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Significant Limitation of Subpart F Substantial Assistance Rules

Notice 2007-13, 2007-5 I.R.B. 5 (January 9, 2007)

Overview

The Treasury Department and the IRS have announced in Notice 2007-13 that the "substantial assistance" rule in subpart F defining foreign base company services income will be applicable only in limited situations, effective the beginning of 2007.

Background

A "United States shareholder" of a controlled foreign corporation ("CFC") must take into income its pro rata share of subpart F income recognized by the CFC during the shareholder's taxable year that ends with or within the CFC's taxable year. Subpart F income includes foreign personal holding company income (passive investment type income) as well as foreign base company income ("FBCI"). Among other things, FBCI includes foreign base company services income, which is defined as income derived by the CFC in connection with the performance of certain services outside the CFC's country of incorporation for or on behalf of a related person. The services that can generate foreign base company services income include "technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial and like services." A person is related to a CFC if the person controls or is controlled by the CFC, or the person is a corporation that is controlled by the same persons that control the CFC. Control means more than 50 percent ownership of the vote or value of stock in the case of a corporation and the capital or profits interest of a partnership. Services are considered performed for or on behalf of a related person if the related person (i) pays the CFC for services rendered by the CFC, (ii) has an obligation to an unrelated person to perform services that are performed by the CFC, or (iii) sells property to an unrelated person and the CFC performs services for the benefit of the purchaser as a condition of the property sale.

In addition, under existing Regulation Section 1.954-4(b)(1)(iv), foreign base company services income includes income from services performed by a CFC outside the CFC's country of incorporation for an unrelated person if a related person has provided "substantial assistance" to the CFC in performing the services for the unrelated party. Substantial assistance includes direction, supervision, services, know-how, financial assistance, and the provision of equipment, material or supplies furnished by a related person that may be either a U.S. or a foreign person. Assistance in the form of direction, supervision, services or know-how is considered substantial if (i) it is provided directly to the CFC and it gives the CFC a principal element in generating the services income from the unrelated party (the "subjective test"), or (ii) the aggregate cost of such services to the CFC (determined after taking any Section 482 adjustments into account) equals at least 50 percent of the cost to the CFC of providing services to the unrelated person (the "objective test"). Financial assistance, equipment, material or supplies are considered substantial assistance only to the extent the price charged for such items is less than an arm's length charge. Even if related party services are not considered "substantial" under the above tests, such services may nevertheless constitute substantial assistance if, based on all facts and circumstances, the aggregate of all services rendered to the CFC by related persons is substantial.

New Regulations

The notice acknowledges that the substantial assistance rule is outmoded in light of the current structure of many U.S.-based multinationals that frequently have globally integrated businesses with capabilities for unrelated customer projects in different geographic locations, based largely on business factors such as

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cost efficiencies. The notice expresses concerns that tax planning to avoid the substantial assistance rule may undermine economically efficient business structures.

The new substantial assistance rule contained in the notice states that income from services rendered to an unrelated person is foreign base company services income only if substantial assistance rendered by one or more related U.S. persons satisfies an objective cost test. The subjective principal element test in the current regulations is no longer applicable, and the new rule only looks to services rendered by U.S. related persons. Under the new objective cost test, a CFC will be treated as receiving substantial assistance only if the aggregate cost of assistance (as defined under the existing regulation) furnished to the CFC by related U. S. persons is at least 80 percent of the aggregate cost to the CFC of providing the services to the unrelated person. CFC costs will be determined after taking any Section 482 adjustment into account.

The notice states that a taxpayer must establish either that the cost of services provided by the CFC itself and by related foreign persons represents more than 20 percent of the total cost of the services rendered to the unrelated person, or by showing the value of assistance provided by U.S.-related persons was less than 80 percent of the total cost of the services rendered to the unrelated person. The notice provides that individuals who are concurrently employees or officers of both the CFC and the U.S.-related person will be considered employees or officers only of the U.S-related person. Thus, compensation cost incurred with respect to such persons will not be considered a cost incurred by the CFC in applying the objective cost test.

In an example in the notice USP, a U.S. corporation, has two wholly-owned CFCs (CFC1 and CFC2). CFC2 enters into a contract with an unrelated foreign person to design a bridge in country Y, which is not CFC2's country of organization. USP performs design and technical services for CFC1 in country Y in connection with the bridge project in exchange for $85x. CFC1 contracts with CFC2 to furnish services it receives from USP as well as other services to CFC2 in exchange for $90x. CFC2 incurs direct costs of $10x in connection with the project to design the bridge. Even though USP renders services to CFC1, the services are taken into account under the notice's objective cost test. Since services rendered directly or indirectly by USP represent at least 80 percent of the total cost of designing the bridge, income derived by CFC2 from the project is foreign base company services income.

Effective Date

The amendment to the regulations will be effective for taxable years of foreign corporations beginning after December 31, 2006, and for taxable years of U.S. shareholders in which or with which such CFC years end. There is no election to apply the more relaxed new rule to pre-2007 taxable years.

Planning Considerations

As a practical matter, the notice repeals the substantial assistance rule because most U.S.-based multinationals should be able to ensure that less than 80 percent of the CFC's cost in rendering services is from related U.S. companies. The notice is generally good news because the substantial assistance rule in the existing regulations is uncertain and a major headache for U.S.-based multinationals. However, the existing rules may continue to be an audit issue in earlier years. The repeal or significant limitation of the substantial assistance rule probably reflects the recognition by the IRS that the concerns that lead to enactment of the rule in the first place are now effectively addressed by other rules such as the transfer pricing rules relating to services. This begs the question why Treasury and IRS felt it was necessary to retain the substantial assistance rule in the form of the 80 percent objective cost test, or why the rule was not changed for open taxable years. As for the new rule, further guidance may be needed on allocating costs among related parties and on documentation. Taxpayers should avoid having concurrent employees or officers in CFCs and U.S. affiliates.

For additional information please contact Bob Cole 202.756.3306 or Kevin Rowe 212.210.9505.

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