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John L. Ruppert

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JOHN L. RUPPERT*

INTRODUCTION

With the proliferation of multinational brother-sister,[1] parent-subsidiary,[2] and other "related groups"[3] of corporations, numerous provisions of the Internal Revenue Code have increasingly become traps for the unwary corporate taxpayer.[4] One area in particular that may be the subject of future scrutiny by the Internal Revenue Service is the interrelationship between the income source determination rules of sections 861 through 864[5] and the withholding at the source requirements of

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* Member Colorado Bar. B.A., Northwestern University (1975); J.D., University of Denver (1978). Editor-in-Chief, DENVER LAW JOURNAL (1977-1978).

1. I.R.C. § 1563(a)(2)(A), (B). Brother-sister corporations are two or more corporations in which five or fewer persons own stock possessing (a) 80 percent of the voting power or at least 80 percent of the total value of shares of all classes of a corporation, and (b) more than 50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of shares of all classes of stock, taking ownership into account only to the extent it is identical with respect to each corporation. For specific examples of the brother-sister relationship *see* Treas. Reg. § 1.1563-1(a)(3)(ii), examples (1)-(2) (1976).

2. I.R.C. § 1563(a)(1)(A), (B). A parent-subsidiary relationship is one or more chains of corporations connected through stock ownership with a common parent if (a) the 80 percent ownership of voting stock or 80 percent total value requirements are met, and (b) the common parent meets the same two tests for at least one of the other corporations. For specific examples of the parent-subsidiary relationship *see* Treas. Reg. § 1.1563-1(a)(2)(ii), examples (1)-(4) (1976).

3. I.R.C. § 1563(a)(3). A combined group of corporations is three or more corporations each of which is a member of a group of corporations described *supra* notes 1-2 and one of which is a common parent corporation in a group of corporations described *supra* note 2 and also is included in a group of corporations described *supra* note 1. For examples of such a relationship *see* Treas. Reg. § 1.1563-1(a)(4)(ii), examples (1)-(2) (1976).

4. In the last 20 years, the area of foreign tax has mushroomed. For a discussion of recent trends in this field *see generally* Brantner, *Taxation and the Multinational Firm*, 65 MANAGEMENT ACCOUNTING 11 (1973); Hammer, *U.S. Taxation of Foreign Corporations and Nonresident Aliens*, 29 So. CAL. TAX INST. 89 (1975); Kragen, *Avoidance of International Double Taxation Arising From Section 482 Reallocations*, 60 CAL. L. REV. 1493 (1972); Lundy, *A Review of U.S. System of Taxation on Foreign Income of Corporations and Subsidiaries*, 160 N.Y.L.J. 34 (1973); Sherfy, *Recent Changes and New Considerations in the International Tax Area*, 53 TAXES 857 (1975); Tillinghast, *United States Income Taxation of Foreign Source Income: A Survey of the Provisions and Problems*, 29 N.Y.U. INST. FED. TAX. 1 (1971).

5. I.R.C. §§ 861-864. These income source determination provisions of the Code

sections 1441 and 1442.[6] "Management fees" agreements present, perhaps, the best example of the potentially difficult problems that these provisions may create for related business entities.

As a starting point, the basic premise of the Code is that a foreign parent corporation, not engaged in a United States trade or business, is nonetheless subject to a flat thirty percent tax on only its United States source fixed or determinable income.[7] Consequently, such factors as the source of an item of income, the nature of the income item, and the very structure of the "management services" agreement that gave rise to the income item are of concern to both the parent corporation and its subsidiary for purposes of avoiding or mitigating unanticipated and often disastrous double taxation.

The potential for such double taxation is simply demonstrated by the following example. The receipt of management services fees by the foreign parent will constitute gross income to the parent and as such will be subject to income tax liability in the foreign state.[8] Simultaneously, the domestic subsidiary

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constitute an exclusive three-tier classification system for allocating items of income to particular sources. These provisions play the primary role in determining what income of a foreign corporation will be subject to United States income tax liability. For a general discussion of the impact of these provisions in the foreign tax area *see generally* Hammer, *supra* note 4; Lundy, *supra* note 4; White, *International Tax Planning with U.S. Source Rules,* 51 TAXES 211 (1973).

6. I.R.C. §§ 1441, 1442. These withholding at the source provisions are the principal method of enforcing the United States tax liability of foreign taxpayers not engaged in a trade or business within the United States. For further discussion of these provisions *see* Sitrick, *New Rules on Withholding Payment of Tax on U.S. Income of Foreign Taxpayers,* 28 J. TAX. 110 (1968).

7. I.R.C. § 881 imposes a tax on income of foreign corporations not connected with a United States business at a flat rate of 30 percent. Treas. Reg. § 1.881-2(a)(3) (1976) expressly states that deductions shall not be allowed in determining the amount subject to tax under section 881. In contrast, a foreign corporation engaged in a United States trade or business, but not having a United States office, is taxed only on its United States source income but at two different rates: 30 percent on its gross income from sources not effectively connected with its United States trade or business (I.R.C. § 881(a)), and at the regular corporate rates on that income effectively connected to its United States trade or business (I.R.C. §§ 882, 864(c)(3)). Finally, foreign corporations engaged in a United States trade or business having a United States office are taxed the same as foreign corporations engaged in a United States trade or business without a United States office except that certain foreign source effectively connected income, as defined in I.R.C. §§ 864(c) and 882, is taxed at domestic corporate rates (I.R.C. § 882).

8. Were the foreign parent corporation a domestic corporation, it is unquestioned that management fee income would constitute gross income to the entity. I.R.C. § 61

(payer) corporation would be entitled to an "ordinary and necessary" business deduction for such management fees on its United States income tax return.[9] If management fees constitute the foreign parent's only income from sources outside its state of incorporation, a successful allocation of such services to sources wholly outside the United States will preclude the parent from incurring any United States tax liability. Assuming that no other income from United States operations was earned by the foreign parent during the taxable year,[10] the foreign parent may decide that no United States tax return need be filed.[11] As a result of the foreign parent's decision not to file a return, the three-year statute of limitations of section 6501(a)[12] would be inapplicable, and pursuant to section

provides: "Except as otherwise provided in this subtitle, gross income means *all income* from whatever source derived, including (but not limited to) the following items: (1) compensation for services, *including fees*." (Emphasis added.) For further discussion *see* Treas. Reg. § 1.61-2(a) (1976). As an example of how a foreign state would treat income from sources outside its boundaries earned by a resident corporation *see* Canadian Income Tax Act, Can. Stat., An Act to Amend the Income Tax Act, c. 63, § 126(2), 126(6), 126(7) (1971).

9. Management fee expenses have been held to be deductible as ordinary and necessary business expenses under I.R.C. § 162. *See* American Savings Bank, 56 T.C. 828, 842-43 (1971); United States Freight Co. & Subsid. v. United States, 70-1 U.S. Tax Cas. ¶ 9244 (Ct. Cl. 1970); Preston Wilson, 20 T.C.M. (CCH) 676 (1961).

10. Unless the corporation falls into the class of foreign businesses not engaged in a United States trade or business, the foreign entity will be subject to the same tax rates as would a domestic corporation on its effectively connected income. *See* I.R.C. §§ 864(c), 882. *See also* note 7 *supra*. For a more detailed discussion of this concept *see* R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS §§ 2.21-.40 (rev. ed. 1977).

11. I.R.C. § 6012(a)(2) requires that "every corporation subject to taxation under subtitle A" must file an income tax return for the taxable year. Treas. Reg. § 1.6012-2(g) (1976) elaborates on this mandate by stating that every foreign corporation which is engaged in a trade or business in the United States or which has become subject to taxation under subtitle A must file a return. Subsection (2) of the regulation creates an exception to the obligation to file a return when the foreign corporation, not engaged in a United States trade or business, has its tax liability satisfied by withholding of tax at the source by one so obligated under I.R.C. §§ 1441 and 1442. Even nonresident foreign corporations are required to file returns for all of their I.R.C. § 881(a) income. If the foreign taxpayer should determine that because it received no I.R.C. § 881(a) income for the taxable year, it need not file a return, the entity may have a return calculated and filed for it by the Revenue Service. *See* I.R.C. § 6020. As an example of the Service's power to file a return for a foreign corporation that failed to file a return *see* Cantrell & Cochrane, Ltd. v. Shea, 39-1 U.S. Tax Cas. ¶ 9388 (S.D.N.Y. 1939).

12. I.R.C. § 6501(a) prescribes a general three-year statute of limitations starting on the date the return was filed, or actually due, whichever is later, in the absence of fraud or failure to file a return. *See generally* 10 MERTENS, LAW OF FEDERAL INCOME TAXATION § 57.01 *et seq.* (rev. ed. 1971).

6501(c)(3) tax may be assessed or a proceeding in court for the collection of such tax may be begun without assessment *at any time.*[13] Should the Service subsequently be successful in classifying the management fees as United States source income, pursuant to sections 1461 and 7501, the payer-subsidiary would be personally liable for a tax deficiency in the amount of thirty percent of the total management fees paid.[14] In effect, the related corporations will be taxed twice on the same management fees income, *i.e.*, once in the parent's home and once in the subsidiary's. Other potential concerns such as section 482 reallocations,[15] denials of excessive deductions,[16] or constructive

13. I.R.C. § 6501(c)(3). Two interesting questions arise at this point: (1) Where does the burden of proof lie, and (2) how does the Service compel production of documents? If the corporate taxpayer fails to file a return, must the Service shoulder the burden of proving that a return should have been filed, or must the taxpayer refute the correctness of the Service's assessment? For a general discussion *see* United States v. Lease, 65-2 U.S. Tax Cas. ¶ 9478, at 96,127 (2d Cir. 1965), where the Second Circuit held that the Service had the burden of coming forward and persuading the trier of fact that the taxpayer had a tax liability. As for the production of documents question *see* I.R.C. § 7602. *See also* Matter of Daniels, 56-1 U.S. Tax Cas. ¶ 9451 (S.D.N.Y. 1956). *See* Bartlett, *Authority of the United States Internal Revenue Service to Obtain Information Solely to Aid Foreign Tax Authorities: United States-Canada Tax Treaty,* 28 BULL. INT'L FISCAL DOCUMENTATION 497 (1974).

