

Notice 2007-13 Announces New and Improved Substantial Assistance Rules

By: Michael J. Miller

INTRODUCTION

Notice 2007-13¹ announces that the Treasury Department and the Internal Revenue Service (“IRS”) will issue new regulations simplifying and significantly limiting the scope of the “substantial assistance” rules. As explained below, the new regulations will provide many taxpayers with far greater comfort that the service fees earned by their controlled foreign corporations (“CFCs”) will escape current taxation under Subpart F.

OVERVIEW OF SUBPART F

Definition of Controlled Foreign Corporation

A foreign corporation will be a CFC if “United States shareholders” own (directly, indirectly, or through the application of certain attribution rules) stock possessing more than 50% of the total value or voting power of all of the outstanding shares of stock of the foreign corporation.² For this purpose, a “United States shareholder” (hereinafter, “U.S. shareholder”) is any U.S. person that owns (directly, indirectly, or through the application of certain attribution rules) stock possessing at least 10% of the total voting power of all of the outstanding shares of stock of the foreign corporation.³

Current Taxation of U.S. Shareholders; Foreign Base Company Services Income

A CFC’s U.S. shareholders generally are subject to current tax on their proportionate shares of any “Subpart F income” earned by the CFC.⁴ Subpart F income generally includes, among other things, “passive” income (*e.g.*, interest, dividends, rents, royalties and capital gains from sales of properties that give rise to passive income) as well as “foreign base company services income.”⁵

“Foreign base company services income” (“FBCSI”) generally includes any income (whether in the form of compensation, commissions, fees, or otherwise) derived from the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services that (A) are performed “for or on behalf of” any related person; and (B) are performed outside the CFC’s country of organization.⁶

In the most straightforward application of the FBCSI rules, a CFC that performs services for its controlling U.S. shareholder (or any other related person) outside its country of organization would be considered to earn FBCSI. The FBCSI rules, however, contain a number of less

obvious applications as well. Some of these present traps for the unwary, while others present traps that are more difficult to escape.

For example, the regulations provide that services performed by a CFC on behalf of a related person include services that a related person “is, or has been, obligated to perform”.⁷ Thus, if a domestic corporation enters into a contract to construct a superhighway in a foreign country and subsequently assigns the contract to its CFC, which performs the contract entirely on its own, the CFC’s services are considered to be performed for or on behalf of the domestic parent, and thus give rise to FBCSI (unless performed in the CFC’s country of organization).⁸ Such a “related person obligation rule” is hardly intuitive, but it has the virtue of being easily avoided in certain circumstances. Subject to all of the other rules that can give rise to FBCSI, well advised taxpayers may be able to avoid falling into the trap by having their CFCs execute the contracts with clients, provided, of course, that the clients are agreeable.⁹

The regulations further provide that services on behalf of a related person include services performed by the CFC with respect to property sold by a related person if the performance of such services is a condition or a material term of the sale.¹⁰ The regulations illustrate this “material term rule” with an example in which a domestic corporation sells an industrial machine that requires specialized installation at a reduced price, subject to the requirement that the customer engage the domestic corporation’s CFC to perform the installation for a specified fee.¹¹ The example concludes without explanation that the services of the CFC are performed on behalf of the domestic parent.

The facts of this example arguably suggest a transfer-pricing concern, *i.e.*, that the domestic parent may be underpricing the domestic component of the transaction and correspondingly overpricing the fees earned by its CFC. Nevertheless, the material term rule applies regardless of how the transactions are priced. Another example applies the material term rule, and reaches the same conclusion, where the domestic parent sells industrial machines with a warranty of performance conditional upon installation and maintenance by a factory-authorized service agency, and where the only authorized service agency is the domestic parent’s CFC.¹² The latter example says nothing about the price charged by either the domestic parent or the CFC.

