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Accountants and Consultants

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Issue:

Notice 2007-13

International Tax Alert

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Issue

The Internal Revenue Service is amending the regulations which define “substantial assistance” for purposes of determining foreign base company services income under Subpart F.

Affecting

Potentially, U.S. taxpayers doing business abroad through the use of related corporations.

Background

Subpart F of the Internal Revenue Code (“IRC”) provides that U.S. taxpayers doing business through the use of certain controlled foreign corporations (“CFCs”) may be subject to current income inclusion when a CFC derives foreign base company services income (“FBCSI”). FBCSI generally includes income for services a CFC performs outside of its country of incorporation for, or on behalf of, a related person (“Subpart F income”). IRC 954(e)(1). In addition, services performed by a CFC may be considered performed for, or on behalf of, a related person when the CFC has received assistance from a related party in order to perform such services. The IRS has issued Notice 2007-13, which amends the criterion for determining when assistance provided by a related party constitutes FBCSI.

The Current Regulations

In further defining FBCSI, the current regulations provide that “services which are performed for, or on behalf of, a related person” include “substantial assistance” furnished by a related person to the CFC. Treas. Reg. §1.954-4(b)(1)(iv). Substantial assistance is generally determined under the current regulations through either one of two tests: (a) the subjective test, or (b) the objective test.

Under the subjective test, assistance (in the form of direction, supervision, services or know-how, financial assistance (not including capital contributions), equipment, material or supplies) is deemed “substantial” if the assistance obtained from related persons provides the CFC with skills which are a principal element in producing the CFC’s services income.

Under the objective test, assistance (in the form of direction, supervision, services or know-how) is deemed substantial if the cost to the CFC of the assistance provided by related persons is 50% or more of the total cost to the CFC of performing the services. Financial assistance would meet the objective test when the amount actually paid by the CFC to the related person is not made at arm's length.

Even if the assistance received from related persons does not rise to the level of substantial under either of these tests, Treas. Reg. §1.954-4(b)(2)(ii)(d) states that such assistance may nevertheless be considered substantial when taken in combination with other assistance provided to the CFC by other related persons.

The Proposed Revisions to the Regulations

Pursuant to Notice 2007-13, the IRS has advised that it is amending the substantial assistance regulations to limit the types of activities that constitute substantial assistance to certain assistance provided, directly or indirectly, by related U.S. persons, rather than any related person, to a CFC.

Further, the proposed regulations will reduce the number of tests for determining when assistance is substantial to a single, objective "cost" test. The cost test will be met when the cost to the CFC of the assistance provided by the related U.S. person equals or exceeds 80% of the total cost to the CFC of performing the services. The test may also be met by the CFC demonstrating that the costs it and/or a related CFC incurred were more than 20% of the total cost to the CFC of performing the service. The examples set forth in the regulations to explain these rules will also be amended.

The regulations to be issued will apply to taxable years of foreign corporations beginning on or after January 1, 2007, and to taxable years of U.S. shareholders in which or with which such taxable years of the CFC ends. Taxpayers may rely on Notice 2007-13 until the amended regulations are issued.

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