The Archaic Subpart F Services Rules: Too Tight? Too Loose? Or, Just Right?

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Introduction

- There are a number of broad categories of subpart F income – including FPHCI, sales income, and services income – focus here is on services income
- The sales income rules of §954(d) have received substantial attention over the years, especially given the focus on evolving legal standards and operating paradigms related to contract/toll manufacturing structures
  - This was the subject of significant regulations on “substantial contribution to manufacturing” (SCM)
- The services income rules of §954(e), however, have received less public attention – most notable guidance in years was Notice 2007-13 (discussed below)
  - This panel intends to help remedy this by focusing on these important rules which have significant implications for taxpayers in an increasingly service oriented global economy and for the government
Introduction (cont)

- Like sales income, service income also has “same country” rules that will be discussed – focus in effect on “do you have a reason to be in that country”
- Unlike the sales income rules, however, the service income rules do not have a complicated “branch” rule (§954(d)(2))
- But, the services income rules do contain a complex “substantial assistance” rule and raise interesting “where are the services performed” considerations
Introduction (cont)

• A key subpart F consideration that is frequently raised, especially in the services income (and sales income) areas, is whether the basic rules are inadequate, outdated, etc. given the dramatic changes in the global economy since enactment in 1962.

• In some sense, the SCM regulations reflect this dynamic in the sales income area in considering alternatives to traditional “physical” manufacturing.

• In services income area, Notice 2007-13 reflects the recognition that global business operations have evolved since 1962. This Notice was intended to rein in, as appropriate, the complicated and sometimes troubling “substantial assistance” rules that can create in effect services income covered by section 954(e) that otherwise might not exist.
  – The Notice generally focuses these rules on situations involving meaningful U.S. base erosion through substantial assistance from related U.S. persons as opposed to a focus on related CFCs.
Introduction (cont)

• In the services income area we will address, as the title of the panel states, whether the service income rules are, in light of an increasingly global economy: Too tight? Too loose? Or just right?

• Lowell is going to address the scope and application of the section 954(e) rules (including Notice 2007-13) in a variety of modern operational settings

• Rob is then going to use his “commenting” role to address a key substantive gating issue: whether the income in question is “sales income,” subject to section 954(d), or instead is “services income” subject to section 954(e)
Services Business Paradigm

• U.S. corporation engaged in a global services business
• Foreign subsidiaries (CFCs) perform services for unrelated foreign customers
• CFCs have 100s of employees, including management and skilled
Is the services income earned by the CFCs subject to current U.S. taxation under Subpart F?
Subpart F Services Income

- CFC performs services for, or on behalf of, a related person (>50% ownership); and
- The services are performed outside of the CFC’s country of organization
1962 Legislative Focus

*Or, high-tax related foreign manufacturer.
Excluded Services Businesses

- **US Parent**
  - **CFC (A)**: Services to Country A Customers
  - **CFC (B)**: Services to Country B Customers
  - **CFC (C)**: Services to Country C Customers
Modern Services Businesses

- Low-Cost Services (A)
- Center of Excellence (B)
- Local Company (C)

Services:
- Skilled Personnel, Mgmt, IP & Risks
- Country C Customers

US Parent
Disregarded Entity Structure

US Parent

Foreign HoldCo (D)

Low-Cost Services (A)

Center of Excellence (B)

Local Company (C)

U.S. View: Services Provided by Foreign Holdco to Country C Customers

Country C Customers

Services

Services

Services
Application of Subpart F

- Foreign HoldCo’s income is not Subpart F services income because the services are provided to unrelated customers.
- No rule treats income from services performed in a foreign branch of a CFC as performed for related persons (unlike Subpart F sales income rules).
- But, must consider deemed related person services rules in the regulations.
Oil Wells, Dams & Highways
1968 Regulations: Deemed Related Person Services

- Related person guarantees CFC’s performance and any related person performs significant related services (or any guaranteed services)
- Related person enters global contract and assigns foreign portion to CFC
- Related person substantially assists the CFC in performing the services
100% Subpart F Income

- **US Parent**
- **Foreign HoldCo (D)**
- **Low-Cost Services (A)**
- **Center of Excellence (B)**
- **Local Company (C)**

