[199] *See* ALI, at 271 n. 53.

[200] *See* n. 191, *supra*.

[201] This feature of the modern services economy has been explicitly described by policy makers as a tax policy challenge. *See, e.g.*, OECD BEPS Project (Action Item 1 materials); Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14), Dec. 2014, at 29–36.

[202] Reg. §1.954-4(c).

[203] *Id. See* Reg. §1.861-4(b) for similar rules for determining the source of services income on the basis of services performed within or outside the United States.

[204] Allocations based on alternative methods (*i.e.*, besides employee time spent) may also be appropriate. The regulations appear to contemplate that the method provided in the regulations might not be appropriate in all cases, by stating that such a method applies in "many cases." Further support for interpreting the regulations as not mandating the particular allocation method in all cases is that the allocation method is provided as part of the "general rule." In addition, the overarching rule in the regulations stating that the allocation determination will depend on the facts and circumstances of each case suggests that it may be possible for a taxpayer to allocate income to services performed inside versus outside its country of organization under an alternative method not described in the regulations. Making a determination based on the particular facts and circumstances using an approach that may not conform to additional specific methods provided is supported by a change to the regulatory language of the Subpart F active trade or business exception for rents and royalties. Former Temp. Reg. §4.954-2(b)(5) had provided a general facts and circumstances test for determining whether rents or royalties were derived in the active conduct of a trade or business, and also contained specific tests. To clarify that the specific tests must be satisfied, the final regulations removed the following phrase from the temporary regulations: "Whether or not rents or royalties are derived in the active conduct of a trade or business is to be determined from all facts and circumstances of each case ...." Reg. §1.954-2(b)(6). The preamble states that: "The final regulations are clarified to reflect that whether rents or royalties are derived in the active conduct of a trade or business is determined solely under the [specific rules in the] provisions of paragraphs (c) and (d)." T.D. 8618, 1995-40 IRB 4, 9 (Oct. 2, 1995).

[205] Several commentators have suggested that there may be a question concerning whether the location of the performance of services by other parties assisting the CFC in performing the services for the customer should be taken into account in determining where the services are performed that give rise to the CFC's income. They observe that the regulations are not entirely clear on this issue. They conclude, however, that the better reading is that the regulations provide for the determination of the location of services based on the location of the CFC's own employees. Sotos, Stenger & Stevenson, *Following Through on Notice 2007-13: Suggestions for Updating the Services Regulations*, 37 Int'l Tax J. 35 (Nov.–Dec. 2011), at pp. 39–40; Bates, Bowers & Cowan, *Tax Planning for Providers of Cross-Border Services*, Tax Notes, Mar. 21, 2005, 1411, at pp. 1417, 1426–27; Maguire & Anolik, *Subpart F and Source of Income Issues in E-Commerce*, Tax Notes, Dec. 25, 2000, at p. 1772. As discussed in section VII.C.3 below, older commentary perhaps implicitly read the rule as only applying to a CFC's employee activities, without any explicit discussion of the issue.

[206] The regulations contain language that distinguishes "services called for by the contract" and "significant services related to such services." *See* Reg. §1.954-4(b)(2) & (3), *Ex.* 6 & *Ex.* 7 (related services included preparing plans and specifications which enabled the submission of bids for the construction of a highway). In addition, for purposes of determining whether a CFC receives substantial assistance from a related person in the form of direction, supervision, services and know-how, the regulations state that such assistance furnished to a CFC is not taken into account unless the assistance so furnished assisted the CFC *directly* in the performance of its services. Reg. §1.954-4(b)(2)(ii)(e). Thus, clerical and accounting services were not taken into account for purposes of this test. Reg. §1.954-4(b)(3), *Ex.* 3.

[207] In analyzing the source of a radio station's advertising income in the *Piedras Negras* case, the Board of Tax Appeals (predecessor to the Tax Court) disregarded U.S. clerical activities such as sorting of mail and dividing up proceeds between the advertisers and the taxpayer. It appears that while such activities were necessary to produce the advertising income, they were still merely ancillary to the service provided to the customers—broadcasting of radio advertising to listeners, and delivering broadcasting content that appeals to potential consumers of the advertisers' products. *Piedras Negras, supra* n. 191.

