

Northwestern Journal of International Law & Business

Volume 18
Issue 1 *Fall*

Fall 1997

The United States' Response to Tax Havens: The Foreign Base Company Services Income of Controlled Foreign Corporations

Eric T. Laity

Follow this and additional works at: <http://scholarlycommons.law.northwestern.edu/njilb>

 Part of the [International Law Commons](#), [Taxation-Transnational Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Eric T. Laity, *The United States' Response to Tax Havens: The Foreign Base Company Services Income of Controlled Foreign Corporations*, 18 *Nw. J. Int'l L. & Bus.* 1 (1997-1998)

This Article is brought to you for free and open access by Northwestern University School of Law Scholarly Commons. It has been accepted for inclusion in *Northwestern Journal of International Law & Business* by an authorized administrator of Northwestern University School of Law Scholarly Commons.

ARTICLES

The United States' Response to Tax Havens: The Foreign Base Company Services Income of Controlled Foreign Corporations

*Eric T. Laity**

I. Introduction.....	3
II. The Types of Relationships	4
A. Related Person Defined.....	4
B. The Types of Tainted Service Relationships.....	5
1. The Related Person as Client.....	5
2. The Related Person as Prime Contractor	6
a. Guaranties Generally.....	7
b. The Guaranty-Plus Rule.....	7
3. Servicing Property Sold by the Related Person	10
4. Substantial Assistance by the Related Person.....	10
a. Related Person's Assistance by Services	11

* B.A., J.D., Harvard University. Professor of Law, Oklahoma City University School of Law. The research for this article was supported in part by a grant from the Kerr Foundation. All companies described in the examples are fictional. Copyright 1997 by Eric T. Laity.

b.	Financial Assistance from Related Person	13
c.	Comparing the Two Regimes.....	14
	Recommendation One	15
	Recommendation Two	16
d.	Substantial Assistance by Guaranties.....	16
	(1) Performance Guaranties.....	16
	(2) Payment Guaranties	17
5.	Other Tainted Service Relationships	18
C.	The Requirement of a Related Person.....	18
1.	Independent Offshore Service Operations	18
2.	Transactions Affecting Foreign Tax Bases.....	19
	a. The Limits of Prescriptive Jurisdiction in Taxation.....	19
	b. The Use of Branches	20
	(1) Branch in a Foreign Market.....	20
	(2) Tax Haven Branch	21
	(3) Combination of Branches	22
	(4) An Argument Against a Branch Rule for Services.....	22
	Recommendation Three.....	23
	c. Minimal Presence in the Foreign Market.....	24
3.	Eliminating the Requirement of a Related Person.....	25
	Recommendation Four.....	26
III.	The Kinds of Services.....	26
A.	Services Included	27
1.	Financial Services.....	27
	a. Factoring	27
	(1) Related-Person Factoring.....	29
	(2) Other Factoring.....	30
	(3) Examples	32
	b. Receivables Financing	34
	c. Leasing Services.....	34
	(1) Rental Income from Leasing	35
	(2) Interest Income from Leasing.....	36
	(3) Caveat About Investments in United States Property	37
2.	Contract Manufacturing.....	38
B.	Services Excluded	38
1.	Services Performed Within the Country of Incorporation.....	38
	Recommendation Five	40
	Recommendation Six.....	40
	Recommendation Seven	42
	Recommendation Eight	42
2.	Certain Marketing Services	43
C.	Preempted Services	43
IV.	Concluding Observations and Summary of Recommendations	46

I. INTRODUCTION

United States multinational corporations save substantial amounts of income tax through the use of foreign base companies organized in tax havens. The United States has responded to the erosion of its tax base through the use of foreign base companies by enacting the Subpart F rules of the Internal Revenue Code (or "Code").¹ Under those rules, the United States taxes its multinational corporations on much of the income derived by their foreign subsidiaries through base company operations in tax havens. Subpart F is only a limited response; significant amounts of income continue to escape U.S. taxation.

This article is a detailed study of the taxation by the United States of foreign base company services income. Foreign base company services income is defined generally as the income derived by a controlled foreign corporation from the performance of services for a related person.² Controlled foreign corporations, in turn, generally are the foreign subsidiaries of U.S. parent corporations.³ A controlled foreign corporation's foreign base company services income is taxed to its U.S. parent corporation, subject to various exclusions and qualifications. This article defines the class of suspect relationships between the controlled foreign corporation and its related persons and delineates the category of relevant services. The article's contributions to the literature on controlled foreign corporations include: the proper coordination of the guaranty-plus rule with the substantial assistance rule;⁴ a critique of the avoidance of tax through the use of branches and, more generally, of the requirement that a related person figure in a tax haven arrangement before the United States imposes tax;⁵ a clear analysis of the complex relationship among related-person factoring, foreign personal holding company income, and foreign base company services income;⁶ and

¹ Subpart F in the parlance of international tax lawyers comprises sections 951-964 of the Internal Revenue Code. Section 954(e) defines foreign base company services income, the subject matter of this article. There is very little legislative history for section 954(e). The provision originated in the Senate as an amendment to what was to become the Revenue Act of 1962, Pub. L. No. 87-834, § 12, 76 Stat. 960, 1006 (1962). S. REP. No. 1881, 87th Cong., 2d Sess. (1962), reprinted in 1962-3 C.B. 703, 785. The Senate Report states only that the purpose of the provision is "to deny tax deferral where a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax for the service income." *Id.* at 790. Code section 954(e) is broader in scope, of course, and reaches a service subsidiary that is separated from a U.S. parent corporation that engages only in services. Examples include corporations engaged in engineering, construction, or oil field services.

² I.R.C. § 954(e)(1)(A) (1994). All citations in this article to Code section 954 are to that section as it appears in the current United States Code, which is dated 1994.

³ The statutory definition of a controlled foreign corporation includes more within its scope and can be found in section 957(a) of the Internal Revenue Code.

⁴ See Parts II.B.2 and II.B.4.d *infra* of this article.

⁵ See Part II.C *infra* of this article.

⁶ See Part III.A.1.a *infra* of this article.

a critique of the exclusion of services performed within a controlled foreign corporation's country of incorporation.⁷ The article recommends a number of changes in the Code's definition of foreign base company services income and the supporting administrative law.

II. THE TYPES OF RELATIONSHIPS

A controlled foreign corporation derives foreign base company services income by rendering services for the benefit of a related person through any of several relationships. This section first touches upon the relevant definition of a related person, then describes the principal relationships that give rise to foreign base company services income, and concludes by evaluating the requirement that a related person participate in the controlled foreign corporation's tax haven service operations. Despite the technical requirements that follow, the reader should keep in mind that the United States is primarily concerned with service operations conducted in foreign jurisdictions that have lower rates of income tax than the United States. If the controlled foreign corporation's services income is subject to a rate of foreign income tax substantially the same as that of the United States, the income will not be taxed to the U.S. parent.⁸

A. Related Person Defined

For the purpose of foreign base company services income, a related person is any entity that controls, is controlled by, or is under common control with the controlled foreign corporation.⁹ The status of related person is not reserved for corporations; individuals, partnerships, trusts, and estates may also be related persons.¹⁰ The definition of related person is not

⁷ See Part III.B.1 *infra* of this article.

⁸ I.R.C. § 954(b)(4).

⁹ I.R.C. § 954(d)(3).

¹⁰ *Id.* Control of a partnership, trust, or estate is defined as the ownership, directly or indirectly, of more than 50% by value of the beneficial interests in the entity. *Id.* The qualifying control of a corporation, on the other hand, may be achieved through either voting power or value. Control of a corporation is defined as the ownership, directly or indirectly, of more than 50% of either the total voting power or the total value of all classes of the corporation's stock. *Id.* Rules similar to those of Code section 958 apply to determine indirect and constructive ownership of interests in a corporation or other entity. *Id.* The indirect ownership principles of section 958(a) are to be applied without regard to whether an entity is foreign or domestic and without regard to whether an individual is a citizen or resident of the United States. Treas. Reg. § 1.954-1(f)(2)(iv) (1995). Prior to the amendment of section 954(d)(3) of the Code by the Tax Reform Act of 1986, P.L. No. 99-514, § 1221(e), 100 Stat. 2085, 2553-54, *reprinted in* 1986-3 (v. 1) C.B. 1, 470-71, the definition of related person did not fully include partnerships. This failure led to arrangements by which controlled foreign corporations would receive income from related partnerships without attracting immediate taxation under Subpart F to their United States shareholders under circumstances in which the same income received from related corporations would have caused immediate taxation to their United States shareholders. *See MCA, Inc. v. United States*, 685 F.2d 1099 (9th Cir.

limited to domestic persons; foreign persons may fall within the definition. Hence, services performed for a foreign person can give rise to foreign base company services income.

B. The Types of Tainted Service Relationships

In general terms, the controlled foreign corporation must perform its services either for a related person as its client or on behalf of a related person as its prime contractor with a third person as the ultimate client.¹¹ There are four specific relationships, among others, with related persons that may cause a controlled foreign corporation's services income to fall within foreign base company services income. A related person may have more than one relationship with a controlled foreign corporation, and a transaction may reflect more than one relationship.

1. *The Related Person as Client*

The first relationship is the straightforward case: when the related person is a client of the controlled foreign corporation. Specifically, foreign base company services income includes the income derived by a controlled foreign corporation from services for which the corporation receives a substantial financial benefit from a related person.¹² Accordingly, a controlled foreign corporation derives tainted income if it performs services under contract with a related person.¹³ The following example illustrates this simple case.

EXAMPLE ONE: *Controlled Foreign Corporation as In-House Provider of Services.* General Oil Company, a Delaware corporation, conducts exploration and production operations in several countries in western Africa and southeastern Asia. It carries out much of its own drilling operations rather than contracting out those operations to third parties. General also follows the practice of organizing a separate subsidiary in each country in which it conducts exploration and production activities. To conduct its foreign drilling operations, General organizes General Drilling Company in Cyprus. Assume that Cyprus imposes no income tax on Drilling's foreign-source income. General's exploration subsidiaries now contract with Drilling each time they need a well to be drilled. Drilling's crews and drilling rigs move from location to loca-

1982) (holding that foreign entities were partnerships and not corporations for tax purposes, and thus, under pre-1987 law, rents and royalties received from the entities by a related controlled foreign corporation were not foreign personal holding company income and thus not Subpart F income).

¹¹ I.R.C. § 954(e)(1)(A).

¹² Treas. Reg. § 1.954-4(b)(1)(i) (1983). All citations in this article to Treasury Regulations section 1.954-4 are to that regulation as it was last amended, which occurred in 1983.

¹³ A controlled foreign corporation also derives tainted income in this sense if it acts as a subcontractor to a related person. The relationship of a controlled foreign corporation as a subcontractor to a related person serving as a general contractor falls more centrally within the tainted class of relationships discussed in Part II.B.2 *infra* of this article.

tion as needed, while Drilling's income is remitted to Cyprus by its in-house clients. Result: Drilling's income from providing services to its sibling corporations is included in General's gross income.¹⁴

2. *The Related Person as Prime Contractor*

Foreign base company services income includes the income a controlled foreign corporation derives from rendering services that a related person is obligated to perform.¹⁵ Hence, a controlled foreign corporation generally derives foreign base company services income if it takes an assignment of a services contract from a related person. In addition, the controlled foreign corporation derives foreign base company services income if it acts as a subcontractor for a related person. Foreign base company services income also includes the income a controlled foreign corporation derives from rendering services that a related person was obligated to perform at some point in the past but is no longer required to perform.¹⁶ Thus, the release of the related person from its obligations under a contract assigned to a controlled foreign corporation does not change the classification of the corporation's services income.¹⁷ The following example illustrates the second type of tainted relationship:

EXAMPLE TWO: *Controlled Foreign Corporation as In-House Subcontractor.* Dominion Power Company, Inc., a California corporation, provides engineering, procurement, and construction services to clients around the world. Dominion will also operate power plants under contract with the owner or give technical assistance to owners who operate their own facilities. Dominion has created two subsidiaries to assist it with its foreign contracts. Dominion Managers Limited ("Managers") and Dominion Operators Limited ("Operators") are both organized in the Republic of Ireland. Assume that the two subsidiaries' foreign-source income is free of Irish income tax. Managers provides construction management services at Dominion's foreign construction sites, while Operators provides on-site short-term technical assistance to owners of foreign power plants. In all cases, clients enter into comprehensive contracts with Dominion for all the services they require. Dominion in turn subcontracts with its two Irish subsidiaries to provide any construction management services and on-site technical assistance called for under the general contract. Result: the income of the two Irish subsidiaries from providing services that Dominion is obligated to provide is included in Dominion's gross income.¹⁸

The reverse situation, when the related person acts as a subcontractor for the controlled foreign corporation, is treated in part II.B.4 of this article.

¹⁴I.R.C. § 954(e).

¹⁵Treas. Reg. § 1.954-4(b)(1)(ii).

¹⁶*Id.*

¹⁷Treas. Reg. § 1.954-4(b)(3), Ex. 5.

