

Reform Intercompany Sales and Services Income Under Subpart F

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This proposal recommends limiting subpart F sales and services income to transactions that erode the U.S. tax base; that when a U.S. company sells goods to its foreign subsidiary, any contract manufacturing be considered to erode that base; and that proposed weakening of the substantial assistance rules be reversed and treat as substantial assistance a foreign subsidiary's use of any intangibles not properly accounted for under sections 367 or 482.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. This is the third in a series of Shelf Project international tax proposals by the author.

The tax community can propose, follow, or edit proposals at <http://www.taxshelf.org>. A longer description of the Shelf Project can be found at "The Shelf Project: Revenue-Raising Proposals That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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I. Background

Section 482 gives the IRS authority to prevent erosion of the U.S. corporate income tax base by artificial intercompany pricing. To illustrate, a domestic corporation may charge too little for goods sold to, or services performed for, a foreign subsidiary. This inflates the subsidiary's profit (which the United States does not tax) while decreasing that of the parent (which the United States does tax).

But enforcement of intercompany pricing requires enormous effort. Hundreds of pages of regulations are still being amended, and they have not been a resound-

ing success. In one famous case,¹ internal company memos stated that low prices for goods sold to a Swiss subsidiary were made only for tax reasons and then focused on the possibility of detection. Yet it took more than 20 years for the government to attribute most of the subsidiary's artificial profit to the parent. In another case, a Cayman Islands subsidiary that contracted to manage a hospital in Saudi Arabia was considered to earn one-fourth of the total profit despite its almost total dependence on the skills and intangible know-how of its domestic parent.² Moreover, the Cayman subsidiary would not have obtained the hospital management contract without the parent guaranteeing its subsidiary's performance.

A. The Revenue Act of 1962

Although the *DuPont* and *HCA* cases were decided well after 1961, the techniques used were known then, when President Kennedy described them as:

artificial arrangements between parent and [foreign] subsidiary regarding intercompany pricing . . . , the shifting of management fees and similar practices which maximize the accumulation of profits in a tax haven.³

That message and related proposals led to the enactment of subpart F, which included a foreign subsidiary's income from certain transactions with related parties (referred to as subpart F income) as current income of the U.S. parent. In significant part, this was intended to make section 482 attribution of subsidiary sales and services income to the parent unnecessary. Whether the transactions resulted in the parent earning \$20 and the subsidiary \$80, or the parent \$80 and the subsidiary \$20, the entire \$100 would be taxed to the parent.

Two major types of subpart F income were sales and services income. The first, sales income, covered a Swiss subsidiary's profit from purchase of inventory from its U.S. parent (a related party) and its resale to unrelated parties. It did not cover the resale profit if the Swiss subsidiary substantially transformed — that is, manufactured — the property it had purchased. For example, if a Swiss subsidiary purchased wood pulp from the parent and transformed it into paper, the profit would not

¹*DuPont de Nemours Inc. v. United States*, 608 F.2d 445 (Ct. Cl. 1979).

²*Hospital Corp. of America (HCA) v. Commissioner*, 81 T.C. 520 (1983). Since the court found that the parent had not transferred any intangibles to the Cayman Islands subsidiary, the subsidiary had no assets on which it could be entitled to any of the services income.

³Special Message by President John F. Kennedy to the Congress, on Taxation (Apr. 20, 1961).

constitute foreign base company sales income.⁴ Manufacturing profit did not warrant subpart F treatment because (to meet competition) manufacturing was considered a legitimate business function abroad, and independent manufacturing capacity of a subsidiary meant that it was not indirectly using the assets of — in effect, acting on behalf of — its parent. Under those conditions, subpart F was not needed to prevent avoidance of section 482.