[208] A potentially broader set of activities may be considered under the "substantial assistance" rules (addressed in section VI.E of this article), but even there the rules specifically narrow this potential scope to focus on significant value drivers in the delivery of the services to the customers. *See* Reg. §1.954-4(b)(1)(iv) and -4(b)(2)(ii), which preliminarily consider activities "contributing to the performance of [the] services," but then carve back human activities that do not assist "directly" in the CFC's performance of the services or do not either provide the CFC with skills constituting a "principal element" in the CFC's performance of the services or constitute at least 50% of the CFC's total costs of performing the services. And the provision of financial or material support (equipment, supplies, *etc.*) is taken into account under the regulations only if the CFC does not pay an arm's length charge for such items. In light of this relatively targeted concept of assistance contributing to the performance of services, it would be surprising to interpret the definition of the services themselves as embracing relatively minor value drivers that are already compensated in a manner that comports with the arm's length standard.

[209] Reg. §1.954-4(c) (emphasis supplied).

[210] Code Sec. 7701(a)(30) defining "persons" as including corporations and partnerships.

[211] *Id.* (emphasis added). It is not necessary to determine income allocated to services performed within a CFC's country, because only income from the performance of services outside the CFC's country can be foreign base company services income, and all other income of the CFC would not be foreign base company services income.

[212] *See* Rev. Rul. 72-357, 1972-2 CB 456, *obsoleted on other grounds* by Rev. Rul. 2003-99, 2003-2 CB 388 (references "employees" and "persons" interchangeably in applying Reg. §1.954-4(c), and seems to take the reference to "employees" in the regulations as a reference to the CFC's own employees); LTR 8025130 (Mar. 27, 1980) (similar language); LTR 8012055 (Dec. 27, 1979) (similar language).

[213] Notice 2007-13, 2007-1 CB 410, which updated the substantial assistance rules, nowhere suggests that the location of the employees of other entities providing the assistance is relevant in determining the location where the services are performed that give rise to a CFC's income. The IRS may have suggested in informal guidance that determining the location of factoring services might take into account activities of other related entities that provide substantial assistance, but there is no clear statement of such an interpretation and no analysis of the regulations. *See* GCM 39220 (May 31, 1983) *revoked* by GCM 39652 (Jul. 22, 1987) and FSA 199917010 (Apr. 30, 1999). The law was changed to address the factoring structure analyzed in the

GCM and FSA, and the Joint Committee explanation of the change appears to assume that the factoring "services" income may not have been foreign base company services income because it was derived from performing services in the CFC's country. *See* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Cong.; P.L. 98-369)*, JCS-41-84 (Dec. 31, 1984), at 365–66.

[214] Professor Laity mentions in his lengthy article on foreign base company services income that a CFC principal might earn a general contractor's return on activities performed by other entities in another country, although he does not suggest that current law would therefore treat a portion of the CFC's income as earned in such other country. In response, it may be observed that any general contractor's return might be better attributed to the CFC's own employees obtaining the contract and overseeing the subcontracted services, and thus the location of the CFC's employees might be a better reference concerning where services giving rise to a general contractor's return are performed. Indeed, even Laity apparently might not object to this result in a situation in which the CFC's employees really do carry out the normal activities of a general contractor—his description of the structures he considered objectionable assumed that the CFC was not in fact capable of carrying out those activities. *See* Laity, at 41-42; *see also* ALI Report, *infra*, at 272.

[215] *See* Sprague & Reid, *supra* (expressing the view that the similar sourcing rules should apply based on the corporation's own personnel and not take into account activities of personnel of other entities); *A.J. Miller*, 73 TCM 2319, Dec. 51,942(M), TC Memo. 1997-134 (1997) (Hong Kong entity's services income not sourced to the U.S. based on services provided by U.S. affiliate); but s*ee Le Beau Tours Inter-America, Inc.*, CA-2, 76-2 USTC ¶9792, 547 F2d 9 (1976), *aff'g per curiam*, DC-NY, 76-1 USTC ¶9302, 415 FSupp 48, *cert. denied*, 97 SCt 1696, 431 US 904 (1977) (attributing to foreign corporation certain activities of U.S. parent corporation performed in support of foreign corporation's business, including bookkeeping, administrative, and promotional services). The source rule cases are not directly relevant authority on Subpart F locational determinations, but a court may consider them analogous authority. In any event, these cases point in different directions and leave both taxpayers and the IRS some room to develop a case based on the particular facts and circumstances, distinguishing whichever case may be problematic to the position.

[216] ALI Report, at 276. Professor Laity also interprets the location apportionment rule as determined based on the activities of the employees of a CFC, and not taking into account activities of employees of entities assisting the CFC. He states: "The country-of-incorporation exclusion exempts all income that the substantial assistance rule targets." Laity, at 42.

[217] This approach is consistent with the updated regulations addressing the manufacturing exception to foreign base company sales income. Reg. §1.954-3(a)(4) (updated foreign base company sales income rules make clear that only activities of the employees of the CFC are taken into account in applying the manufacturing exception and determining the location of manufacturing). *See also* Reg. §1.863-3(c) (for purposes of determining whether the manufacturing sourcing rules apply, only production activity conducted directly by the taxpayer is taken into account).