- Services from Low-Cost Services (A) to Foreign HoldCo (D)
- Services from Foreign HoldCo (D) to Center of Excellence (B)
- Services from Center of Excellence (B) to Local Company (C)

- Guarantee Performance
- Assign Country C Contracts
- Substantial Assistance
- Country C Customers
- Services
Substantial Assistance

• Regs—Facts and circumstances; assistance furnished by related persons is a “principal element” in producing the income, or 50% of the costs of performing the services

• Notice 2007-13—Cost of assistance furnished by related U.S. persons equals or exceeds 80% of total costs to the CFC of performing the services (or the CFC and related CFCs incur more than 20% of the costs)
Reasons for Change

- International services businesses have significantly expanded since the 1960s
- Services businesses are globally integrated with support capabilities in different geographic locations
- So, substantial assistance rules curtailed to avoid causing taxpayers to change the way they do business
- But, substantial assistance rule applies where U.S. persons provide so much assistance a CFC can’t be said to provide the services on its own
Regs: Two Categories of Assistance

• Direction, supervision, services, and know-how that assist the CFC *directly* in the performance of the services

• Financial assistance (other than contributions to capital), equipment, material, or supplies to the extent the amount paid is less than an arm’s length charge
Costs Included in 80% Test?

- Costs of only *direct* assistance (e.g., not marketing and advertising)?
- Only amount less than arm’s length payments for tangible assets?
- Only payments for know how (not costs of other intangibles)?
- Spread lump sum payments over the life of an asset?
Regarded Entity Structure

- **US Parent**
  - **Low-Cost Services (A)**: Services
  - **Center of Excellence (B)**: Services, Skilled Personnel, Mgmt, IP & Risks
  - **Local Company (C)**: Services, Country C Customers

Country C Customers
1964 Regulations: Country Where Services Performed

- Facts and circumstances
- Physical location of persons performing the services resulting in the income
- Generally apportion services income based on employee time spent within and outside the CFC’s country
- In apportioning income, relative weight is given to the value of various functions
What Activities Considered?

• Only services activities contracted for, not related activities (e.g., marketing & advertising)?
• Only CFC’s employees, not activities of other entities (e.g., subcontractors)?
• Only individuals, not equipment (e.g., server)?
• Note: Regs apportion income by reference only to employee activities resulting in the income
Location of Activities of Subcontractors?

- US Parent
  - Low-Cost Subcontractor (A)
  - Unrelated Subcontractor (B)
  - CFC Principal (C)

Services

Guarantee Performance

Foreign Customers

Skilled Services, Mgmt, IP & risks (residual profit)
Apportioning Principal’s Income

• Better view is to apportion income based solely on location of performance of services by Principal’s employees

• No portion of Principal’s net services income should be apportioned to Countries A or B
  – Subcontractors compensated on an arm’s length basis
  – Principal’s employees generate the residual profit
Location of Equipment?

- **US Parent**
- **CFC ServicesCo (Country A)**
- **Servers (Countries B&C)**
- **Foreign Customers**

Substantial Assistance (e.g., if IP counted)
Royalty Structures: Low Foreign Taxes

Diagram:

- **Foreign IPCo (A)**
- **DE ServiceCo (B)** (Royalty disregarded)
- **CFC ServiceCo (B)** (Royalty §954(c)(6))
- **Foreign Customers**
- **Fees For Services**
Obama 2016 Budget:
Foreign Base Company Digital Income

- IP developed by related persons
- CFC does not substantially contribute to property or services giving rise to income
- Same country of use exception
Legislative Proposals: Current U.S. Taxation of Low-Taxed Income

Current U.S. taxation of low-taxed income at reduced rate (15% or 19%)
Recommendations

• Congress with tax reform should repeal the Subpart F services category and address low-tax foreign structures considering the modern services economy

• Treasury and IRS should modernize the regulations
  – Curtail deemed related person rules eliminating unsupportable burdensome conditions (Notice 2007-13)
  – Clarify that location of services is determined by taking into account only contract-fulfilling activities of the CFC’s own employees
Part Two: Services vs. Sales Income

• What you might expect
  – The FBC sales rules of section 954(d) apply to income from sales
  – The FBC services rules of section 954(e) apply to income from services
• But you would be wrong (at least sometimes)
FBC Magic