Services income was defined as services performed for or on behalf of the U.S. parent. The regulations, influenced by situations like those in *HCA*, treat services as performed for the U.S. parent if the parent either furnishes substantial assistance or guarantees the subsidiary's performance and furnishes some assistance.⁵ As with manufacturing and sales income, services profit did not warrant subpart F treatment, because (to meet competition) performing services abroad was considered a legitimate business function. The capacity of a subsidiary to perform them without substantial assistance or guarantee meant that it was not indirectly using the assets of — in effect, acting on behalf of — its parent. Again, in those circumstances, subpart F was not needed to prevent avoidance of section 482.

B. No Longer the 1960s

Two aspects of the 1960s economic activity that shaped subpart F have become less relevant today. The first is how much less conducting a business corresponds with physical activity: manufacture of heavy products at a factory and the performance of services by people at a specific location. The old nexus may explain why subpart F sales income did not encompass goods manufactured or sold for use in the country of local incorporation, and why services income did not encompass services performed in the local country.⁶

Now, how products are sold and services are performed — as well as the products and services themselves — may be divorced from a specific location.⁷ Moreover, the products and services increasingly consist of furnishing intangibles: information, data, entertainment, communications, finance. The changes invite reassessment of the importance of where a sale takes place or where services are performed, as well as of differing subpart F results that depend on characterizing intangible transactions as sales of property or the performance of services.

Accompanying (although independent of) the diminishing importance of place is the diminishing importance of incorporation. For U.S. tax purposes, the check-the-box regulations allow domestic parent corporations to treat foreign-incorporated subsidiaries as if they do not exist.⁸

⁴Reg. section 1.954-3(a)(4), Example 1.

⁵Reg. section 1.954-4(b).

⁶Section 954(d)(1)(A) and (B) and section 954(e)(1)(B), still in effect.

⁷As stated in Treasury's "Selected Tax Policy Implications of Global Electronic Commerce," (Nov. 1996), often referred to as the Discussion Draft: "Electronic commerce may dissolve the link between an income-producing activity and a specific location." Section 7.2.3.1 of the draft.

⁸Reg. section 301.7701-2(a) and -3(a).

A second change has been loss of American economic hegemony. Although national interest prompted subpart F's preservation of the U.S. tax base, only absolute dominance could give the United States the luxury of trying to preserve other countries' tax bases as well. Subpart F deterred U.S. multinationals from siphoning sales and services income to low-tax foreign jurisdictions not only from themselves, but also from their high-taxed foreign subsidiaries.⁹

C. The Sea Change

The Tax Reform Act of 1986 reflected a sea change. For purposes of the foreign tax credit, the act treated deductible payments of interest and royalties from foreign subsidiaries to U.S. parents — which eroded a foreign tax base — in the same way as dividends. Legislative background described this as an incentive for U.S. multinationals to reduce their foreign taxes.¹⁰ The 2006 enactment of section 954(c)(6) was just extending that logic when it exempted foreign-to-foreign interest and royalties from subpart F.

Even before section 954(c)(6), check-the-box regulations had allowed much the same result. Interest and royalties paid by a disregarded German subsidiary to its disregarded Irish affiliate would not be subpart F income — in fact, for U.S. purposes, it would not be income at all. Assuming that the only entity recognized for U.S. tax purposes was the Netherlands parent of both, no amounts were being paid to anyone: A single Netherlands company cannot pay interest or royalties to itself. Check-the-box similarly nullified subpart F for services income between foreign affiliates. If the disregarded Irish company performed untaxed services for a third party on behalf of the disregarded German affiliate, the Netherlands parent would be considered to be performing services solely on its own behalf.

Check-the-box did not, however, nullify subpart F for sales income. For example, under Netherlands law the profit of an Irish sales *branch*, as well as that of a subsidiary, may still be excluded from Netherlands income. Section 954(d)(2) provides that if the Irish branch has substantially the same tax effect as would an Irish subsidiary (that is, the low-taxed Irish profit is excluded from high-taxed Netherlands income), for purposes of subpart F the branch will be considered an Irish corporation purchasing goods from its Netherlands parent and reselling them.¹¹

⁹Low-taxed dividends, interest, and royalties from one foreign subsidiary to another were, until the 2006 enactment of section 954(c)(6), a species of subpart F income known as foreign personal holding company income. See section 954(c) (personal holding company income), 954(d) (sales income), and 954(e) (services income). For the statutory mechanics, see sections 952(a)(2) and 954(a)(2).

