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§ 1.954–4 Foreign base company services income.

(a) *Items included.* Except as provided in paragraph (d) of this section, foreign base company services income means income of a controlled foreign corporation, whether in the form of compensation, commissions, fees, or otherwise, derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which—

(1) Are performed for, or on behalf of a related person, as defined in paragraph (e)(1) of § 1.954–1, and

(2) Are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

(b) *Services performed for, or on behalf of, a related person*—(1) *Specific cases.* For purposes of paragraph (a)(1) of this section, ''services which are performed for, or on behalf of, a related person'' include (but are not limited to) services performed by a controlled foreign corporation in a case where—

(i) The controlled foreign corporation is paid or reimbursed by, is released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing such services;

(ii) The controlled foreign corporation performs services (whether or not with respect to property sold by a related person) which a related person is, or has been, obligated to perform;

(iii) The controlled foreign corporation performs services with respect to property sold by a related person and the performance of such services constitutes a condition or a material term of such sale; or

(iv) Substantial assistance contributing to the performance of such services has been furnished by a related person or persons.

(2) *Special rules*—(i) *Guaranty of performance.* Subparagraph (1)(ii) of this paragraph shall not apply with respect to services performed by a controlled foreign corporation pursuant to a contract the performance of which is guaranteed by a related person, if (*a*) the related person's sole obligation with respect to the contract is to guarantee performance of such services, (*b*) the controlled foreign corporation is fully obligated to perform the services under the contract, and (*c*) the related person (or any other person related to the controlled foreign corporation) does not in fact (*1*) pay for performance of, or perform, any of such services the performance of which is so guaranteed or (*2*) pay for performance of, or perform, any significant services related to such services. If the related person (or any other person related to the controlled foreign corporation) does in fact pay for performance of, or perform, any of such services or any significant services related to such services, subparagraph (1)(ii) of this paragraph shall apply with respect to the services performed by the controlled foreign corporation pursuant to the contract the performance of which is guaranteed by the related person, even though such payment or performance is not considered to be substantial assistance for purposes of subparagraph (1)(iv) of this paragraph. For purposes of this subdivision, a related person shall be considered to guarantee performance of the services by the controlled foreign corporation whether it guarantees performance of such services by a separate contract of guaranty or enters into a service contract solely for purposes of guaranteeing performance of such services and immediately thereafter assigns the entire contract to the controlled foreign corporation for execution.

(ii) *Application of substantial assistance test.* For purposes of subparagraph (1)(iv) of this paragraph—

(*a*) Assistance furnished by a related person or persons to the controlled foreign corporation shall include, but shall not be limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies.

(*b*) Assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how shall not be considered substantial unless either (*1*) the assistance so furnished provides the controlled foreign corporation with skills which are a principal element in producing the income from the performance of such

services by such corporation or (*2*) the cost to the controlled foreign corporation of the assistance so furnished equals 50 percent or more of the total cost to the controlled foreign corporation of performing the services performed by such corporation. The term ''cost'', as used in this subdivision (*b*), shall be determined after taking into account adjustments, if any, made under section 482.

(*c*) Financial assistance (other than contributions to capital), equipment, material, or supplies furnished by a related person to a controlled foreign corporation shall be considered assistance only in that amount by which the consideration actually paid by the controlled foreign corporation for the purchase or use of such item is less than the arm's length charge for such purchase or use. The total of such amounts so considered to be assistance in the case of financial assistance, equipment, material, and supplies furnished by all related persons shall be compared with the profits derived by the controlled foreign corporation from the performance of the services to determine whether the financial assistance, equipment, material, and supplies furnished by a related person or persons are by themselves substantial assistance contributing to the performance of such services. For purposes of this subdivision (*c*), determinations shall be made after taking into account adjustments, if any, made under section 482 and the term ''consideration actually paid'' shall include any amount which is deemed paid by the controlled foreign corporation pursuant to such an adjustment.

(*d*) Even though assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how is not considered to be substantial under (*b*) of this subdivision and assistance furnished by a related person or persons in the form of financial assistance (other than contributions to capital), equipment, material, or supplies is not considered to be substantial under (*c*) of this subdivision, such assistance may nevertheless constitute substantial assistance when taken together or in combination with other assistance furnished by a related person or persons which in itself is not considered to be substantial.