[218] The *Piedras Negras* case, discussed *supra*, did note the location of equipment in explaining its source determination, but that factor presumably was not dispositive in view of the fact that it also aligned with the location of the employees who performed the services (in part through the use of the equipment). And as noted above, sourcing case law is not directly relevant for purposes of subpart F, although it may be seen as helpful analogous authority.

[219] This has been noted in the U.S. trade or business, permanent establishment, and profit attribution contexts. *See, e.g.*, U.S. Dep't of the Treasury, "Selected Tax Policy Implications of Global Electronic Commerce," at 25 (1996) ("Computer servers can be located anywhere in the world and their users are indifferent to their location. It is possible that such a server, or similar equipment, is not a sufficiently significant element in the creation of certain types of income to be taken into account for purposes of determining whether a U.S. trade or business exists. It is also possible that if the existence of a U.S.-based server is taken into account for this purpose, foreign persons will simply utilize servers located outside the United States since the server's location is irrelevant."); OECD, *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions* (Feb. 2001) (treating server functions as routine and therefore not attributing substantial profit to server location as such, for example where a taxpayer owns or leases servers in a particular country); OECD Model Income Tax Convention Commentary, Art. 5. ¶ 42.10 (finding that, where a foreign enterprise does not own or lease servers in a particular country, no dependent agent permanent establishment should arise simply by reason of contracting with and delivering services to customers through the use of servers through web hosting services arrangements). A different analysis of course would apply if the CFC's business were actually the provision of server services to its customers, as opposed to the provision of other services relying in part on servers as a sort of utility.

[220] Reg. §1.954-1(e)(4).

[221] As discussed above, where a single transaction gives rise to portions of income in more than one category of Subpart F income, generally each such portion must be separately analyzed under the appropriate category under Code Sec. 954. Reg. §1.954-1(e)(2).

[222] *See* Code Secs. 954(g) and 907(c)(2) together treating certain services income as foreign oil-related income and potentially as foreign base company oil-related income.

[223] *See* Code Sec. 954(b)(6).

[224] Code Sec. 954(e) (last sentence).

[225] Reg. §1.954-1(e)(2) and (3).

[226] Reg. §1.954-1(e)(3); Rev. Rul. 86-155, 1986-2 CB 134.

[227] Code Sec. 954(e).

[228] Code Sec. 954(d)(1). There are other differences between the definitions of foreign base company sales income and foreign base company services income which make the classification of commissions or fees as sales or services income consequential. For example, assistance received by a CFC from a related person is irrelevant for purposes of applying the foreign base company sales income rules, but may result in treating a CFC as providing services on behalf of a related person for purposes of the foreign base company services income rules. Also, the foreign base company sales income rules contain a foreign branch rule that can cause a portion of sales income to be Subpart F income, but there is no branch rule for purposes of determining whether services income is foreign base company services income. Finally, income that is classified as sales income can qualify for a manufacturing exception even if the CFC is transacting with related persons, whereas no similar exception is available for services income.

[229] *See British Timken Ltd.*, 12 TC 880, Dec. 16,992 (1949), *acq.* 1949-2 CB 1 (sales commissions received pursuant to consignment arrangement treated as services); Rev. Rul. 60-55, 1960-1 CB 270 (commissions paid to a foreign corporation for securing purchase orders from foreign customers treated as compensation for services); *M. Sinclair*, 19 TCM 602, Dec. 24,207(M), TC Memo. 1960-113 ((1960) (compensation paid for a "finder's fee" for services in locating a business opportunity treated as income from the provision of services); CCA 201343020 (Nov. 1, 2013) (income derived from services involving a marketing structure was services income, where the activities performed "involve finding, sponsoring, and ultimately uniting buyers and sellers"); *Hawaiian Philippine Co.*, CA-9, 39-1 USTC ¶9263, 100 F2d 988, 991 (1939) (income from processing sugar received from farmers treated as services income); Rev. Rul. 74-331, 1974-2 CB 282 (*Ex.* 3) (similar conclusion).

[230] S. Rep. No. 1881, 87th Cong. 2d Sess. 84 (1962) at 790.

[231] *Id.* (emphasis added).

[232] *Id.* (emphasis added).

[233] Reg. §1.954-3(a).

[234] For a discussion of treatment of certain fees and commissions as sales income, *see* Klein, Perez, Iribarren & Beeman, *International Tax: A Quest to Resolve Overlap Between Foreign Base Company Sales and Foreign Base Company Services*, ABA SECTION TAX'N NEWS QUARTERLY, Vol. 32, No. 3 (Spring 2013).