¹⁸I.R.C. § 954(e).

a. Guaranties Generally

Under a guaranty, the guarantor is obligated to perform the specified obligations of a third person in the event that the third person defaults in its performance. The guarantor can be said to have contingent obligations under the third person's contract. In that sense, a guaranty from a related person of a controlled foreign corporation's obligations under a service contract would cause the corporation's income to fall within foreign base company sales income; the corporation has rendered services that a related person is obligated to perform. And indeed, a guaranty by a related person of a controlled foreign corporation's performance of a service contract at times can be viewed as a disguised assignment of the service contract. The guaranty can be a disguised assignment when the client has negotiated the contract with the related person and relied on the related person's skills in entering into the contract. Hence, a related person's guaranty of a controlled foreign corporation's service contract in some circumstances must cause the corporation's income to fall within foreign base company services income. On the other hand, the related person's guaranty may simply be conventional assistance to the controlled foreign corporation for which the related person receives a fee. Such a guaranty is an instance of the more general phenomenon of a related person assisting a controlled foreign corporation in the performance of its contracts. The rules governing assistance by a related person are stated in part II.B.4 of this article.

b. The Guaranty-Plus Rule

The guaranty-plus rule is used to determine whether a guaranty creates the second type of prohibited relationship. In general, a guaranty given by a related person taints a controlled foreign corporation's service income if the related person assumes any obligations in connection with the corporation's project in addition to the guaranty. Even if the guaranty slips by the guaranty-plus rule, it must still be analyzed under the substantial assistance rule given in part II.B.4 of this article. Conversely, the fact that a guaranty meets the requirements of the substantial assistance rule does not render it immune from the guaranty-plus rule.

The guaranty-plus rule is most easily understood when it is expressed as a permissive rule with various fatal exceptions. The general rule permits a related person to guaranty the controlled foreign corporation's service contracts.¹⁹ The exceptions are four in number. First, the related person's guaranty of performance taints the controlled foreign corporation's income

¹⁹Treas. Reg. § 1.954-4(b)(2)(i). Although the related person, by its guaranty, becomes obligated to perform the contract in the event of the controlled foreign corporation's default, the guaranty by itself does not taint the income that the corporation derives from performing the contract. *Id.* Only upon the default of the controlled foreign corporation does the obligation of the related person to perform become definite.

if the related person has any other obligation relative to the contract.²⁰ Such obligations would be obligations other than the obligations guaranteed, since the third exception deals with the related person's performance of a guaranteed obligation. Hence, an example of an obligation "relative to" the contract might be the related person's agreement to finance the client's payment for services rendered by the controlled foreign corporation.

Second, the related person's guaranty causes the controlled foreign corporation's income to fall within foreign base company services income if the corporation is not fully obligated to perform the contract.²¹ This exception literally makes no sense in that the related person typically would have no obligation under its guaranty if the related person had no obligation under the service contract. The drafters of the regulations probably envisioned the guarantor's obligation being absolute rather than contingent if the controlled foreign corporation had no obligation under the contract. Such would be the case if the related person took the unusual step of guarantying that the ostensible contract would be performed rather than guarantying that the controlled foreign corporation would perform its obligations under the contract.

Third, the related person's guaranty causes the controlled foreign corporation's income to fall within foreign base company services income if the related person in fact performs any of the guaranteed services or pays for their performance by another person.²² Hence, if a related person honors its guaranty by performing the contract after the default of the controlled foreign corporation, whatever income the corporation derived prior to its default becomes foreign base company services income.

Fourth, a related person's guaranty of performance taints the controlled foreign corporation's services income if the person performs significant services related to the guaranteed services or pays for such related services to be performed by another person.²³ This exception has a number of ramifications. First, the partial assignment of a services contract by a related person to a controlled foreign corporation is not permitted.²⁴ Second, a related person cannot enter into a separate services contract for the same project for which it has guaranteed another services contract.²⁵ Consider the following example:

²⁰ *Id.*

²¹ *Id.*

²² *Id.* The third exception applies even if the related person's performance or payment for performance does not qualify as substantial assistance to the controlled foreign corporation in its performance of services under the rules stated in Part II.B.4 of this article. *Id.*

²³ *Id.* The fourth exception applies even if the related person's performance or payment for performance does not qualify as substantial assistance to the controlled foreign corporation in its performance of services under the rules stated in Part II.B.4 of this article.

²⁴ *See id.*

²⁵ *See id.*

EXAMPLE THREE: *Guarantying a Controlled Foreign Corporation's Service Contract.* Commonwealth Construction Company, Inc., a Texas corporation, and two of its foreign subsidiaries have been successful in winning contracts for the engineering, procurement, and construction of a large power plant in India. The construction contract has been won by Commonwealth's Indian subsidiary, the procurement services contract has been won by Commonwealth's newly-organized subsidiary in the Maldives Islands, and Commonwealth itself has won the engineering contract. The terms of the project require both Commonwealth and its Indian subsidiary to guaranty the performance of the procurement services contract by the new Maldives subsidiary. The income derived by the Maldives subsidiary will be included in Commonwealth's gross income, since each related person who has guarantied its procurement services contract is also performing significant services related to the guarantied services.²⁶

There is a third ramification. A guaranty may take the form of the related person entering into the service contract itself and immediately assigning the entire contract to the controlled foreign corporation for performance.²⁷ However, a related person cannot assign a construction contract without tainting the assignee's income if the related person prepared the plans and specifications required to bid on the contract.²⁸ The related person's preparation of the pre-bid plans and specifications constitutes the performance of significant services related to the guarantied services,²⁹ and thus the assignment fails the guaranty-plus rule.

²⁶The income derived by the Maldives Islands subsidiary from its procurement services is not foreign base company sales income. See I.R.C. § 954(d). In this case, the subsidiary's purchasing activity is not conducted on behalf of a related person, but on behalf of an independent client. See Part III.C *infra* of this article for a discussion of the preemption of foreign base company services income by the category of foreign base company sales income. Example Fifteen in Part III.C illustrates a more conventional engineering, procurement, and construction arrangement.

²⁷Treas. Reg. § 1.954-4(b)(2)(i). The related person must have entered into the services contract solely for the purpose of guarantying its performance. *Id.*

²⁸Treas. Reg. § 1.954-4(b)(3), Ex. 7.

²⁹Two examples in the regulations suggest, as a fifth exception, that a guaranty by a related person causes the income derived by a controlled foreign corporation from the performance of guarantied services to fall within foreign base company services income if the corporation is incapable, at the time it enters into the services contract, of performing the contract. Treas. Reg. § 1.954-4(b)(3), Exs. 4, 6. The suggestion is a vestige of an earlier formulation of the substantial assistance test for foreign base company services income. The earlier formulation provided that if a controlled foreign corporation performed services but was incapable of performing those services without assistance by a related person, the income derived by the corporation from such services was eligible for inclusion in foreign base company services income. Memorandum dated November 5, 1968 from Sheldon S. Cohen, Commissioner of Internal Revenue to Stanley S. Surrey, Assistant Secretary of the Treasury, 1968 TM LEXIS 11 (discussing in its attachment the reasons for changing the earlier formulation of Treasury Regulations section 1.954-4(b)(1)(iv) to its current formulation). Although they exhibit vestiges of the earlier regulation, the two examples do raise the issue of a

3. *Servicing Property Sold by the Related Person*

Foreign base company services income includes the income derived by a controlled foreign corporation from services relating to property sold by a related person.³⁰ The performance of those services must be a material term of the sale by the related person.³¹ For example, the controlled foreign corporation might install and maintain equipment manufactured by a related person. If the corporation performs its services as a subcontractor of the related person, its income will qualify as foreign base company services income.³² A second example is that of a customer who, in order to qualify for a discounted price on equipment manufactured by a related person, contracts with a controlled foreign corporation to install the equipment. Although the requirement that the controlled foreign corporation be hired for the installation of the equipment would not appear as a term of the contract, the requirement is a condition to obtaining a contract with the discounted price. Again, the corporation's income from the installation services qualifies as foreign base company services income.³³ In a third example, the related person may offer a warranty on equipment it manufactures that is conditioned upon the equipment being installed and maintained by a factory-authorized service agency. If the only authorized agency is the controlled foreign corporation, the installation and maintenance income is foreign base company services income.³⁴ The same result should obtain if there are several authorized service agencies, but they are all controlled foreign corporations for which the manufacturer is a related person.

4. *Substantial Assistance by the Related Person*

If a related person renders substantial assistance to a controlled foreign corporation as it provides services, the corporation's income from those services falls within foreign base company services income.³⁵ At first glance, specifying this relationship between the controlled foreign corporation and a related person as one of the types that produces tainted services income looks misguided. The Code calls for the controlled foreign corporation to render a service to the related person, and not the reverse. The animus of this fourth type of relationship is to flush from cover those services nominally provided by a controlled foreign corporation to a third person but for which the corporation has insufficient resources to perform the services itself. The substantial assistance of a related person might indicate

related person's guaranty serving as substantial assistance to a controlled foreign corporation. This issue is discussed in Part II.B.4 of this article.

³⁰Treas. Reg. § 1.954-4(b)(1)(iii).

³¹*Id.*

³²Treas. Reg. § 1.954-4(b)(3), Ex. 1.

³³Treas. Reg. § 1.954-4(b)(3), Ex. 8.

³⁴Treas. Reg. § 1.954-4(b)(3), Ex. 9.

³⁵Treas. Reg. § 1.954-4(b)(1)(iv).

that the service contract has been awarded to an insubstantial controlled foreign corporation on the strength of the related person's resources, and thus that the service contract effectively is being performed by the related person behind the front presented by the poseur controlled foreign corporation. If a related person acts as subcontractor to a controlled foreign corporation to a substantial degree, the rule views the related person as the true prime contractor. The rule runs the risk of serious overbreadth, of course, since the presence of an unrelated subcontractor in a major construction project is not an indication of a lack of economic substance on the part of the prime contractor. The manner in which substantial assistance is defined is key.

The definition of substantial assistance divides the assistance rendered by a related person into three categories. First, the related person might furnish services or know-how.³⁶ Second, the related person might give financial assistance or furnish equipment, material, or supplies.³⁷ The third category is residual and includes all other assistance that a related person might give to a controlled foreign corporation.³⁸ The first two categories differ in their conception of substantiality. In particular, the fact that the controlled foreign corporation pays market rates for the assistance of the related person is irrelevant for services within the first category but renders harmless the assistance in the second category. Despite the differences, the substantiality of a related person's assistance to a controlled foreign corporation may be established by aggregating the various forms of assistance by a related person and by aggregating the assistance given by all persons related to the controlled foreign corporation.³⁹ There are no specific demands made on assistance falling within the residual category. Whether or not such assistance is substantial presumably is a question for the fact finder.

a. Related Person's Assistance by Services

The first category of assistance includes services rendered by the related person that contribute to the corporation's performance of its own services.⁴⁰ Such services may consist of the related person's supervision or direction of the controlled foreign corporation's services.⁴¹ The first category also includes the provision of know-how by the related person that contributes to the corporation's performance of its services.⁴² The inclusion

³⁶Treas. Reg. § 1.954-4(b)(2)(ii)(a).

³⁷*Id.*

³⁸*Id.*

³⁹Treas. Reg. § 1.954-4(b)(2)(ii)(d). Know-how or a service that does not directly assist the controlled foreign corporation in the performance of its services may not be aggregated to meet the substantiality requirement. Treas. Reg. § 1.954-4(b)(2)(ii)(e).

⁴⁰Treas. Reg. § 1.954-4(b)(2)(ii)(a).

⁴¹*Id.*

⁴²*Id.*

of know-how in this category of assistance may seem odd, since know-how is a species of intellectual property. Know-how frequently must be demonstrated to be useful, however, and for that reason seems sufficiently akin to a service to be included in this first category of assistance.

In order to be considered substantial, the know-how or service furnished by the related person must meet an initial test and satisfy either of two conditions. The initial test requires the service or know-how directly to assist the controlled foreign corporation in the performance of its services.⁴³ Then, the first condition stipulates that the assistance must provide the controlled foreign corporation with skills that are a principal element in producing the income from the services it renders.⁴⁴ The alternate condition requires that the cost to the controlled foreign corporation of the assistance, after any adjustments under section 482 are made, be equal to fifty percent or more of the total cost to the corporation of performing its services.⁴⁵ Hence, the cost of the services performed by the controlled foreign corporation itself or by unrelated subcontractors must be equal to or less than the cost of the assistance provided by a related person. The alternate condition permits the related person to act as a subcontractor of the controlled foreign corporation, but within bounds. Of course, if the first condition is met, the relative contributions of the controlled foreign corporation and the related person are irrelevant. It is immaterial under the initial test and the two conditions that the controlled foreign corporation has paid market rates for the assistance of the related person.

The seconding of employees to a controlled foreign corporation raises the issue of substantial assistance. If the employees so lent are technical and supervisory personnel, and even if they are paid by the controlled foreign corporation, the income the corporation derives from performing its service contract falls within foreign base company services income.⁴⁶ The assistance of the related person both directly assists the controlled foreign corporation in the performance of its services and is a principal element in producing the income derived by the controlled foreign corporation from its services contract. If the loaned employees paid by the controlled foreign corporation are clerical and accounting personnel, however, the assistance is not considered to be direct assistance to the performance of a service contract⁴⁷ and therefore the assistance cannot be a principal element in pro-

⁴³Treas. Reg. § 1.954-4(b)(2)(ii)(e).

⁴⁴Treas. Reg. § 1.954-4(b)(2)(ii)(b).

⁴⁵*Id.*

⁴⁶Treas. Reg. § 1.954-4(b)(3), Ex. 2. An employee professional who is lent to a controlled foreign corporation may be a related person in the employee's own right. Tech. Adv. Mem. 95-27-010 (Apr. 7, 1995) (employee was a United States shareholder by virtue of being the sole beneficiary of a controlling grantor trust and thus was a related person).