(*e*) Assistance furnished by a related person or persons to a controlled foreign corporation in the form of direction, supervision, services, or know-how shall not be taken into account under (*b*) or (*d*) of this subdivision unless the assistance so furnished assists the controlled foreign corporation directly in the performance of the services performed by such corporation.

(iii) *Special rule applicable to distributive share of partnership income.* A controlled foreign corporation's distributive share of a partnership's services income will be deemed to be derived from services performed for or on behalf of a related person, within the meaning of section 954(e)(1)(A), if the partnership is a related person with respect to the controlled foreign corporation, under section 954(d)(3), and, in connection with the services performed by the partnership, the controlled foreign corporation, or a person that is a related person with respect to the controlled foreign corporation, provided assistance that would have constituted substantial assistance contributing to the performance of such services, under paragraph (b)(2)(ii) of this section, if furnished to the controlled foreign corporation by a related person. This paragraph (b)(2)(iii) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Controlled foreign corporation A is paid by related corporation M for the installation and maintenance of industrial machines which M Corporation manufactures and sells to B Corporation. Such installation and maintenance services by A Corporation are performed for, or on behalf of, M Corporation for purposes of section 954(e).

Example 2. Controlled foreign corporation B enters into a contract with an unrelated person to drill an oil well in a foreign country. Domestic corporation M owns all the outstanding stock of B Corporation. Corporation B employs a relatively small clerical and administrative staff and owns the necessary well-drilling equipment. Most of the technical and supervisory personnel who oversee the drilling of the oil well by B Corporation are regular employees of M Corporation who are temporarily employed by B Corporation. In addition, B Corporation hires on the open

market unskilled and semiskilled laborers to work on the drilling project. The services performed by B Corporation under the well-drilling contract are performed for, or on behalf of, a related person for purposes of section 954(e) because the services of the technical and supervisory personnel which are provided by M Corporation are of substantial assistance in the performance of such contract in that they assist B Corporation directly in the execution of the contract and provide B Corporation with skills which are a principal element in producing the income from the performance of such contract.

Example 3. Controlled foreign corporation F enters into a contract with an unrelated person to construct a dam in a foreign country. Domestic corporation M owns all the outstanding stock of F Corporation. Corporation F leases or buys from M Corporation, on an arm's length basis, the equipment and material necessary for the construction of the dam. The technical and supervisory personnel who design and oversee the construction of the dam are regular full-time employees of F Corporation who are not on loan from any related person. The principal clerical work, and the financial accounting, required in connection with the construction of the dam by F Corporation are performed, on a remunerated basis, by full-time employees of M Corporation. All other assistance F Corporation requires in completing the construction of the dam is paid for by that corporation and furnished by unrelated persons. The services performed by F Corporation under the contract for the construction of the dam are not performed for, or on behalf of, a related person for purposes of section 954(e) because the clerical and accounting services furnished by M Corporation do not assist F Corporation directly in the performance of the contract.

Example 4. Controlled foreign corporation D, a wholly owned subsidiary of domestic corporation M, procures and enters a contract with an unrelated person to construct a superhighway in a foreign country, but such person enters the contract only on the condition that M Corporation agrees to perform, or to pay for the performance by some person other than D Corporation of, the services called for by the contract if D Corporation should fail to complete their performance. Corporation D is capable of performing such contract. No related person as to D Corporation pays for, or performs, any services called for by the contract, or pays for, or performs, any significant services related to such services. The construction of the superhighway by D Corporation is not considered for purposes of section 954(e) to be the performance of services for, or on behalf of M Corporation.