[235] Reg. §1.954-3(a)(1)(iii), *Ex.* 3. *See also* LTR 7947050 (Aug. 23, 1979) (commissions received by a CFC

for selling products on behalf of a related person analyzed as sales income).

[236] LTR 201325005 (May. 28, 2013). *See* Yoder, *Subpart F Manufacturing Exception Applies to Sales Commissions*, 42 Tax Mgmt. Int'l J. 633 (10/11/13).

[237] The ruling treats all of the payments received by the branch from the related CFC for manufacturing and selling activities as income to be analyzed under Code Sec. 954(d), and no portion of the payments received by the branch is analyzed as services income subject to Code Sec. 954(e). *Cf.* Regs. §1.954-1(e)(2) & (3) (rules addressing separable character of income generated from a single transaction and rules for determining the predominant character of income from a transaction where the income is not separately determinable).

[238] TAM 8536007 (May 31, 1985).

[239] *See also Brown Group, Inc.*, 104 TC 105, Dec. 50,436 (1995), *vac'd and rem'd*, CA-8, 96-1 USTC ¶50,055, 77 F3d 217 (1996) (the courts analyzed commission income derived by a partnership from purchasing products on behalf of a related person as sales income for purposes of the foreign base company income rules).

[240] The ruling states in support of its position that (1) no services were provided by CFC to third persons, and (2) its function was to directly assist its parent and not any third person. It is not entirely clear why these circumstances affect the determination of whether the CFC's income is treated as sales income (not services income), since the Code and regulations expressly provide that commissions derived from purchasing products on behalf of a related person are treated as sales income. For a discussion of the TAM, *see* Gordon & Newman, *LTR 8536007 (May 31, 1985)—Sales or Services Income?*, 15 Tax Mgmt. Int'l J. 21 (Jan. 10, 1986).

[241] LTR 201332007 (Apr. 15, 2013). *See* Yoder, *Subpart F Manufacturing Exception Applies to Procurement Commissions*, 42 Tax Mgmt. Int'l J. 762 (Dec. 13, 2013).

[242] The ruling treats all of the payments received by the CFC for procurement activities as income to be analyzed under Code Sec. 954(d), and no portion of the payments received by the CFC is analyzed as services income subject to Code Sec. 954(e).

[243] Reg. §1.954-4(b)(1)(ii).

[244] Reg. §1.954-4(d).

[245] *See also* Reg. §1.954-3(a)(4)(iv)(b) (listing "substantial contribution" activities that are taken into account under the manufacturing exception to foreign base company sales income, including demand forecasting, quality control, product scheduling, vendor selection, and various manufacturing-related activities). It would seem that these activities should not be considered as purchasing or selling activities, because they are treated as manufacturing activities.

[246] Reg. §1.954-4(b)(3), *Exs.* 1, 8 and 10.

[247] Reg. §1.954-4(b)(3), *Ex.* 9.

[248] TAM 8509004 (Nov. 23, 1984) ("The actual sales activities with respect to a product and parts is undertaken either by locally established sales subsidiaries of Parent which, pursuant to agency agreements, act as commission agents for the CFC, or by a network of approximately 60 independent sales agents, which also act as Commission agents for the CFC, pursuant to agency agreements.").

[249] This is an area that would benefit greatly from further guidance. In the preamble to the final foreign base company sales income regulations issued in 2011, the IRS indicated that it was considering whether to issue guidance on "the scope of, and relationship between, [foreign base company sales income] and foreign base company services income." *See* T.D. 9563, IRB 2012-6, 354 (Dec. 19, 2011). The 2015-16 Priority Guidance Plan includes an item for "[g]uidance under 954, including regarding foreign base company sales and services income." *See* Department of the Treasury and Internal Revenue Service, 2015-2016 Priority Guidance Plan (Jul. 31, 2015).

[250] Reg. §1.954-3(a)(4)(iv)(b).

[251] The sales process consisted of several steps. First, customers (whether related or unrelated) would contact CFC1 to purchase goods, and CFC1 would then negotiate the terms of the sale with the customer. Second, CFC1 would then communicate the terms of the sale to CFC2. Third, CFC2 would then negotiate the price for the goods with the direct supplier, arrange for the goods to be delivered to the customer, and invoice the customer. Fourth, after CFC2 would receive payment from the customer, it would record the sales revenue. Finally, CFC2 would then pay CFC1 an intercompany referral fee based on the sale's gross margin (equal to 50 percent of the gross sales margin for related-party sales). The taxpayer took the position that CFC1 continued to perform services for the customer following the sale and receiving the intercompany referral fee.

