Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Agency Attribution for Purposes of Sourcing Services Income

This Chief Counsel Advice responds to your request for assistance under sections 861 and 904 of the Internal Revenue Code (Code). This memorandum addresses whether activities performed by a wholly-owned controlled foreign corporation in Country X can be attributed to its U.S. shareholder (USP) for purposes of sourcing USP's services income to determine USP's credit limitation under section 904(a) with respect to each separate limitation category. This advice may not be used or cited as precedent.

LEGEND

USP (TAXPAYER) =
CFC =
COUNTRY X =

ISSUE

For purposes of sourcing USP's services income under section 861 and Treas. Reg. § 1.861-4 to determine USP's credit limitation under section 904(a), are CFC's activities attributed to USP, thereby increasing USP's foreign-source income?

CONCLUSION

In the case of an entity deriving services income, the source of such income generally is determined by reference to the place at which the entity's employees or other agents perform such services. In a case (as in focus here) in which an entity subcontracts to another entity (subcontractor) work that the first entity (contractor) has contracted to provide, then, unless the subcontractor is treated as an agent for such purpose, the source of income derived by the contractor is not determined by reference to the place of performance by the subcontractor. Rather, the contractor's income is properly determined by the place at which its own employees or other agents act in connection with such services, which may include, apart from any directly provided services, various other functions (for example, marketing, coordination among entities involved in providing the services, monitoring and quality control, and maintaining customer relations).

National Carbide Corp. v. Commissioner[1] provides a six-factor test to determine whether a subsidiary corporation should be considered an agent of the parent corporation. *Commissioner v. Bollinger*[2] recognized the need for additional filters that the IRS may apply in testing the legitimacy of a taxpayer's claim that its subsidiary corporation is its agent. CFC does not satisfy the tests in *National Carbide* and *Bollinger*. For these reasons, CFC is not considered an agent of USP for Federal income tax purposes, and the activities of CFC cannot be attributed to USP for purposes of sourcing USP's services income under section 861 and Treas. Reg. § 1.861-4 to determine USP's gross income within the relevant section 904(d) separate limitation categories.

FACTS

USP is a domestic corporation that provides risk management services, insurance and reinsurance brokerage, and human resource (HR) consulting and outsourcing. As part of its HR consulting and outsourcing business, USP enters into service agreements with customers to manage and administer part or all of customer HR programs and to provide consulting services related to the design, implementation, communication, and operation of the HR programs.

Typical service agreements between USP and its customers state that USP will provide services to its customers and that customers will compensate USP for the provision of services based on a set fee schedule delineated in the service agreements. USP bears the ultimate responsibility for delivering the services, including guaranteeing that services are delivered in accordance with the standards articulated in the agreements. The service agreements permit USP to enter into subcontracts with other parties in connection with the services to be rendered, but in such a case USP remains responsible to its clients for the services provided by the subcontractor. The service

[1] 336 U.S. 422 (1949).
[2] 485 U.S. 340 (1988).

agreements neither specify the identity of any potential subcontractor nor generally limit the parties with which USP may enter into a subcontract. Customers' data may not be stored, transmitted, or accessed outside the United States unless the customer provides advance written authorization.

USP contracts with its wholly-owned CFC incorporated in Country X to provide a substantial part of the services for which USP's U.S. customers have contracted. A representative agreement states that CFC shall provide "outsourcing support/IT services" to USP in consideration for CFC performing the contracted services, CFC's cost of travel related to the services, and a mark-up supported by the most current transfer pricing study. Under a typical provision of services arrangement, USP's customers pay USP 100x for the contracted services, and USP pays CFC 20x for its services.[3]

The representative agreement describes CFC as the subcontractor of USP. The representative agreement does not state that CFC has the power to enter into arrangements with third parties that bind USP or that CFC otherwise serves as the agent of USP. A study prepared by USP to support that CFC is paid arm's length compensation indicates that CFC is hired in a "limited risk/subcontracting capacity." CFC does not maintain business relationships with USP's customers. CFC does not commit to provide services to USP's customers, and CFC is not responsible for resolving USP's customer's issues.