Example 5. Domestic corporation M is obligated under a contract with an unrelated person to construct a superhighway in a foreign country. At a later date M Corporation assigns the entire contract to its wholly owned subsidiary, controlled foreign corporation C, and the unrelated person releases M Corporation from any obligation under the contract. The construction of such highway by C Corporation is considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

Example 6. Domestic corporation M enters a contract with an unrelated person to construct a superhighway in a foreign country. Corporation M immediately assigns the entire contract to its wholly owned subsidiary, controlled foreign corporation C. The unrelated person does not release M Corporation of its obligation under the contract, the sole purpose of these arrangements being to have M Corporation guarantee performance of the contract by C Corporation. Corporation C is capable of performing the construction contract. Neither M Corporation nor any other person related to C Corporation pays for, or performs, any services called for by the construction contract or at any time pays for, or performs, any significant services related to the services performed under such contract. The construction of the superhighway by C Corporation is not considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

Example 7. The facts are the same as in example 6 except that M Corporation, preparatory to entering the construction contract, prepares plans and specifications which enable the submission of bids for the contract. Since M Corporation has performed significant services related to the services the performance of which it has guaranteed, the construction of such highway by C Corporation is considered for purposes of section 954(e) to be the performance of services for, or on behalf of, M Corporation.

Example 8. Domestic corporation M manufactures an industrial machine which requires specialized installation. Corporation M sells the machines for a basic price if the contract of sale contains no provision for installation. If, however, the customer agrees to employ controlled foreign corporation E, a wholly owned subsidiary of M Corporation, to install the machine and to pay E Corporation a specified installation charge, M Corporation sells the machine at a price which is less than the basic price. The installation services performed by E Corporation for customers of M Corporation purchasing the machine at the reduced price are considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

Example 9. Domestic corporation M manufactures and sells industrial machines with a

warranty as to their performance conditional upon their installation and maintenance by a factory-authorized service agency. Controlled foreign corporation F, a wholly owned subsidiary of M Corporation, is the only authorized service agency. Any installation or maintenance services performed by F Corporation on such machines are considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

Example 10. Domestic corporation M manufactures electric office machines which it sells at a basic price without any provision for, or understanding as to, adjustment or maintenance of the machines. The machines require constant adjustment and maintenance services which M Corporation, certain wholly owned subsidiaries of M Corporation, and certain unrelated persons throughout the world are qualified to perform. From among the numerous persons qualified and available to perform adjustment and maintenance services with respect to such office machines, foreign corporation B, a customer of M Corporation, employs controlled foreign corporation G, a wholly owned subsidiary of M Corporation, to adjust and maintain the office machines which B Corporation purchases from M Corporation. The adjustment and maintenance services performed by G Corporation for B Corporation are not considered for purposes of section 954(e) to be performed for, or on behalf of, M Corporation.

(c) *Place where services are performed.* The place where services will be considered to have been performed for purposes of paragraph (a)(2) of this section will depend on the facts and circumstances of each case. As a general rule, services will be considered performed where the persons performing services for the controlled foreign corporation which derives income in connection with the performance of technical, managerial, architectural, engineering, scientific, skilled, industrial, commercial, or like services are physically located when they perform their duties in the execution of the service activity resulting in such income. Therefore, in many cases, total gross income of a controlled foreign corporation derived in connection with each service contract or arrangement performed for or on behalf of a related person must be apportioned, between income which is not foreign base company services income and that which is foreign base company services income, on a basis of employee-time spent within the foreign country under the laws of which the controlled foreign corporation is created or organized and employee-time spent without the foreign country under the laws of which such corporation is created or organized. In allocating time spent within and without the foreign country under the laws of which the controlled foreign corporation is created or organized, relative weight must also be given to the value of the various functions performed by persons in fulfillment of the service contract or arrangement. For example, clerical work will ordinarily be assigned little value, while services performed by technical, highly skilled, and managerial personnel will be assigned greater values in relation to the type of function performed by each individual.

(d) *Items excluded.* Foreign base company services income does not include—

(1) Income derived in connection with the performance of services by a controlled foreign corporation if—

(i) The services directly relate to the sale or exchange of personal property by the controlled foreign corporation,

(ii) The property sold or exchanged was manufactured, produced, grown, or extracted by such controlled foreign corporation, and

(iii) The services were performed before the sale or exchange of such property by the controlled foreign corporation;

(2) Income derived in connection with the performance of services by a controlled foreign corporation if the services directly relate to an offer or effort to sell or exchange personal property which was, or would have been, manufactured, produced, grown, or extracted by such controlled foreign corporation whether or not a sale or exchange of such property was in fact consummated; or

(3) For taxable years beginning after December 31, 1975, foreign base company shipping income (as determined under §1.954–6).

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