⁴⁷Treas. Reg. § 1.954-4(b)(3), Ex. 3. Note that the assistance of clerical and accounting personnel cannot be as easily identified with specific service contracts as the assistance of technical and supervisory personnel.

ducing the income derived from the contract. The income is not considered to be foreign base company services income.⁴⁸ The practice of the Internal Revenue Service in its private rulings is to treat the presence of shared officers and directors as substantial assistance to the controlled foreign corporation by a related person.⁴⁹

When the related person is a controlled foreign corporation as well, both corporations realize foreign base company services income absent an applicable exception. Not only has the assisted corporation realized tainted income by virtue of the substantial assistance rule, but the assisting corporation has rendered services for a related person. The assisting corporation has tainted its remaining income by placing its separable income in a tax haven entity.

b. Financial Assistance from Related Person

The second category of aid consists of financial assistance that contributes to the corporation's performance of its services.⁵⁰ Such financial assistance may take the form of providing equipment, material, or supplies to the controlled foreign corporation.⁵¹ Financial assistance does not include contributions that a related person might make to the controlled foreign corporation's capital.⁵² Presumably, financial assistance includes the assistance given when a related person provides services in kind. If so, the loan of clerical or administrative personnel by a related person would be financial assistance if the controlled foreign corporation does not pay for their help. Financial assistance frequently cannot be identified with specific service contracts of the controlled foreign corporation.

The assistance rendered by the related person must be substantial if it is to cause the controlled foreign corporation's service income to be classified as foreign base company services income.⁵³ Only a portion of the financial assistance is measured for substantiality. The relevant portion is the margin by which the market value of the full assistance exceeds the amount paid by the controlled foreign corporation for such assistance, determined after any adjustments under section 482 are made.⁵⁴ The margin of assis-

⁴⁸ *Id.* If the controlled foreign corporation did not pay for the clerical and administrative services provided by these seconded employees, their services may constitute financial assistance within the meaning of Treasury Regulations section 1.954-4(b)(2)(ii)(a). Part II.B.4.b *infra* of this article discusses the point.

⁴⁹ Tech. Adv. Mem. 81-27-017 (Mar. 26, 1981); Tech. Adv. Mem. 81-14-015 (Dec. 18, 1980). For additional background on the Service's practice in private rulings on the matter of shared officers and directors, see Gen. Couns. Mem. 38,065 (Aug. 24, 1979).

⁵⁰ Treas. Reg. § 1.954-4(b)(2)(ii)(a).

⁵¹ *Id.*

⁵² *Id.*

⁵³ Treas. Reg. § 1.954-4(b)(1)(iv).

⁵⁴ Treas. Reg. § 1.954-4(b)(2)(ii)(c). One is justified in asking whether any margin of assistance can possibly remain, if the section 482 adjustments are properly made. The regula-

tance is then measured for substantiality by comparing it with the profit derived by the controlled foreign corporation from the performance of its services.⁵⁵ Substantiality apparently is a question of fact, since there is no guidance in the regulations for measuring substantiality. If the controlled foreign corporation has paid market rates for the financial assistance it has received from the related person, there can be no margin of assistance. In such circumstances, the controlled foreign corporation derives no foreign base company services income.

c. Comparing the Two Regimes

The substantial assistance rule distinguishes between financial assistance and assistance by services in two principal ways. First, there is no directness requirement for a related person's financial assistance as there is for a related person's assistance by furnishing services or know-how. Thus, a service or know-how that does not directly assist the controlled foreign corporation in the performance of its services, and hence does not come within the first category of aid, is still eligible to fall within the second category of aid. In particular, seconding clerical or administrative personnel to a controlled foreign corporation may still cause problems for the corporation.

The second principal difference between the two regimes lies in the effect of the controlled foreign corporation's payment for the assistance it has received. The fact that the controlled foreign corporation has compensated the related person for assistance by services does not remove the taint of Subpart F from the corporation's resulting income. Paying for the related person's financial assistance does, however. (And hence, seconding clerical or administrative personnel to a controlled foreign corporation will not cause the corporation to realize foreign base company services income if the corporation pays for the assistance.)

The reason for distinguishing between financial assistance and assistance by services when the corporation is paying for the assistance is unclear. Why should a controlled foreign corporation, in order to carry out a services contract, be required to contract with unrelated persons for any necessary know-how or technical and supervisory personnel but be able to

tions leave open the possibility that the Service will be selective in its section 482 adjustments, leaving a margin of assistance to satisfy the substantial assistance test. Memorandum dated November 5, 1968 from Sheldon S. Cohen, Commissioner of Internal Revenue to Stanley S. Surrey, Assistant Secretary of the Treasury, 1968 TM LEXIS 11, at *11-*13. Furthermore, section 482 adjustments do not always strive to mimic the pricing achieved in arms-length transactions. For example, at one time the safe-harbor leasing rule of section 482 was based on depreciated cost plus a small markup; the failure to factor in the effects of inflation made the adjustment particularly unrealistic. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 273-274 (1987).

⁵⁵Treas. Reg. § 1.954-4(b)(2)(ii)(c).

contract with related persons for equipment and finance? All of these resources are important requirements for completing a services contract; the distinction is not convincing that some of these resources directly assist the controlled foreign corporation in the performance of its services while other resources only indirectly assist. The assumption of the regulations seems to be that know-how and technical and supervisory personnel are hallmarks of a service business, and any necessary equipment or finance is not.⁵⁶ From that point of view, attempts to gain the necessary personnel or know-how from a related person belies the corporation's claim to substance as an established service organization, but attempts to obtain necessary equipment or finance do not. Yet, it is not at all unusual for established service organizations to bring in subcontractors. A controlled foreign corporation should be able to bring in related persons as subcontractors as long as the corporation pays for the subcontracted services. Payment for those services by the controlled foreign corporation reduces its income and thus the income being sheltered in a tax haven; the income received by the related person will be subject to the rules of taxation in the related person's jurisdiction. If the related person is also a controlled foreign corporation, its income from acting as a subcontractor will, in turn, fall within foreign base company services income absent an applicable exclusion.⁵⁷ This will be true even in the extreme case of a controlled foreign corporation that assigns its entire contract to a single related subcontractor and pockets only a markup as the general contractor.

RECOMMENDATION ONE: Amend Treasury Regulations section 1.954-4(b)(2)(ii) to provide that assistance by a related person that provides services or know-how to a controlled foreign corporation is deemed to be insubstantial if the controlled foreign corporation pays for such assistance at market value.

Recommendation One would unify the first two categories of aid for purposes of determining whether a related person has substantially assisted a controlled foreign corporation. Both categories would be subject to the criterion of whether the corporation has paid for the assistance. But why stop there? Why not abolish the substantial assistance rule in favor of section 482 of the Code? With both in place, the substantial assistance rule simply increases the effect of a significant section 482 reallocation. If the correction to intercompany pricing indicated under section 482 is significant enough to describe substantial assistance to the controlled foreign cor-

⁵⁶ An alternate assumption of the regulations might be that intercompany pricing between related persons is significantly more difficult to monitor under section 482 when the assistance is given by services or know-how than when the assistance is financial, so that related person transactions should simply be deemed to give rise to foreign base company services income without regard to payments made by the recipient of the assistance if the assistance is given through services or know-how.

⁵⁷ The rules governing the inclusion within foreign base company services income of income derived by a controlled foreign corporation from acting as a subcontractor to a related person are stated in Part II.B.2 of this article.

poration, the Internal Revenue Service ("Service") has the option not to make the section 482 reallocation and instead to invoke the substantial assistance rule to throw all of the controlled foreign corporation's purported service income into the United States tax base. In that sense, the substantial assistance rule acts as a disguised penalty for significant underpayment by a controlled foreign corporation in its transactions with related persons. The substantial assistance rule can be justified only by the difficulties encountered in administering section 482. When seen in this light, the proper statutory authority for the substantial assistance rule is section 482 rather than section 954(e).

RECOMMENDATION TWO: Delete the substantial assistance rule from the regulations by eliminating Treasury Regulations sections 1.954-4(b)(1)(iv) and (2)(ii) and the corresponding examples. If general rules are needed to overcome the administrative expense of applying section 482 on a case-by-case basis, add those general rules to the regulations under section 482.

d. Substantial Assistance by Guaranties

Another form of assistance by a related person is that of giving guaranties. Guaranties fall into two groups: performance guaranties and payment guaranties.⁵⁸ Analysis of guaranties under the substantial assistance rule begins by recalling the three categories of aid used by the definition of substantial assistance: assistance by know-how or services, financial assistance, and a residual category of aid.⁵⁹

(1) Performance Guaranties

When a related person guaranties the services of a controlled foreign corporation, it provides a service that contributes to the corporation's performance of its own services; the guaranty enables the corporation to perform services. In this sense, a performance guaranty falls within the first category of assistance. Such assistance usually fails to be substantial, however.⁶⁰ The giving of a performance guaranty does not provide the controlled foreign corporation with skills, and hence cannot provide the corporation with skills that are a principal element in producing the income from the services it renders. Nor is it likely that the cost of the performance guaranty to the controlled foreign corporation equals or exceeds fifty percent of the total cost to the corporation of performing its services. Hence, performance guaranties will rarely qualify as substantial assistance of the services-or-know-how variety.

⁵⁸Treas. Reg. § 1.954-4(b)(2)(i), (2)(ii)(c). Substantial assistance by rendering services is discussed in Part II.B.4.a *supra* of this article.

⁵⁹See Treas. Reg. § 1.954-4(b)(2)(ii)(a).

⁶⁰*Id.*

When a related person furnishes a performance guaranty without charge or at a reduced charge to the controlled foreign corporation, it gives financial assistance that contributes to the corporation's performance of its services. In this sense, a performance guaranty falls within the second category of assistance. If the difference between the value of a guaranty and the amount paid by the controlled foreign corporation for the guaranty is substantial in comparison with the corporation's income from performing its services, the corporation realizes foreign base company services income, subject to exclusions discussed elsewhere in this article.⁶¹ Note that the comparison this time is to the corporation's income rather than its costs. For that reason, we cannot predict that the financial benefit will be insubstantial.

A performance guaranty might fall within the residual category of aid. Whether assistance falling with the residual category is substantial apparently is a question of fact, since the regulations provide no rules on the matter.

Performance guaranties must also be analyzed under the guaranty-plus rule,⁶² which raises the question of the relationship between the guaranty-plus rule and the substantial assistance rule. Under the guaranty-plus rule, a related person's guaranty may cause the controlled foreign corporation to realize foreign base company services income even if the related person's services do not qualify as substantial assistance.⁶³ A more difficult question arises on that rare occasion when a performance guaranty is satisfactory under the guaranty-plus rule, but qualifies as substantial assistance. The guaranty-plus rule and the substantial assistance rule must operate independently of one another, since they arise from independent bases for classifying a controlled foreign corporation's income as foreign base company services income.⁶⁴ Hence, the guaranty-plus rule cannot be used to shield a performance guaranty from the substantial assistance rule.

(2) Payment Guaranties

When a related person guaranties the payments of a controlled foreign corporation, it gives financial assistance that contributes to the corporation's performance of its services. If the payments guarantied are those under a loan agreement, the guaranty may act as an indirect loan from the related person itself. In any event, the guaranty of a loan induces the lender to provide financial assistance. A guaranty of payments under other kinds of agreements also induces a third person to deal with the controlled foreign corporation. For example, the related person might guaranty the corpora-

⁶¹Treas. Reg. § 1.954-4(b)(2)(ii)(c). Substantial assistance by giving financial assistance is discussed in Part II.B.4.b *supra* of this article.

⁶²The guaranty-plus rule is discussed in Part II.B.2.b *supra* of this article.

⁶³Treas. Reg. § 1.954-4(b)(2)(i).

⁶⁴Treas. Reg. § 1.954-4(b)(1)(ii), (iv).

tion's obligations under an employment contract with its president. The corporation would be required to pay a fee for a guaranty made by an unrelated person, and thus a free guaranty from a related person is financial assistance. Payment guaranties fall within the second category of aid.

Payment guaranties are not subject to the guaranty-plus rule and can be analyzed under the substantial assistance rule alone.⁶⁵ If the difference between the value of a guaranty and the amount paid by the controlled foreign corporation for the guaranty is substantial in comparison with the corporation's income from its service operations, the corporation realizes foreign base company services income, subject to exclusions discussed elsewhere in this article.⁶⁶ A payment guaranty may also fall within the residual category of aid; if so, its substantiality as assistance is determined by the fact finder.

5. *Other Tainted Service Relationships*

The preceding four types of tainted service relationships do not exhaust the possibilities.⁶⁷ Any service performed by a controlled foreign corporation for the benefit of a related person generally gives rise to foreign base company services income.⁶⁸

C. The Requirement of a Related Person

Each of the relationships that give rise to foreign base company services income involves a person related to the controlled foreign corporation. This requirement of a related person prevents Subpart F from reaching all tax haven service operations controlled by U.S. multinational companies. In particular, Subpart F does not reach independent offshore service operations or operations for which a foreign branch of the controlled foreign corporation serves as the related person. An interrelated question is the extent to which Subpart F should protect foreign tax bases from erosion by tax haven service operations.

1. *Independent Offshore Service Operations*

A controlled foreign corporation must perform services for the benefit of a related person in order to derive foreign base company services income. Services performed for the benefit of an unrelated person do not give rise to tainted income. Hence, a controlled foreign corporation can shelter its offshore services income with impunity as long as its services are performed for an unrelated person. Consider the following two examples.

⁶⁵ See Treas. Reg. § 1.954-4(b)(2)(i).

⁶⁶ Treas. Reg. § 1.954-4(b)(2)(ii)(c).

⁶⁷ Treas. Reg. § 1.954-4(b)(1).

⁶⁸ I.R.C. § 954(e)(1)(A).

EXAMPLE FOUR: *Independent Foreign Client.* Contract Drilling, Ltd., a wholly-owned Bermudan subsidiary of a U.S. oilfield services company, drills five oil wells in western Africa under contract with Petrole de France, S.A., an unrelated French corporation. Bermuda imposes no income tax. The income derived by Contract Drilling from its contract with Petrole de France is not foreign base company services income because its services were not performed for the benefit of a related person. Contract Drilling is free to reinvest all of its income in its operations, free of U.S. tax.

EXAMPLE FIVE: *Independent U.S. Client.* Contract Drilling, Ltd., from the previous example, drills four wells in Indonesia under contract with Moody Oil, Inc., an unrelated Delaware corporation. Again, Contract Drilling's income from the contract is free of income tax in Bermuda and is not foreign base company services income.