[252] The pre-sale services included performing the sales function (*i.e.*, the functions performed by a typical, unrelated sales broker) including the solicitation of a sale. The post-sale services included: (1) responding to shortages, issues with quality and damages resulting from delays in delivery; (2) handling billing disputes and negotiating claim settlement with customers; (3) managing credit risk exposure by tracking [a] customer's overall purchase volume, pattern, and collecting formal and informal information about a customer's credit risk; (4) tracking outstanding invoices and taking necessary actions to collect payment on behalf of the affiliate; and (5) keeping the customer up to date on current price trends, market dynamics and other factors impacting supply and prices. It is not clear that the taxpayer actually needed to concede that all of the pre-sale services should be treated as sales-type income.

[253] *See* Reg. §1.954-4(b)(3), *Exs.* 1, 8 and 10.

[254] Regarding point (3), the FAA states as follows: "However, unlike in the examples, scenarios which clearly delineate between the sale and service function, in the instant case there is no such demarcation. In each example, the amount of the fee for services is separately stated from the sales price, thereby providing an objective and easily quantifiable basis for determining the amount of foreign base company sales income from services income. In the instant case, even if the post-sales functions were contracted for – which there is no indication that they were – the amount of the fee is not separately stated or contingent on the successful completion of the separate function."

[255] Reg. §1.954-1(e)(1).

[256] Reg. §1.954-1(e)(2) and (3).

[257] *See* LTR 201332007 (Apr. 15, 2013) (including a taxpayer representation that it will follow sales characterization for all services performed in connection with property purchased or sold on behalf of a related person); LTR 201325005 (May. 28, 2013) (same). It should not be inferred from these PLRs (or from anything in the Code and regulations) that relatedness has any bearing on these characterization determinations. If a taxpayer performs the same activities as did the taxpayers in these PLRs, except on behalf of unrelated persons, the IRS should not be able to argue that sales-connected services can only be characterized as sales-type income for Subpart F purposes where such characterization helps the IRS (by producing foreign base company sales income) as opposed to the taxpayer (by producing sales-type income that is not foreign base company sales income due to the absence of the necessary related-party transaction). Thus, the IRS should not be able to force a taxpayer under these circumstances into foreign base company services income analysis, with the possibility of deemed-related treatment under the substantial assistance rule.

[258] 1986-2 CB 134.

[259] *See* LTR 8536007 (May 31, 1985) (assumes that CFC's commission income is analyzed either as sales or services income); LTR 7947050 (Aug. 23, 1979) (sales commissions qualifying for exception to foreign base company sales income category not analyzed under the foreign base company services income category); LTR 201332007 (Apr. 15, 2013) (commissions received for performing procurement activities were tested under the foreign base company sales income rules and qualified for the manufacturing exception, and were not analyzed under the foreign base company services income rules); LTR 201325005 (May. 28, 2013) (fees received for performing manufacturing, marketing and selling activities were tested under the foreign base company sales income rules and qualified for the manufacturing exception, and were not tested under the foreign base company services income rules).

[260] There are two general exceptions to income being treated as foreign base company income that also apply to exclude foreign base company services income: (1) the *de minimis* exception (Code Sec. 954(b)(3)(A)); and (2) the high-tax exception (Code Sec. 954(b)(4)). In addition, the earnings and profits limitations may reduce the amount of foreign base company services income currently included in the income of U.S.

shareholders (such reduction may be subject to recapture in a subsequent year). Code Sec. 952(c). But *see* Code Sec. 954(b)(3)(B) (income that falls outside the definition of foreign base company services income may be foreign base company income under the 70-percent full inclusion rule).

[261] An exception also is provided for income that falls within the definition of foreign base company oil related income. Code Sec. 954(b)(6).

[262] Code Sec. 954(e)(2)(A); Reg. §1.954-4(d)(1).

[263] Code Sec. 954(e)(2)(B); Reg. §1.954-4(d)(2).

[264] Code Sec. 954(e) (last sentence).

[265] The exception is temporary, most recently renewed for taxable years beginning before Jan. 1, 2026. Code Sec. 954(c)(6)(C).

[266] Code Sec. 954(e).

[267] *Id*.

[268] Note that the objective of such structures is not to reduce U.S. taxes, but foreign taxes.

[269] *See* Treasury Subpart F Study, at pp. 80–81 (illustrates remote provision of processing customer orders and product delivery services through the use of computer software, and indicates that such services income falls outside the definition of foreign base company services income because the services are performed in the CFC's country of organization). *See also* Yoder, *Planning Techniques Described in the Treasury's Subpart F Study*, 30 Tax Mgmt. Int'l J. 221 (May 11, 2001). If the Singapore entity is considered as performing services for related persons, it is important that it not be disregarded into a non-Singapore holding company, because in such case, its income would be foreign base company services income.