14. I.R.C. § 1442 imposes a withholding at the source tax of 30 percent on United States source income earned by a foreign corporation. I.R.C. § 7501 provides that any person required to withhold internal revenue tax from any person shall hold such monies in a special trust fund. The amount of such fund shall be assessed, collected, and paid in the same manner, and subject to the same requirements, as are applicable with respect to the taxes from which such fund arises. *Id.* I.R.C. § 1461 states that every person required to withhold taxes is liable for such tax. Treas. Reg. § 1.1461-3(b) (1976) states that for failure to pay the withheld tax to the Service, the withholding agent may be subject to penalties under I.R.C. §§ 6653, 7502. In addition, the withholding agent may be subject to penalties under I.R.C. §§ 6651, 6656, and 7203 for failure to file a return, for willful failure to file a return, and for failing to make a timely deposit of taxes withheld, respectively.

15. I.R.C. § 482. For a good discussion of the impact of section 482 in the multinational corporate context *see* Barnett, *Recent Developments in Allocation of Income,* 46 FLA. B.J. 607 (1972); Brown, *Canada-United States Tax Relations Problems,* 28 TAX. EXEC. 1 (1975); Delise, *Section 482 Allocations of Income to Stockholders for Services Rendered to Closely Held Corporations,* 1972 UTAH L. REV. 491; Kauder, *International Allocations of Income: Problems of Administration and Compliance,* 9 J. INT'L LAW & ECON. 1 (1974); Kragen, *supra* note 4; McGowan, *Taxation of the Multinational,* 22 R.I.B.J. 4 (1973); Wolpe, *When and How Section 482 Is Applied,* 6 PRAC. ACCT. 37 (1973); Note, *Section 482—Internal Revenue Code—Burden of Proof: Arm's Length Dealing,* 25 BAYLOR L. REV. 392 (1973); Note, *New Developments In Allocation of Income Among Commonly Controlled Entities Under Section 482,* 57 MINN. L. REV. 559 (1973); Note, *Allocation—Section 482,* 4 RUT.-CAM. L.J. 445 (1973).

16. I.R.C. § 162(a)(1) provides that there shall be allowed as a deduction all the ordinary and necessary expenses incurred in carrying on a trade or business, including

dividend treatment,[17] which may present additional and related taxation difficulties, are beyond the scope of this paper.

This article will attempt to examine the interaction of the source determination rules of sections 861 through 863 and the withholding at the source requirements of sections 1441 and 1442 in the specific setting of a management services agreement between a foreign parent corporation[18] and its domestic,[19] American subsidiary. Because the United States-Canadian Income Tax Treaty[20] is generally representative of United States income tax treaties as a class, its analogous income source determination provisions will be examined also in some detail. The primary purpose of this article will be to analyze the aforementioned statutory provisions in light of the relevant case law, revenue rulings, and treaty provisions. In addition, those procedures which may assist the taxpayer in supporting

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a reasonable allowance for salaries or other compensation for personal services actually rendered. *See also* Treas. Reg. § 1.162-7 (1976). For an in-depth analysis of the reasonable compensation issue *see* [1977] STAND. FED. TAX REP. (CCH) ¶ 1370-1370.06. *Cf.* Fogg, *How to Apply the Current Rules to Increase Deductions for Professional Fees,* 18 TAX ACCT. 352 (1977) (discussion of analagous payments: startup expenses, computer software expenses, and appraisal fees).

17. Especially in the area of related or controlled corporations' dividend payments in the guise of compensation for services rendered may be recast by the Service as constructive dividends pursuant to I.R.C. §§ 301, 316. *See generally* J. Lupowitz Sons, Inc. v. Comm'r, 497 F.2d 862 (3d Cir. 1974) (bona fide advances between corporations were not constructive dividends); Sammons v. Comm'r, 472 F.2d 449 (5th Cir. 1972) (the test for determining whether intercorporate transfers constitute constructive dividends is whether the majority stockholder primarily benefited); Rushing v. Comm'r., 52 T.C. 888, *aff'd on other grounds,* 441 F.2d 593 (5th Cir. 1971) (adoption of the primary benefit test); *but see* McLemore v. Comm'r, 494 F.2d 1350 (6th Cir. 1974) (two intercorporate transfers were constructive dividends to the sole shareholder, for one allowed him to pay off a personal obligation and the second was not a binding obligation). *See also* Frank, *Brother-Sister Transfer of Funds,* 53 TAXES 693 (1975); Young, *Provoking, Invoking, and Revoking 'Phantom' Dividends,* 21 TUL. TAX INST. 68 (1972).

18. I.R.C. § 7701(a)(5). Foreign, when applied to a corporation, means an entity which is not domestic.

19. I.R.C. § 7701(a)(4) defines "domestic," when applied to a corporation, as referring to an entity created or organized in the United States or under the laws of the United States or of any State.

20. Convention for the Avoidance of Double Taxation and Prevention of Fiscal Evasion in the Case of Income Taxes Between the United States and Canada, March 4, 1942, 56 Stat. 1399, 6 Bevans 244, T.S. No. 983, *as amended by* Supplementary Convention, June 12, 1950, 2 U.S.T. 2235, T.I.A.S. No. 2347, *as amended by* Supplementary Convention, Aug. 8, 1956, 8 U.S.T. 1619, T.I.A.S. No. 3916, *as amended by* Additional Supplementary Convention, Oct. 25, 1966, 18 U.S.T. 3186, T.I.A.S. No. 6415 [hereinafter cited as Convention Between the United States and Canada Respecting Double Taxation].

its allocation of management services to sources wholly or predominantly outside of the United States will be identified and discussed.

I. STATUTORY LAW

A. *Withholding at the Source*

Section 1442 requires that in the case of foreign corporations subject to tax under subtitle A, a tax of thirty percent shall be withheld at the source on those items of income enumerated in section 1441(b).[21] Section 1441(a) and (b) require that all persons having control over, or payment of salaries, wages, premiums, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, to the extent such items constitute gross income from sources within the United States, shall deduct and withhold at the source a tax equal to thirty percent thereof.[22]

Nowhere in the statute or regulations does the phrase "management fees" appear. Possibly anticipating an argument to the contrary, the Service promulgated regulation 1.1441-2(a) which specifically states that forms of income other than those enumerated were meant to be included within section 1441(a).[23] Additionally, the regulation indicates that "fixed or determinable annual or periodical gain" was meant merely to be descriptive of the "character of a class of income."[24] In conjunction with the Service's extremely broad interpretation of the statute, the courts have also given a broad sweep to the language of section 1441. Alimony payments,[25] proceeds from

21. I.R.C. § 1442, entitled Withholding of Tax on Foreign Corporations.

22. I.R.C. § 1441(a), (b).

23. Treas. Reg. § 1.1441-2(a)(1) (1976) specifically provides: "Section 1441(b) specifically includes in such income [see the list in the text accompanying note 22 *supra*] . . . but other kinds of income are included, as, for instance, royalties."

24. *Id.* The regulation also provides that the term fixed or determinable annual or periodical income is merely descriptive of the character of a class of income. If an item of income falls within the class it is immaterial whether payment of that item is made in a series of repeated payments or in a single lump sum.

"Fixed" is defined as payable in amounts definitely predetermined. *Id.*; Treas. Reg. § 1.1441-2(a)(2) (1976). "Determinable" is defined as subject to a basis of calculation by which the amount to be paid may be ascertained. *Id.* Finally, income need not be paid annually if it is paid periodically, that is to say, from time to time, whether or not at regular intervals. *Id.*

25. *See* A. Lamm, 34 T.C.M. (CCH) 473 (1975); W.A. Howkins, 49 T.C. 689 (1968); Gerard Trust Corn Exch. Bank v. Comm'r, 194 F.2d 708 (3d Cir.), *cert. denied*, 344 U.S. 821 (1952); Rev. Rul. 283, 1965-2 C.B. 25; Rev. Rul. 53, 1954-1 C.B. 156. *But*

the maturity or surrender of a life insurance policy,[26] royalties,[27] and the earnings of professional athletes[28] have all been found to fall within the general language of section 1441(b).[29] Though prior case law has treated "management fees" as a form of income or gain within the statutory language, no opinion has identified the specific form of income it constitutes.[30] For withholding at the source purposes, the issue may be totally irrelevant, however, for sections 1441 and 1442 draw no distinction (for tax purposes) among such broad classes of income as "compensation," "remuneration," and "fixed or determinable annual or periodic gain, profits and income."[31]

B. *Source Determination Rules*

A second element must also be present for the withholding at the source obligation to arise. In addition to the income or gain being within the general class described in section 1441(b),

cf. Rev. Rul. 108, 1969-1 C.B. 192 (alimony payments to a nonresident alien by a United States ancillary administrator of a nonresident alien estate were not United States source income and were not subject to withholding tax at the source).

26. *See* Rev. Rul. 51, 1964-1 C.B. (Part I) 322 (amounts received by a nonresident alien, from sources within the United States, upon surrender or maturity of a life insurance policy were United States source income).

27. *See* Treas. Reg. § 1.1441-2(a)(1) (1976). *See also* Kimble Glass Co., 9 T.C. 183 (1947); Comm'r v. Celanese Corp., 140 F.2d 339 (D.C. Cir. 1944).