In each example, the U.S. tax base has suffered erosion. If Contract Drilling's income had been realized by its parent, the income would have been subject to U.S. tax under the United States' system of worldwide income taxation. Moreover, the lack of an income tax in Bermuda may have led to an economically inefficient choice of a place in which to conduct business. Tax considerations may have skewed an investment decision of a U.S.-controlled business, and, if so, the result is not the most efficient from the point of view of the world economy. Recommendation Four will address these two problems by suggesting the elimination of the related person requirement for foreign base company services income.⁶⁹

2. *Transactions Affecting Foreign Tax Bases*

The tax bases of foreign jurisdictions can also be reduced by the tax haven operations of U.S. multinational business. Subpart F addresses the erosion of foreign tax bases. The United States is justified in addressing the erosion of foreign tax bases through Subpart F, but Subpart F's protection of foreign tax bases has its shortcomings.

a. *The Limits of Prescriptive Jurisdiction in Taxation*

Code section 954(e) taints service relationships that have little potential for reducing the U.S. tax base. Consider the following example.

EXAMPLE SIX: *Offshore Operations Targeted at a Foreign Market.* Software Services, Ltd., a Singapore corporation, is a fully staffed and capitalized controlled foreign corporation. Software establishes a subsidiary in each country in which it hopes to obtain service contracts. Its subsidiary in Pakistan, Software Services of Pakistan, Ltd., has entered into a contract to provide services to a customer in Karachi. Although some of the work is performed by Software Pakistan, the bulk of the work is subcontracted out to the parent company. The parent company does not perform those services in Singapore, but in-

⁶⁹ Recommendation Four is given in Part II.C.3 *infra* of this article.

stead performs the services in Malaysia. The income attributable to the subcontract is not part of the Pakistani tax base. Code section 954(e), in the absence of an applicable exception, characterizes the income from the subcontract as foreign base company services income. In so doing, section 954(e) discourages the erosion of the Pakistani tax base.

Is it appropriate for the United States to take such interest in preventing the erosion of foreign tax bases? The answer lies with the limits under international law of a nation's prescriptive jurisdiction.

The erosion of a foreign tax base cannot be prevented completely by legislative action of the foreign country itself. The services performed outside the country by a base company owned by an alien parent company are beyond reach; the foreign government does not have prescriptive jurisdiction under international law over the shareholder of the base company.⁷⁰ In order for a state to reach the worldwide income of a corporation, the corporation must be a resident of that state.⁷¹ If the corporation is not a resident of the state, the state may tax only the income of the corporation that arises from sources within that state.⁷² Hence, a state is powerless to reach income of a nonresident corporation that is not derived from sources within its own territory. The erosion of foreign tax bases due to U.S. multinational business must be addressed by the United States, the nation with prescriptive jurisdiction over the parent companies.

There is an analogous problem for the U.S. tax base. The United States cannot reach base company operations assisting a project located in the United States if the offshore company is controlled from a foreign country. Only the foreign country with prescriptive jurisdiction over the ultimate shareholders can protect the U.S. tax base from erosion. Dealing with base companies is partly a matter of collective action. To reduce the use of tax havens, countries must safeguard each other's tax bases from erosion by offshore companies controlled by their nationals.

b. The Use of Branches

Code section 954(e) does not prevent all forms of erosion in foreign tax bases due to the activities of U.S. controlled businesses. One cause of erosion not addressed by section 954(e) is the use of branches.

(1) Branch in a Foreign Market

Section 954(e) does not address the situation of the U.S.-controlled tax haven corporation that establishes a branch in a foreign market. The jurisdiction in which the market is located will find it difficult to discourage the diversion of income to the tax haven. The jurisdiction has only the branch to tax and, under the international law of prescriptive jurisdiction, may only

⁷⁰ RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW §§ 411, 412 (1987).

⁷¹ RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 412(1)(a) (1987).

⁷² RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 412(1)(b), (c) (1987).

tax the income arising from sources within its territory.⁷³ Consider the following example.

EXAMPLE SEVEN: *Tax Haven Corporation with Branches in Foreign Markets.* Global Marketing Services, Ltd. is a controlled foreign corporation organized in the Channel Islands. Global provides telephonic marketing services to clients from a call center it operates outside Dublin. Global is subject to a rate of income tax in Ireland substantially below that prevailing in the United States. Global has established branches in the member states of the European Union to market its services and handle client relations. In all cases, clients deal with their local branch and not with the Dublin operation. The income derived by Global from its call center in Ireland is not foreign base company services income.

In contrast with its effect in Example Six (with a local subsidiary in Pakistan), section 954(e) does not reach the Irish income in Example Seven. The separate existence of the European branches is not recognized by the Internal Revenue Code; hence, there are no related persons for whom the controlled foreign corporation is performing services. In the case of tax haven sales operations, the problem is addressed by a branch rule; sales and manufacturing branches are deemed to be separate entities for some of the purposes of Subpart F.⁷⁴ No similar rule exists for tax haven service operations. A branch rule for services would deem the European branches to be a separate corporation related to the Irish corporation. The controlled foreign corporation would then be performing services for a related person. A branch rule would thus establish the requisite contractor relationship between the Dublin operation and the local branches.

(2) Tax Haven Branch

A branch rule for services could also address the problems arising from foreign branches of corporations organized in jurisdictions with territorial tax systems. Under a territorial income tax system, a country taxes its corporations only on their income arising from domestic sources; foreign-source income is excluded from tax. When a controlled foreign corporation is organized in a jurisdiction with a territorial income tax system, a tax haven branch can serve as a base company itself. Consider the following example.

EXAMPLE EIGHT: *Serving the Market of Residence from a Tax Haven Branch.* Civil Engineering, S.A. is a controlled foreign corporation incorporated in Venezuela. Assume that Venezuela has a territorial income tax system and recognizes transactions between a head office

⁷³*Id.*

⁷⁴I.R.C. § 954(d)(2). For an analysis of the branch rule for sales operations, see Eric T. Laity, *The Foreign Base Company Sales Income of Controlled Foreign Corporations*, 31 CORNELL INT'L L.J. (forthcoming 1997/1998) [hereinafter *Foreign Base Company Sales Income*].

and its foreign branches for tax purposes. Civil prepares drawings and specifications required by clients' infrastructure projects. Civil sub-contracts most of the work to its branch in the Netherlands Antilles. Assume that the rate of income tax in the Antilles is minimal. Under Venezuela's territorial income tax system, the income derived by the branch is not taxable. Hence, the Antilles branch functions as a foreign base company for Civil without the need for a separate incorporation to shelter its income from full taxation.

A branch rule for services would deem the Antilles branch to be a separate corporation for which the Venezuelan operation is a related person. The branch would then be performing services for a related person, and its income would be foreign base company services income.⁷⁵

(3) Combination of Branches

A branch rule for services could also distinguish between foreign branches in different countries and treat them as separate entities. Consider the following example.

EXAMPLE NINE: *Serving Another Market from the Tax Haven Branch.* Civil Engineering, S.A., from the previous example, also has a branch in Rio de Janeiro from which it markets its services to clients in Brazil. Most of the engineering work for Brazilian clients is subcontracted to the Antilles branch. The work that must be done onsite is performed by Civil's Brazilian branch. Brazil has a worldwide system of taxation for its own corporations. Assume that Brazil's source-based taxation for nonresident corporations does not reach Civil's income derived from performing services in the Antilles. The income derived by the Antilles branch is sheltered from Brazilian and Venezuelan income tax. Yet, the income is not foreign base company services income for purposes of United States taxation.

The present section 954(e) does not reach the income in question because the Antilles branch is part of the same entity as the Brazilian branch; no related person is involved. In order to reach the Antilles income, a branch rule for services could deem the Antilles and Brazilian branches to be separate corporations and related to each other. Then, the Antilles branch would perform services for the Brazilian branch, a related person, and its services income would fall within foreign base company services income, absent an applicable exception.

(4) An Argument Against a Branch Rule for Services

In the case of Examples Eight and Nine, an argument against adopting a branch rule for services is that Venezuela is able to prevent the erosion of

⁷⁵ Any branch rule for services must provide that the branch is not a separate entity for purposes of the country-of-incorporation exclusion; otherwise, that exclusion would defeat the purpose of a branch rule for services. The country-of-incorporation exclusion is discussed in Part III.B.1 *infra* of this article.

its own tax base. Venezuela has the power under international law to adopt a worldwide system of taxation for corporations resident in Venezuela and thus can reach the income of the branch in the Antilles.⁷⁶ Under this reasoning, the United States should not override a decision made by a jurisdiction with a territorial tax system concerning matters within that jurisdiction's competence.

At the outset, two comments about the scope of the criticism should be made. First, the criticism does not apply to the situation described in Example Seven (the Irish calling center). In that example, the jurisdictions in which the relevant markets are located have prescriptive jurisdiction only over branches. Those jurisdictions cannot prevent the erosion of their tax bases. A branch rule by which the United States prevents the erosion of those jurisdictions' tax bases is appropriate. Second, to the extent that the criticism is valid against a branch rule for services, it would also be valid against the existing branch rule for sales income. If the political judgment is formed that a branch rule for services can be justified only when applied to branches in markets and not to tax haven branches, the branch rule for sales income should be conformed to that limitation.

The criticism is subject to two counterarguments. First, in Example Nine, Venezuela's is not the only foreign tax base affected by the operations of the tax haven branch. Brazil suffers from the circumstances described in Example Nine as its own companies fail to compete with a foreign company that enjoys the tax haven regime available to it by virtue of its home country's territorial tax system. It is not within Brazil's power to discourage the tax avoidance taking place in Example Nine. Second, leaving the problem to the jurisdiction with a territorial tax system has another externality. To the extent that the ultimate parent company is basing its investment decision on the noneconomic factor of taxation, the operations of the tax haven branch are not efficient for the worldwide economy. These two externalities of a territorial income tax system are appropriately of concern to other jurisdictions. The only jurisdiction outside the territorial tax system able to address the externalities under international law is the jurisdiction with prescriptive jurisdiction over the ultimate parent corporation. In Examples Eight and Nine, that jurisdiction is the United States.⁷⁷

RECOMMENDATION THREE: Amend Code section 954(e) by adding a branch rule similar to the one at Code section 954(d)(2)⁷⁸ and,

⁷⁶ RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 412(1)(a) (1987).

⁷⁷ The United States may have reason to act beyond that of contributing to needed collective action. The efficiency of the investment decisions of U.S. parent corporations can be of importance to U.S. labor policy; tax-induced foreign investment may decrease potential U.S. employment.

⁷⁸ The branch rule for sales income is not flawless; see the discussion and recommendations in *Foreign Base Company Sales Income*, *supra* note 74. The proposed branch rule for services income ought to reflect the recommended changes in the branch rule for sales income.

if neither Recommendations Six nor Eight is adopted, provide that the country-of-incorporation exclusion is available when the branch rule applies only for the income from services that are performed and used in the same country.

A branch rule would not be required if the related person requirement were dropped from Code section 954(e).

c. Minimal Presence in the Foreign Market

Another form of foreign tax base erosion that Code section 954(e) does not address is caused by tax haven arrangements that require no related person for their execution. The presence of a related person is required in order for section 954(e) to apply to the tax haven arrangement. Consider the following example:

EXAMPLE TEN: *Serving a Foreign Market without a Local Presence.* Software Services, Ltd., from Example Six, has no local subsidiary in Pakistan. Software itself enters into the services contract with the customer in Karachi. All services are performed outside Pakistan and in a tax haven. Software has insufficient activity in Pakistan to have a permanent establishment there for purposes of Pakistani source-based income taxation. Software's income from the services contract is free of Pakistani income tax. The company's income is not foreign base company services income.

With no local subsidiary in Pakistan, Software is not providing services to a related person. Without a related person, Software's tax haven income escapes the strictures of Subpart F. Subpart F will not counteract the effect on the Pakistani income tax base of Software's reduction in its local presence while serving the Pakistani market.

An expansion of Pakistani source-based taxation might be an appropriate response to the perceived erosion of the Pakistani income tax base. Consider the distinction between the place in which services are performed and the place in which those services are used. In Example Ten, the services are performed in a tax haven, but are used in Pakistan. One might then suggest that Pakistan add the income arising from services that are used within Pakistan to its tax base and collect the tax by a withholding requirement imposed on Pakistani consumers of services. More generally, source-based taxation in each jurisdiction could be expanded to add the income arising from services that are used within that jurisdiction.

This proposal has its drawbacks. It would lead to an increase in international double taxation since service income would potentially be taxed by both the country of performance and the country of use. However, such double taxation could be handled either through a tax credit in the country of use for the tax paid to the country of performance or by expanding tax treaties to give an exclusion from taxation in the country of use. In addition, this proposal is accompanied by technical problems arising from the notion of consuming services. The consumer of the service would generally be the person who pays for the services, and withholding would be re-

quired at the time the services are paid for, regardless of whether the services are ever used or are used a number of times and in a number of places. A presumption would have to be created as to the place of use if the services are not in use at the time of payment.

An alternative to the proposal is simply to eliminate the requirement of a related person for the immediate taxation of foreign base company services income and allow Code section 954(e) to handle the matter. More generally, one would allow the country with prescriptive jurisdiction over the base company's parent to handle this perceived erosion of source-based taxation.

3. Eliminating the Requirement of a Related Person

The requirement of a related person prevents Code section 954(e) from addressing the erosion of foreign tax bases either when a base company uses a branch to mimic the operations of another base company or when the base company reduces its presence in the country of use below the threshold needed to support source-based taxation by that country. In addition, the related person requirement prevents section 954(e) from addressing the erosion of the United States tax base from independent base company operations. For these reasons, base company operations with unrelated persons should be included within the scope of section 954(e). Tax base erosion can be a symptom of the inefficient allocation of resources in the world economy; the erosion suggests that tax considerations are affecting business decisions that should be driven by economics alone.

