



1999

Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income

Robert J. Peroni

J. Clifton Fleming

Stephen E. Shay

Follow this and additional works at: <https://scholar.smu.edu/smulr>

Recommended Citation

Robert J. Peroni, et al., *Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 455 (1999)
<https://scholar.smu.edu/smulr/vol52/iss2/7>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

GETTING SERIOUS ABOUT CURTAILING DEFERRAL OF U.S. TAX ON FOREIGN SOURCE INCOME*

*Robert J. Peroni**
J. Clifton Fleming, Jr.***
Stephen E. Shay*****

TABLE OF CONTENTS

I.	INTRODUCTION	457
II.	DEFERRAL INCENTIVE: HOW DOES IT WORK AND WHAT IS IT?	458
III.	LEGISLATIVE EVOLUTION OF ANTI-DEFERRAL PROVISIONS	470
	A. ORIGINS OF THE DEFERRAL PRIVILEGE	470
	B. EARLY ANTI-DEFERRAL MEASURES.....	470
	1. <i>Sections 367(a) and 482</i>	470
	2. <i>Foreign Personal Holding Companies</i>	475
	C. ADOPTION OF SUBPART F AND SUBSEQUENT AMENDMENTS	476
	1. <i>Background</i>	476
	2. <i>The Original Scope of Subpart F and Related Provisions</i>	478
	a. Overview.....	478
	b. The Subpart F Taxing Mechanism and the Base Company Income Rules	479
	c. Related Anti-Deferral Provisions	481
	d. Observations	482
	D. ANTI-DEFERRAL LEGISLATIVE DEVELOPMENTS SINCE 1962.....	482
	1. <i>Piecemeal Expansion of Subpart F: 1963-1984</i>	482
	2. <i>The Tax Reform Act of 1986: Expansion of Subpart F</i>	483
	3. <i>The Tax Reform Act of 1986: Adoption of the Passive Foreign Investment Company (PFIC) Regime</i>	486

* Copyright © 1998 by Robert J. Peroni, J. Clifton Fleming, Jr. and Stephen E. Shay. All rights reserved.

** Robert Kramer Research Professor of Law, George Washington University.

*** Associate Dean and Ernest L. Wilkinson Professor of Law, Brigham Young University.

**** Partner, Ropes & Gray, Boston.

a.	Overview.....	486
b.	The PFIC Rules In Brief	487
4.	<i>The Expansion and Contraction of Subpart F (or Contraction and Expansion of Deferral) in the 1990s</i>	488
a.	Legislative Developments	488
b.	The Saga of I.R.S. Notice 98-11 and I.R.S. Notice 98-35	490
E.	OBSERVATIONS ON THE EVOLUTION OF U.S. ANTI-DEFERRAL REGIMES	491
IV.	NON-U.S. CONTROLLED FOREIGN COMPANIES AND FOREIGN INVESTMENT FUND REGIMES	492
A.	CONTROLLED FOREIGN COMPANY LEGISLATION	492
1.	<i>Background</i>	492
2.	<i>Other Countries' Approaches to CFC Legislation</i> ..	494
3.	<i>Observations</i>	495
B.	FOREIGN INVESTMENT FUND LEGISLATION	495
V.	THE MERITS OF DEVELOPING AN APPROACH TO ENDING THE DEFERRAL SUBSIDY	497
VI.	CRITERIA FOR DEVELOPING AN ANTI- DEFERRAL APPROACH AND AN EXPLANATION FOR PATHS NOT TAKEN.....	497
VII.	THE WRONG WAY TO END DEFERRAL FOR CFCS—AN EXPANDED SUBPART F REGIME	501
VIII.	ANOTHER SUBOPTIMAL WAY TO END DEFERRAL—THE ROSTENKOWSKI-GRADISON BILL	506
IX.	THE RIGHT WAY TO END DEFERRAL— TREATMENT OF THE FOREIGN CORPORATION AS A PASS-THROUGH ENTITY WITH RESPECT TO ITS U.S. SHAREHOLDERS	507
A.	INTRODUCTION	507
B.	DESCRIPTION OF THE PASS-THROUGH PROPOSAL.....	508
C.	SIMPLIFICATION AND OTHER BENEFITS OF THE PASS-THROUGH PROPOSAL	512
D.	PROBLEMS WITH THE PASS-THROUGH PROPOSAL	515
E.	NARROWER VERSION OF PASS-THROUGH PROPOSAL THAT WOULD APPLY ONLY TO "UNITED STATES SHAREHOLDERS" OF CONTROLLED FOREIGN CORPORATIONS	516
F.	ANOTHER NARROWER VERSION OF THE PASS-THROUGH PROPOSAL	519
X.	TRANSITION ISSUES	519
A.	EFFECT OF THE PASS-THROUGH PROPOSAL IN THE ABSENCE OF TRANSITION RELIEF	519
B.	ALTERNATIVE TRANSITION RULES	520