[270] Reg. §301.7701-2(a), -2(c)(2)(i).

[271] Unlike the foreign base company sales income rules, the foreign base company services income rules do not contain a foreign branch rule. *See* Code Sec. 954(d)(2) (branch rule applicable to sales income).

[272] The regulations also treat a CFC as performing services on behalf of a related person where the related person enters a services contract with a customer and assigns it to the CFC. Reg. §1.954-4(b)(1)(i).

[273] *See* discussion above at sec. VI.E.

[274] As discussed above, if such costs are counted, issues arise concerning whether lump sum payments are taken into account in the year paid or over a period of years, and how such costs are allocated among various services arrangements. There is support in the regulations for not counting cost sharing payments. *See* Reg. §1.482-7(j)(3) (cost-sharing payments "generally will be considered the payor's costs of developing intangibles ….").

[275] Reg. §1.954-4(b)(2)(i).

[276] A CFC also will be considered as performing services on behalf a related person if the CFC performs the services for an unrelated person with respect to property sold by a related person and the performance of such services constitutes a condition or material term of the sale (*e.g.*, maintenance or warranty services). Reg. §1.954-4(b)(1)(iii).

[277] The deemed related person rules in the regulations would need to be considered.

[278] Code Sec. 954(c); Reg. §1.954-2(d).

[279] The intangibles holding company may own or have access to the intangible property through a license arrangement, purchase of intangible property, R&D services arrangement, or cost sharing arrangement (or some combination).

[280] Some of these structures (*e.g.*, "Double Irish / Dutch Sandwich" structures) have been the subject of considerable public attention in recent years. For an example of such a structure, suppose CFC1 is an Irish non-resident company, organized under Irish law but not taxable on a residence basis anywhere (Ireland has since amended its laws to prevent this result). CFC1 owns DE1, a Dutch BV disregarded as a separate entity for U.S. tax purposes. CFC1 and DE1 have no employees. DE1 owns DE2, an Irish operating company disregarded for U.S. tax purposes, but taxed on a residence basis by Ireland. DE2 earns revenue from providing services to unrelated customers and/or affiliates around the world. CFC1 owns the key intangible property rights (either outright or as a result of a cost-sharing arrangement), which it licenses to DE1, which in turn licenses the intangible property to DE2 for DE2 to exploit in the performance of its services. DE2 thus pays a royalty to DE1, which in turn pays a royalty to CFC1, with the effect that substantial premium profits come to rest at CFC1. DE2 deducts the royalties paid to DE1, thus substantially reducing its taxable income in Ireland. The use of DE1, the Dutch BV, prevents the Irish withholding tax that otherwise would apply to a royalty from an Irish company to a Bermuda company. Dutch tax is paid on DE1's small spread between royalties received and royalties paid. CFC1, where most of the income comes to rest, is not taxed anywhere. No current U.S. tax is created under the Subpart F foreign personal holding company income rules, because the royalties are disregarded for Subpart F purposes. No Subpart F foreign base company services income arises, either because DE2 performs its services for unrelated parties, or, where related parties are involved, DE2 performs its services in Ireland, CFC1's country of organization.

[281] Code Sec. 954(c)(6) (temporary, most recently extended through taxable years beginning before Jan. 1, 2026, and widely expected to be extended further).

[282] Similarly, the cost sharing regulations historically have not required that a participant to the cost sharing arrangement actively engage through its own employees in developing or exploiting the intangibles created (although under the most recent version of the regulations it may be difficult for a participant without an active trade or business to earn a premium return).

[283] *See* Notice 2007-9, 2007-1 CB 401. *See also* Yoder, *New CFC Look-Through Exception*, 25 Tax Mgmt. Int'l J. 451 (Aug. 11, 2009); Yoder, *Practical Application of the CFC Look-Thru Rule Under Notice 2007-9*, 36 Tax Mgmt. Int'l J. 288 (Jun. 8, 2007).

[284] The payment of the royalty by the Dutch BV to the Dutch CV generally would not be subject to Dutch withholding taxes.

[285] In 1999 the IRS and Treasury issued proposed regulations that would have applied the foreign personal holding company income rules to the disregarded royalty payment under certain circumstances. Proposed Reg. §1.954-9; *see* Preamble to Prop. Reg., 64 FR 37727 (Jul. 13, 1999). These regulations have never been finalized. *See* Notice 98-35, 1998-1 CB 34; Yoder, *Notice 98-35: Subpart F Hybrid Entity Regulations in Suspense*, 27 Tax Mgmt. Int'l J. 427 (Sep. 1, 1998).