28. *See* Rev. Rul. 503, 1975-2 C.B. 352 (the Service illustrated the tax treatment for amounts earned in the United States by French or British boxers and trainers); Rev. Rul. 107, 1973-1 C.B. 376, *amplifying* Rev. Rul. 543, 1970-2 C.B. 172 (nonresident alien journalist who wrote articles in the United States while under contract to a domestic news service had United States source income); Rev. Rul. 543, 1970-2 C.B. 172 (prize money earned by a nonresident boxer and nonresident professional golfer was United States source income subject to withholding); Rev. Rul. 17, 1955-1 C.B. 388 (that portion of payments for manufacturing "know-how" and personal services performed outside the United States in connection with instruction of employees with respect to such "know-how" is *in the nature of* royalty income and, therefore, subject to withholding of tax at the source).

29. Other forms of income, not mentioned in I.R.C. § 1441(b), but still subject thereto, are: Rev. Rul. 108, 1974-1 C.B. 248 (sign-on fees with a sports team); Rev. Rul. 479, 1958-2 C.B. 60 (prizes, commissions, and winnings at the racetrack).

30. Yardley and Co., Ltd., 11 B.T.A.M. (P-H) ¶ 42,482 (1942) is the only case to date that has discussed the treatment for source-determination purposes of management fees. The opinion, however, never clearly determined what class of income such fees specifically come within (for purposes of I.R.C. §§ 1441, 1442). Such phrases as "remuneration," "compensation," or "gain" clearly seem broad enough, both in the letter and spirit of § 1441 to encompass the concept of management fees.

31. I.R.C. § 1441(b). Section 1441(b) prescribes a general rule for all the forms of income it encompasses. For that reason, it is of little concern which specific form of income management fees constitute. The rule is the same regardless of the classification.

it must also constitute "income from sources *within* the United States."[32] Should the income constitute income from sources without the United States, the withholding at the source requirement of section 1442 is inapplicable.[33]

Generally, the Service's complement of weapons consists of three interrelated provisions. Section 861 defines the concept of United States source income,[34] section 862 defines the concept of foreign source income,[35] and section 863 includes any items not specifically found in the preceding two sections.[36] As with sections 1441 and 1442, none of these sections mentions "management fees."

In contrast to the breadth and sweep of sections 1441 and 1442, however, the very structure of the income source determination provisions negates any argument that "management

32. I.R.C. § 1441(a). The language of the statute is: "[H]aving the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the United States) . . . ." *See also* Treas. Reg. § 1.1441-1 (1976).

33. *See* Treas. Reg. § 1.1441-3(a) (1976). The regulation states: "To the extent that items of income constitute gross income from sources without the United States, they are not subject to withholding under § 1.1441-1." The regulation then cross references one to the income source determination rules of I.R.C. § 861 *et seq. See generally* Burge, *Current Trends in the Taxation of Multinational Enterprises*, 52 TAXES 746 (1974).

34. I.R.C. § 861. The statute allocates the following items of income to sources within the United States: interest, dividends, personal services compensation, rentals and royalties from property located in the United States, gains from the sale or exchange of realty in the United States, gains from the sale or exchange of personalty purchased without but sold within the United States and certain underwriting income. Treas. Reg. § 1.861-1(a) (1976) notes that the statute specifically allocates these items of income to sources within the United States. In effect, the statute irrebutably presumes that the items of income enumerated are from sources within the United States.

35. I.R.C. § 862. Section 862 briefly states that for each of the items of income enumerated in I.R.C. § 861, if generated without the United States, an irrebutable presumption arises that the income is from sources without the United States. Treas. Reg. § 1.862-1(a) (1976) states: "The following items of gross income *shall* be treated as income from sources without the United States." (Emphasis added.)

36. I.R.C. § 863(a) provides that: "Items of gross income . . . other than those specified in sections 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States." The final sentence of § 863(a) states that the remainder if any shall be included in full as taxable income from sources within the United States. *Id.* It would appear that this provision may be read as a catch-all. *See* Op. A.G. 5, I-2 C.B. 192 (1922) (the Attorney General opined that damages paid by a domestic corporation to a foreign corporation for breach of a contract were income from sources within the United States because any income from the completed contract would have been income from sources within the United States). Arguably, the last sentence of § 863(a) would have encompassed these facts. *See* notes 70-71 *infra* for the discussion of an analogous question: allocation burden.

fees" may be included within those specific items of income conclusively allocated entirely to either United States or foreign sources by sections 861 and 862.[37] Section 863 specifically states that items of gross income other than those specified in sections 861(a) and 862(a) shall be allocated or apportioned to sources within or without the United States under regulations prescribed by the Secretary.[38]

Though the Commissioner has been empowered to promulgate allocation rules under section 863, he has ony done so with respect to certain businesses such as transportation services and telegraph and cable services.[39] Regulation 1.861-4(b), however, may offer some guidance to the taxpayer attempting to allocate or apportion management services. The regulation states that gross income from sources within the United States includes *compensation for labor or personal services performed in the United States* irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time for payment.[40] The logical questions therefore

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37. *See* note 36 *supra.* I.R.C. § 863 expressly requires that income be allocated to its proper source. The statute precludes one from designating an item of income as "substantially" or "predominately" from one source, thereby imposing a duty on the taxpayer to specifically support his alleged allocation of such an item. *See* Le Beau Tours Inter-America, Inc. v. United States, 76-1 U.S. Tax Cas. ¶ 9302 (S.D.N.Y. 1976), whereby the court questioned the continued validity of Comm'r v. Piedras Negras Broadcasting Co., 42-1 U.S. Tax Cas. ¶ 9384 (5th Cir. 1942). The Southern District Court of New York questioned the Fifth Circuit Court of Appeals' allocation of "certain insignificant activities." 76-1 U.S. Tax Cas. ¶ 9302, at 83,693 n.2.

38. I.R.C. § 863(a).

39. The only regulations promulgated to date by the Service under I.R.C. § 863 are primarily concerned with transportation services (Treas. Reg. § 1.863-4 (1976)), the sale of personal property (Treas. Reg. § 1.863-3 (1976)), and communication services (Treas. Reg. § 1.863-5 (1976)). In addition, recent regulations have been proposed under I.R.C. § 861 allowing a taxpayer to treat income from certain aircraft and vessels as income from sources within the United States. *See* Proposed Treas. Reg. § 1.861-9 (1976), 40 Fed. Reg. 30971 (1975).

40. Treas. Reg. § 1.861-4 (1976). The language of the regulation appears to be aimed at the performance of services by a nonresident alien individual. That is exclusive focus of subsection (1) of the regulation. *Id.* § 1.861-4(a)(1). Nowhere in the statute or regulation are foreign corporations specifically mentioned, either as included or excluded from the statute's scope. As will be discussed in the text and accompanying notes 45-73 *infra,* courts have simply assumed that foreign corporations are within the spirit and letter of the statute. The Ninth Circuit expressly addressed this issue, however, in Comm'r v. Hawaiian-Phillipine Co., 100 F.2d 988, 991 (9th Cir.), *cert. denied,* 307 U.S. 635 (1939), when it held that the statute did apply to corporations. *See* note 69 *infra,* for further discussion of the *Hawaiian-Phillipine Co.* decision.

Nonetheless, § 863 has been extensively applied to foreign corporations. The major difficulty that has arisen centers around the issues of by whom, how, and where does become (1) can a corporation perform personal services, and (2) how and where does a corporation perform such services.[41]

For years beginning after December 31, 1975, when services are performed partly within and without the United States, the amount to be included in gross income from sources within the United States shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case. In many cases, the proper method of allocation will be on a time basis but in other cases another method will be acceptable.[42] In contrast, for taxable years beginning before January 1, 1976, regulation 1.861-4(b)(2) mandates the use of a time basis allocation for services performed partially within and partially without the United States:

> If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis; that is, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.[43]

Regulation 1.863-4(c) also suggests a similar time based method of allocation for the performance of certain transportation services.[44]

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a corporation act? *See* Rev. Rul. 55, 1960-1 C.B. 270, at text and accompanying notes 50-51 *infra;* Rev. Rul. 17, 1955-1 C.B. 388 (payments by a domestic corporation to a foreign corporation for instructing its personnel were not United States source income). *See* note 69 *infra.*

41. That a time basis allocation of personal services by foreign corporations seems logical is a different issue from whether the statute mandates such a method of allocation. *Hawaiian-Phillipine Co.,* 100 F.2d at 991, best summarized the issue by noting that (1) the Commissioner failed to cite any authority for the proposition that corporations could not perform personal services, (2) no reason was advanced for excluding corporations from the reach of the statute, and (3) I.R.C. § 7701 expressly includes a corporation within the definition of person. In any event, a time based allocation of services performed by a corporation, whether they may be classed as personal services or not, appears most logical.

42. Treas. Reg. § 1.861-4(b)(1) (1976).

43. *Id.* § 1.861-4(b)(2). Unfortunately, the regulation gives no indication of what other method of allocation might be permissable for the Service to use.

44. *See* Treas. Reg. § 1.863-4(c) (1976). The regulation allows for the use of a "reasonable method" of apportionment, but suggests a proration based on the propor-

II. CASE LAW

In the management services area, the case law clearly supports the "place of performance" allocation test adopted under regulation 1.861-4(b) for labor and personal services for individuals as well as corporate taxpayers.

In *Appeal of G. H. Salmon*[45] the Board of Tax Appeals expressly sanctioned the "place of performance" test for allocating services within and without the United States. In *Salmon* the taxpayer spent two years in India renovating an Indian factory recently purchased by his New York based employer and claimed that his wages were foreign source income. The Service argued to the contrary and alleged a deficiency only slightly in excess of the $84.00 tax liability calculated by the taxpayer. On review the Board of Tax Appeals concluded that the taxpayer was taxable only upon the portion of the compensation paid him for services rendered within the United States.[46]

In *British Timkin, Ltd. v. Commissioner,*[47] a 1949 Tax Court case, the court again faced the issue of whether fees paid to a foreign corporation constituted United States or foreign source income. In this instance a United States firm sold parts to foreign purchasers who had previously dealt exclusively with a foreign supplier. The domestic corporation received the foreign supplier's permission to sell to the foreign buyers and, in exchange, agreed to pay the foreign supplier a twenty percent

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tion which the number of days the ship was within the territorial waters of the United States bears to the total number of days on the voyage. This method of allocation was explained in Rev. Rul. 495, 1972-2 C.B. 414, *superseding* I.T. 2098, III-2 C.B. 167 (1924). *Compare* Treas. Reg. 1.863-4(c) (1976) *with* Treas. Reg. § 1.863-5(b) (1976) (concerning telegraph and cable services) *and* Treas. Reg. § 1.863-3(c) (allocation of personal property sales income).