USP solicits customers, markets services to them, and enters the contracts to provide services to the customers. CFC is not involved in this process and is not a party to the contracts.

CFC recruits, hires, and supervises its own employees, although USP provides some of the initial training to CFC's employees. After USP determines the specific type of product required by its customers as determined under the contract between USP and its customers, including software designed for customers' HR departments, USP provides CFC with the necessary IP infrastructure to develop the product. CFC is responsible for certain production tasks associated with developing the software (such as coding and testing the software), but USP at all times owns the rights to the software and performs all conceptual development, core design, sales and marketing, and post-sales client support for the final product. According to Taxpayer's transfer pricing study, CFC's role in producing software "is limited to that of a back-end software developer." Additionally, CFC processes and analyzes USP's client's data for HR management services for which USP's clients contract with USP.

[3] This CCA does not address the allocation of income under section 482.

LAW AND ANALYSIS

Section 904 limits the total amount of the credit allowed under section 901[4] that may be used to offset the United States tax liability on foreign-source income in a taxable year. To calculate the section 904(a) limitation within each separate limitation category, it is necessary to determine the source (U.S. or foreign) of each item of income.

Sourcing Compensation for Services Income

Services income of a taxpayer is sourced as domestic or foreign based on where the services are performed by the taxpayer. Section 861(a)(3) provides that compensation for personal services performed within the United States shall be treated as income from sources within the United States, and section 862(a)(3) provides that compensation for personal services performed outside the United States shall be treated as income from sources outside the United States. When services are performed by a corporation or other entity partly within and partly outside the United States, Treas. Reg. § 1.861-4(b)(1)(i) provides as follows:

> In the case of compensation for labor or personal services performed partly within and partly without the United States by a person other than an individual, the part of that compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on the basis that most correctly reflects the proper source of the income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on the time basis, as defined in paragraph (b)(2)(ii)(E) of this section, will be acceptable.

A corporation or other entity generally is considered to earn income from services provided through its employees (or certain other agents).[5] The Code and regulations do not specify when the activities of a putative agent should be attributed to the service provider for purposes of sourcing services income. Certain case law provides some guidance.

Where a taxpayer providing services enters into a contract with another taxpayer that performs some component of the services undertaken by the first taxpayer, such as an arrangement described as a subcontract, the situs of the services performed by the second taxpayer is not taken into account for sourcing the first taxpayer's income unless the second taxpayer is the agent of the first taxpayer. For example, in *Le Beau Tours*

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[4] Sections 901(a) and (b) of the Code allow a credit for the amount of income, war profits, and excess profits tax (collectively, an income tax) paid or accrued to a foreign country.

[5] *See, e.g., Bank of America v. U.S.,* 680 F.2d 142, 150 (Ct. Cl. 1982) (holding that negotiation commissions received by a U.S. bank from foreign banks in export letter of credit transactions were charged for personal services and should be sourced by analogy as personal services under §§ 861(a)(3) and 862(a)(3) to the U.S. bank's U.S. offices, where the services were performed).

Inter-America, Inc. v. United States,[6] the taxpayer failed a 95% foreign source-based test under section 921 because taxpayer itself did not deliver foreign hotel and tour services, but rather subcontracted for those services from foreign operators functioning as independent contractors.[7] And in *Miller v. Commissioner,*[8] the foreign corporate taxpayer's income for R&D services was not U.S. source income even though it had subcontracted performance of the relevant R&D services to its domestic affiliate, which performed the services in the United States, because the affiliate was considered by the court to function as an independent contractor.