[286] *See* Yoder, *Code Sec. 954(c)(6) and The Same Country Rules for Sales and Services Income*, 6 J. Tax'n Global Trans. 3 (Fall 2006).

[287] A disadvantage of relying on the look-through exception provided by Code Sec. 954(c)(6) is that it is temporary, and while it has been consistently extended since initially enacted in 2006, on a number of occasions the extension was enacted retroactively. In addition, it is not a certainty that the exception will continue to be extended indefinitely (although the exception enjoys widespread bipartisan support, as reflected not only in the tax extenders legislation but also in most tax reform proposals and in the Obama Administration's budget proposals).

[288] Reg. §1.954-4(b)(2)(ii)(a).

[289] *Id*.

[290] Reg. §1.954-4(b)(2)(ii)(e).

[291] Reg. §1.954-4(b)(2)(ii)(c).

[292] Technical Memorandum accompanying T.D. 6981, 1968-2 CB 314, 1968 TM Lexis 11.

[293] As mentioned above, there is no support in the language of the Code or legislative history for treating a CFC that receives services from a related person as performing services for or on behalf of a related person.

[294] The IRS and Treasury in Notice 2007-13, 2007-1 CB 410 recognized that reasons similar to the reasons for updating the substantial assistance rule may indicate the guarantee rule similarly should be updated, requesting comments on the issue.

[295] Reg. §1.954-4(b)(1)(iii).

[296] This is already a reasonable interpretation of the current regulations but could be stated more clearly.

[297] This approach is also consistent with other IRS Subpart F guidance focusing exclusively on CFC employee activities in determining whether a CFC is treated as engaging in a particular activity. *See* Reg. §1.954-3(a)(4)(i) (updated foreign base company sales income rules, making clear that only activities of the employees of the CFC are taken into account in applying the manufacturing exception); *see also* T.D. 9733 (Sep. 2, 2015) (adopting a similar approach under the active rents and royalties exception to the foreign personal holding company income rules, under new Reg. §1.954-2T(c)(1)(i) and (d)(1)(i)).

[298] This issue has been discussed in detail in the tax treaty and U.S. trade or business contexts. *See* OECD, *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions* (Feb. 2001) (not attributing

substantial profit to server location, on the basis that the functions are routine); U.S. Dep't of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce*, at 25 (1996) (noting the possibility that "if the existence of a U.S.-based server is taken into account [in U.S. trade or business determinations], foreign persons will simply utilize servers located outside the United States since the server's location is irrelevant."). *See also* Monica Gianni, *The OECD's Flawed and Dated Approach to Computer Servers Creating Permanent Establishments*, 17 VAND. J. ENT. & TECH. L. 1 (2014), available at *scholarship.law.ufl.edu/facultypub/608* (arguing that the OECD's existing approach to servers, under which servers in some circumstances may give rise to a permanent establishment, weighs servers too heavily, in part due to the routine nature of server activity and the potential manipulability of server location to achieve tax planning objectives, and cataloguing substantial body of prior commentary to the same effect).

[299] This kind of distinction also has been made in the controlled services regulations. *See* Reg. §1.482-9(b)(8) (making clear through several examples that various support services generally may be eligible for cost-only pricing under the services cost method, but that this would not be the case for a taxpayer actually engaged and specializing in the business of providing these services to others).

[300] *See, e.g.*, Laity, *The United States' Response to Tax Havens: The Foreign Base Company Services Income of Controlled Foreign Corporations*, 18 NW. J. INT'L L. & BUS. 1 (1997–98); Report of the Task Force on International Tax Reform, 59 Tax Lawyer 649 (2006) (an ABA report whose principal draftsman was Stephen E. Shay). For another perspective, *see* Dilworth, *Tax Reform: International Tax Issues and Some Proposals*, 35 INT'L TAX J. 5 (2009).

[301] Code Sec. 954(c)(6).

[302] *Cf.* Code Sec. 954(d)(2) (foreign base company sales income branch rule).

[303] *See* New York State Bar Association Letter to Treasury regarding Notice 98-11, *reprinted in* Tax Notes Today, Apr. 20, 1998 ("Subpart F was a compromise between an Administration that sought to end all deferral of income earned by foreign subsidiaries and a Congress that was only willing to end deferral with respect to certain types of income. The lines drawn in subpart F represent a series of legislative judgments intended to balance the competing policies of permitting US multinationals to compete effectively with their foreign counterparts while preventing US multinationals operating in foreign jurisdictions from having an unfair competitive advantage over their US counterparts. In any particular case not explicitly covered by the statute, therefore, it may be difficult to discern which policy should control the tax result.").

