Subpart F Services Income:
Presentation Abstract

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- **Business Paradigm**—U.S. corporation engaged in a global services business, with foreign subsidiaries performing services outside the U.S. for unrelated foreign customers. The foreign subsidiaries have hundreds of employees, including high level management and personnel with specialized skills.

- **Taxation of Foreign Services Income**
  - Services income earned by foreign subsidiaries (CFCs) of U.S. companies from operations outside the U.S. is not subject to U.S. taxation; rather, the income is within the taxing jurisdiction of foreign countries. Earnings resulting from such income are taxed in the U.S. when repatriated (with a credit for foreign taxes).
  - Subpart F provides that earnings arising from certain services income derived by a CFC are deemed repatriated currently. This accelerated taxation applies to income from services performed outside the CFC’s country of organization for or on behalf of related persons.

- **Proposition**—The Subpart F services rules—which have remained essentially unchanged since the 1960s—are ill-fitting and disruptive for modern services businesses, and should be repealed (Congress should consider the proper approach to services structures subject to low foreign taxes as part of overall international tax reform). While awaiting tax reform, the Treasury and IRS should curtail overbroad rules in the regulations that deem related person services transactions, and clarify regulatory rules for determining the location of services.

- **Discussion**
  - In 1962 Congress designed the Subpart F services rules to target services supporting sales of industrial machines by related persons (installation & maintenance services).
    - The operational structure excluded from Subpart F was a CFC performing services in its country of organization generally for local customers.
    - Today’s services economy is much larger and more multifaceted than the services economy of 50 years ago (e.g., consulting, e-commerce, financial,
Customers are serviced by multiple entities from different geographic locations, with skilled employees traveling to different countries, which inevitably results in Subpart F income, even with substantial operational substance and a structure driven by business needs.

- Any international tax reform legislation providing new rules for taxing earnings of CFCs should repeal the Subpart F services rule, and ensure that the realities of the modern services economy are considered in the design of the new rules.

- The burdens imposed on modern services businesses by out-of-date law can be reduced by organizing a foreign holding company that owns operating foreign branches or disregarded entities, generally eliminating related-person transactions in providing services to unrelated foreign customers (except where a CFC is a subcontractor for a related U.S. or regarded foreign entity).

- No rule deems services performed in a foreign branch of a CFC as performed for related persons (unlike the Subpart F sales rules).

- But, regulations contain broad, non-branch-dependent rules that can deem services as being performed for a related person if a related person guarantees performance, assigns the foreign contract, or substantially assists in the performance of the services. These rules can cause all of the income in a branch structure to become Subpart F services income, by deeming related-person services transactions in a context in which the CFC inherently will be performing services outside its country, due to the use of foreign branches.

  - The expansive rules in the regulations are not derived from the language of the Code or legislative history.

  - These 1968 regulations were designed for major construction projects (building dams, drilling oil wells, constructing highways), which have little similarity with most modern services businesses.

  - The IRS and Treasury recognized that the deemed related services rules can inappropriately burden modern services businesses, and in Notice 2007-13 announced regulations that would substantially limit one of the rules; other rules should be similarly curtailed or eliminated.

- Because of the Subpart F consequences that can result from the application of the deemed related person services regulations to a branch or disregarded entity structure, a U.S. corporation might instead conduct its foreign services operations in separate CFCs. Subpart F does not apply to related person services income derived by a CFC from performing services within its country of organization.
Under the regulations (which were issued in 1964), services income is earned in the country where persons are physically located when they perform the services, and services income is generally apportioned based on value-weighted employee time spent within and outside the CFC’s country.

For modern services businesses with significant employee travel, multiple parties in different locations contributing to the services, remote provision of services and the use of equipment, the determination of where services are performed raises important new issues.

To eliminate possible uncertainty, the regulations should be clarified to confirm that only activities of a CFC’s employees performing the contracted-for services are taken into account, and not activities of subcontractors, or the location of equipment (such as a computer server); such a rule would minimize complexity, and neither the Code nor policy considerations support a more inclusive rule.

A portion of income from services may be subject to low foreign tax without the application of Subpart F in structures in which services are provided in a location remote from the customer, or an IP holding company has rights to IP necessary to perform the services.

Current law provides this result—there is no rule requiring that services be performed in the customer’s country and no services branch rule, and Subpart F does not apply to royalties received from a related CFC (or to disregarded royalties).

Legislation (not regulations) should address whether and under what circumstances income subject to low foreign taxes relative to the country where the services are used should be currently subject to U.S. tax, which is a debate with no clear answer (this is addressed in subsequent sessions).