C. STANDARDS FOR EVALUATING CLAIMS FOR TRANSITION RELIEF	521
XI. CONCLUSIONS	523
APPENDIX A	525

I. INTRODUCTION

THE so-called “deferral privilege” is one of the fundamental features of the U.S. system for taxing international income. Under that privilege, a U.S. person that conducts business or investment activity abroad through a foreign corporation generally does not pay U.S. tax on the foreign source earnings of the foreign corporation until those earnings are distributed to the U.S. person or the U.S. person sells the foreign corporation’s stock.¹ When the foreign country involved is one that imposes only low rates of tax, this privilege allows U.S. taxpayers to defer substantial amounts of U.S. tax at the cost of only a small foreign levy. Hence, the deferral privilege operates as a tax “subsidy” of sorts for U.S. persons with operations in low tax foreign countries and provides a major incentive for U.S. persons to shift their business operations and investments to foreign countries that impose little or no tax on the earnings of the foreign corporation.²

To prevent abuse of the deferral privilege, Congress over the years has enacted a number of so-called “anti-deferral” regimes, which curtail deferral in certain circumstances but leave the privilege intact in a large residual area.³ These anti-deferral regimes, including the controlled foreign corporation provisions of Subpart F of the Code,⁴ are among the most complicated provisions in the Internal Revenue Code. Moreover, these anti-deferral rules were created in a different era, when manufacturing activity dominated the domestic and world economies and international trade was a far less significant component of the world economy; thus, the design of these rules has not kept pace with the changing nature

1. See, e.g., CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 335-36 (1997).

2. See *infra* text accompanying notes 51-54.

3. The deferral privilege has been the subject of extensive commentary. See, e.g., Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check-the-Box*, 74 *TAX NOTES* 219 (1997) [hereinafter Avi-Yonah, *End Deferral*]; Asim Bhansali, Note, *Globalizing Consolidated Taxation of United States Multinationals*, 74 *TEX. L. REV.* 1401 (1996); Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 *TAX NOTES* 581 (1990); Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 *TAX NOTES* 1165 (1996); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 *CORNELL L. REV.* 18 (1993); Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 *TAXES* 1062 (1988); John McDonald, Comment, *Anti-Deferral Deferred: A Proposal for the Reform of International Tax Law*, 16 *NW. J. INT'L L. & BUS.* 248 (1995); Peter Merrill & Carol Dunahoo, *'Runaway Plant' Legislation: Rhetoric and Reality*, 72 *TAX NOTES* 221 (1996); Paul W. Oosterhuis & Roseann M. Cutrone, *The Cost of Deferral's Repeal: If Done Properly, It Loses Billions*, 58 *TAX NOTES* 765 (1993); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 *TAXES* 1042 (1996).

4. I.R.C. §§ 951-964.

of the global marketplace and international investment structures. The anachronistic nature of Subpart F and the other anti-deferral rules in the Code has spawned increasing numbers of intricate planning strategies to avoid the impact of these rules and preserve the deferral privilege.⁵ The complex, incomplete, and anachronistic nature of these rules has prompted us to reconsider the appropriate scope of the U.S. anti-deferral regimes.