45. 3 B.T.A. 838 (1926), *acq.* V-1 C.B. 5 (1926).

46. The Board of Tax Appeals stated: "As a nonresident alien the taxpayer would be taxable only upon such portion . . . as was paid him for *services rendered within* the United States." *Id.* at 839 (emphasis added). Subsequent cases have sanctioned this "place of performance test" for the source allocation of personal services income. *See, e.g.*, William N. Dillin, 56 T.C. 228 (1971), *acq.* 1975-1 C.B. 1 (citing Karrer v. United States, 152 F. Supp. 66, 71 (Ct. Cl. 1957)) (source is determined by the situs of the services rendered, not the location of the payer, residence of the taxpayer, place of contract, or place of payment).

47. 12 T.C. 880 (1949), *acq.* 1949-2 C.B. 1. The petitioner was a British corporation. All of the capital stock of petitioner was purchased by American Timken in 1928. Subsequently, the two corporations executed licensing and trademark agreements. *Id.* at 881.

commission on all such sales.[48] At the time the parties executed their agreement, the domestic firm owned slightly more than fifty percent of the foreign supplier's stock. The court looked closely at the situs of the foreign corporation's services. The factors the court found to be determinative were (1) the foreign corporation maintained no office or place of business in the United States, (2) no officer of such corporation visited the United States, and (3) the foreign corporation was not engaged in a trade or business within the United States.[49] As a result the court concluded that all of the services rendered by the foreign subsidiary had been performed without the United States.

Both the *Salmon* and *British Timken, Ltd.* cases were subsequently cited in Revenue Ruling 60-55.[50] In that instance, a

48. *Id.* at 881-85. The court expressly noted that American Timken could not have sold its bearings to petitioner's distributors and customers without petitioner's consent, unless it chose to violate the territorial sales agreement between the companies. *Id.* at 887.

49. *Id.* at 888. The court held that the source of the petitioner's income was exclusively in the British Empire, which was the situs of the sales activities of the petitioner's agents. In this instance, therefore, the court believed that the corporation acted where its agents conducted business. In support of this allocation, the court cited three earlier decisions. The earliest of the three was Sabatini v. Comm'r, 98 F.2d 753 (2d Cir. 1938), *modifying* 32 B.T.A. 705 (1935). In *Sabatini*, the court held that a nonresident author's income from certain copyrights constituted income from sources within the United States. It is interesting to note that *Sabatini* did not involve personal services but instead focused on the issue of royalty income. *Id.* at 755.

The second decision cited by the *Timken* court was Comm'r v. Piedras Niegras Broadcasting Co., 43 B.T.A. 297 (1941), *aff'd*, 127 F.2d 260 (5th Cir. 1942). In *Piedras*, 95% of a Mexican radio station's income came from United States advertising pursuant to contracts executed at its Mexican office. *Id.* at 301. The court held, however, that because the services were rendered at the point of transmission, all of the services were performed outside of the United States. 127 F.2d at 261. In the opinion of the Board of Tax Appeals, it was expressly noted that there had been no contention that radio broadcasting constituted services rendered partly within and without the United States. 43 B.T.A. at 314. The Fifth Circuit ignored this fact in their majority opinion. Because of this, *Piedras* is of questionable value in regard to the *Timken* Case.

Finally, the *Timken* court cited Korfund Co., 1 T.C. 1180 (1943). The *Timken* court's reliance on *Korfund* is also highly suspect in light of the fact that *Korfund* expressly followed *Sabatini* and distinguished *Piedras* on the ground that *Piedras* did not involve personal services. *Id.* at 1187.

For discussion of the "place of performance" test in a sale of goods setting, see Phillip Bros. Inter-Continent Corp. v. United States, 1966-1 U.S. Tax Cas. ¶ 9421, 85,993-86,005 (S.D.N.Y. 1966).

50. Rev. Rul. 55, 1960-1 C.B. 270. Of primary concern to the Service in this instance, was the fact that the foreign taxpayer corporation maintained its sales and service personnel permanently outside of the United States. The Service cited, with approval, the following passage from *British Timken Ltd.*, 12 T.C. 880, 887:

foreign corporation agreed to solicit purchase orders from foreign buyers for a domestic American corporation. In the event that buyers circumvented the agent or purchased directly from the American corporation, the seller was nonetheless obligated to pay a commission for the foreign corporation's "promotional services." Without extensive analysis the Service concluded that all of the promotional work by the foreign corporation was performed exclusively in foreign countries.[51] Consequently, the fees paid were held to be entirely foreign source income.

Only one case has directly reviewed the issue of "management fees." In *Yardley & Co., Ltd. v. Commissioner*,[52] a British corporation supplied "managerial services" to its United States subsidiary in return for fifteen percent of the subsidiary's profits. The specific services performed by the parent corporation were (1) arranging for shipment to the subsidiary of foreign source materials, (2) maintenance of a research laboratory, (3) exclusive laboratory testing and experimentation, (4) all advertising and art work, and (5) general consultation on policy matters.[53] The domestic subsidiary, two years after the "management fees" arrangement had been executed, formally identified in the minutes of a board of directors meeting the above-mentioned services as the basis for the "management fees."[54]

> [W]e do not regard the fact that the situs of the sales was within the United States as determinative of the source of petitioner's income. . . . It is the situs of the activity or property which constitutes the source of the compensation paid and not the situs of the sales by which it is measured that is of critical importance.

Id. at 271.

51. The Service noted that the commissions paid in recognition of the fact that the sales would not have been made except through the services of the taxpayer and that any promotion so performed was done exclusively in foreign countries. *Id.* at 271-72. Though unclear, there appeared to be some ownership relationship between the foreign and domestic entities. The ruling was vague on this point.

52. 11 B.T.A.M. (P-H) 1219 (1942).

53. *Id.* at 1222, 1225. The shipment arrangements concerned shipments from British and various other foreign ports. *Id.* The testing laboratory was located in Britain. *Id.*

54. *Id.* at 1224. The only documentation of the nature of the services rendered by the foreign corporation to the domestic subsidiary rested in some hastily drawn meeting minutes. The specific resolution adopted by the board of directors stated that the payments were made "in consideration of the use of the name 'Yardley,' and of other good and valuable considerations." *Id.* At trial, the Secretary of the domestic subsidiary testified that it was really the intention of the directors to focus on the other good and valuable considerations and that use of Yardley's name was an erroneous expression. *Id.* The president of the American corporation testified that he understood

The Board of Tax Appeals concluded that ninety percent of the British corporation's services were performed without the United States.[55] Without explaining the basis for this precise allocation, the Board appears to have adopted the exact percentage allocation suggested by the chairman of the board of Yardley and Co., Ltd.,[56] the taxpayer.

Subsequent cases have elaborated only slightly on the method for allocating services to within and without the United States. In 1973, the Tenth Circuit reversed and remanded *Tipton & Kalmbach, Inc. v. United States*.[57] In *Tipton & Kalmbach*, a Colorado corporation contracted to perform engineering services incident to the design and construction of certain canals in West Pakistan. Two of the taxpayer's principal officers spent sixty to eighty percent of their time working in the taxpayer's Denver office.[58] In attempting to support its contention that fees generated were foreign source income, the taxpayer relied heavily on *Commissioner v. Piedras Negras Broadcasting Co.*,[59] where the Fifth Circuit held that advertis-

the payment to have simply arisen as an ordinary charge by the foreign parent corporation. *Id.* For further elaboration of the testing services performed *see* 11 B.T.A.M. (P-H) at 1226. Mr. Pitt, one of the directors of the British corporation, testified that the fees merely covered "services rendered and travelling expenses." *Id.* at 1225.

55. *Id.* at 1227.

56. *Id.* at 1226-27. It is difficult, looking at the opinion alone to determine exactly how the Board came to so precise an allocation of services to within and without the United States. The Board stated: "We are convinced that a maximum of 10 percent of the services for which the payments in question were made were rendered in the United States and that the remaining 90 percent were rendered by the British Corporation in England." *Id.* at 1226. The Board never specifically identified those services that were rendered within the United States, nor the method of allocation that resulted in such services accounting for ten percent of the total. The Board never discussed a time basis allocation method, or any other method, for that matter. Consequently, the opinion is of some guidance in identifying those elements of managerial services that lend themselves to source allocation under I.R.C. §§ 861-863, but the opinion offers little assistance in identifying the actual allocation method.

57. 73-2 U.S. Tax Cas. ¶ 9541 (S.D.N.Y. 1973).

58. The taxpayer's services were performed by expatriate personnel in Pakistan, Pakistan nationals, and employees in the taxpayer's Denver office. Messrs. Tipton and Kalmbach spent approximately 20 to 40 percent of their time in Pakistan. The remainder of their time was spent in the Denver office. *Id.* at 81,727. The court did not indicate the nature of the work performed by these men while in the Denver office. *Compare* Tipton & Kalmbach, Inc., 73-2 U.S. Tax Cas. ¶ 9541, *with* Yardley, 11 B.T.A.M. (P-H) 1219 (in *Tipton* as opposed to *Yardley*, the court was less concerned with the nature of the services rendered and more concerned with the manner of allocation. *Id.* at 81,728).