Taxpayer refers to *InverWorld v. Commissioner,*[9] which it asserts supports the notion that the location of services performed by a subsidiary benefitting clients of its parent company and pursuant to a contract with the parent company can determine the source of services income of the parent company from such clients even without the existence of an agency relationship. In that case, the Tax Court held that a Cayman corporation earned U.S. source income, including services income, on the basis that its U.S. subsidiary functioned as its dependent agent, including that it regularly entered transactions binding its Cayman parent company (notwithstanding contractual language disavowing any agency relationship between the parties). Thus, contrary to Taxpayer's claim, an agency relationship was present in respect of the services income in *InverWorld*. Moreover, in a case in which the issue is taxable nexus with the United States, a lesser standard for attribution of activities applies than for U.S. tax purposes generally.[10] Finally, *InverWorld* involved an assertion of agency by the IRS, and hence the additional filters of the *Bollinger* factors, described below, was not required.

Agency Attribution

In certain cases, an individual or entity obligated to perform services may retain a third party to perform all or part of the services. If that third party acts as an agent on behalf of such individual or entity (principal) rather than for its own account, the income derived from such services may be attributed in appropriate cases to the agent's principal (less an arm's length fee for the agent's services).

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[6] 547 F.2d 9, 11 (2d Cir. 1976).

[7] 415 F. Supp. 48, 52 (S.D.N.Y. 1976), *aff'd per curiam*, 547 F.2d 9 (2d Cir. 1976). The domestic corporation compensated by U.S. clients for organizing package tours abroad was considered a separate service business dealing directly with the customers. Taxpayer also was considered to derive more than five percent of its services in the United States based on administrative services provided by U.S. based individuals legally employed by the domestic group parent company.

[8] T.C. Memo. 1997-134.

[9] T.C. Memo. 1996-301.

[10] *See*, *e.g.*, *Helvering v. Boekman*, 107 F.2d 388 (2d Cir. 1939) ("It can hardly be that when an alien employs agents in this country to do things from which he collects a profit, Congress intended him to escape, though it meant to tax him, if he came here to do them himself. The income, *de facto,* certainly comes from local activities which are carried on for the benefit of the alien; and 'the natural aim of Congress would be to reach it.' *Helvering v. Stockholms, etc., Bank*, 293 U.S. 84, 89, 55 S.Ct. 50, 52, 79 L.Ed. 211.")

Certain Supreme Court cases have addressed the issue of agency in the context of a corporation and its subsidiary. In *National Carbide Corp. v. Commissioner*,[11] the Supreme Court held that the profits of three wholly-owned subsidiaries conducting production activities were not properly attributed to the parent company under an agency theory. The Court articulated six factors for determining whether agency exists:

> [1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent on the fact that it is owned by the principal if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent.[12]

Nearly four decades later, in *Bollinger*, the Supreme Court clarified the *National Carbide* test for when a taxpayer may successfully assert that the activities of a corporation are attributable to its controlling shareholder on the basis of agency. The issue in *Bollinger* was whether, for federal income tax purposes, certain shareholders owned real estate assets the title to which was held by a wholly-owned corporation.[13] The properties at issue had been arranged by the shareholders to be acquired by the corporation in order to avoid usury law restrictions on loans to non-corporate borrowers. The corporation had entered into written agreements that provided that it held the properties as "agent and nominee" for the sole purposes of securing financing and would operate as directed by the shareholders. In addition, the shareholders undertook all material activities with respect to the construction and operation of the real estate, and the banks providing the financing regarded the shareholders as the actual owner of the properties. On the facts before it, the Supreme Court upheld the taxpayer's agency claim. It cautioned, however, that "it is reasonable for the Commissioner to demand unequivocal evidence of genuineness in the corporation-shareholder context [of agency], in order to prevent evasion of *Moline."* It proceeded to state why the particular facts before it provided such unequivocal evidence:

> It seems to us that the genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset.

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[11] 336 U.S. 422 (1949).

[12] *Id.* at 437.

