

## Part III - Administrative, Procedural, and Miscellaneous

### Modification of the Substantial Assistance Rules

Notice 2007-13

#### SECTION 1. OVERVIEW

This notice announces that the Treasury Department and the Internal Revenue Service (the IRS) will amend Treas. Reg. §1.954-4(b)(1)(iv) and (b)(2)(ii) and the examples thereunder, which provide that substantial assistance rendered by a related person or persons to a controlled foreign corporation (“CFC”) is included within the definition of foreign base company services income under section 954(e) of the Internal Revenue Code (Code). These amended regulations will limit the types of activities that constitute substantial assistance to certain assistance rendered, directly or indirectly, by a United States person or persons (as the term is defined in section 957(c) of the Code) to a related CFC. Until regulations reflecting these changes are issued, taxpayers may rely on this notice.

In addition, in light of the repeal of the foreign base company shipping income rules under subpart F, this notice confirms that income that previously was foreign base company shipping income will continue to be foreign base company income to the extent that it is within the definition of a remaining category of foreign base company income. This notice also clarifies that Treas. Reg. §1.954-6, which provides rules

addressing foreign base company shipping income, is effective only for purposes of applying the rules for the withdrawal of previously excluded subpart F income from qualified investments under section 955.

## SECTION 2. SUBSTANTIAL ASSISTANCE RULES

### A. BACKGROUND

Under section 951(a)(1)(A)(i) of the Code, a United States shareholder of a CFC includes in gross income each year its pro rata share of the CFC's subpart F income for the taxable year of the CFC which ends with or within such taxable year of the shareholder. Section 952(a)(2) defines the term "subpart F income" to mean, in part, foreign base company income (as defined under section 954).

Section 954(a)(3) of the Code defines "foreign base company income" to include "foreign base company services income" for the taxable year. Section 954(e)(1) defines "foreign base company services income" for purposes of section 954(a)(3) to mean income derived in connection with the performance of services which are performed (1) for, or on behalf of, any related person and (2) outside the country under the laws of which the CFC is created or organized. The statute does not explicitly provide for substantial assistance rules under section 954(e). Those rules are promulgated under the Secretary's authority under section 7805(a) to issue regulations interpreting the term "for, or on behalf of, any related person" under section 954(a)(3).

Treas. Reg. §1.954-4(b)(1)(iv) defines "services which are performed for, or on behalf of, a related person" to include substantial assistance contributing to the performance of services by a CFC that has been furnished by a related person or

persons. Treas. Reg. §1.954-4(b)(2)(ii) sets forth the rules for the application of the substantial assistance test. Treas. Reg. §1.954-4(b)(2)(ii)(a) states, in general, that assistance “shall include, but shall not be limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies.” Treas. Reg. §1.954-4(b)(2)(ii)(b) and (c) then provide separate tests depending on whether the assistance provided by the related person or persons is in the form of (1) direction, supervision, services or know-how, or (2) financial assistance, equipment, material or supplies.

Treas. Reg. §1.954-4(b)(2)(ii)(b) provides that assistance 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 in the form of direction, supervision, services or know-how will be considered substantial if the assistance provides the CFC with skills which are a principal element in producing the income from the performance of such services by such CFC (the principal element test). For example, a CFC enters into a contract with an unrelated person to drill an oil well. The technical and supervisory personnel who oversee the drilling of the well are employees of M, a person related to CFC. In such an instance, the services performed by CFC for the unrelated party are considered foreign base company services because the services performed by M substantially assist CFC in the performance of the contract and the services performed by M are a principal element in producing the income from the performance of the drilling contract. Cf. Treas. Reg. §1.954-4(b)(3), Ex. 2.

Alternatively, under the objective test, assistance in the form of direction,

supervision, services or know-how may be substantial if the cost to the CFC of the assistance furnished by persons related to the CFC equals 50 percent or more of the total cost to the CFC of performing the services performed by such CFC (the cost test). For these purposes, costs are determined after taking into account adjustments (if any) made under section 482. See Treas. Reg. §1.954-4(b)(2)(ii)(b).