The elimination of the related person requirement would greatly simplify the definition of foreign base company services income. The complexity of the rules defining the four service relationships, including the guaranty-plus and substantial assistance rules, would be eliminated. A branch rule for services income would not be required.

One could simply define foreign base company services income as income that is derived by a controlled foreign corporation from the performance of services that are used outside the country that taxes the corporation on the basis of residence. The U.S. foreign tax credit would continue to reduce the problem of double taxation when the controlled foreign corporation's jurisdiction of residence taxation imposes a tax on the same income. In addition, the general Subpart F exclusion for high-tax income would be available for income subject to a foreign income tax substantially equal to the U.S. income tax.⁷⁹ The expanded definition of foreign base company services income would encourage U.S. service organizations to perform services where the services are to be used, that is, in the markets for those services, rather than in a tax haven.

⁷⁹I.R.C. § 954(b)(4).

One criticism of eliminating the related person requirement is based on economies of scale. In the case of services, the analogue to economies of scale in manufacturing is the specialization of tasks that is possible in a large service organization. If the related person requirement were eliminated, a U.S. multinational would have to establish a service operation in each foreign jurisdiction in which it had a market, so the criticism might go, thus eliminating the possibility of basing its service operation in one of those jurisdictions and exporting services to the other markets. It is true that basing a service operation to serve several national markets in a jurisdiction with an income tax rate materially less than the U.S. income tax rate would result in foreign base company services income under the proposal. If, however, the service operation were based in a jurisdiction in which the tax rate is substantially the same as (or higher than) the U.S. rate of tax, the income generated by the service operation would not generate foreign base company services income.

RECOMMENDATION FOUR: Amend Code section 954(e)(1) to define foreign base company services income as the income derived by a controlled foreign corporation from the performance of services that are to be used outside the country that taxes the controlled foreign corporation on the basis of residence.

III. THE KINDS OF SERVICES

Most kinds of services rendered by a controlled foreign corporation can give rise to foreign base company services income. Exceptions exist for two reasons. First, the limited pursuit of the policy of capital import neutrality has led to exceptions intended to permit U.S. businesses to compete on an equal footing with companies native to foreign jurisdictions, including those native to tax havens.⁸⁰ Second, a number of exceptions arise from the interplay of foreign base company services income with other types of tainted tax haven income. Although such exceptions exclude income from foreign base company services income, the income still attracts additional U.S. income tax for the U.S. parent corporation. In addition to the specific exceptions examined here, one should keep in mind the general exclusion of income arising from services performed in foreign jurisdictions that tax the income at a rate comparable to the maximum corporate rate in the United States.⁸¹ Services that give rise to such income are, in effect, excluded from the services that give rise to foreign base company services income.

⁸⁰For a brief discussion of the policy of capital import neutrality, see CHARLES H. GUSTAFSON & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* ¶ 1091 (1991).

⁸¹I.R.C. § 954(b)(4).

A. Services Included

The services that give rise to foreign base company services income are varied. They include technical, managerial, engineering, architectural, scientific, skilled, industrial, and commercial services.⁸² Financial services rendered by a controlled foreign corporation generally are not included, since the income from financial services usually is included in another category of foreign base company income that has priority over foreign base company services income. There are exceptions, however, and hence some financial services do generate foreign base company services income. Furthermore, contract manufacturing by a controlled foreign corporation can give rise to foreign base company services income.

1. Financial Services

Financial services that otherwise give rise to foreign base company services income usually give rise to foreign personal holding company income, a class of income that takes precedence over foreign base company services income.⁸³ For example, foreign personal holding company income generally includes the interest and rental income of a controlled foreign corporation.⁸⁴ Hence, a controlled foreign corporation's income from leasing services generally is included in its foreign personal holding company income. Nevertheless, there are exceptions to the scope of foreign personal holding company income,⁸⁵ and as a result it is possible for a controlled foreign corporation's income from financial services to fall through the net held out for its foreign personal holding company income and into its foreign base company services income.

a. Factoring

Under limited circumstances, a controlled foreign corporation can derive foreign base company services income from factoring operations.⁸⁶ A controlled foreign corporation engaged in factoring derives income from two types of relationships. On the one hand, the factor derives income from its relationships with its clients, as the factor purchases accounts receivable from the clients and then collects those receivables. On the other hand, the factor may derive interest income from its relationships with the account debtors themselves, if the receivables provide for the payment of interest.

⁸²I.R.C. § 954(e)(1).

⁸³Treas. Reg. § 1.954-1(e)(4)(i)(D) (1995).

⁸⁴I.R.C. § 954(c)(1)(A).

⁸⁵For a general taxonomy of those exceptions, see Eric T. Laity, *Defining the Passive Income of Controlled Foreign Corporations*, 21 N.C. J. INT'L LAW & COM. REG. 293 (1996) [hereinafter *Passive Income of Controlled Foreign Corporations*].

⁸⁶The Chief Counsel's office of the Service has concluded that factoring is a service for purposes of foreign base company services income. Gen. Couns. Mem. 39,220, 1984 IRS GCM LEXIS 100, at *23, 28, 32 (Apr. 24, 1984).

The income derived by the controlled foreign corporation from its client relationships is its factoring income. A controlled foreign corporation's factoring income, in turn, can be divided into two components. The factor always derives fee income for assuming the credit risk on the receivables it has purchased and for providing the service of collecting the receivables. The factor may also derive interest income from discounting the receivable for immediate payment to the seller of the receivable.⁸⁷ The factor receives payment of either component of factoring income by collecting the receivable in full, but paying the seller of the receivable a lesser amount. Hence, a controlled foreign corporation engaged in factoring may derive three possible types of income: interest income from account debtors, fee income from its clients, and interest income from its clients. All three types of income derived by a factor generally fall within a controlled foreign corporation's foreign personal holding company income and thus generally will not fall within foreign base company services income. The exceptions are discussed below.

A preliminary distinction must be made in order to understand those exceptions. One type of factoring in which a controlled foreign corporation can engage is related-person factoring. Under the rules governing related-person factoring, all of the income that a controlled foreign corporation can derive from its relationships with clients as a result of such factoring is re-characterized as interest income from account debtors.⁸⁸ In addition, the rules governing related-person factoring remove some of the exceptions from foreign personal holding company income otherwise available for interest income from an account debtor.⁸⁹ Hence, the factoring activity of a controlled foreign corporation must be separated into related-person factoring and other factoring before the various rules governing foreign personal holding company income and foreign base company services income may properly be applied.

One might think that factoring performed for or on behalf of a related person would necessarily fall within related-person factoring. On that assumption, any factoring that would otherwise give rise to foreign base company services income would necessarily constitute related-person factoring. The assumption is false. The definition of a related person for purposes of related-person factoring differs from the definition of related person for purposes of foreign base company services income.⁹⁰ In addition, the rele-

⁸⁷For a brief discussion of the distinction between the factor's interest income from its client and the factor's fee or commission income, see Gen. Couns. Mem. 39,220, 1984 IRS GCM LEXIS 100, at *3-4, 14-15 (Apr. 24, 1984).

⁸⁸I.R.C. § 864(d)(1).

⁸⁹I.R.C. §§ 864(d)(5)(A)(iii), (iv).

⁹⁰Related persons, for purposes of related-person factoring, consist of those persons related to the controlled foreign corporation within the meaning of section 267(b) of the Code, the U.S. shareholders of the controlled foreign corporation, and those persons related to any of the U.S. shareholders within the meaning of section 267(b) of the Code. I.R.C. §§

vant transactions are defined differently.⁹¹ As a result of these differences, both related-person factoring and other factoring must be analyzed in order to determine a corporation's foreign base company services income.

(1) Related-Person Factoring

Related-person factoring consists of the acquisition of accounts receivable from a person related to the factor within the meaning of Code section 267(b).⁹² All income derived by a controlled foreign corporation from a receivable acquired from a related person generally is recharacterized as interest income from the account debtor.⁹³ An exception applies if the transferor of the receivables was created and operates in the controlled foreign corporation's country of incorporation.⁹⁴ The income from such receivables is treated under the rules applicable to other factoring and enjoys the benefit of the exceptions available under those other rules.⁹⁵ Unless the

864(d)(1), (4). A related person for purposes of foreign base company services income is defined in section 954(d)(3) of the Code and discussed earlier in this article. See *supra* Part II.A of this article. The differences in the two definitions of related person result in several anomalies. A controlled foreign corporation can purchase receivables from a related estate without engaging in related-person factoring. In addition, a controlled foreign corporation can purchase receivables from certain related persons without engaging in related-person factoring due to the absence of a voting power test in section 267(b) and the lack of an indirect ownership test in some parts of section 267(b). Compare I.R.C. § 954(d)(3) (use of a voting power test and an indirect ownership test to satisfy the ownership requirement), with I.R.C. § 267(b)(2), (8), (10), (11), (12) (no use of a voting power test) and I.R.C. § 267(b)(10), (11), (12) (no use of an indirect ownership test). When the related person is a corporation, Code section 267(b)(3) assures the use of voting power and indirect ownership tests by incorporating Code section 1563(a) with modifications. See I.R.C. §§ 267(b)(3), (f)(1).

⁹¹The pertinent factoring transactions for purposes of related-person factoring consist of the acquisition of accounts receivable from a related person. I.R.C. § 864(d)(1). Acquisitions of receivables include the receipt of a security interest in receivables as collateral for a loan and the receipt of receivables as a capital contribution. Temp. Treas. Reg. § 1.864-8T(c)(1)(i) (1988). The acquisition may be made indirectly from the related person, I.R.C. § 864(d)(1), and hence any receivable on which a related person is the original account creditor is considered to be acquired from a related person. Temp. Treas. Reg. § 1.864-8T(c)(3)(i) (1988). In contrast, the factoring that takes place within the tainted service relationships for foreign base company services income must be conducted by the controlled foreign corporation for or on behalf of a related person. I.R.C. § 954(e)(1). Such factoring includes the acquisition by a controlled foreign corporation of accounts receivable from unrelated persons that would otherwise have been acquired by a person related to the controlled foreign corporation.

⁹²I.R.C. §§ 864(d)(1), (d)(4).

⁹³I.R.C. § 864(d)(1).

⁹⁴I.R.C. § 864(d)(7). There is an additional requirement for the same-country exception. The exception is not available if the related person would have derived from the receivable, if it had retained the receivable, either foreign base company income or income effectively connected with the conduct of a business in the United States. *Id.*

⁹⁵The exception literally is from the scope of paragraph (1) of Code section 864(d) and not from the scope of the entire subsection. I.R.C. § 864(d)(7). This raises the possibility

same-country exception applies, all three types of income that a controlled foreign corporation might derive from an acquired receivable are recharacterized as interest from an account debtor: the actual interest income from the account debtor, the fee income from the factoring client, and the interest income, if any, from the factoring client. Furthermore, such recharacterized income constitutes part of the controlled foreign corporation's foreign personal holding company income.⁹⁶ Such recharacterized income is ineligible for the two exceptions from foreign personal holding company income otherwise available for interest income. First, none of the income from such a receivable may qualify for the exclusion for export financing interest income.⁹⁷ Second, none of the income may qualify for the exclusion for interest income received from certain related account debtors incorporated and operating in the controlled foreign corporation's country of incorporation.⁹⁸ Since all such income constitutes foreign personal holding company income, none of the income qualifies as foreign base company services income of the controlled foreign corporation.⁹⁹ In sum, a controlled foreign corporation may derive foreign base company services income from related-person factoring only if the same-country exception applies. The same-country exception is only a necessary condition; it is not a sufficient condition for a controlled foreign corporation's income from related-person factoring to fall within foreign base company services income.

(2) Other Factoring

The income that a controlled foreign corporation derives from factoring operations that do not fall within the definition of related-person factoring is governed by the rules stated below.

that subparagraph (5)(A) of Code section 864(d) still applies to any actual interest income from account debtors and thus that such income is not eligible for the two exclusions from foreign personal holding company income. But this is not a cogent reading of the subsection since subparagraph (5)(A) applies only to income to which paragraph (1) applies. By virtue of paragraph (7), paragraph (1) no longer applies even to true interest income from account debtors. Therefore, subparagraph (5)(A) does not apply to actual interest income from account debtors under accounts falling within the same country exception to related-person factoring. Thus, interest income from account debtors remains eligible for the standard exclusions from foreign personal holding company income: those for export financing interest income and for interest received from certain related persons incorporated and operating in the controlled foreign corporation's country of incorporation. I.R.C. §§ 954(c)(2)(B), (c)(3)(A).

⁹⁶I.R.C. § 954(c)(1)(A).

⁹⁷I.R.C. § 864(d)(5)(A)(iii).

⁹⁸I.R.C. § 864(d)(5)(A)(iv).

⁹⁹Treas. Reg. § 1.954-1(e)(4)(i)(D). The amount paid by a factor for accounts receivable acquired from related persons may also be included in the controlled foreign corporation's Subpart F income if the receivables constitute United States property under Code section 956(c). I.R.C. §§ 951(a)(1)(B), 956(a), (c)(3). For a discussion of this point, see Eric T. Lacity, *Anatomy of Sections 951(a)(2)(B) and 956 of the Internal Revenue Code*, 14 VA. TAX REV. 71, 105-108 (1994) [hereinafter *Anatomy*].

(A) *Interest Income from Account Debtors*

Interest income received by a controlled foreign corporation from account debtors by virtue of other factoring operations generally falls within the corporation's foreign personal holding company income.¹⁰⁰ Exceptions exist for export financing interest income and for interest paid by certain related corporate account debtors incorporated and operating in the controlled foreign corporation's country of incorporation.¹⁰¹ If one of those exceptions to foreign personal holding company income applies,¹⁰² the interest income is eligible for inclusion in the corporation's foreign base company services income.