This Article discusses and critiques the various methods for curtailing deferral of U.S. income tax on foreign source income. We conclude that the most effective way to deal with the deferral issue is to treat a foreign corporation as a pass-through entity for U.S. income tax purposes with respect to U.S. persons holding stock in the corporation. Our proposal, however, provides special rules for less than 10% U.S. shareholders in non-U.S.-controlled foreign corporations.

The Article begins in Part II with an explanation and theoretical analysis of the deferral incentive. Part III of the Article then traces the legislative evolution of the anti-deferral provisions of the current U.S. tax law. Part IV is an overview discussion of anti-deferral regimes employed in foreign jurisdictions. This discussion provides a comparative benchmark for designing a revised anti-deferral regime for the U.S. tax system. Part V is an explanation of why developing a technically sound approach for ending deferral is an important enterprise, even though the policy controversy concerning the desirability of deferral probably cannot be resolved. Part VI enunciates the criteria we believe should be used in constructing a sound regime for curtailing deferral and why we believe that the pass-through approach is the superior one. Parts VII and VIII examine the two principal alternative approaches to revising the anti-deferral regimes, both of which we believe are inferior to our pass-through approach—an expanded Subpart F regime and the Rostenkowski-Gradison bill (which was never enacted into law). In Part IX, we present our proposal to treat foreign corporations as pass-through entities with respect to U.S. persons holding stock in such entities and explain how enactment of such a proposal could lead to other reforms in the international tax rules of the United States. Part X focuses on an important and difficult area of any tax reform proposal—namely, transition issues. Finally, Part XI provides a brief summary of our conclusions.

II. DEFERRAL INCENTIVE: HOW DOES IT WORK AND WHAT IS IT?

This part of the Article will provide an overview and theoretical analysis of the deferral incentive. Current U.S. income tax (subject to the al-

5. See, e.g., I.R.S. Notice 98-35, 1998-27 I.R.B. 25; David Rosenbloom, *International Tax Arbitrage and The "International Tax System"* 39 (October 21, 1998) (unpublished manuscript, on file with SMU Law Review) (referring to Subpart F as an "ossified statutory scheme").

lowance of a credit for foreign income tax⁶) is generally paid on income realized from:

1. U.S. business or investment activities carried on by an individual, corporation, LLC⁷ or partnership.⁸
2. Foreign business or investment activities carried on by a foreign branch of a U.S. corporation.⁹
3. Foreign business or investment activities carried on by a U.S. individual or by an LLC or partnership composed of U.S. members or partners.¹⁰

Under the doctrine of *Moline Properties, Inc. v. Commissioner*,¹¹ the U.S. income tax law usually regards a foreign corporation, whether or not controlled by U.S. persons, as a foreign taxpayer that is legally distinct from its shareholders.¹² This principle applies to any entity (including an LLC) classified as a foreign corporation for U.S. tax law purposes, whether under the current "check-the-box" entity classification system¹³ or under the prior "corporate resemblance" entity classification regulations.¹⁴ Thus, except to the extent that the Internal Revenue Code's various anti-deferral regimes provide otherwise, U.S. tax on foreign source business and investment income earned by a U.S. person through a foreign corporation, even a U.S.-taxpayer-controlled foreign corporation,¹⁵ is generally deferred until the income is repatriated to the United States through corporate distributions or until the stock is sold.¹⁶ These anti-deferral regimes have different trigger points (i.e., definition of the entity covered by the anti-deferral regime, types of income as to which deferral is curtailed, and types of U.S. shareholders for whom deferral is cur-

6. See I.R.C. § 901(a).

7. In this Article, the abbreviation "LLC" refers to a limited liability company formed under U.S. law and taxed on a pass-through basis.

8. See I.R.C. §§ 1, 11, 61(a)(2), 61(a)(13), 702, 864(b), 864(c), 871(b), 875(1), 882.

9. See I.R.C. §§ 11, 61(a)(2).

10. See I.R.C. §§ 1, 11, 61(a)(2), 61(a)(13), 702.

11. 319 U.S. 436 (1943).