59. 43 B.T.A. 297, *aff'd*, 127 F.2d 260 (5th Cir. 1942). See the discussion of the *Piedras* majority opinion in note 49 *supra*. The *Tipton* court attempted to distinguish the *Piedras* decision on the ground that in *Piedras* all of the services were held to have

ing fees paid by Americans to a Mexican based radio station represented income generated wholly from services performed outside the United States. Though a minor amount of activities were rendered within the United States, the Fifth Circuit attributed *all* of the income to that country where the predominant service, broadcasting, was performed.[60]

In *Tipton & Kalmbach*, the Tenth Circuit distinguished the decision in *Piedras Negras* on the basis that *no* United States source services were performed in that case.[61] The Service advocated a payroll basis method of allocation of the taxpayer's services.[62] The district court indirectly supported the Service's position by finding that the taxpayer had failed to establish its right to a method of allocation *other* than the payroll cost basis.[63] Citing regulation 1.861-4(b) concerning labor and personal services and noting that the taxpayer's ex-

been rendered outside of the United States, while in *Tipton*, some services were concededly performed within the United States. 73-2 U.S. Tax Cas. at 81,728. The *Tipton* court, in an indirect reference to *Piedras*, stated: "Furthermore, Code sections 861(a)(3) and 862(a)(3) do not attribute all of a taxpayer's income to the country where most of its services are performed." *Id.*

60. *See* note 49 *supra*. In this early allocation case, the dissent clearly appeared to be approaching an interpretation of I.R.C. §§ 861-863 more consistent with the present interpretation of those provisions. The dissenting opinion of Judge McCord noted that (1) many of Piedras' programs originated from a Texas based studio, (2) programs were aimed at American listeners, (3) 95 percent of the advertising income came from United States citizens, (4) Piedras' agents solicited funds in the United States, (5) contracts were entered into within the United States, (6) Piedras availed itself of American banks, and (7) a United States mail address was maintained. 127 F.2d 261-62. In spite of the numerousness of these "contacts" within the United States, the majority opinion elected to ignore these factors and focus exclusively on the issue of where the actual transmissions originated. *Id.* at 261.

61. *See* notes 59 and 60 *supra*. The *Piedras* decision stands as questionable support in all allocation cases because the Board of Tax Appeals noted that the decision was argued on an "all-or-nothing" basis, without any discussion of the possibility of allocation. 43 B.T.A. at 314. *See* note 49 *supra*.

62. The Service took the position that the income generated by the services performed should have been apportioned between United States and Pakistani sources in the same proportions as were the taxpayers' payroll costs. 73-2 U.S. Tax Cas. at 81,729. The basis for such an allocation method, in the Service's opinion, was that source allocation would be more accurate. *Id.*

63. 72-2 U.S. Tax Cas. ¶ 9563 (D. Colo. 1972). The court noted: "Section 1.861-4(b) of the Treasury Regulations on Income Tax [concerning personal services source allocation] was not intended to apply to service-performing corporations." *Id.* at 85,304. The court then shifted the burden to the plaintiff-taxpayer to show that it was entitled to a different method of allocation than the payroll cost method supported by the Service. *Id.* at 85,306. In effect, the district court gave the Service carte blanche authority to use whatever method of source allocation maximized tax liability.

hibits contained sufficient uncontroverted figures to utilize the time basis allocation, the Tenth Circuit reversed and remanded the case, stating that

> [n]either system of allocation [time or payroll] can reflect with complete exactness the amount of taxable income and consequently we hold that the Internal Revenue Service should abide by its own regulations [time basis allocation] when they are not in conflict with an express statutory provision.[64]

In March 1976 in *Le Beau Tours Inter-America, Inc. v. United States,*[65] the Southern District Court of New York found the continued validity of *Piedras Negras Broadcasting Co.* questionable in light of the *Tipton & Kalmbach* decision.[66] In *Le Beau Tours* the taxpayer alleged that the arrangement and packaging of foreign tours took place in Latin America by means of direct and personal contact with the foreign hotels. In examining the facts the court found that the taxpayer's selecting, administering, and supervising of tours in Latin America were services performed outside of the United States. To the degree, however, that the plaintiff carried on these activities within the United States, United States source income was being generated.[67] In a footnote the court noted that a substantial portion of the taxpayer's income-generating activities, such as developing packaged tours and providing assistance to American tourists, was performed within the United States.[68]

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64. *Id.* at 81,728. More specifically, the Tenth Circuit Court of Appeals noted that: "The Internal Revenue Service is thus not free to apply an *ad hoc* method of allocation when Treas. Reg. § 1.861-4(b) does not abuse the allocation issue in this case." 73-2 U.S. Tax Cas. at 81,729. A long line of precedent supports the proposition that if the taxpayer is bound by a regulation, the Service is equally bound. *See* Brofman v. United States, 67-2 U.S. Tax Cas. ¶ 12 494, at 85,644 (5th Cir. 1967); Miller v. Comm'r, 333 F.2d 400, 403 (8th Cir. 1964); McCord v. Granger, 201 F.2d 103, 107 (3d Cir. 1952); Pacific Nat'l Bank v. Comm'r., 91 F.2d 103, 105 (9th Cir. 1937); Warner Bros. Pictures, Inc. v. Westover, 70 F.Supp. 111, 115 (S.D. Cal. 1947). *See generally* MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 3.20 (1942).

65. 76-1 U.S. Tax Cas. ¶ 9302 (S.D.N.Y. 1976).

66. The Court stated "*Commissioner v. Piedras Negras Broadcasting Co., supra,* whatever its validity after *Tipton and Kalmbach* is in conflict with the decision here." *Id.* at 83,693 n.2.

67. The court noted: "While this court does not believe that the plaintiff can properly be considered a wholesale seller of hotel space and tours, . . . the plaintiff is engaged in a service business in which services are performed both in the United States and abroad." *Id.* at 83,692. The specific services performed by the taxpayer were: (1) personal inspections of hotels, (2) developing total tour packages, (3) maintaining representatives in foreign countries to assist tourists, and (4) selecting, administering, and supervising tours. *Id.* at 83,692-93.

68. The court said: "Here it appears that a fairly substantial portion of the activi-

In retrospect the only clear pattern discernible from these allocation cases is that the taxpayer bears a heavy burden of proof.[69] Should the taxpayer fail to substantiate his alleged allocation of services to a specific source, he faces the possibility that such services will be classified as performed wholly or predominantly *within* the United States.[70] In *Sax Rohmer* just

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ties which generated Le Beau Inter-America's income—as distinguished from that of its local hotel and tour operators—took place in the United States." *Id.* at 83,693 n.2.

69. The source allocation of income from services performed by a corporation has arisen in various other decisions, also. *See* Comm'r v. Hawaiian Phillipine Co., 100 F.2d 988, 991 (9th Cir.), *cert. denied,* 307 U.S. 635 (1939) where the court noted that the time basis allocation of services performed by a corporation was within both the letter and spirit of the personal services income allocation guides of I.R.C. §§ 861-863 (at that time I.R.C. § 119(c)). It is interesting to note that *Hawaiian Phillipines* received only passing mention in an obscure footnote in the *Piedras Negras* decision, 127 F.2d at 261 n.2. For further elaboration on the *Hawaiian Phillipines* decision *see generally* Annot. 160 A.L.R. 559, 589 n.5 (1946).

For other instances of corporate performed services falling under the concept of source allocation *see, e.g.,* Yokohama Ki-Ito Kwaisha, Ltd., 5 B.T.A. 1248, 1256-57 (1927) (a foreign corporation which took orders for, or entered into contracts for the sale of, silk in the United States, through an agent in the United States, received income from within the United States to the extent of the difference between the selling price and its cost); Comm'r v. East Coast Oil Co., 85 F.2d 322, 323 (5th Cir.), *cert. denied,* 299 U.S. 608 (1936) (where a Mexican corporation negotiated for the sale of Mexican oil to United States businesses, but the title to the property passed at the place of shipment and delivery occurred in Mexico, the fact that the payments were made in the United States did not change the status of this income as generated by services performed outside of the United States).

See also Rev. Rul. 154, 1976-1 C.B. 191 (compensation paid a domestic corporation by a foreign country for property of the domestic corporation previously expropriated was held to be income from sources without the United States); Rev. Rul. 198, 1971-1 C.B. 210 (income of a foreign corporation from the sale of tuna caught in international waters to United States canners was income from sources without the United States); Rev. Rul. 194, 1967-1 C.B. 183 (income of a foreign corporation from the sale of mineral ore extracted in the foreign corporation's homeland to United States buyers, through an independent agent located in the United States is income from sources without the United States).

For a generalized discussion of the above issues *see generally* Brigg & Hufbauer, *Expropriation Losses and Tax Policy,* 16 HARV. INT'L L.J. 533 (1975); Caplin, *Trading With Related Foreign Entities: Current American Tax Perspective,* 9 AKRON L. REV. 223 (1975).

70. Where there is no basis upon which an allocation or apportionment of income to sources within and without the United States can be made, the full amount must be deemed to be from sources within the United States. In short, the taxpayer carries the burden of proof concerning allocation. *See, e.g.,* Wodehouse v. Comm'r., 177 F.2d 881, 883 (2d Cir. 1949); Molnar v. Comm'r, 156 F.2d 924 (2d Cir. 1946); Rohmer v. Comm'r, 153 F.2d 61 (2d Cir.), *cert. denied,* 328 U.S. 862 (1946); Estate of Alexander Marton, 47 B.T.A. 184 (1942). Particular attention should be paid to Misbaurne Pictures, Ltd. v. Johnson, 189 F.2d 774 (2d Cir. 1951) (the appellants presented no basis upon which to allocate income, so the entire amount was allocated to United States sources).

such an all-or-nothing allocation was imposed upon a taxpayer who failed to substantiate his claimed allocation of lump sum payments between United States source and Canadian source serial rights to stories published by the taxpayer in both countries.[71]

The case law and revenue rulings concerning the proper source allocation of foreign corporation-performed management services is meager. Because such a determination is primarily a factual issue, one may anticipate a willingness on the Service's part to contest such allocations between related corporate entities. A foreign corporation not engaged in a trade or business within the United States is taxed at a rate of thirty percent only on its United States source income.[72] Again, if management fees constitute the foreign parent's only income from the United States, a successful allocation of such services to sources wholly outside the United States will preclude the parent from incurring any United States income tax liability.[73] It is not surprising, therefore, that the Service may refuse to let the related corporations' source allocation go unchallenged.