(B) *Factoring Income*

Factoring income in both its guise as fee income and its guise as interest income from the factoring client generally constitutes foreign personal holding company income. There is a narrow category of factoring income that does not, however, and thus is eligible for inclusion in a controlled foreign corporation's foreign base company services income. To define that category, one turns first to the class of foreign personal holding company income known as income equivalent to interest. Both the fee income and the interest income from clients of a controlled foreign corporation that is engaged in factoring other than related-person factoring generally constitute income equivalent to interest and thus are included in the corporation's foreign personal holding company income.¹⁰³ Excluded from the classification of income equivalent to interest is the income derived from maturity factoring.¹⁰⁴ Also excluded is the income derived from factoring a qualifying account receivable if payment for the receivable is made on or after the date

¹⁰⁰I.R.C. § 954(c)(1)(A).

¹⁰¹I.R.C. §§ 954(c)(2)(B), (3).

¹⁰²Such interest income cannot then fall within the income-equivalent-to-interest class of foreign personal holding company income. Treas. Reg. § 1.954-2(h)(4)(i) (excluding stated interest income from a receivable from factoring income).

¹⁰³I.R.C. § 964(c)(1)(E); Treas. Reg. § 1.954-2(h)(4)(i). An argument can be made that a controlled foreign corporation's interest income from factoring clients falls within the foreign personal holding company income category of dividends, interest, rents, royalties, and annuities (DIRRA) rather than income equivalent to interest (IEI) if the interest income from factoring clients can be separately identified. Treas. Reg. § 1.954-2(a)(2). The regulatory provisions governing IEI sidestep the sometimes difficult question of separating factoring income into fee income and interest income from clients by treating the two components together. Treas. Reg. § 1.954-2(h)(4)(i). Factors of consumer receivables do not routinely separate their factoring income into the two components and believe that all of their factoring income is fee income. If separately-identified interest income from factoring clients falls within DIRRA rather than within IEI, it becomes eligible for the exclusions from foreign personal holding company income for export finance interest income and interest paid by certain related corporate payors. I.R.C. §§ 954(c)(2)(B), (c)(3). Those two exclusions are not available for income falling within IEI.

¹⁰⁴Treas. Reg. § 1.954-2(h)(4)(ii)(B), (C).

on which interest under the receivable begins to accrue.¹⁰⁵ In order to qualify for this exception, the receivable must bear an interest rate that equals or exceeds 120% of the federal short-term rate.¹⁰⁶ In the case of either maturity factoring or the factoring of qualifying accounts receivable, it is unlikely that the factor derives any interest income from its factoring clients.¹⁰⁷ The fee income derived from such factoring does not fall within foreign personal holding company income and thus is eligible for inclusion in the factor's foreign base company services income.

(3) Examples

The following examples illustrate some of the circumstances in which factoring gives rise to foreign base company services income.

EXAMPLE ELEVEN: *Related-Person Factoring and Foreign Base Company Services Income (Same-Country Exception; Export Finance Exception; Qualified Receivables).* Grand Company, Inc., a Delaware corporation ("U.S. Grand"), manufactures oilfield equipment in the United States from domestic components. U.S. Grand sells the equipment to Grand Venezuela, S.A., a wholly-owned subsidiary incorporated and operating in Venezuela. Grand Venezuela in turn sells the equipment to customers for use in Venezuela at prices quoted in U.S. dollars. Grand Venezuela sells the equipment on the following terms: the purchase price is due in ninety days, with interest accruing from ten days after the sale at 120% of the short-term federal rate in the United States. Ten days after each sale, Grand Venezuela sells the account receivable to Grand Finance, S.A., another wholly-owned subsidiary of U.S. Grand incorporated in Venezuela. The price paid for the receivable is its face value discounted by two percent, which is paid immediately to Grand Venezuela. Grand Finance conducts all of its operations at a branch in the Cayman Islands where U.S. Grand's bank maintains an office as well. Grand Finance's factoring income is foreign base company services income, but its interest income from account debtors is not.

¹⁰⁵Treas. Reg. § 1.954-2(h)(4)(ii)(B).

¹⁰⁶*Id.*

¹⁰⁷ In the case of maturity factoring, the factor advances no funds to its factoring client prior to the maturity date of the receivable. In the case of qualifying receivables, the receivable on the date of transfer is already accruing interest from the account debtor at a market rate of interest. If the factor does derive any interest income from its factoring client in the course of maturity factoring or the factoring of qualifying accounts receivable, that interest income continues to be excluded from income equivalent to interest and ought to fall within the subset of foreign personal holding company income reserved from dividends, interest, rents, royalties, and annuities (DIRRA). I.R.C. § 954(c)(1)(A). Once within that subset, the interest income from factoring clients becomes eligible for the exclusions for export financing interest and for interest received from related payors. I.R.C. § 954(c)(2)(B), (3). Again, the likelihood of there being any interest income from factoring clients derived through maturity factoring or the factoring of qualifying receivables is small.

Grand Finance's factoring falls within the same-country exception to related-person factoring. The interest income it receives from account debtors falls within the export financing interest exception to foreign personal holding company income. The interest income from account debtors is not foreign base company services income, as it is income arising out of a relationship with unrelated persons. Grand Finance's factoring income falls within the qualified receivables exception to income equivalent to interest and, therefore, is not foreign personal holding company income. The factoring income arises from Grand Finance's performing factoring services for Grand Venezuela, a related person within the meaning of Code section 954(d)(3), and therefore is foreign base company services income.¹⁰⁸

EXAMPLE TWELVE: *Non-Related Person Factoring and Foreign Base Company Services Income (Different Transactions; Export Finance Exception; Maturity Factoring)*. Grand Finance, S.A., from Example Twelve, also purchases accounts receivable from unrelated dealers of equipment manufactured by U.S. Grand. Some of those dealers are based in Argentina. Since Grand Finance does not have the experience with Argentine oilfield service companies required to assess their credit risk, Grand Finance receives credit analyses on proposed Argentine account debtors from a Grand affiliate in Argentina, Grand Argentina, S.A. Such analysis is essential to a viable factoring operation. Grand Argentina, a wholly-owned subsidiary of U.S. Grand, has sold drilling muds to Argentine oilfield service companies for decades and from that experience has amassed the necessary credit histories and market perspectives. With the necessary credit analyses provided by Grand Argentina, Grand Finance purchases acceptable accounts receivable from independent dealers in Argentina ten days after the underlying sale of equipment. Each receivable is due thirty days after the sale of the equipment and no interest accrues on the receivable until after the due date. Grand Finance's own credit line is not sufficient to offer its Argentine factoring clients the option of immediate payment. Hence, all of Grand Finance's factoring of Argentine accounts is maturity factoring: Grand Finance pays for each account receivable at the time the receivable is due. The price paid for each receivable is its face value discounted by two percent. Grand Finance's factoring income is foreign base company services income.

Grand Finance is not acquiring receivables from related persons in Argentina, and hence its factoring is not related-person factoring. Grand Finance's factoring income falls within the maturity factoring exception from income equivalent to interest and therefore does not constitute foreign personal holding company income. For each Argentine receivable it purchases, however, Grand Finance receives the substantial assistance of Grand Argentina, a related person. Grand Finance's factoring income is

¹⁰⁸If Grand Finance conducted its operations in Caracas rather than the Cayman Islands, its factoring income would not be foreign base company services income due to the country-of-incorporation exception discussed *supra* in Part III.B.1 of this article.

therefore foreign base company services income. In the event that a receivable is not paid when due and Grand Finance receives interest income from the account debtor, the interest income is foreign personal holding company income.

b. Receivables Financing

Receivables financing under some circumstances qualifies as related-person factoring. The acquisition of receivables for the purposes of related-person factoring includes the receipt of a security interest in receivables as collateral for a loan.¹⁰⁹ Hence, receivables financing conducted by a controlled foreign corporation for related persons within the meaning of Code section 267(b) constitutes related-person factoring. If the controlled foreign corporation were to derive any income from the pledged receivables, the income generally would be characterized as interest income on a loan to the account debtors themselves.¹¹⁰ Such income would be foreign personal holding company income and could not be classified as foreign base company services income.¹¹¹ But in financial terms, of course, a lender derives no income from receivables held as collateral and at most is acting as a collection agent for the borrower. Apparently, the intent of the regulations is to characterize, for tax purposes, loan payments made by the borrower out of revenue collected from the pledged receivables as interest income of the lender from loans made to the account debtors.

Receivables financing that does not constitute related-person factoring yields interest income that generally falls within foreign personal holding company income. Either of two exceptions from foreign personal holding company income may apply: the exception for export financing interest income or the exception for interest paid by certain related corporate borrowers incorporated and operating in the controlled foreign corporation's country of incorporation.¹¹² If either exception applies, the income is eligible for inclusion in foreign base company services income.

c. Leasing Services

The income derived by a controlled foreign corporation from leasing services generally constitutes foreign personal holding company income. There are exclusions, however, from foreign personal holding company income, and as a result leasing income can fall through the classification of foreign personal holding company income and into foreign base company services income if one of those exclusions applies.

¹⁰⁹Temp. Treas. Reg. § 1.864-8T(c)(1)(i) (1988).

¹¹⁰I.R.C. § 864(d)(1). The same-country exception of Code section 864(d)(7) is available for qualifying accounts receivable.

¹¹¹See Part III.A.1.a(1) *supra* of this article.

¹¹²I.R.C. § 954(c)(2)(B), (3).

A controlled foreign corporation may derive rental income, interest income, or sales income from its leasing activities, depending on the manner in which its leases are characterized. If the corporation's leases are true leases, it derives rental income. If the corporation's leases are recharacterized as loans to the purported lessees, it derives interest income. If the corporation's leases are recharacterized as installment sales of property, it derives a combination of interest income and sales income. Both rental income and interest income generally constitute foreign personal holding company income.¹¹³ Sales income does not fall within foreign personal holding company income, although it may fall within the separate category of tainted tax haven income known as foreign base company sales income.¹¹⁴

(1) Rental Income from Leasing

There is an exclusion from foreign personal holding company income for rental income derived in the active conduct of a business from an unrelated person.¹¹⁵ The exclusion is available primarily to lessors who manufacture the products they lease and to lessors who have a substantial marketing organization.¹¹⁶ For that reason, the typical leasing company, even if it is successful in having its leases characterized as true leases, will have difficulty coming within the exclusion and must classify its leasing income as foreign personal holding company income. If the lessor can take advantage of the exclusion for active rental income, however, the lessor then needs to determine whether its rental income may be characterized as foreign base company services income.

A second exclusion from foreign personal holding company income is available for rental income. Rental income received by a controlled foreign corporation from a related corporation for the use of property located within the controlled foreign corporation's country of incorporation generally is excluded from foreign personal holding company income.¹¹⁷ This exclusion permits the leasing of property to a related person and, in some circumstances, can be paired with an exclusion from foreign base company

¹¹³I.R.C. § 954(c)(1)(A).

¹¹⁴I.R.C. § 954(d).

¹¹⁵I.R.C. § 954(c)(2)(A).

¹¹⁶Treas. Reg. § 1.954-2(c)(1)(i), (iv). The substantiality of a marketing organization is usually a question of fact, but the regulations provide for a safe harbor based on the level of the organization's expenses compared to the lessor's rental income from leased property. Treas. Reg. §§ 1.954-2(c)(1)(iv), (2)(ii).

¹¹⁷I.R.C. § 954(c)(3)(A)(ii). The exclusion does not require that the related person be incorporated in the same country as the controlled foreign corporation. The exclusion is not available for payments of rent that reduce the Subpart F income of the payor. I.R.C. § 954(c)(3)(B). Nor is the exclusion available for payments of rent that create or increase a deficit in the payor's earnings and profits that can be used to reduce Subpart F income under section 952(c). *Id.*

services income for services performed within the lessor's country of incorporation.¹¹⁸ Although the location of the leasing operations is a question of fact, the location of the personnel administering the operations can be more decisive than the location of the leased property.¹¹⁹ Hence, the two exclusions overlap if the controlled foreign corporation's personnel administering its leasing operations are located within its country of incorporation and the leased property also is located within that country. In that situation, a controlled foreign corporation can conduct leasing operations for related persons as lessees and exclude its rental income from both foreign personal holding company income and foreign base company services income.

(2) Interest Income from Leasing

In the case of interest income, there is an exclusion from foreign personal holding company income for export financing income.¹²⁰ The exclusion for export financing income excludes a narrow class of interest income derived from financing export sales of American-made goods. Because of the exclusion's requirement that the exported property be manufactured by the controlled foreign corporation or a related person¹²¹ and because of the interplay of the exclusion with related-person factoring,¹²² the exclusion is available primarily to controlled foreign corporations that finance the sales by independent dealers of property produced by the corporation or a person related to the corporation.¹²³ If the lessor can take advantage of the exclusion for export financing interest income, however, the lessor then needs to determine whether its interest income falls within foreign base company services income.

Another exclusion from foreign personal holding company income is available for interest income. Interest income received by a controlled foreign corporation from a related corporation that is incorporated and operates within the controlled foreign corporation's country of incorporation generally is excluded from foreign personal holding company income.¹²⁴ The same-country exclusion for interest is similar to the same-country exclusion

¹¹⁸ I.R.C. § 954(e)(1)(B). This exclusion from foreign base company services income is discussed in Part III.B.1 *infra* of this article.

¹¹⁹ Treas. Reg. § 1.954-4(c).

¹²⁰ I.R.C. § 954(c)(2)(B).

¹²¹ I.R.C. § 904(d)(2)(G)(i).

¹²² I.R.C. § 864(d).