Treas. Reg. §1.954-4(b)(2)(ii)(c) states, in general, that financial assistance, equipment, material, or supplies furnished by a person related to the CFC shall be considered assistance only in the amount, after taking into account adjustments (if any) made under section 482, by which the consideration actually paid by the CFC to the related person for the purchase or use of such item is less than the arm's length charge for such purchase or use. The total of all such amounts from all related persons is compared with the profits derived by the CFC from the performance of the services to determine whether the related party's contributions qualify as substantial assistance.

Treas. Reg. §1.954-4(b)(2)(ii)(d) expands on the tests in Treas. Reg. §1.954-4(b)(2)(ii)(b) and (c) by providing that, even if assistance furnished by a related person or persons to a CFC is not considered substantial under paragraphs (b) or (c) in isolation, it may nevertheless constitute substantial assistance when taken together or in combination with other assistance furnished by a related person or persons to the CFC. Treas. Reg. §1.954-4(b)(2)(ii)(e) provides that, in applying Treas. Reg. §1.954-4(b)(2)(ii)(b) and (d), assistance in the form of direction, supervision, services, or know-how shall not be taken into account, unless the assistance so furnished assists the CFC directly in the performance of the services performed. Treas. Reg. §1.954-4(b)(3) sets

forth examples, including examples addressing the application of the substantial assistance test.

## B. DISCUSSION

The substantial assistance rules were published as final regulations in 1968 (TD 6981). 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 service income. Since the regulations were published in 1968, there has been a substantial expansion in the reach of the global economy, particularly in the provision of global services. As a result, many of the U.S. multinationals that provide services outside of the United States currently have globally integrated businesses with support capabilities for unrelated customer projects in different geographic locations, largely based on factors such as expertise and cost efficiencies.

For example, a CFC may contract with an unrelated person to provide installation and subsequent repair services. A related CFC, however, is the foreign corporation that provides the repair services. Although the foreign related CFC that is providing the support services will continue to have foreign base company services income to the extent that it performs those services outside of its country of incorporation, it does not seem appropriate in the current global economy to continue to treat the profits of the CFC contracting to furnish services to the unrelated person as foreign base company

services income because of the support services provided by a related foreign person. If the substantial assistance regulations are not amended to deal with these types of businesses 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 by, for example, requiring a taxpayer to duplicate a full service infrastructure in each country.

The Treasury Department and the IRS, however, 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 provides 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. Accordingly, the Treasury Department and the IRS will revise the regulations to eliminate the substantial assistance rules, except in certain limited instances in which a United States person or persons provide sufficient assistance directly or indirectly to a related CFC.

### C. PROPOSED GUIDANCE

The Treasury Department and the IRS will amend Treas. Reg. §1.954-4(b)(1)(iv) and (b)(2)(ii) and the examples thereunder. Treas. Reg. §1.954-4(b)(1)(iv) as amended will provide that services performed by a CFC in a case where substantial assistance by a related United States person or persons (as the term is defined in section 957(c) of the Code) contributes to the performance of such service will constitute “services which are performed for, or on behalf of, a related person.” Treas. Reg. §1.954-4(b)(2)(ii) as amended will provide that “substantial assistance” consists of assistance furnished

(directly or indirectly) by a related United States person or persons to the CFC if the assistance satisfies an objective cost test. The subjective “principal element” test will no longer apply to determine substantial assistance. For purposes of the objective cost test, the definition of the term “assistance” will include, but will not be 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 United States person to a CFC.

The cost 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. The term “cost” will be determined after taking into account adjustments, if any, made under section 482 of the Code.

Taxpayers may apply the cost test either by demonstrating that the assistance provided, directly or indirectly, by related United States persons is below the 80 percent cost threshold, 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. For this purpose, services provided by a CFC itself are not assistance provided “indirectly” by a related United States person (or persons).