[13] Although *Bollinger* involved the ownership of property, the principles articulated in it apply equally in the context of claimed attribution of activities, as illustrated most obviously by the decision's express clarification of its holding in *National Carbide*, which involved a claimed attribution of income from production activities.

These three factors have been considered in effect to comprise a conjunctive test which, if met, and if agency otherwise is shown based on common law factors, generally should allow the owner of a corporation to claim that the corporation is acting as its agent.[14] The additional filters that *Bollinger* permits the IRS to apply in order to assure a genuine agency are, by design, restrictive, in order to reduce the risk that the IRS would be whipsawed by a taxpayer arguing against its chosen form to claim that the activities of a subsidiary can be attributed to its sole shareholder.[15]

Courts have applied *Bollinger* in both inbound and outbound international tax controversies where agency attribution was at issue. For example, in *First Chicago Corp. v. Commissioner*, the Tax Court applied the *Bollinger* test in holding that the taxpayer's principal subsidiary, a U.S. bank, could not aggregate its ownership of voting shares in a foreign bank with the shares held by its related subsidiaries to meet the ten percent ownership threshold under former section 902, because the bank's subsidiaries were not shown to be the bank's agents.[16] And in *New York Guangdong Finance, Inc. v. Commissioner*, the Tax Court quoted *Bollinger* in holding that a Chinese company had not provided "unequivocal evidence" that its Hong Kong subsidiary was acting as its agent for purposes of whether the taxpayer was liable for withholding tax on interest paid to the subsidiary.[17]

Analysis

The facts do not indicate that the relationship between USP and CFC meets the tests articulated by the Supreme Court for a taxpayer to show that a corporation acts as an agent on behalf of its shareholder(s).

As a threshold matter, CFC fails to meet the six factors articulated in *National Carbide* to determine whether a corporation functions as an agent. First, CFC does not operate in the name and for the account of USP. The subcontracts between CFC and USP do not vest CFC with the power to hold itself out to USP's customers as doing business in the capacity of USP's agent.[18] Rather, CFC performs back-end software development and data analysis, among other functions, at the direction of USP, which bears the ultimate responsibility for delivering the services to its clients under its own name. Representative agreements allow USP to enter into subcontracts with other entities to

[14] The Court also noted that payment of an agency fee is not necessarily required for a valid agency.
[15] *See Northern Indiana Public Service Co. v. Commissioner,* 105 T.C. 341, 348 (1995).
[16] 96 T.C. 421 (1991), ***aff'd***, 135 F.3d 457 (7th Cir. 1998).
[17] T.C. Memo 2008-62, aff'd, 588 F.3d 889 (5th Cir. 2009). Also, in *Northern Indiana Public Service Co. v. Commissioner*, the Tax Court referred to *Bollinger* in the context of holding that a conduit financing entity was not an agent of its sole shareholder, the taxpayer, for purposes of whether the taxpayer was liable for withholding tax under section 1441 on interest paid to Euronote holders. 105 T.C. 341, 348 (1995), ***aff'd*** *on other grounds*, 115 F.3d 506 (7th Cir. 1997).
[18] ***Cf. Ourisman v. Comm'r***, 82 T.C. 171, 180-82 (1984) (***rev'd*** on different grounds) (finding that the first factor was satisfied when a wholly-owned corporation acquired record title of its partnership shareholders' real property and took out loans on behalf of its partnership shareholders; the creditors were aware that the corporation represented the partnership).

render the services for which USP's customers have contracted, but these agreements mention CFC only in a subcontracting capacity without stating that CFC otherwise serves as the agent of USP. Second, the representative agreements between USP and its customers do not cause USP to be bound by CFC's actions. CFC provides agreed services for its own account to USP; the agreements between USP and CFC state that CFC will operate as a subcontractor in a "limited risk" capacity. Third, CFC does not receive third-party funds and so does not transmit them to USP. USP receives all remuneration from its customers, and CFC is compensated with an arm's length payment for the tasks it performs for USP. For such reason, the fourth factor is not applicable. Fifth, USP's control over CFC does not appear in excess of the type of control that a parent corporation would exert over its wholly-owned subsidiary, and, accordingly, CFC's "relations with" USP appear to be "dependent upon the fact that it is owned by the principal."[19] Sixth, the facts do not support that CFC's business purpose is the carrying on of the normal duties of an agent; CFC is acting for its own account as would a typical group subsidiary and not for the account of USP.