¹²³ For a discussion with examples of the interplay between related person factoring and the exclusion for export financing interest income, see *Passive Income of Controlled Foreign Corporations*, *supra* note 85, at 300-04.

¹²⁴ I.R.C. § 954(c)(3)(A)(i). The exclusion is not available for portfolio interest or for interest derived from related-person factoring. I.R.C. § 864(d)(5)(A)(iv); Treas. Reg. § 1.954-2(b)(4)(ii)(C) (1995). For a discussion of the detailed rules governing the exclusion, see *Passive Income of Controlled Foreign Corporations*, *supra* note 85, at 307-17.

for rental income.¹²⁵ The two same-country exclusions are not identical, however. In particular, the same-country exclusion for interest income places restrictions on the related person's place of incorporation, the location of its trade or business, and the use or location of its assets.¹²⁶

The same-country exclusion for interest permits the financing of property for a related person and, in some circumstances, can be paired with an exclusion from foreign base company services income for services performed within the lessor's country of incorporation.¹²⁷ Although the location of the leasing operations is a question of fact, the location of the personnel administering the operations may be decisive.¹²⁸ Hence, the two exclusions overlap if the controlled foreign corporation's personnel administering its financing operations are located within its country of incorporation and the related corporation is incorporated and operates within that country. In that situation, a controlled foreign corporation can conduct financing operations for related persons as financial lessees and exclude its interest income from both foreign personal holding company income and foreign base company services income.

(3) Caveat About Investments in United States Property

Regardless of the characterization of the lease, the controlled foreign corporation may run afoul of section 956 of the Code if the leased property is used in the United States or if the lessee is a United States person. If the transaction is a true lease and the property is used in the United States, the controlled foreign corporation owns tangible property in the United States and thus has invested in United States property.¹²⁹ If the lessee is an unincorporated United States person or a related U.S. corporation, then regardless of how the lease is characterized the controlled foreign corporation holds an obligation of a United States person and thus an investment in United States property.¹³⁰ In either of these situations, the value of the

¹²⁵ As is true of the exclusion for rental income, the exclusion for interest income received from a related person is not available for payments that reduce the Subpart F income of the payor. I.R.C. § 954(c)(3)(B). Nor is the exclusion available for payments that create or increase a deficit in the payor's earnings and profits that can be used to reduce Subpart F income under section 952(c). *Id.*

¹²⁶ The payor must have a trade or business located in its country of incorporation. I.R.C. § 954(c)(3)(A)(i)(II); Treas. Reg. § 1.954-2(b)(4)(i)(A)(3) (1995). In addition, a substantial part of the payor's assets must both be used in that trade or business and be located in the payor's country of incorporation. Treas. Reg. § 1.954-2(b)(4)(iv) (1995).

¹²⁷ I.R.C. § 954(e)(1)(B). This exclusion from foreign base company services income is discussed in Part III.B.1 *infra* of this article.

¹²⁸ Treas. Reg. § 1.954-4(c).

¹²⁹ I.R.C. § 956(c)(1)(A). "United States property", "United States person", and "United States shareholder" are terms of art for the Code. The terms are defined respectively at §§ 956(c), 957(c), and 951(b)

¹³⁰ I.R.C. §§ 956(c)(1)(C), (2)(F). There is no exception permitting a controlled foreign corporation to hold obligations of domestic partnerships and other unincorporated entities.

United States property is taxed to the United States shareholders of the controlled foreign corporation to the extent of the corporation's available earnings and profits.¹³¹ For that reason, controlled foreign corporations should refrain from leasing property to be located in the United States and from leasing to either unincorporated United States persons or related U.S. corporations.

2. *Contract Manufacturing*

Contract manufacturing by the controlled foreign corporation for a related person generally gives rise to foreign base company services income.¹³² In addition, contract manufacturing for any other person, for which the controlled foreign corporation's fee is paid by a related person, also generally gives rise to foreign base company services income. The fee received by the controlled foreign corporation from the related person for the corporation's manufacturing services constitutes a substantial financial benefit and thus constitutes foreign base company services income in the absence of an exclusion.¹³³ As long as the controlled foreign corporation conducts its contract manufacturing services within its country of incorporation, the fee income is excluded from foreign base company services income.¹³⁴ Hence, the controlled foreign corporation should avoid conducting manufacturing services at a foreign branch if the client is a related person.

B. Services Excluded

Two categories of services cannot give rise to foreign base company services income, even when the controlled foreign corporation renders the services for or on behalf of a related person.

1. *Services Performed Within the Country of Incorporation*

The first category consists of those services performed within the controlled foreign corporation's country of incorporation.¹³⁵ The first exclu-

A domestic corporation is related to the controlled foreign corporation if the domestic corporation is a United States shareholder of the foreign corporation or if 25% of its stock by voting power is held by United States shareholders of the foreign corporation. I.R.C. § 956(c)(2)(F). For a discussion of the exception permitting a controlled foreign corporation to hold the obligations of unrelated United States corporations, see *Anatomy*, *supra* note 99, at 92, 104 (1994).

¹³¹ I.R.C. §§ 951(a)(1)(B), 956(a).

¹³² I.R.C. § 954(e)(1)(A).

¹³³ Treas. Reg. § 1.954-4(b)(1)(i).

¹³⁴ I.R.C. § 954(e)(1)(B). The country-of-incorporation exclusion is discussed in Part III.B.1 *infra* of this article.

¹³⁵ I.R.C. § 954(e)(1)(B). Determining the location at which a service is rendered is a question of fact. Treas. Reg. § 1.954-4(c). In general terms, however, a service will be considered to be rendered where the people who perform the service are physically located while carrying out their duties. *Id.* When part of a service contract is performed within the

sion is consistent with the general approach of Subpart F to permit a controlled foreign corporation to conduct business activities wholly within its country of incorporation without attracting U.S. income tax to its United States shareholders.¹³⁶ Congress has followed the policy of capital import neutrality in this area to permit U.S. multinationals to conduct business in foreign markets under tax burdens that approximate those borne by local competitors.¹³⁷

There are three problems with the exclusion. First, a number of jurisdictions do not necessarily tax on the basis of residence those corporations that are incorporated within their borders. Instead, these jurisdictions tax on the basis of residence those corporations that are managed or controlled from the jurisdiction. This variation among jurisdictions permits tax avoidance by a U.S. multinational enterprise inconsistent with the policy of capital import neutrality. The multinational incorporates a controlled foreign corporation in a jurisdiction that taxes on the basis of residence only those corporations that are controlled or managed from the jurisdiction. The new subsidiary is then managed and controlled from another jurisdiction that either taxes, on the basis of residence, only those corporations that are incorporated there, or has no income tax at all. As a result of such an arrangement, the new subsidiary can derive income from services performed within its country of incorporation free of the constraints of foreign base company services income, while bearing a local tax burden lighter than that of its local competitors. To avoid this result, the exclusion should be keyed to the country that imposes tax on the income of the controlled foreign corporation on the basis of residence.

controlled foreign corporation's country of incorporation and part is performed outside, the gross income generated by the service contract must be apportioned between excluded income and other income. The apportionment is made on the basis of employee time and the relative value of that time. *Id.*

¹³⁶This general approach is seen in Subpart F's treatment of tax haven sales transactions. As long as the underlying goods are produced or sold in the controlled foreign corporation's country of incorporation, the income arising from transactions in those goods is excluded from the sales income taxed to the corporation's United States shareholders. I.R.C. § 954(d)(1)(A). Somewhat similar is the exclusion from foreign personal holding company income of dividends and interest income received from related persons incorporated and conducting operations in the controlled foreign corporation's country of incorporation, I.R.C. § 954(c)(3)(A)(i), and of royalties and rental income received from related persons derived in connection with using property within the controlled foreign corporation's country of incorporation. I.R.C. § 954(c)(3)(A)(ii). The purpose of those same-country exclusions from foreign personal holding company income differs from the exclusions from foreign base company services and sales income. In the case of passive income, the same-country exclusions permit a U.S. multinational to use multiple entities within a foreign jurisdiction without adverse effects under Subpart F. For a discussion of the point, see *Passive Income of Controlled Foreign Corporations*, *supra* note 85, at 307, 318.

¹³⁷For a brief account of capital import neutrality as a basis for international tax policy, see GUSTAFSON & PUGH, *supra* note 80, at 17-18.

RECOMMENDATION FIVE: Amend Code section 954(e)(1)(B) to provide that foreign base company services income is derived from services performed outside the country that imposes tax on the income of the controlled foreign corporation on the basis of residence.

In the event that no country taxes the controlled foreign corporation on the basis of residence, the corporation would not be entitled to the benefits of the country-of-residence exclusion. In the event that the corporation is resident in two countries for tax purposes, the corporation would be entitled to exclude income derived from the performance of services in either country.

A second problem with the exclusion is its emphasis on the place where services are performed without concern for the place where the services are consumed. The exclusion is available for services performed, but not necessarily used, in the controlled foreign corporation's country of incorporation. The emphasis on the place where services are performed is partly a result of the effort to key the exception to services that generate income that is taxed by the corporation's country of incorporation. U.S. source rules for income derived from services generally provide that services income arises in the country of performance. As presently written, the exclusion permits the erosion of foreign tax bases through the use of regional base companies organized in tax havens. Such a base company performs substantial services in its country of incorporation under contracts with clients in neighboring countries. The services are used in the neighboring countries, but the income generated by the contracts can be free from tax in those jurisdictions. The income does not constitute foreign base company services income for two reasons: frequently there is no related person necessary to the arrangement, and the country-of-incorporation exception excludes the income derived by the base company from the performance of services within its home jurisdiction. Even in those circumstances where the application of the branch rule proposed elsewhere in this article would create a related person from the corporation's activities, the country-of-incorporation exclusion remains.¹³⁸ As discussed elsewhere in this article, the United States must address some of the arrangements that cause the erosion of foreign tax bases, just as the United States must rely upon the efforts of foreign jurisdictions to protect its own tax base from some types of tax avoidance.¹³⁹ The problem can be addressed by keying the exclusion to the place where services are used, in addition to the place where services are performed. Putting aside the previous recommendation for the moment, we might propose the following:

RECOMMENDATION SIX: Amend Code section 954(e)(1)(B) to provide that both the performance and use of services must take place in the controlled foreign corporation's country of incorporation in order

¹³⁸ A branch rule for services income is proposed in Part II.C.2.b(4) *supra* of this article.

¹³⁹ The limits of prescriptive jurisdiction in taxation are discussed briefly in Part II.C.2.a *supra* of this article.

for the income from such services to be excluded from the corporation's foreign base company services income.

The recommendation would counter the following erosion of the United States tax base:

EXAMPLE THIRTEEN: Standard Banking Corporation, a Delaware corporation with operations in North Carolina, incorporates a wholly-owned subsidiary in Bermuda. The subsidiary processes data under contract with its U.S. parent, using high-speed data transmission lines between Bermuda and the United States. The subsidiary is compensated for its services, and the parent company deducts the fees it pays to the data processing subsidiary. Bermuda levies no income tax on the earnings of the subsidiary.

Under current law, the subsidiary's income is not taxed to its U.S. parent by the United States, since the services giving rise to the income fall within the country-of-incorporation exclusion. Although the services are performed in Bermuda, the services are consumed in the United States. The U.S. tax base is eroded by moving the performance of the services offshore. The Bermudan subsidiary is not competing with other Bermuda companies to provide services in the Bermudan market. In addition, the place of performance, Bermuda, is unrelated to the nature of the services; the services could be performed anywhere. Recommendation Six would require the services to be consumed in Bermuda in order for the income derived from those services to be excluded from foreign base company services income. Services and telecommunications being what they are, the place of performance of many services can easily be moved from jurisdiction to jurisdiction by moving the relevant personnel. The country-of-incorporation exclusion at present permits the avoidance of U.S. and foreign income taxation without necessarily furthering the policy of capital import neutrality.

The third problem with the exclusion lies in its application to controlled foreign corporations that receive substantial assistance from related persons in their performance of services. When a controlled foreign corporation receives substantial assistance from a related person in the performance of its services, the income derived by the corporation generally is foreign base company services income.¹⁴⁰ The inclusion is justified on the theory that the related person is in substance the true general contractor of the services and has been disguised by the nominal role of the controlled foreign corporation as the ostensible prime contractor.¹⁴¹ Under this theory, the related person has attempted to segregate some of its services income within a controlled foreign corporation subject to a low rate of tax. The income so segregated consists at least of the income accruing to the efforts of a general contractor after its subcontractors have been paid. Hence, the

¹⁴⁰Treas. Reg. § 1.954-4(b)(1)(iv).

¹⁴¹Substantial assistance by a related person is discussed in Part II.B.4 *supra* of this article.

general contractor's markup on the subcontractors' services is being segregated from the related person's services income and placed into a separate tax haven corporation. Under this approach, the controlled foreign corporation is assumed to have insufficient resources to act as the general contractor.

In light of this theory, the country-of-incorporation exclusion should not be available for services performed by a controlled foreign corporation with the substantial assistance of a related person. Those services by definition have been moved to a tax haven and ostensibly performed by a corporation established there. The country-of-incorporation exclusion exempts all income that the substantial assistance rule targets. One group has suggested that the exclusion continue to be available to income derived with substantial assistance but be modified so that the services must be performed in the related person's country of incorporation in order to qualify for the exclusion.¹⁴² That suggestion, however, does not take into account the situation in which the controlled foreign corporation has no permanent establishment in the related person's jurisdiction and thus might not be subject to tax by that jurisdiction on its service income. The exclusion should not exempt services performed in the related person's jurisdiction if the income derived from those services is not taxed by that jurisdiction. Putting aside the previous two recommendations for the moment, we can propose the following:

RECOMMENDATION SEVEN: Amend Code section 954(e)(1)(B) to provide that, in the event that a controlled foreign corporation receives substantial assistance in the performance of its services from a related person, the income from such services shall not be excluded from foreign base company services income if the assisted services were performed in the controlled foreign corporation's country of incorporation. Rather, such services shall be excluded from foreign base company services income if the controlled foreign corporation and the related person are incorporated in the same country and such services are performed in that country.