The rationale for the material term rule is less than crystal clear. For what it’s worth, however, the transactions to which the rule applies “look like” transactions in which a person related to the CFC contracts to provide services to unrelated customers and then hires the CFC to perform those services on its behalf.¹³

Substantial Assistance Rules

Going far beyond even the expansive rules described above, the regulations provide that services performed “on behalf of” a related person include services performed by the CFC where “[s]ubstantial assistance contributing to the performance of such services has been furnished by a related person or persons.”¹⁴ The rationale for deeming a CFC to *provide* related-person services merely because it *receives* services (or other assistance) from a related person is doubtful, and there is a legitimate question as to whether the fiction adopted by the regulations would be upheld if challenged. Not surprisingly, the substantial assistance rules are often overlooked, presumably unintentionally.

The regulations identify eight forms of assistance that may be considered substantial, namely direction, supervision, services, know-how, financial assistance (other than contributions to

capital), and equipment, material, or supplies.¹⁵ Such assistance is divided into two categories, which may loosely be referred to as intangible and tangible.

Intangible assistance, such as that in the form of direction, supervision, services, or know-how, may be substantial under either a subjective or an objective test. Under the subjective test, assistance is considered substantial if it provides the CFC with skills that are a “principal element” in producing the income derived by the CFC from the performance of services.¹⁶ Under the objective test, assistance is considered substantial if its cost to the CFC equals 50% or more of the CFC’s total costs of performing the services.¹⁷ Under both the objective and subjective tests, intangible assistance is taken into account only if it assists the CFC “directly” in the performance of its services.¹⁸

For purposes of applying the objective test, the regulations expressly provide that the CFC’s costs are determined after taking into account the transfer-pricing rules of §482.¹⁹ Therefore, taxpayers cannot avoid generating FBCSI under the substantial assistance rules by underpricing supervision, services, and other intangible assistance provided to the CFC by related persons.

Turning to tangible assistance, the regulations provide that financial assistance (other than contributions to capital), equipment, material, and supplies furnished by a related person are taken into account only to the extent that the amount paid by the CFC for the purchase or use of such items falls short of the arm’s length charge for such purchase or use.²⁰ Therefore, taxpayers can avoid an undesirable provision of financial assistance by ensuring that they charge arm’s-length prices for any financial contributions to their CFCs.²¹ Taxpayers that, for whatever reason, fail to do so must compare the amount of assistance provided to the CFC with the profits derived by the CFC from its performance of services.²² The results of such comparison determine, in some unspecified fashion, whether the tangible assistance furnished by one or more related persons to the CFC is substantial.²³ Obviously, the application of this test is highly uncertain.

Even if neither the intangible nor tangible assistance furnished to a CFC is itself substantial under the tests above, the regulations provide that the two together may nevertheless reach this threshold.²⁴ The regulations do not specify what combination of insubstantial intangible assistance and insubstantial tangible assistance may achieve substantiality.

In light of the various uncertainties described above, it often is extremely difficult for taxpayers and their advisors to determine with a high degree of confidence whether a CFC’s service income constitutes FBCSI by reason of the substantial assistance rules.

NOTICE 2007-13

Notice 2007-13 greatly simplifies and curtails the scope of the substantial assistance rules. The new regulations promised by the Notice will replace the separate tests for different categories of assistance with one all-encompassing substantial assistance test. The single test will be objective, eliminating several subjective elements of the current rules. Furthermore, only assistance provided by U.S. persons will be taken into account under the new regulations.

Pursuant to Notice 2007-13, the new regulations will provide that substantial assistance consists of assistance furnished (directly or indirectly) by related U.S. persons to the CFC if the assistance satisfies an objective cost test. The Notice provides that, for this purpose, “assistance” will include 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.²⁵

According to the Notice, the objective cost test “will be satisfied if the cost to the CFC of the assistance furnished by the related U.S. person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services.” Of key importance is that, under the new test, only assistance furnished by U.S. persons is taken into account. Services provided by one CFC to another CFC, for example, will no longer result in substantial assistance.

The Notice emphasizes that services may be provided “indirectly” by a related U.S. person. For this purpose, services performed by a CFC itself are not considered to have been indirectly provided by a related U.S. person. However, “employees, officers or directors of the CFC who are concurrently employees, officers, or directors of a related United States person during a taxable year of the CFC will be considered employees, officers or directors solely of the related United States person for such taxable year.” Although not expressly stated, the clear import of this rule is that the services of such employees, officers, and directors are considered to have been indirectly provided by the related U.S. employer.