III. UNITED STATES-CANADIAN INCOME TAX TREATY

Section 894 of the Code provides that income of any kind, to the extent required by any treaty obligation of the United States, shall be exempt from taxation.[74] In addition, section 7852(d) states that no provision of the tax code shall apply where its effect would be contrary to any treaty of the United States.[75]

The United States-Canadian Income Tax Treaty has been subject to numerous modifications and supplements since its signing in 1942.[76] Numerous provisions of the treaty exempt

71. Rohmer v. Comm'r, 5 T.C. 183 (1945), *aff'd.*, 153 F.2d 61 (2d Cir.), *cert. denied*, 328 U.S. 862 (1946). It is interesting to note that all of the cases in note 70 *supra* were concerned with the taxpayers' allocations of serial rights to publications or movies. *See also* Note, *Taxation of Income from Literary Property Owned by Nonresident Aliens*, 54 YALE L.J. 879 (1945).

72. *See* note 7 and accompanying text *supra*.

73. *Id.*

74. I.R.C. § 894. The United States has signed tax treaties with over 40 different countries. For a brief synopsis of each treaty *see* [1977] 5 STAND. FED. TAX REP. (CCH) ¶ 4200 *et seq.*

75. I.R.C. § 7852(d).

76. Convention Between the United States and Canada Respecting Double Taxation, *supra* note 20. For an additional source where the entire United States-Canadian Income Tax Treaty may be found, *see* [1977] 5 STAND. FED. TAX REP. (CCH) ¶ 4222-24.

certain income earned by Canadian taxpayers in the United States from United States taxation in an attempt to minimize the possibility of double taxation of the taxpayer.[77] Summarizing various provisions of the treaty, regulation 519.102 exempts "industrial and commercial profits of a Canadian enterprise having no permanent establishment in the United States" from United States taxation.[78] Additionally, regulation 519.103(a) provides that the mere fact that a Canadian parent corporation has a domestic subsidiary in the United States shall not constitute the maintenance of a "permanent establishment" in the United States by that Canadian parent.[79] Any

For a discussion of the treaty and its impact, *see generally* Brown, *Canada-United States Tax Relations*, 28 TAX. EXEC. 1 (1975); McKie, *U.S.-Canadian Tax Treaty*, 66 PROC. NAT'L TAX A.-TAX INST. AMERICA 67 (1973); Mullens, *The Tax Treaty Between Canada and the USA: A U.S. Viewpoint*, 27 TAX EXEC. 53 (1974); Patrick, *U.S.-Canadian Tax Treaty*, 66 PROC. NAT'L TAX A.-TAX INST. AMERICA 67 (1973); Stileman, *The Tax Treaty Between Canada and the U.S.A.: A Canadian Viewpoint*, 27 TAX EXEC. 52 (1974).

77. The following classes of income have been exempted from taxation by other than its state of incorporation: (1) industrial and commercial profits (article I), 56 Stat. at 1399, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,023; (2) certain income from the operation of ships or aircraft (article V), 56 Stat. at 1401, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,024; (3) wages or salaries paid by governmental entities (article VI), 56 Stat. at 1401, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,024-25; (4) annuities (article VIA), 2 U.S.T. at 2237, T.I.A.S. No. 2347, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,025; (5) certain forms of personal services compensation (amended article VII), 8 U.S.T. at 1621-22, T.I.A.S. No. 3916, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,025-26; (6) sales or exchanges of capital assets (article VIII), 56 Stat. at 1402, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,026; (7) visiting professors' income (article VIIIA), 2 U.S.T. at 2238 T.I.A.S. No. 2347, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,026; (8) funds to maintain students (article IX), 56 Stat. at 1402, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,026; (9) income derived by charitable organizations (article X), *id.* Various other forms of income are also exempt, *e.g.*, directors' fees (article XIIIB), royalties (article XIIIC), 2 U.S.T. at 2239-40, T.I.A.S. No. 2347, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,028-29. For a brief discussion of the interrelationship of management fees and the United States-Canadian Tax Treaty from a Canadian tax perspective *see generally* O'Keefe, *Management Fees and Withholding Tax*, 23 CAN. TAX. J. 130 (1975).

78. 56 Stat. at 1399, T.S. No. 983, [1977] 5 STAND. FED. TAX REP. (CCH) at 48,023. *See specifically* 26 C.F.R. § 519.102 (1976) *reproduced in* [1977] 5 STAND. FED. TAX REP. (CCH) at 48,035. The specific language of the regulation is: "Industrial and commercial profits of a Canadian enterprise having no permanent establishment in the United States." *Id.*

79. 26 C.F.R. § 519.103(a) (1976), [1977] 5 STAND. FED. TAX REP. (CCH) at 48,037. For a discussion of the "commercial and industrial profits" concept and the "permanent establishment" concept *see* Donray, Ltd. v. United States, 301 F.2d 200, 208 (9th Cir. 1962) (Canadian corporations which are limited partners in a United States partnership maintain a permanent establishment within the United States);

hope, however, that management fees earned by a Canadian corporation might fall within this exemption is clearly negated by regulation 519.103(d), which provides that "industrial and commercial profits" are those profits arising from "industrial, mercantile, manufacturing, or like activities of a Canadian enterprise"; fees or charges for managerial activities are expressly excluded from the definition of "industrial and commercial profits."[80]

Regulation 519.105[81] provides for a "time basis" allocation

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Comm'r v. Consolidated Premium Iron Ores, Ltd., 265 F.2d 320, 324-25 (6th Cir. 1959) (a foreign corporation did not have a United States permanent establishment when it had no assets in the United States, maintained no United States bank accounts, had no real United States office and had not delegated to anyone in the United States power to execute contracts); F. Handfield, 23 T.C. 633, 638 (1955) (an individual residing in Canada who effected the sale of Canadian-made post cards through an American distributor had a permanent establishment in the United States); Rev. Rul. 562, 1973-2 C.B. 434, 435 (interest received from borrowers in the United States by a Canadian bank did not qualify as industrial or commercial profits); Rev. Rul. 263, 1965-2 C.B. 561, 561-62 (maintenance of United States offices to solicit business for a Canadian corporation to be performed in Canada constituted a permanent establishment in the United States); Rev. Rul. 113, 1963-1 C.B. 410, 411 (a United States corporation which purchased goods on consignment from a Canadian corporation did not constitute a permanent establishment in the United States); Rev. Rul. 282, 1955-1 C.B. 634, 635 (a Canadian corporation having an agent in the United States with discretionary authority to buy or sell has a United States permanent establishment).

80. 26 C.F.R. § 519.103(d) (1976), [1977] 5 STAND. FED. TAX REP. (CCH) at 48,037.

81. 26 C.F.R. § 519.105 (1976), [1977] 5 STAND. FED. TAX REP. (CCH) at 48,039. The regulation provides that:

> Except as provided in section 119(a)(3) of the Internal Revenue Code, gross income from sources within the United States includes compensation for labor or personal services performed within the United States regardless of the residence of the payor, of the place in which the contract for service was made, or of the place of payment. If a specific amount is paid for labor or personal services performed in the United States, such amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis, i.e., there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

For further discussion of the allocation of personal services income under the Treaty, *see* Rev. Rul. 66, 1976-1 C.B. 189, 190 (salary paid a Canadian hockey player of compensation for labor or personal services performed partly within and partly without the United States by a Canadian individual that is almost identical to that found in regulation 1.861-4(b)(2).[82] The treaty provisions do not appear to apply to corporate-performed services, and it is difficult to determine if this provision was so drafted purposely or inadvertently.

An alternative argument for excluding management services from United States taxation may exist under article XII(B) of the treaty. The provision states that "director's fees" paid by a corporation to a director residing in one of the contracting states for services at directors' meetings held in the "other" controlling state shall be exempt from tax by the "other" state.[83] Though superficially appealing, the taxpayer subsidiary must overcome the following weaknesses inherent in such an argument: (1) directors' fees are not defined by the statute; (2) directors' fees are paid directly to directors, while management fees are usually paid to the parent corporation; and (3) often management services are performed primarily by nondirector experts and technicians. Thus, it appears that none of the exemptions created by the United States-Canadian Income Tax Treaty were meant to encompass "management fees."[84]

IV. SUGGESTED TAX PLANNING TECHNIQUES

In light of the inability to bring United States source "management services" fees within any of the United States-

by a United States team which plays some games in Canada is income partly from within and partly from without the United States); Rev. Rul. 330, 1957-2 C.B. 1013, *modifying* Rev. Rul. 24, 1956-1 C.B. 851 (allocation of employees' income for transportation services rendered partly within and partly without the United States); Rev. Rul. 119, 1954-1 C.B. 156, 157 (income of a Canadian corporation from personal appearances of an entertainer in the United States is not personal services income, but rather exempt commercial or industrial profits).

82. *See* text and accompanying notes 39-44 *supra*.

83. *See* 2 U.S.T. at 2239-40, T.I.A.S. No. 2347, [1977] 5 STAND FED. TAX REP. (CCH) at 48,028-29.

84. Merely finding that none of the exemptions in the United States-Canadian Income Tax Treaty apply to management fees does not automatically subject the Canadian parent and domestic subsidiary to the withholding at the source requirements of I.R.C. § 1442. If so alleged, the Service must carry the burden of proof that the foreign corporation fraudulently failed to file a return. *See* note 11 *supra*. *See also* I.R.C. § 7454(a). In those cases, however, where the Service has only alleged failure to file a return, the taxpayer must carry the burden of proving that the Service's deficiency calculation is incorrect. *See, e.g.*, King Tsak Kwong, 12 T.C.M. (CCH) 1136, 1140 (1953); Broadcast Measurement Bureau, Inc., 16 T.C. 988 (1951).