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 for purposes of this Notice.

The examples under Treas. Reg. §1.954-4(b)(2)(ii) will be amended to reflect the

amendments to the regulations. The application of the proposed cost test is illustrated by the following examples.

Example 1: 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 or a related CFC (CFC2).

Example 2: 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) that exceed 80 percent of the total cost to CFC2 for performing the contract.

Example 3: 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 \$60x. CFC1 contracts with CFC2 to provide those services and others to CFC2 for \$70x. CFC2 uses those services together with services it performs itself that cost CFC2 \$30x to design the bridge for FP. CFC2 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 CFC2.

#### D. EFFECTIVE DATE

Regulations to be issued incorporating the guidance set forth in this notice will apply to taxable years of foreign corporations beginning on or after January 1, 2007 and to taxable years of United States shareholders in which or with which such taxable years of the foreign corporations end. Until such regulations are issued, taxpayers may rely on this notice.

### SECTION 3. FOREIGN BASE COMPANY SHIPPING RULES

Section 415 of the American Jobs Creations Act ("AJCA") repealed sections 954(a)(4) and 954(f) of the Code, (the foreign base company shipping rules). It also

made conforming amendments by repealing sections 954(b)(6) and (b)(7) and striking a reference to foreign base company shipping income in section 954(b)(5). These changes are effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end. Further, section 415 of the AJCA enacted a special safe harbor for certain leasing activities under section 954(c)(2)(A). The special safe harbor rule has been addressed in a separate published guidance project. See Notice 2006-48, 2006-21 I.R.B. 1.

As a result of, and as of the effective date of, the repeal of the foreign base company shipping income rules, Treas. Reg. §1.954-1(e)(4)(i)(A), which provides that income that qualifies as foreign base company shipping income will not be considered insurance income or income in any other category of foreign base company income, is obsolete and Treas. Reg. §1.954-6, which prescribes rules for determining foreign base company shipping income, is only effective for purposes of applying the rules for the withdrawal of previously excluded subpart F income from qualified investments under section 955. Accordingly, Treas. Reg. §1.954-6 will be amended to include new applicability language.

Moreover, the repeal of sections 954(a)(4) and 954(f) of the Code was only intended to eliminate the separate category of foreign base company shipping income. It was not intended to exclude income from subpart F that would otherwise qualify under another category of foreign base company income. Income that might have been described in sections 954(a)(4) and 956(f) before the AJCA still must be tested under

the remaining categories of foreign base company income. Consequently, this notice confirms that income described in section 954(f) as it existed before its repeal will continue to constitute subpart F income to the extent that it falls within another category of foreign base company income.

#### SECTION 4. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments on the new substantial assistance rules proposed in this notice. Comments are requested on whether the new rules are appropriately targeted and whether any modifications to the rules should be made before they are promulgated as regulations. In particular, comments are requested on whether the proposed cost test is appropriate for certain industries, and if not, how the rules could be modified or supplemented to properly address those industries while still addressing the Treasury Department's and the IRS' concerns about shifting profits offshore to CFCs organized in low tax jurisdictions. In addition, the Treasury Department and the IRS understand that taxpayers are also concerned with the special rule concerning a guaranty of performance contained in Treas. Reg. §1.954-4(b)(2)(i). The Treasury Department and the IRS are reviewing this rule, particularly in light of Treas. Reg. §1.482-9T, and request comments on whether changes to this rule are warranted and, if so, how it should be modified.

Written comments on the issues addressed in this notice may be submitted to the Office of Associate Chief Counsel International, Attention: Notice 2007-13, room 4710, CC:INTL:BR2, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, 20224. Alternatively, taxpayers may submit comments electronically to

Notice.Comments@m1.irs.counsel.treas.gov. Comments will be available for public inspection and copying.

#### SECTION 5. DRAFTING INFORMATION

The principal author of this notice is Ethan Atticks of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Ethan Atticks at (202) 622-3840 (not a toll-free call).