A taxpayer may satisfy its burden of proving that assistance is not substantial under the objective 80% test set forth above by showing either that the assistance provided by related U.S. persons costs less than 80 percent of the CFC’s total cost in performing the services or, alternatively, “by demonstrating that the cost of the services provided *by the CFC itself and/or by a related CFC*, is more than 20 percent of the total cost to the CFC of performing the services.”²⁶ Thus, the taxpayer can demonstrate either that less than 80% of the CFC’s costs are “bad” or that more than 20% of the CFC’s costs are “good.”

The following examples, drawn from those found in Notice 2007-13, illustrate the new rules described in the Notice:²⁷

Example 1

USP, a U.S. corporation, wholly owns I Co, an Indian corporation, and G Co, a German corporation. I Co contracts with FP, an unrelated foreign person, to design a bridge in Brazil. I Co incurs \$100x of total costs in designing the bridge. USP performs supervisory services in connection with the contract for which I Co pays it a fee. I Co directly performs services in connection with the contract that cost I Co \$15x (and that are performed outside of India). G Co provides centralized support services related to the performance of the contract for which I Co pays G Co \$10x.

The example concludes that I Co does not receive substantial assistance in the performance of its contract because more than 20% of I Co’s costs are attributable to services furnished directly by I Co or a related CFC (G Co). The example does not specify the arm’s-length fee paid to USP for supervisory services but apparently that amount is important to the conclusion only insofar as it plays a role in determining I Co’s total costs (\$100x). Although the example specifies that the assistance provided by USP is in the form of supervisory services, this information is not necessary to the conclusion. Under the single objective test of the new regulations, the same rules apply to both intangible and tangible assistance.

Under the existing regulations, taxpayers and their advisors would find it extremely difficult to get comfortable on the facts above. First, the assistance provided to I Co would take into

account the services provided by G Co as well as those provided by USP. Second, under the subjective test, there would be a significant concern as to whether the services provided by USP and G Co are a “principal element” in producing I Co’s income from designing the bridge. Third, additional information would be needed to determine whether the 50% cost test of the existing regulations was satisfied.

Example 2

USP, a U.S. corporation, wholly owns I Co, an Indian corporation, and G Co, a German corporation. I Co contracts with FP, an unrelated foreign person, to design a bridge in Brazil. In connection with the contract, USP performs design and technical services for G Co, for which G Co pays USP \$85x. G Co provides those services and services that it performs directly to I Co, for which I Co pays \$90x. I Co uses those services and services that it performs directly (at a cost of \$10x and outside of India) to design the bridge for FP. I Co’s total costs attributable to the performance of its contract are \$100x.

The example concludes that I Co receives substantial assistance from related U.S. persons, because 85% of the costs incurred by I Co are attributable to services indirectly provided by USP (through G Co). Few tax practitioners would have thought that substantial assistance could have been avoided in this fashion, but the example is still helpful.

The new regulations will be effective for taxable years of CFCs beginning on or after January 1, 2007, and for the taxable years of U.S. shareholders in which or with which such taxable years of the CFCs end.

OBSERVATIONS AND OPEN ISSUES

Notice 2007-13 provides much-welcome relief for taxpayers by significantly curtailing the scope of the substantial assistance rules and eliminating many of the uncertainties of the existing regulations.

Under the objective 80% test of the new regulations, taxpayers will no longer need to fear the highly subjective tests that apply under the existing regulations for determining: (1) whether intangible assistance furnished by related persons is a “principal element” in producing the income derived by the CFC from its performance of services; (2) whether tangible assistance furnished by related persons exceeds some unspecified threshold of substantiality when compared with the profits derived by the CFC from its performance of services; and (3) whether the combination of intangible and tangible assistance furnished by related persons is substantial, even though each may be insubstantial on its own.

Another critical component of the new regulations is the fact that only assistance from U.S. persons will be taken into account in applying the objective 80% test. Thus, for example, services provided by one CFC to another CFC will no longer result in substantial assistance.