Canadian Income Tax Treaty exemption provisions, foresighted tax planning in such transactions is an absolute necessity. Of greatest value to the taxpayer is preventative tax planning aimed at avoiding any question as to where management services were performed. Reactive, post-transaction tax advice often can do little to mitigate or lessen the tax impact of an already-completed transaction. Unfortunately, all too often tax questions are not recognized until after they become tax problems.

A. *Management Fee Payment Planning*

Although not precluding a contest by the Service, pretransaction preventative tax planning coupled with extensive documentation will certainly place the management fee-paying domestic subsidiary in a more defensible position. If any lesson may be learned from the *Yardley* case,[85] it is that the taxpayer must carry his burden of proof as to the allocation of services within and without the United States.

Consequently, prior to the adoption of a management services arrangement, the following items should be extensively documented in the minutes of the board of directors meetings of both the subsidiary and the parent corporations:

1. The management services agreement should be embodied in a formal written contract.[86]

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85. *See* 11 B.T.A.M. (P-H) at 1222-27. The taxpayer had numerous witnesses testify on its behalf. The witnesses were the domestic subsidiary's accountant, president, and other officers. Such testimony was supplemented by numerous pieces of correspondence. *See also* notes 70-71 and accompanying text *supra.*

86. The purpose served by a written management services agreement is primarily an evidentiary one. Not that only in *British Timken Ltd.*, 12 T.C. at 880, 881-83, and Rev. Rul. 55, 1960-61 C.B. at 271, were the taxpayers foresighted enough to reduce their agreements to written contracts. In both those instances, the court and the Service found, in accordance with those agreements, that none of the foreign corporation's services were performed in the United States. *Compare Le Beau Tours*, 76-1 U.S. Tax Cas. at 9302, *with Tipton & Kalmbach, Inc.*, 72-2 U.S. Tax Cas. at 85,304-05, where the court noted that written agreements executed by the parties were highly explicit concerning the allocation of services to particular sources. *See also Yardley and Co., Ltd.* 11 B.T.A.M. (P-H) at 1223, where the Board noted that it was unclear whether the management services agreement was written or oral. In those cases where the petitioner is successful in his claimed services allocation, the courts have focused on the existence and terms of the written agreements. *See British Timken, Ltd.*, 12 T.C. at 887; Rev. Rul. 55, 1960-1 C.B. at 271. In *Yardley and Co., Ltd.*, 11 B.T.A.M. (P-H) at 1225-26, the Board found a plethora of other documentation to support its findings. In those cases where the plaintiff is unsuccessful in its proposed allocation, the courts make no mention of the terms of the contracts. *See Le Beau Tours*, 76-1 U.S. Tax Cas. at 83,692-93; *Tipton & Kalmbach, Inc.* 73-2 U.S. Tax Cas. at 81,727-28. Without

2. The formula used in calculating the management fee should be clearly identified.[87]
3. If possible, the corporation should avoid tying management fees to gross or net profits. Preferably, fees should be tied to a time basis allocation method.[88]
4. Fees should be determined in advance of the beginning of the corporation's fiscal year.[89]
5. If possible, there should be documentation of comparable fees paid by comparable companies for comparable services.[90]
6. The management services agreement should clearly identify the nature of the services to be performed and the specific location where such services are to be performed.[91]

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attributing more to these distinctions than they merit, at the very least, it may noted that written contracts executed by a foreign parent and its domestic subsidiary would be of some evidentiary value.

87. Not only should the formula be identified, it should also adhere closely to the time basis allocation method outlined in Treas. Reg. § 1.861-4(b)(2) (1976). By anticipating problem areas under such an allocation method, careful drafting may serve to reduce potential attacks by the Service. In *Yardley and Co., Ltd.*, the Board accepted and adopted the taxpayer's own method of allocation. 11 B.T.A.M. (P-H) at 1226-27. *Compare* Wodehouse v. Comm'r, 117 F.2d at 883, where the court cited the following language of the Tax Court: "The parties to the contract were best able to make a proper allocation and segregation of the respective values. They neglected or chose not to do so," but held instead that the taxpayer's agent's testimony was sufficient, *with* Rohmer v. Comm'r, 153 F.2d at 65, where the court simply noted that the taxpayers, who had the burden, offered *no direct proof* on the allocation issue. The obvious benefit of a reasonable method of allocation, adopted by the parties in a written agreement, is its effect on the Service's burden of going forward.

88. One of the primary dangers in tying "management services fees" determinations to a percentage of some form of profits, is that the fees begin to resemble actual or constructive dividends. *See* I.R.C. §§ 301, 316. Under I.R.C. § 861(a)(2), dividends received from a domestic corporation are presumptively allocated to sources within the United States, in their entirety. *See also* Treas. Reg. § 1.861-3(b) (1976). Though there are exceptions and mitigations of this "all-or-nothing" rule, it is much safer to simply avoid any question that management fees might constitute dividends.

89. This strategy should be implemented to avoid any of the problems attendant upon a reclassification of management services fees as dividends. *See* note 88 *supra*.

90. In *Yardley and Co., Ltd.*, the domestic subsidiary's president testified that: "even if they [the management services] could have been obtained in the United States . . . [it] 'would have undoubtedly cost us more than the 15 percent we pay London.'" 11 B.T.A.M. (P-H) at 1228. In short, such a search for comparable domestic services and the negative results therefrom may be some evidence that only foreign sources remained as available suppliers. In light of the location test adopted for personal services under I.R.C. § 861 and its regulations, indirect support in this manner may be of some assistance. *See* Rohmer v. Comm'r, 177 F.2d at 883.

91. *See* note 87 and accompanying text *supra*. In *Yardley and Co., Ltd.*, the

7. Arm's length attempts at employing an independent party to perform similar services should be documented, if made.[92]

8. Finally, the agreement should contain a provision whereby interest is charged on the "management fee" account's outstanding balance.[93]

B. *Operational Stage Planning*

In addition to preventative tax planning prior to entering into a management services agreement, certain steps or policies may be implemented during the life of the contractual relationship between the related business entities that will bolster the assertion that management services were performed wholly or predominantly outside of the United States. At this stage, the maintenance of accurate and complete records is an absolute necessity. The following procedures will constitute persuasive evidence in support of the taxpayer's allocation:

1. Steps 1 through 8 of the previous section should be performed, if not already done.[94]

2. Any amendments to the agreement must be formally adopted, and the reason for the amendment should be clearly documented.[95]

3. Fees incurred must be actually paid or accrued with interest.[96]

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taxpayer eventually identified the services, with great specificity, that the foreign parent corporation performed. 11 B.T.A.M. (CCH) at 1225-26. *See also British Timken, Ltd.*, 12 T.C. at 887, 888, where the court identified and examined the specific services rendered by the foreign corporation to the domestic entity.

92. *See* notes 89 and 90 and accompanying text *supra*.

93. *Id.*

94. In *Yardley and Co., Ltd.*, a formal resolution identifying the specific services that were being compensated for was not adopted until June 5, 1930, but the actual payments began sometime in 1928. 11 B.T.A.M. (P-H) at 1223-25. Consequently, even "midstream" documentation, when supported by other evidence may be sufficient grounds upon which the taxpayer may substantiate his alleged allocation.

95. *See* text and accompanying notes 86-93 *supra*. Again the formal resolution adopted in *Yardley and Co., Ltd.*, on June 5, 1930, had as its primary purpose the correction of the earlier 1928 minutes where the domestic corporation designated use of the name Yardley as the *quid pro quo* for the 15 percent of profits payment to the foreign corporation. 11 B.T.A.M. (P-H) at 1224-25. *See* note 54 *supra*.

96. This function is more a requirement of the nature of deductible payments than it is a question of an income source allocation. *See* I.R.C. § 162(a)(1) and Treas. Reg. § 1.162-7 (1976). *See* First Nat'l Benefit Society v. Comm'r, 8 T.C.M. (CCH) 841, 847, *aff'd per curiam*, 183 F.2d 191 (9th Cir. 1950) (cash basis taxpayer must deduct compensation payments when actually paid); Vander Poel, Francis & Co., 8 T.C. 407, 410-12 (1947) (only salary actually paid is deductible). *But cf.* Globe-Gazette Printing Co.,

4. The following records accurately reflecting time spent on subsidiary, as opposed to parent, related business must be maintained:
   (a) employee time cards,[97]
   (b) trips by parent officers to the subsidiary's offices,[98] and
   (c) phone bills and research time spent resolving issues raised during these calls.[99]

5. Inventory and supply records must accurately reflect the above-outlined components.[100]
6. Preferably, meetings and visits should be held at the parent's offices and not at the subsidiary's.[101]

C. *Post-Deficiency Notice Planning*

The "post-deficiency notice" period may be the most difficult time frame within which to build support for one's contention that a Canadian parent's managerial services were performed wholly or predominantly without the United States. It

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16 B.T.A. 161, 165-66 (1929) (If taxpayer is on the accrual method, actual payment is not a prerequisite. The salary is only deductible during the year in which it accrued.)

97. The use of employee time cards is one method of documentation readily available to the corporate taxpayer and also perfectly consistent with the time based allocation method of I.R.C. § 861 and Treas. Reg. § 1.861-4(b)(2) (1976). *See* notes 42 and 43 and accompanying text *supra*.

98. The travel by executive officers to the domestic corporation's plant in the United States, twice a year, in *Yardley and Co., Ltd.*, appeared to be the major service rendered by the British parent within the United States. 11 B.T.A.M. (P-H) at 1226. *See also* Comm'r v. Piedras Negras Broadcasting Co., 42-1 U.S. Tax Cas. 356, 357 (5th Cir. 1942) (McCord, J., dissenting) (the dissent stressed the numerous activities actually performed by the taxpayer or its agents in the United States). *But cf. Tipton & Kalmbach, Inc.*, where the Tenth Circuit rejected a payroll cost method of allocation urged by the Service. 73-2 U.S. Tax Cas. at 81,728. Instead the court required the Service to apply the time method of allocation outlined in the regulations. *Id.*

It is important to note here that often the actual physical time spent within the United States will be minimized when compared to the time allocated to services rendered outside of the United States.