• Income from services can be treated as sales income for FBC purposes
• Agenda today is to spotlight the obscure little rule requiring that transformation, and to –
  – Explore when it applies
  – Consider its practical impact
  – Ponder the possibility of a remand back to services
A Stealth Recast

- Under section 954(d)(1), FBC sales income includes commissions or fees earned “in connection with” purchases or sales of personal property to, from, or on behalf of a related person
  - But only if the property is neither produced nor consumed in the CFC’s country of incorporation, and subject to exceptions
- Commissions and fees are typically compensation for services
- Legislative history expresses intent to reach arrangements in which a CFC performed sales or purchasing activities for a related person but didn’t take title to the property – and thus earned commissions or fees rather than gain on sale
A Stealth Recast

Thus, a CFC that earns commissions or fees for services in connection with related-party purchases or sales of property (rather than buying the goods and reselling them) may be treated as earning sales income, not services income, for FBC purposes.
When Does the Recast Apply?

• Applies to commissions or fees earned “in connection with” four types of transactions
  – the purchase of personal property from a related person and its sale to any person
  – the sale of personal property to any person on behalf of a related person
  – the purchase of personal property from any person and its sale to a related person, or
  – the purchase of personal property from any person on behalf of a related person

• So who needs to be doing what to whom?
Services Treated as Sales?

- COE provides sales support to related manufacturer
- COE conducts most activities in country of incorporation
- If treated as sales income for FBC purposes, COE’s income likely to be FBC sales
- But does the COE earn fees “in connection with” one of the four FBC sales categories?
Regulatory Example of Commissions Treated as Sales Income

- N, a U.S. corporation, ships products it manufactures in the United States
- N Corp. pays Country X CFC C a commission of 6% of the gross selling price of all property shipped by N Corp. as the result of orders solicited by CFC C in foreign countries Y and Z
- CFC C does not take title to the property sold
- Gross commissions received by CFC C in connection with the sales constitute FBC sales income
The example does not state the basis for its conclusion that commissions earned by CFC C are FBC sales income.

But presumably this is because the CFC’s commissions are derived in connection with “the sale of personal property to any person on behalf of a related person” – even though the CFC itself does not sell that property.

Example 3, §1.954-3(a)(1)(iii)
Impact of the Recast

• Different FBC rules and exceptions apply to sales vs. services income
  – Location of activities in country of incorporation would exclude income from FBC services – but not from FBC sales
  – Substantial contribution exception applies to sales but not services
  – No branch rule under FBC services
Impact of the Recast (cont)

- Depending on whether income is tested under the FBC sales or services rules, taxpayers may have dramatically different outcomes
  - For example, if a CFC performs activities in-country, services treatment would avoid FBC income; see FAA 20153301F
  - Conversely, if a CFC makes a substantial contribution to manufacturing, sales treatment would avoid FBC income; see PLRs 201325005 and 201332007
Taxpayer characterized its intercompany referral income as part sales and part services income.

Taxpayer argued pre-sale services income was FBC sales income and post-sale services income was services income performed within its country of incorporation and thus non-subpart F income.

The IRS concluded that Taxpayer had not substantiated that the referral fees were for post-sale services, and such service fees were nonetheless derived in connection with its sales.

Diagram:
- CFC 1
- CFC 2
- Customer Broker (Country X)
- Sales Broker
- Pre-sale services
- Referral Fees
- Post-sale services
- Sales
- Country X Customer
Interpretive Issues

• Applying FBC sales rules to a CFC that doesn’t actually sell anything can be tricky
  – Exception for sales of property “manufactured, produced, or constructed by such [CFC]”
  – Substantial contribution to manufacturing
  – Purchasing services treated as sales

• IRS has taken a reasonable approach, consistently applying the sales recast
PLR 201325005

- FSub2 remits a fee to Branch for its support services relating to the manufacturing, marketing, and selling of Products
- Branch never takes title to Products
- Taxpayer represents that Branch makes a substantial contribution to the manufacture of Products
- IRS concludes that Branch’s service fees are excluded from FBC sales income
• CFC purchases Products from unrelated vendors
• FDE is paid a commission based on a percentage of the ordered Products for its procurement-related activities
• FDE never takes title to Products
• Taxpayer represents that CFC is engaged in manufacturing, and FDE makes a substantial contribution
• IRS concludes FDE’s procurement fees are excluded from FBC sales income
The Takeaways