¹⁰Section 904(d)(3) and the 1986 blue book description at 866.

¹¹The section 954(d)(2) branch rule embodies perhaps the purest expression of the United States as tax policeman. It evinces U.S. unwillingness to tolerate avoidance of Netherlands tax that the Netherlands itself tolerates.

Another infirmity of the section 954(d)(2) branch rule is that it contemplates and literally applies only to a branch deriving
(Footnote continued on next page.)

II. The Current Situation

The enormous changes since subpart F was enacted require rethinking foreign base subpart F sales and services income. The approach to both should coalesce, since the difference between sale of goods and the performance of services continues to narrow. There should be at least three modernizing changes.

1. In view of globalization, eliminating the exception from subpart F for local incorporation.
2. In view of encouragement of U.S. multinationals to reduce their foreign taxes, restricting subpart F to transactions that erode the U.S. tax base. This would entail at least repeal of the section 954(d)(2) branch rule, and might well go further and limit subpart F sales and services income to transactions that reduce U.S. taxable income.
3. Concomitant with having subpart F sales and services income limited to the U.S. tax base, ensuring preservation of that base, in two ways:
 - stopping the avoidance of subpart F sales income by contract manufacturing; and
 - stopping the avoidance of subpart F services income when foreign subsidiaries perform services with substantial assistance by a United States parent which has expatriated intangibles.

Recommendations

1. Local Incorporation. The exclusion from subpart F of profit from sale of goods manufactured or used in the country of incorporation, or from services being performed in that country, has lost whatever rationale it had. As the Treasury Discussion Draft on electronic commerce states:

Electronic commerce may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. . . .

Services frequently no longer need to be produced at the place where they are consumed.¹²

Accordingly, there remains little reason to continue the local incorporation exceptions and it is recommended that section 954(d)(1)(A) and (B), as well as section 954(e)(1)(B), be repealed.

2. Limiting subpart F income. As previously mentioned, foreign tax credit rules encourage U.S. multinationals to erode foreign tax bases. Section 954(c)(6) and check-the-box regulations likewise encourage that erosion by excluding payments of interest, royalties, and services

“such income” — that is, income from purchasing and reselling goods. (In a subpart F study issued in 2000, Treasury stated that Congress was concerned about locating either a sales or manufacturing branch outside the country of incorporation. It cited as support page 84 of the Senate report on the Revenue Act of 1962. But that page does not refer to a branch outside the country of incorporation.)

¹²“Selected Tax Policy Implications of Global Electronic Commerce,” *supra* note 7, sections 7.2.3.1 and 3.2. The first sentence was previously quoted in that note.

income between foreign subsidiaries from subpart F. This eliminates the rationale for using sales income alone to preserve foreign tax bases, particularly since with respect to intangibles less clarity exists between the transfer of property and services. At the least, then, the section 954(d)(2) branch rule should be repealed. More logically, related subpart F sales and services income should be limited to transactions with U.S. persons.

3. Preserving the U.S. tax base. Subpart F sales income does not include profit from the sale of property that a foreign subsidiary has substantially transformed — that is, manufactured. Foreign subsidiaries have successfully come within this exception by hiring another party to physically produce the goods at a fixed price — say, cost plus.