Interestingly, one portion of the Notice arguably can be read to suggest that assistance provided by foreign persons other than a CFC *is* taken into account in applying the new objective test. As noted above, the Notice provides that a taxpayer may satisfy its burden of proving that assistance is not substantial under the objective 80% test by showing either that the assistance provided by related U.S. persons costs less than 80 percent of the CFC’s total cost in performing the services or, alternatively, “by demonstrating that the cost of the services provided *by the CFC*

itself and/or by a related CFC, is more than 20 percent of the total cost to the CFC of performing the services.”²⁸

It is extremely odd that the Notice uses the term “related CFC” instead of, say, “related foreign person.”²⁹ Nevertheless, it seems perfectly clear (and an IRS representative has informally confirmed) that the language quoted above was not intended to suggest that services provided by a related foreign person other than a CFC are necessarily taken into account towards the 80% threshold. Rather, such language merely was intended to clarify that, instead of demonstrating that “bad costs” do not exceed 80%, a taxpayer can get to the same place by demonstrating that the CFC’s “good costs” exceed 20%.³⁰

Nevertheless, the Notice’s use of the term “related CFC” instead of, say, “related foreign person” may reflect a concern that certain assistance furnished by a non-CFC may be characterized as indirectly furnished by a related U.S. person. For example, if a CFC’s domestic parent is an 80% partner of a foreign partnership that provides assistance to the CFC, the IRS may well characterize 80% (or more) of such assistance as having been indirectly provided by the domestic parent. Presumably, the new regulations will include additional guidance regarding the circumstances in which a related U.S. person will be considered to indirectly provide assistance to a CFC.

Another important question that the new regulations will need to address is the appropriate time-frame to be considered in applying the objective 80% test to services provided over a multiyear period. As noted above, that test “will be satisfied if the cost to the CFC of the assistance furnished by the related United States person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services.”

This language arguably suggests that the objective 80% test must be applied by comparing the relevant costs over the entire life of a contract or project. Moreover, this would seem to best advance the apparent policy objective of determining whether the CFC has sufficient substance to participate in the performance of its obligations in a meaningful way.³¹ Nevertheless, such an approach would be extremely unworkable in practice, because it may be impossible for a CFC’s U.S. shareholders to determine whether the CFC received substantial assistance, and therefore earned FBCSI, when they file their returns. Would taxpayers be permitted to file on the basis of anticipated future events? Would taxpayers file their returns differently depending on when they file? Would taxpayers have an affirmative obligation to file amended returns if the facts ultimately turn out to be less favorable than originally anticipated? What recourse would the IRS have if the statute of limitations period for a year is closed by time all of the relevant information becomes available?

Notwithstanding its theoretical merits, the practical difficulties in administration strongly militate against the “wait and see” approach. Therefore, the application of the objective 80% test should be based solely on the costs incurred during the taxable year of the CFC. If this point is not clarified in the new regulations, however, taxpayers and their advisors may feel emboldened to take a different view.

A related question is how the objective 80% test should be applied where two projects are contemplated under a single contract. For example, if a CFC enters into a single contract to design a dam and a bridge for a related person, should the objective 80% test be applied separately to the dam and bridge or on an aggregate basis? At present, there does not appear to

be any clear answer. A taxpayer that, for whatever reason, prefers to separate the two projects may wish to enter into separate contracts to increase the odds of achieving the desired result.

Yet another unanswered question is what types of costs should be included as costs of the CFC in performing services. For example, are non-cash costs such as depreciation and amortization taken into account? What about allocable costs for overhead? It appears that any costs of the CFC that are deductible or amortizable under U.S. Federal income tax principles should be taken into account to the extent attributable to its performance of services, but comfort on these points will need to await further guidance.

Interestingly, all of these are questions that also arise under the objective test of the existing regulations and that have gone unanswered for decades. Presumably, the Treasury Department and the IRS have not considered such guidance to be a priority because the subjective test could be used instead of the objective test.³² Now that the subjective test will no longer apply, there will be a stronger need for guidance on the application of the objective test.