99. Phone bills are another method of allocation based on "time." It must not be forgotten, however, also to include all the hours spent by foreign personnel at the foreign corporation's office resolving any problems raised during these phone calls.

100. *See, e.g., Yardley and Co.*, Ltd., 11 B.T.A.M. (P-H) at 1222, 1225. *See also* Comm'r v. East Coast Oil Co., 85 F.2d 322, 323 (5th Cir.), *cert. denied*, 299 U.S. 608 (1936).

101. *See* note 98 *supra*. This appears to be one way to eliminate the major element of United States source services: advice rendered during trips to the domestic subsidiary's plant or offices. When "location" is as crucial to a transaction's source determination as it is under I.R.C. §§ 861-863, the loss of a travel expenses deduction under I.R.C. § 162(a)(2) is a small price to pay for the foreign parent.

must be remembered, however, that even partial documentation of the source of the services will be helpful. Section 863 clearly indicates that the taxpayer may prove partial allocation of management services under the income source provisions.[102]

Assuming the entities had not anticipated income source allocation problems, the worst possible situation occurs when the statute of limitations on the Canadian tax liability has run, but the statute has not run on the American subsidiary's return.[103] In such a situation, the Service may allege that the management services were performed wholly within the United States, and therefore the American subsidiary should have withheld at the source on such fees.[104] If the Service is successful, the related group will be faced with double taxation: a thirty percent withholding at the source tax on the subsidiary as well as Canadian corporate income tax liability on the parent. Other less onerous but nonetheless serious double taxation possibilities may arise, depending on when the taxpayers become aware of their position.[105]

Fortunately, various administrative procedures have been developed to minimize the possibility of international double taxation. The United States-Canadian Income Tax Treaty specifically provides in Articles IV[106] and XVI[107] for an administrative mechanism known as the "competent authority."[108] In the

102. *See* notes 39-69 and 85-101 and accompanying text *supra*.

103. The potential for such a situation is not unlikely. Except in cases of fraud or misrepresentation, the Canadian Minister must notify any taxpayer in writing of a deficiency within four years from the day the tax was due. Can. Stat., Act to Amend the Income Tax Act, c. 63, § 152(4) (1971). In contrast, the Internal Revenue Service may assess the tax at any time if the taxpayer has filed a false or fraudulent return or failed to file a return at all. I.R.C. § 6501(c)(1)-(3). *See* note 12 *supra*.

104. *See* notes 21-33 and accompanying text *supra*. In this instance, if the statute of limitations had run on the Canadian tax return, but no American return was filed, the Service could assess a withholding at the source tax against the domestic subsidiary.

105. If the assessment by the Service occurs within four years of the date that the Canadian return was filed, a refund could be requested by the foreign parent from its taxing authority. Can. Stat., Act to Amend the Income Tax Act, c. 63, § 164(1)-(3) (1971).

106. Convention Between the United States and Canada Respecting Double Taxation, *supra* note 20.

107. *Id.*, 56 Stat. at 1404.

108. The competent authorities were designated in the Protocal to the Tax Treaty as the Commissioner and the Minister and their duly appointed representatives. (Protocal § 4). *Id.*, 56 Stat. at 1408. The "competent authority" procedures have recently been the subject of much literature, *see* Cole, *Competent Authority Procedure: Inter-*

United States the competent authority function is bifurcated into the Assistant Commissioner Compliance and the Assistant Commissioner Technical.[109] By treaty the United States competent authority and his foreign counterpart are empowered to negotiate arrangements minimizing or eliminating double taxation.[110]

Revenue procedures 70-18[111] and 77-16[112] outline the steps to be followed by a taxpayer in requesting competent authority assistance. Revenue procedure 70-18 is exclusively concerned with the possibility of double taxation arising from section 482 reallocations,[113] while revenue procedure 77-16 is concerned with double taxation arising from the availability to a United States taxpayer of credits, exemptions, reduced tax rates, or other benefits provided under an income tax treaty.[114] Though the question of the determination of the source of a particular item of income does not fall squarely within the categories addressed by either of these rulings, the procedures outlined should offer the taxpayer some guidance.

The competent authority alternative is not free from draw-

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national Tax Counsel Gives His Views, 35 J. TAX. 8 (1971); Hanlon, *The Competent Authority: Settlement of International Tax Disputes*, 1975 TAX ADVISER 4; O'Donnell, *A Provision-By-Provision Analysis of Rev. Proc. 70-18: Many Questions Remain*, 35 J. TAX. 12 (1971); Pergament and Auderieth, *The "Competent Authority" Rules for Section 482 Relief: An Analysis of Rev. Proc. 70-18*, 35 J. TAX. 2 (1971); Comment, *The Competent Authority Concept in United States Tax Treaties*, 2 LAW & POL. INT'L BUS. 232 (1970).

109. *See* Hanlon, *supra* note 108, at 4.

110. See Convention Between the United States and Canada Respecting Double Taxation, *supra* note 20. By January of 1975, 68 cases had been referred to the United States competent authority and 60 had resulted in full relief from double taxation. Hanlon, *supra* note 108 at 7-8.

111. Rev. Proc. 18, 1970-2 C.B. 493.

112. Rev. Proc. 77-16, 1977-19 I.R.B. 35.

113. Section 1. The Purpose and Scope of Rev. Proc. 70-18 states that it is concerned exclusively with allocation of income questions. 1970-2 C.B. at 493. The Revenue Procedure then outlines the procedures to be followed where the treaty country proposes the allocations, *Id.* at 494-96, and the procedures to be followed where the Internal Revenue Service proposes the allocations. *Id.* at 496-97. The Procedure also outlines the general responsibilities of the competent authority. *Id.* at 498.

114. Rev. Proc. 77-16, 1977-19 I.R.B. 35 outlines the procedures whereby a taxpayer may present his request for relief from double taxation, *id.* at 35-37, and the procedures to be followed by the competent authority, *id.* at 37-38. Section 7 recognizes that taxpayers of the United States may request advance rulings as an alternative to the competent authority procedures. *Id.* at 38. Section 1, Purpose and Scope of the Procedure, makes it clear that Rev. Proc. 77-16 was not meant to encroach in any way on the problems addressed by Rev. Proc. 70-18. *Id.* at 35.

backs. Many questions have been left unanswered even by the revenue procedures. First, the criteria for acceptance of a case by the competent authority have not been published.[115] Second, all the taxpayer may request is "consideration"; the granting of consideration by the competent authority does not guarantee relief from double taxation.[116] Finally, the question remains as to what relief, if any, the taxpayer will be afforded if the competent authorities fail to agree.[117] Though the Service (through the competent authority) has demonstrated a willingness to help taxpayers facing potential double taxation, preventative tax planning may eliminate the need to rely on the ambiguous and uncertain competent authority procedures developed in recent years.

CONCLUSION

The relative paucity of case law and revenue rulings in the area of income source determination of foreign parent-performed management services is no indication of the importance of the issue. Management services agreements are a valuable tax planning tool for both the subsidiary and the parent corporation. However, the ramifications of poorly planned or

115. Prior to the release of Rev. Proc. 70-18 Commissioner Thrower had identified three criteria for acceptance by the competent authority: (1) the economic double taxation issue had to have been established and fully explored at the administrative level; (2) an informal agreement had to exist between the Service and the United States taxpayer as to how much of a settlement would be acceptable; and (3) the request had to merit consideration. O'Donnell, *supra* note 108, at 14. One finds no mention of the criteria for acceptance in either Rev. Proc. 70-18 or Rev. Proc. 77-16. *See* notes 111-112 *supra*.

116. Pergament and Auderieth, *supra* note 108, at 4. *See* Rev. Proc. 70-18, 1970-2 C.B. at §§ 5.01, 5.02 and 9.01. *See also* Rev. Proc. 77-16, 1977-19 I.R.B. at §§ 2.02, 4.03 and 6; Cole, *supra* note 108, at 9-10.

117. It would appear that the taxpayer is left with his other alternative administrative and judicial remedies. *See* 1970-2 C.B. at 498 (sec. 9.04); 1977-19 I.R.B. at 38 (sec. 6.04). O'Donnell has noted that: "Unless the taxpayer's foreign affiliate is successful in any legal action, if any it is able to bring in the foreign country, the taxpayer appears to be eternally burdened with a double taxation situation." O'Donnell, *supra* Note 108, at 13-14. See also Pergament and Auderieth, *supra* note 108, at 4 (taxpayer is limited to his administrative and judicial remedies if he refuses to accept the competent authorities' compromise or if the competent authority refuses to consider the case). Hanlon has noted however that as of January 1975, 68 cases had been closed by the competent authority, in which 60 resulted in full relief from double taxation, four in partial relief, and four without relief due to procedural barriers. Hanlon, *supra* note 108, at 7-8. Hanlon concludes: "In short, the record demonstrates our overall success in resolving these issues. Only a small number of cases were closed without relief to the taxpayers, and this was caused by a procedural barrier, not a breakdown in negotiations." *Id.* at 8.

unplanned management services agreements may have a twofold effect: unanticipated recognition of United States source income and, even more deleterious, subjection to potential double taxation.

This article has attempted to identify those procedures that may be implemented by related corporations to minimize the possibility of United States source income recognition or double taxation. Because the structure of the income source provisions permits partial income source allocation, every attempt to document the source of every possible management service performed should be made at the earliest possible date. In conclusion, the relationship of parent corporation and subsidiary is such that because of the ever-present concern for avoiding even the appearance of a section 482 non-arm's-length transaction, many of the procedures and forms of documentation advocated by this article will entail little additional preparation, if any. Consequently, the implementation of these procedures will prepare the taxpayers for, if not protect them from, Service scrutiny of parent-subsidiary management services agreements under sections 861 through 864 of the Internal Revenue Code.