12. See Treas. Reg. §§ 1.11-1(a), 1.881-1; 1 JOSEPH ISENBERGH, INTERNATIONAL TAXATION 1:22 (2d ed. 1999).

13. See Treas. Reg. §§ 301.7701-1, -2, -3, (as amended by T.D. 8697, 1997-1 C.B. 215).

14. See T.D. 6503, 1960-2 C.B. 409; T.D. 7515, 1977-2 C.B. 482.

15. In this Article, such an entity is hereinafter referred to as a "controlled foreign corporation" or a "CFC."

16. See GUSTAFSON, PERONI & PUGH, *supra* note 1, at 335-41. When the income is reported by the U.S. shareholder as an actual dividend, as an inclusion under one of the anti-deferral regimes or as a deemed dividend under Section 1248 on the sale of a CFC's stock, the U.S. shareholder will obtain an indirect foreign tax credit for a proportionate amount of the creditable foreign taxes paid or accrued by the foreign corporation (which are "deemed paid" by the U.S. shareholder at the time of the dividend, income inclusion or deemed dividend income) if the U.S. shareholder owns at least 10% of the voting stock of the foreign corporation and is either a U.S. domestic corporation or an individual who elects under section 962 to be taxed as a corporation with respect to the income. See I.R.C. §§ 902, 960. The amount of the U.S. shareholder's actual dividend, income inclusion or deemed dividend will be "grossed up" (i.e., increased) by the amount of the foreign corporation's foreign taxes deemed paid by the U.S. shareholder. See I.R.C. § 78. The U.S. shareholder will also receive a direct credit for any foreign tax withheld from an actual dividend. See I.R.C. § 901.

tailed) and different anti-deferral mechanisms (i.e., current income inclusion, characterization of the U.S. shareholder's gain from sale of stock in the entity as ordinary income, or interest charge on the deferred U.S. income tax at the time that the U.S. shareholder receives a dividend distribution from the foreign corporation or realizes gain from a sale of the corporation's stock). They also overlap to some considerable extent; thus, a U.S. shareholder's ownership interest in a foreign corporation may be subject to more than one of these anti-deferral regimes at the same time.¹⁷

The Code's anti-deferral regimes, however, constitute a weak barrier to deferral, particularly with respect to active business income. For example, the CFC provisions¹⁸ are the most comprehensive of these regimes. When they apply, they impose current U.S. tax on five categories of current CFC income, including both active and passive items, that are collectively referred to as Subpart F income.¹⁹ The tax is implemented by treating U.S. persons who own at least 10% of the voting power of a CFC's stock,²⁰ actually or by statutory attribution,²¹ as if each had received a dividend of their pro rata shares of the CFC's Subpart F income for the year.²² In addition, these same persons are also treated as receiving dividends equal to their pro rata shares of the CFC's earnings and profits that have not been previously or currently taxed to them as Subpart F income and that are invested in certain U.S. assets during the year.²³ Section 960 adds that U.S. persons who are charged with receipt of either of these constructive dividends are also entitled to an indirect credit for foreign income tax liabilities allocable thereto, if the U.S. persons actually own at least 10% of the CFC's voting stock and if the U.S. persons are either domestic corporations or individuals who have elected under section 962 to be taxed as domestic corporations.²⁴

The preceding CFC regime, however, applies only if more than 50% of the voting power or value of the CFC's shares²⁵ is owned by U.S. persons who each own at least 10% of the voting power of the CFC's stock.²⁶

17. The Code contains various rules for coordinating the application of these regimes in the light of their overlapping scope. See, e.g., I.R.C. §§ 551(g), 951(c), (d), (f), 1293(g)(1)(A), 1297(d), (e).

18. I.R.C. §§ 951-964, 1248. For a detailed discussion of the Subpart F provisions, see 1 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ch. B3 (1992).