• A CFC that performs selling or purchasing activities on behalf of a related party, without taking legal title to or ownership of the property being sold, may be treated for FBC purposes as earning sales income

• Manufacturing and sales support, along with procurement services, may constitute “substantial contribution” to manufacturing conducted by a related CFC
Representations in the 2013 PLRs

• Both Taxpayers represent “consistent” treatment of “income derived in connection with the sale of personal property” as FBC sales income, regardless of whether such income could also be considered FBC services income
  – The PLRs do not re-analyze the income as services income for purposes of Section 954(e)
  – But could the income be re-analyzed as FBC services income?
Potential Overlap

- Assume that a CFC earns sales-related services income that is tested under the FBC sales rules, and excluded from FBC sales income by an exception.
- Should such income again be tested under the FBC services rules, given that it was, after all, services income to begin with?
• Income from purchasing or sales services provided by COE is initially tested as sales income, and is excused from FBC sales treatment under the substantial contribution rule.
  • Should that income be tested again as services income?
• If retesting as services is required, it may result in FBC services income, e.g. if services are not performed in country of incorporation.
Sales/Services Overlap

• The structure of the FBC sales and services rules suggests that income belongs in one category or the other
  – Rev. Rul. 86-155 treats the two categories as mutually exclusive
• But a coordination rule in Treas. Reg. § 1.954-1 provides for retesting among specified categories of FBC income
Coordination Rule

• Under the Treas. Reg. § 1.954-1 coordination rule:
  – Income potentially falling into more than one category is first tested in a priority category
  – But if excused from that category by an applicable exception, it is again tested in the next lower-priority category etc.

• Some commentators have read this rule to override the Rev. Rul. 86-155 treatment of FBC sales and services categories as mutually exclusive, and thus to require retesting between those categories

• But this is not what the regulation says
Coordination Rule (cont)

• The rule applies when specified income may potentially fall into two or more specifically-listed FBC categories
  – For example, gains from precious metals sales may be both FPHC commodities gains and FBC sales income; the rule gives priority to FPHC commodities gain

• By its terms the rule does not require retesting as between FBC sales and services categories, as they are not among the listed categories of FBC income
Reading IRS Tea Leaves

• The two 2013 PLRs do not specifically address the issue discussed here
• But FBC sales reps provided in the 2013 PLRs only make sense if income tested as FBC sales income is not required to be retested as FBC services income
• And this reading of the regulatory text is supported by:
  – Rev. Rul. 86-155
  – Section 954(e)(2)
  – Substantial justice and fair play
...the term “foreign base company sales income” means income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with

- the purchase of personal property from a related person and its sale to any person,
- the sale of personal property to any person on behalf of a related person,
- the purchase of personal property from any person and its sale to a related person, or
- the purchase of personal property from any person on behalf of a related person where—

  - the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and
  - the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.
In general. The computations of gross foreign base company income and gross insurance income are limited by the following rules . . .

(A) If income is foreign base company shipping income, pursuant to section 954(f), it shall not be considered insurance income or income in any other category of foreign base company income.

(B) If income is foreign base company oil related income, pursuant to section 954(g), it shall not be considered insurance income or income in any other category of foreign base company income, except as provided in paragraph (e)(4)(i)(A) of this section.

(C) If income is insurance income, pursuant to section 953, it shall not be considered income in any category of foreign base company income except as provided in paragraph (e)(4)(i)(A) or (B) of this section.

(D) If income is foreign personal holding company income, pursuant to section 954(c), it shall not be considered income in any other category of foreign base company income, other than as provided in paragraph (e)(4)(i)(A), (B) or (C) of this section.

(ii) Income excluded from other categories of gross foreign base company income. Income shall not be excluded from a category of gross foreign base company income or gross insurance income under this paragraph (e)(4) by reason of being included in another category of gross foreign base company income or gross insurance income, if the income is excluded from that other category by a more specific provision of section 953 or 954. . .