CONCLUSION

Notice 2007-13 provides welcome relief to CFCs and their U.S. shareholders by simplifying and significantly limiting the scope of the substantial assistance rules. Nevertheless, a number of open issues will need to be resolved in order for taxpayers and the IRS to apply the objective 80% test. Moreover, other aspects of the regulations also are badly in need of updating. As discussed above, the related person obligation rule and the material term rule are far from intuitive; and these rules now seem particularly inappropriate in light of the new substantial assistance rules. One can only hope that further guidance is on the way.

¹ 2007-13 I.R.B. 410 (Jan. 29, 2007).

² Section 957(a) of the Internal Revenue Code of 1986, as amended (the “Code”). Except as otherwise expressly indicated, all “§” references herein are to the Code and all “Treas. Reg. §” references are to the treasury regulations promulgated thereunder.

³ §951(b).

⁴ §951(a)(1)(A)(i).

⁵ *See generally* §§951(a)(1)(A)(i), 952(a)(2) & 954.

⁶ §954(e)(1). The latter requirement has the effect of exempting from FBCSI all income from services performed within the CFC’s country of organization.

⁷ Treas. Reg. §1.954-4(b)(1)(ii).

⁸ Treas. Reg. §1.954-4(b)(3), Ex. (5).

⁹ In certain circumstances, and particularly during the CFC’s start-up phase, a client may reasonably require some comfort that the CFC’s better-capitalized domestic parent will stand behind the obligations of the CFC. Subject to certain significant limitations, a CFC’s domestic parent (or another related person) can provide a guarantee to the client without triggering FBCSI under the related person obligation rule. *See* Treas. Reg. §1.954-4(b)(2)(i).

¹⁰ Treas. Reg. §1.954-4(b)(1)(iii).

¹¹ Treas. Reg. §1.954-4(b)(3), Ex. (8).

¹² Treas. Reg. §1.954-4(b)(3), Ex. (9).

¹³ A similar observation can be made about the related person obligation rule.

¹⁴ Treas. Reg. §1.954-4(b)(1)(iv).

¹⁵ Treas. Reg. §1.954-4(b)(2)(ii)(a).

¹⁶ Treas. Reg. §1.954-4(b)(2)(ii)(b).

¹⁷ Treas. Reg. §1.954-4(b)(2)(ii)(b).

¹⁸ Treas. Reg. §1.954-4(b)(2)(ii)(e).

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- ¹⁹ Treas. Reg. §1.954-4(b)(2)(ii)(e).
- ²⁰ Treas. Reg. §1.954-4(b)(2)(ii)(c).
- ²¹ To the extent that the application of the transfer-pricing rules is uncertain, there would be some incentive for taxpayers to err on the side of charging their CFCs too much, rather than too little. Presumably, the IRS will not object.
- ²² Unsurprisingly, taxpayers that are not cognizant of the substantial assistance rules attempt to minimize the income that they report from transactions with their CFCs.
- ²³ Treas. Reg. §1.954-4(b)(2)(ii)(c). The regulation does not explain what relationship between those two amounts is necessary for such tangible assistance to be substantial.
- ²⁴ Treas. Reg. §1.954-4(b)(2)(ii)(d).
- ²⁵ Furthermore, it is understood that the reference to know-how refers generally to all intangible property. *See* Bennett, “Intangibles to Count Under Cost Test in New Substantial Assistance Regime,” 15 Daily Tax Rep’t. at G-6 (1/24/07).
- ²⁶ Emphasis added.
- ²⁷ Assume that all fees set forth in the examples are at arm’s length.
- ²⁸ Emphasis added.
- ²⁹ Presumably, any services provided by an unrelated U.S. or foreign person are considered to be provided by the CFC itself.
- ³⁰ Thus, for example, a taxpayer would meet its burden by showing that more than 20% of the CFC’s costs are attributable to assistance provided by a related nonresident alien.
- ³¹ The Notice states that the Treasury Department and the IRS “remain concerned about the ability of related United States persons to shift profits offshore to CFCs organized in low tax jurisdictions in cases where the related United States person or persons provide so much assistance to the CFC that the CFC cannot be said to be providing services on its own account and thus acting as an independent entity.”
- ³² *See, e.g.*, TAM 9527010.