Recommendations Five, Six, and Seven can be integrated into the following composite proposal:

RECOMMENDATION EIGHT: Amend Code section 954(e)(1)(B) to provide that the income derived by a controlled foreign corporation from the performance of services for, or on behalf of, a related person is foreign base company services income unless the services are both performed and used in the country that imposes tax on the income of the controlled foreign corporation on the basis of residence. If the controlled foreign corporation performs services with the substantial assistance of a related person, the income derived by the controlled foreign

¹⁴²The American Law Institute ("ALI") has made this suggestion informally, but limits its application to situations in which the related person is a United States person. The ALI does not make a formal recommendation. AMERICAN LAW INSTITUTE, *supra* note 54, at 275-76, 286.

corporation from those services should be foreign base company services income unless the income of both the controlled foreign corporation and the related person is taxed on the basis of residence by the same country and the services are both performed and used in that country.

2. Certain Marketing Services

The second category of services excluded from foreign base company services income generally consists of marketing services performed by a controlled foreign corporation in connection with property it has manufactured or intends to manufacture.¹⁴³ The second exclusion is consistent with the approach of Subpart F not to attack tax haven manufacturing operations.¹⁴⁴ The exclusion permits a controlled foreign corporation to provide marketing services to a related person for products the corporation has manufactured. The following example illustrates the use of this exclusion.

EXAMPLE FOURTEEN: *Marketing Campaign for the Benefit of Local Retailers.* Cellphones, Ltd., a controlled foreign corporation organized in the Republic of Ireland, manufactures cellular telephones for the European market. Cellphones has organized local sales subsidiaries in most of the member states of the European Union to distribute cellular phones manufactured by Cellphone. Cellphone mounts a European Union-wide advertising campaign to promote its product. The marketing campaign benefits Cellphone's European sales subsidiaries, which are related persons. To pay for the marketing effort, Cellphone charges each of its sales subsidiaries an arms-length marketing fee on each cellular phone sold by Cellphone to the sales subsidiary after the beginning date of the campaign. Cellphone's income from the marketing fee does not fall within foreign base company services income, however, since the marketing services are performed in connection with property Cellphone has manufactured.

C. Preempted Services

A number of other services do not give rise to foreign base company services income. These services give rise to income that falls within an-

¹⁴³ I.R.C. § 954(e)(2); Treas. Reg. § 1.954-4(d)(2). In order for income to qualify for the exclusion, the underlying services must be performed prior to the sale of the property and must be directly related to the property's sale. I.R.C. § 954(e)(2). Hence, this article characterizes those services as marketing services. The marketing services need not be successful; the services may be rendered in connection with an offer to sell qualifying property. I.R.C. § 954(e)(2)(B). The disposition of the property may take the form of an exchange. I.R.C. § 954(e)(2). The qualifying property may be manufactured, produced, grown, or extracted by the controlled foreign corporation. *Id.*

¹⁴⁴ Subpart F generally excludes from its scope the income arising from the manufacturing and sale of goods by a controlled foreign corporation, regardless of the presence of related persons in the transactions. Treas. Reg. § 1.954-3(a)(4)(i). For an analysis of the manufacturing exclusion from foreign base company sales income, see *Foreign Base Company Sales Income*, *supra* note 74.

other category of foreign base company income. Hence, it is the coordination of the various categories of tainted tax haven income that excludes the services that otherwise might produce foreign base company services income. When possible foreign base company services income also falls within another category of foreign base company income, the choice between the two categories is made by reference to a partial list of priorities.¹⁴⁵ The components of the income are to be determined separately and each component categorized separately.¹⁴⁶ If the components cannot be determined separately, the predominant character of the underlying transaction is determined and the entire income is given that characterization.¹⁴⁷

Any of the other categories of foreign base company income conceivably can overlap with foreign base company services income. Those other categories are foreign personal holding company income, foreign base company shipping income, foreign base company oil-related income, and foreign base company sales income. Foreign personal holding company income always is determinable separately and takes priority over foreign base company services income.¹⁴⁸ In the event that an exclusion from foreign personal holding company income applies, the income is eligible for inclusion in foreign base company services income.¹⁴⁹ Most financial services give rise to foreign personal holding company income and, therefore, do not give rise to foreign base company services income.¹⁵⁰ Shipping services that give rise to foreign base company shipping income cannot give rise to foreign base company services income. The regulations settle any conflict between the two categories in favor of shipping income.¹⁵¹ Foreign base company oil-related income also takes precedence over foreign base company services income.¹⁵² Insurance income, although not a category of foreign base company income, also takes precedence over foreign base company services income.¹⁵³

The order of priority between foreign base company sales income and foreign base company services income is less clear. There are times, of course, when a controlled foreign corporation derives sales income while also performing services. The two components can frequently be separated and quantified. In those instances when the two components cannot be separated, the predominant character test assists in classifying the compos-

¹⁴⁵Treas. Reg. § 1.954-1(e)(4)(i).

¹⁴⁶Treas. Reg. § 1.954-1(e)(2).

¹⁴⁷Treas. Reg. § 1.954-1(e)(3).

¹⁴⁸Treas. Reg. § 1.954-1(e)(3), (4)(i)(D).

¹⁴⁹Treas. Reg. § 1.954-1(e)(4)(ii).

¹⁵⁰The relationship between foreign personal holding company income and foreign base company services income in the case of income from selected financial services is analyzed in Part III.A.1 of this article.

¹⁵¹Treas. Reg. §§ 1.954-1(e)(4)(i)(A), 1.954-4(d)(3).

¹⁵²Treas. Reg. § 1.954-1(e)(4)(i)(B).

¹⁵³Treas. Reg. § 1.954-1(e)(4)(i)(C).

ite income. The most difficult problem arises from the fact that there are two services that by definition give rise to foreign base company sales income. These services are the purchasing and selling services rendered by a controlled foreign corporation for the benefit of a related person.¹⁵⁴ The income from those services is a candidate for both foreign base company sales income and foreign base company services income. There are no authorities suggesting the proper characterization of such income other than the general maxim that a more specific reference takes precedence over the more general. This maxim suggests that the specific reference to such service income within the definition of foreign base company sales income determines the characterization of the income as sales income. The Service has ruled privately that the income derived by a controlled foreign corporation from acting as a purchasing agent for a related person is foreign base company sales income and not foreign base company services income.¹⁵⁵ Consider the following example.

EXAMPLE FIFTEEN: *Engineering, Procurement, and Construction Contract.* Commonwealth Construction Company, Inc., a Texas corporation, has organized two wholly-owned subsidiaries in its effort to win contracts from clients in India. The first, Commonwealth of India, Ltd., was organized in India as a construction company. The second, Commonwealth Procurement Services, Ltd., was organized in the Maldiv Islands. Commonwealth of India now wins an engineering, procurement, and construction contract to build an oil refinery outside Mumbai. Commonwealth of India subcontracts the engineering out to its parent in the United States and subcontracts out the procurement services to its sibling, Commonwealth Procurement Services ("Procurement"). Procurement derives income from purchasing the necessary materials and equipment for the new refinery on behalf of Commonwealth of India. Such income constitutes foreign base company sales income, since it arises from the purchase of goods on behalf of a related person for use outside the Maldiv Islands.¹⁵⁶

When Procurement acts as a purchasing agent for Commonwealth of India, it engages in a service that might generate foreign base company services income¹⁵⁷ in the absence of the Code provisions that create the category of foreign base company sales income.¹⁵⁸ Procurement is per-

¹⁵⁴I.R.C. § 954(d)(1).

¹⁵⁵Priv. Ltr. Rul. 85-36-007 (May 31, 1985). The ruling assumes that the income cannot be both types of income simultaneously, and that the category of sales income, which specifically refers to transactions in which a controlled foreign corporation acts as a purchasing agent, takes precedence over the category of services income.

¹⁵⁶I.R.C. § 954(d)(1). Depending on the wording of the procurement subcontract, Procurement may instead be purchasing goods and reselling them to a related person for use outside the Maldiv Islands. Procurement's income would still fall within foreign base company sales income. *Id.*

¹⁵⁷Treas. Reg. § 1.954-4(b)(1)(ii).

¹⁵⁸I.R.C. § 954(a)(2), (d)(1).

forming a service that a related person is obligated to perform.¹⁵⁹ If Procurement performs the service outside the Maldives, its country of incorporation, the attendant income would be foreign base company services income.

The country-of-incorporation exclusions differ for foreign base company sales income and foreign base company services income. The exclusion for sales income is keyed to the place where a product originates or is used,¹⁶⁰ while the exclusion for services income is keyed to place of performance.¹⁶¹ In Example Fifteen, Procurement cannot take advantage of the country-of-incorporation exclusion from foreign base company sales income since the products neither originate, nor are ultimately used, in Procurement's country of incorporation. On the other hand, Procurement could take advantage of the country-of-incorporation exclusion from foreign base company services income if it performs its services within the Maldives. If one of the country-of-incorporation exclusions applies but not the other, there is no overlap between the categories of foreign base company sales income and foreign base company services income.

IV. CONCLUDING OBSERVATIONS AND SUMMARY OF RECOMMENDATIONS

There is a surprising lack of litigation in this area of international taxation. This lack may be due to the internal structure of section 954(e): its rules appear trivial in their scope after the application of its exclusions. If it is true that the scope of section 954(e) is trivial, the section raises very little revenue and hence does little either to combat the erosion of the U.S. tax base or to enhance economic efficiency. Empirical research would be appropriate to determine the revenue actually raised by section 954(e), either directly by its application to base company operations or indirectly by its deterrent effect as other Code provisions pick up income that seeks to avoid section 954(e).

The suspected culprit in rendering section 954(e) trivial in scope is the country-of-incorporation exclusion. The exclusion exempts all income arising from the performance of services within the tax haven in which the controlled foreign corporation is incorporated.¹⁶² The ostensible reason for such an exclusion is to permit a U.S. multinational to serve a foreign market on an equal footing with its local competitors.¹⁶³ The exclusion assumes, however, that the controlled foreign corporation would be incorporated in the jurisdiction of the foreign market. In light of the fact that services can

¹⁵⁹ For a discussion of this type of service relationship between a controlled foreign corporation and a related person, see Part II.B.2 *supra* of this article.

¹⁶⁰ I.R.C. § 954(d)(1).

¹⁶¹ I.R.C. § 954(e)(1)(B).

¹⁶² I.R.C. § 954(e)(1)(B).

¹⁶³ For a brief account of capital import neutrality as a basis for international tax policy, see GUSTAFSON & PUGH, *supra* note 80, at 17-18.

be performed at locations other than the client's place of business, the exclusion is not adequately keyed to the foreign market served by the controlled foreign corporation. The performance of a number of services can be moved easily from the jurisdiction of the foreign market to a tax haven, together with the controlled foreign corporation's place of incorporation. Recommendations Five through Eight suggest changes to the country-of-incorporation exclusion to conform it to its purpose.¹⁶⁴ Recommendation Five would change the definition of a controlled foreign corporation's home jurisdiction from its country of incorporation to the country that taxes the corporation on the basis of residence. Recommendation Six would correct the definition of the foreign market served by the controlled foreign corporation from its country of incorporation to the country in which its services are used by the client. Recommendation Seven would change the relevant home jurisdiction for a controlled foreign corporation that receives substantial assistance from a related person to the country that taxes the related person on the basis of residence. Recommendation Eight integrates the three preceding recommendations into a single proposal should all three be acceptable to policymakers.

The suspected accomplice in rendering section 954(e) trivial in scope is the related-person requirement. The related-person requirement ensures that foreign base company services income does not include the income that arises from independent service operations in tax havens, even when those operations target markets in other jurisdictions.¹⁶⁵ Eliminating the related-person requirement and relying on the combination of a reformed country-of-incorporation exclusion and the high-tax exclusion¹⁶⁶ to maintain the competitive position of U.S. multinationals would enlarge the scope of section 954(e) and better preserve the U.S. tax base. Recommendation Four suggests the elimination of the related-person requirement.¹⁶⁷

If the political process is not amenable to the repeal of the related-person requirement, then the related-person requirement needs to be refined. Recommendation Three would add a branch rule that would treat certain foreign branches of a controlled foreign corporation as separate corporations able to satisfy the related-person requirement.¹⁶⁸ Recommendations One and Two would refine the related-person requirement as it is embodied in the substantial assistance rule. Recommendation Two would eliminate the substantial assistance rule altogether and leave the necessary

¹⁶⁴ See Part III.B.1 *supra* of this article for the text and a discussion of these recommendations.

¹⁶⁵ See Part II.C.1 *supra* of this article.

¹⁶⁶ I.R.C. § 954(b)(4). In effect, the high-tax exclusion excludes from foreign base company services income any income of a controlled foreign corporation that bears a rate of foreign tax substantially equal to that of the United States corporate income tax.

¹⁶⁷ See Part II.C.3 *supra* of this article.

¹⁶⁸ See Part II.C.2 *supra* of this article for the requisite discussion. The recommendation itself appears in Part II.C.2.b(4) *supra*.

monitoring of assistance by a related person to Code section 482.¹⁶⁹ If section 482 cannot be administered effectively by the Service in the area of foreign base company services operations, the substantial assistance rule should be modified in accordance with Recommendation One. Recommendation One would permit a related person to assist a controlled foreign corporation by furnishing services or know-how on the same basis as a related person is permitted to give financial assistance.¹⁷⁰

¹⁶⁹ See Part II.B.4.c *supra* of this article.

¹⁷⁰ See Part II.B.4.c *supra* of this article.