The IRS initially took the position that if a foreign subsidiary was manufacturing goods, the actual physical producer must (as an agent) be a branch of the subsidiary. It therefore attempted to apply both the manufacturing branch and comparative foreign tax rate rules, but lost. Accordingly, in Rev. Rul. 97-48,¹³ the Service agreed not to attribute the place of physical production to the foreign subsidiary. Under that view, a foreign subsidiary could be manufacturing a product without doing it anywhere. An IRS official has indicated that there will be upcoming guidance on contract manufacturing that will make taxpayers “happy.”¹⁴

Recommendation

If subpart F sales income includes profit by foreign subsidiaries only on resale of property sold to them by a U.S. person, the importance of rules for contract manufacturing should diminish. But when that property *is* sold to a foreign subsidiary by a U.S. person, avoidance of the subpart F sales income by contract manufacturing arrangements of the foreign subsidiary should not be allowed.

The U.S. parent, rather than the foreign subsidiary, could have entered into the contract manufacturing arrangement without any real economic difference. Accordingly, any arrangement by a foreign subsidiary for the contract manufacture of goods purchased from a U.S. related party should be considered done on behalf of the U.S. parent. The subsidiary would not be considered to have transformed the property, and the resale profit would be treated as foreign base company sales income. This would cover contract manufacturing arrangements with either related or unrelated parties.

¹³1997-2 C.B. 89, *Doc 97-31487*, 97 TNT 223-3. Neither of the subpart F cases that the ruling agreed to follow mentioned contract manufacturing cases identifying the manufacturer in an excise tax context. *See Carbon Steel Co. v. Llewellyn*, 251 U.S. 501 (1920); *Charles Peckat Mfg. Co. v. Jarecki*, 196 F.2d 849 (7th Cir. 1952); *Polaroid Corporation v. United States*, 235 F.2d 276 (1st Cir. 1959). Moreover, cases such as *Suzy's Zoo v. Commissioner*, 273 F.3d 875, *Doc 2001-29250*, 2001 TNT 227-64 (9th Cir. 2001), involve the question of who is the manufacturer.

¹⁴Dustin Stamper, “DiFronzo Defends Forthcoming Regs on Triangular Reorganizations,” *Tax Notes*, June 11, 2007, p. 1010, *Doc 2007-13416*, 2007 TNT 108-2.

Contract manufacturing would be defined broadly. Provisions about title and risk of loss would be given little weight, particularly within an affiliated group (where it has little economic significance).

Foreign Base Company Services Income

As previously mentioned, the check-the-box regulations have effectively nullified subpart F services income between related foreign corporations. But a recent proposed modification of the substantial assistance rules would also effectively nullify them even when they erode the U.S. tax base. Notice 2007-13¹⁵ states that Treasury and the IRS will revise the foreign base company services regulations to eliminate the substantial assistance test, except when a U.S. person provides sufficient assistance to a foreign subsidiary. In that case, Treasury and the IRS are concerned that the foreign subsidiary may effectively act as the U.S. parent's agent — that is, use the parent's intangibles to perform the services.

In brief, the modification would:

- eliminate the subjective test of substantial assistance, which is whether the assistance is “a principal element” in producing the income;
- dilute the regulations’ objective test, under which providing 80 percent of the costs constitutes substantial assistance; and
- cripple the objective percentage test by taking into account only the cost of assistance provided by a U.S. parent. (The cost of assistance provided by related foreign subsidiaries would not count.)

Moreover, the current regulations have rules about a U.S. parent guaranteeing its foreign subsidiary's performance of services. The subsidiary is considered to be performing services on behalf of the parent if the parent either pays for or performs any such services (or a significant portion of related services). Notice 2007-13 states that Treasury and the IRS understand that taxpayers are concerned about the guarantee of performance test and that it is being reviewed in light of regulations under section 482.

Impetus for the change is stated to be “substantial expansion in the reach of the global economy, particularly in the provision of global services.” It is said that, as a result, many U.S. multinationals have foreign subsidiaries with support capabilities, and that present regulations may impair those multinationals’ efficient operation.