Further, even if some agency attributes are present, CFC has not provided unequivocal evidence of a genuine agency and hence is not treated as an agent of USP when the filters of *Bollinger* are applied. First, there is no evidence of a written agency agreement between USP and CFC delegating authority for CFC to act on behalf of USP and thus to bind USP by CFC's actions.[20] On the contrary, the representative agreement between USP and CFC does not describe CFC as an agent, but rather as a subcontractor hired and compensated on a limited risk basis. Nothing in the representative agreement states that CFC may bind USP by its actions with third parties. Because no written agency agreement exists in the service agreement between USP and CFC or in any other materials provided, the first prong of the conjunctive criteria is not satisfied.

The second and third factors in *Bollinger* look to whether CFC functions as agent of USP, and not principal, in all dealings with respect to the services performed by it, and whether CFC is held out as the agent, and not principal, in all its dealings with third parties with respect to such services. USP also fails to meet these criteria of *Bollinger*. CFC does not function as USP's agent with respect to the service activities CFC

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[19] *Bollinger* marginalized the independent significance of the fifth factor as follows: "We think the fifth National Carbide factor—so much more abstract than the others—was no more and no less than a generalized statement of the concern, expressed earlier in our own discussion, that the separate entity doctrine of Moline not be subverted." Similarly, a pre-*Bollinger* case, *Roccaforte v. Comm'r*, 708 F.2d 986, 990 (5th Cir. 1983), commented on the factor as follows: "Closely-held corporations often function as agents or surrogates for their owners. Under *Moline,* however, they are treated as separate, taxable entities. If a taxpayer could, by the simple expedient of relying upon characteristics common to all such corporations, avoid tax liability, the separate entity regime would collapse." The concern was addressed by the additional filters enunciated in *Bollinger*.

[20] See the first two *National Carbide* factors, which under *Bollinger* should be reflected in a written agreement in order to evidence the genuineness of an agency relationship. The service agreements between USP and its customers preclude USP from assigning or delegating its duties without its customers' prior authorization. This is not inconsistent with normal subcontracting, and in fact the service agreements permit USP to subcontract with other parties for the provision of services, without a requirement to disclose the identity of potential subcontractors.

conducts and is not held out as USP's agent in all dealings with USP and USP's customers. In all dealings with its customers, USP represents that it bears the ultimate responsibility for delivering the various services for which customers have contracted and guarantees that these services will be performed in accordance with the service contracts, to which CFC is not a party. CFC does not enter into contracts on behalf of USP, does not commit to provide its services to USP's customers, and is not responsible for resolving USP's customer's issues or otherwise responsible to such USP's customer. CFC's customer relationship is with USP. In sum, CFC's activities are indistinguishable from that of a typical subcontractor, and any control exercised by USP is no different from that held by virtue of USP's ownership of the stock of CFC and its role as the contracting party with USP's customers.

None of the three factors indicated by the Supreme Court in *Bollinger* as providing, conjunctively, satisfactory evidence of a genuine agency in the face of a claim of agency by a corporation with respect to its owner against the IRS are present in this case. Further, even if alternative evidence might be probative (as to which we express no view), we understand that none has been provided in this case. Accordingly, CFC's activities cannot be attributed to USP in sourcing USP's services income that USP receives from its third-party customers.

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Please contact Andrew Naughton at (202) 317-5356 if you have any further questions.