[304] *Estate of Whitlock*, 59 TC 490, Dec. 31,797 (1972). *See also Dougherty*, 60 TC 917, 927, Dec. 32,138 (1973) (noting the "multiplicity of legislative purposes which underlay the enactment of Subpart F," and finding that "the search for a unified legislative purpose in Subpart F proves to be elusive").

[305] *W.R. Lovett*, 80-1 USTC ¶9432, 621 F2d 1130 (1980) (quoting *V. Calamano*, SCt, 57-2 USTC ¶9750, 354 US 351, 357, 77 SCt 1138 (1957)).

[306] The IRS recently prevailed in the *Whirlpool* case, which addressed the application of the branch rules under Code Sec. 954(d)(2). *Whirlpool Financial Corp. & Consolidated Subs.*, 154 TC 142, Dec. 61,661, 154 TC No. 9 (May 5, 2020). The Tax Court's *Whirlpool* decision was recently upheld by the Sixth Circuit. *Whirlpool Financial Corp.*, CA-6, 2022-1 USTC ¶50,101, 128 AFTR 2021-6822 (2021). ***[NTD: Consider updating if rehearing granted/denied prior to publication.]***

[307] 95 TC 348, Dec. 46,899 (1990).

[308] *Id.*, at 350.

[309] 95 TC 579, Dec. 47,001 (1990).

[310] *Id.* at 592.

[311] *Id.* at 594.

[312] The IRS has expressly stated that it will follow *Ashland* and *Vetco*. Rul. 97-48, 1997-2 CB 89. *See also* Preamble to 2008 Proposed Regulations, 73 FR 10,716, 10,718 (noting that Rev. Rul. 97-48 states that the IRS will follow *Ashland Oil* and *Vetco* and "therefore confirms that the IRS will not treat a separate contract manufacturer as a branch for purposes of Code Sec. 954(d)(2)."). Though the Obama administration included a proposal in its 2014 budget submissions that would have effectively reversed the *Vetco* decision, that proposal was not enacted. *See* Yoder, *President's Budget Would Apply Subpart F to Toll Manufacturing Arrangements*, 43 TAX MGMT. INT'L J. 496 (Aug. 8, 2014).

[313] CA-8, 96-1 USTC ¶50,055, 77 F3d 217 (1996), *rev'g* 104 TC 105, 111, Dec. 50,436 (1995).

[314] Congress amended Code Secs. 954(d)(3)(A) and (B) in 1986 to apply to taxable years beginning after Dec. 31, 1986. Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2085, §1221(e)(1). The current version of these sections does apply to partnerships.

[315] Code Sec. 954(d)(1).

[316] 77 F3d at 222. The IRS and Treasury later amended the Code Sec. 954 regulations to provide that Subpart F income includes a CFC's distributive share of any item of gross income of a partnership to the extent such income would have been Subpart F income if received directly by the CFC partner. T.D. 9008, 67 FR 48020 (Jul. 23, 2002).

[317] CA-9, 82-2 USTC ¶9552, 685 F2d 1099 (1982).

[318] *See* [n. 304] above (Congress subsequently amended the Code to treat certain partnerships as related persons for purposes of the foreign base company income rules).

[319] 122 TC 324, Dec. 55,630 (2004).

[320] *Dover Corp.*, 122 TC at 352.

[321] Notice 2003-46, 2003-28 IRB (Jul 14, 2003). *See* Yoder, *Pre-Sale Branch Election for CFC Target: Dover, 122 TC 324, Dec. 55,630. Says No Subpart F Income*, 33 TAX MGMT. INT'L J. 474 (Aug. 13, 2004).

[322] Code Sec. 250(a)(1)(A).

[323] For a discussion of essentially the same observation in the context of the Camp Proposal, *see* Noren, *Testimony Before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives* (Nov, 17, 2011), available at *waysandmeans.house.gov* ("If the existing subpart F rules are indeed thought to be inadequate in controlling income shifting, and a new approach can be found that more appropriately balances the various competing policy considerations, then perhaps that new approach should replace the existing subpart F categories rather than sitting alongside them."). *See also* Noren, *The Ways and Means Committee International Tax Reform Discussion Draft: Key Design Issues*, 41 TAX MGMT. INT'L J. 167, 175 (Apr. 13, 2012).

[324] Although the proposal does so imprecisely, as the country tax base being eroded is not necessarily the country where the relevant related party for Code Sec. 954(e) (or (d)) purposes is located. *See* David G. Noren, *What Role for Subpart F in a GILTI 2.0 World?*, 50 TAX MGMT. INT'L J. 11 (Nov. 5, 2021).