Discussion

The proposed modification of what constitutes substantial assistance rewards prior tax avoidance. It benefits those companies that have successfully avoided U.S. taxes by expatriating intangibles: It would let use of those intangibles avoid future U.S. taxes. U.S. parents could avoid subpart F services income because their foreign subsidiaries have “support capabilities.” But they have those support capabilities only because U.S. parents have transferred to them valuable intangibles — know-how, reputation, workforce, and technology — without receiving U.S. taxable income equal to that value. Under

sections 367 and 482, the U.S. transferor of an intangible should receive “income commensurate with” its value, so that the tax *value* of U.S.-developed intangibles is not expatriated but remains within U.S. tax jurisdiction.

In many if not most cases, the time for asserting taxable income from those transfers has expired. But that should not enable a foreign subsidiary to use the expatriated intangibles without the U.S. transferor being considered to have provided the subsidiary with substantial assistance. Income from those intangibles belongs within U.S. tax jurisdiction. Their use by a foreign subsidiary to perform services should be considered as performed with assistance from — that is, on behalf of — a related U.S. person that did not receive adequate consideration for transferring the income-producing assets to it.

Similar avoidance could occur by the suggestion in the notice to replace subpart F income from guarantee of performance with allocations under section 482. This runs the film of subpart F backward. The provisions for subpart F sales and services income were enacted to forestall allocations under section 482. To go back to section 482 would bring back endless and expensive controversies. It would also give amnesty to companies that have avoided the application of section 482 (or section 367) to expatriation of their intangibles.

Recommendation

It is recommended that the current substantial assistance and guarantee of performance rules be limited to services performed on behalf of a U.S. person, but also that they be retained and strengthened. In that context, it is recommended that services performed by a foreign subsidiary be considered performed on behalf of a related U.S. person to the extent that those services use intangibles obtained from a related U.S. person. This rule would not apply if it were shown that the U.S. transferor received (or is receiving) payments equal to the value of the intangibles transferred.¹⁶ It would apply only to the extent that value of the services (whether for a related or unrelated person) depends on the use of expatriated intangibles.

The amount of revenue at stake can be inferred from the current concern of companies that provide services abroad. Moreover, as far back as 1982, McDermott — a publicly traded U.S. corporation in the business of providing oil drilling services — became a subsidiary of what until then had been *its* Panamanian subsidiary. It did so to avoid estimated subpart F income (under the substantial assistance rules) of \$585 million over the following five years.¹⁷ In 1986 Congress's concern over nonapplication of the substantial assistance rules (by reason of nontaxation in the country where the services were performed)¹⁸ led it to amend section 954(b)(4).

In short, U.S. parents have enabled their foreign subsidiaries to perform services abroad by expatriating

¹⁶It would also not apply if it were shown that the foreign subsidiary obtained or developed the intangibles independently of the U.S. affiliated group.

¹⁷See *Bhada v. Commissioner*, 89 T.C. 959 (1989), at 961-962.

¹⁸See *Hospital Corp. of America*, *supra* note 2.

¹⁵Notice 2007-13, 2007-5 IRB 410, *Doc* 2007-726, 2007 TNT 7-7.

intangibles to them without adequate consideration. Use of those intangibles constitutes substantial assistance to the subsidiary in performing the services. The government should meet the stealth avoidance of sections 367 and 482 by resorting to subpart F, not by scuttling it.¹⁹

III. Conclusion

These recommendations are intended to modernize the increasingly outdated assumptions of subpart F.

¹⁹This recommendation constitutes a corollary of a proposal in the Feb. 4 article, that companies report the intangibles of their foreign subsidiaries and describe how the subsidiaries acquired them.

Local incorporation matters little today. Restricting sales and services income to erosion of the U.S. tax base accords with what has been done in other areas.

The services proposals focus on preventing erosion of the U.S. tax base. Each rests on indirect use of a U.S. parent's assets — which is the furnishing of substantial assistance. The central issue of the U.S. international tax system has become the expatriation of U.S. intangibles abroad. In the case of services income, the proposals intend to mitigate the result of that expatriation.²⁰

²⁰Repeal of the passive foreign investment company exception for foreign subsidiaries, proposed in the Jan. 28 article, is also intended to mitigate the effect of expatriating intangibles.