19. See I.R.C. §§ 951(a)(1)(A)(i), 952. Although Subpart F income is usually foreign source, see I.R.C. § 952(b), it is theoretically possible for U.S. source passive income that has been subjected to U.S. withholding tax to, nevertheless, be included in Subpart F income, see I.R.C. §§ 952(b), 954(c)(1)(A); Treas. Reg. § 1.952-1(b)(2).

20. See I.R.C. § 951(a)(1), (b).

21. See I.R.C. §§ 951(b), 958(a), (b).

22. See I.R.C. § 951(a)(1)(A)(i), (a)(2).

23. See I.R.C. §§ 951(a)(1)(B), 956, 959; Treas. Reg. § 1.959-1(c) Ex.; Melvin S. Adess, Barbara M. Angus & Keith E. Villmow, *The Erosion of Deferral: Subpart F After the 1993 Act*, 47 TAX LAW. 933, 954 (1994).

24. See I.R.C. §§ 960(a)(1), 962(a); see also I.R.C. § 902.

25. See I.R.C. § 957(a). The 50% threshold is lowered to 25% for certain foreign insurance companies by sections 953(c) and 957(b).

26. See I.R.C. §§ 951(b), 957(a).

Moreover, constructive dividends of Subpart F income and amounts invested in U.S. assets are imputed only to those U.S. shareholders who own, actually or by statutory attribution, at least 10% of the CFC's stock voting power.²⁷ This means that the CFC provisions are avoidable to the extent that U.S. persons keep their ownership of a CFC's stock from exceeding 50% of the voting power or value of the outstanding shares or to the extent that each U.S. shareholder restricts his, her, or its stock ownership to shares possessing less than 10% of voting power.²⁸ Furthermore, Subpart F income excludes manufacturing income.²⁹ Thus, a CFC is effectively outside the Subpart F constructive dividend provisions to the extent that its income is earned through selling goods of its own manufacture. By carefully observing the stock ownership rules described above³⁰ or by ensuring that a CFC has only manufacturing income and that it avoids investments in U.S. assets, U.S. shareholders of a CFC can, and do, readily avoid current U.S. tax on the CFC's income.³¹

Section 1248 is often mentioned as included in the Code's CFC provisions. Generally speaking, section 1248 employs a complex set of rules to convert gain recognized on disposition of CFC stock from capital gain to dividend income.³² Nevertheless, it is largely ineffectual as an anti-deferral device because it does not affect deferral's time-value-of-money benefit illustrated below.³³

27. See I.R.C. § 951(a)(1).

28. For an example of a corporate inversion transaction designed to avoid the Subpart F rules, see the Helen of Troy corporate expatriation transaction, discussed *infra* note 78. The IRS responded to these corporate inversion transactions by issuing the anti-inversion rules in I.R.S. Notice 94-46, 1994-1 C.B. 356, and Treas. Reg. § 1.367(a)-3(c) (as amended by T.D. 8702, 1997-1 C.B. 92). For a more recent corporate inversion transaction, see the Tyco corporate expatriation by merger into ADP.

29. See Treas. Reg. § 1.954-3(a)(4); *Interview with Daniel M. Berman*, 76 TAX NOTES 1387, 1389-90 (1997); N.Y. St. Bar Ass'n Tax Sec., *Notice 98-11: Tax Treatment of Hybrid Entities*, 79 TAX NOTES 877, 882 (1998); David R. Tillinghast, *An Old-Timer's Comment on Notice 98-11*, 78 Tax Notes 1739 (1998).

30. However, one must caveat the indirect stock ownership rules in section 958(a) and the constructive stock ownership rules in section 958(b).

31. See Adess, Angus & Villmow, *supra* note 23, at 935; Mike Cooper, Gary Melcher & Clint Stretch, *Suddenly Saving Foreign Taxes is Abusive? An Untenable Proposal*, 79 TAX NOTES 885, 886 (1998); 1 ISENBERGH, *supra* note 12, at 1:22-1:23.

32. See GUSTAFSON, PERONI & PUGH, *supra* note 1, at 410-11; 2 KUNTZ & PERONI, *supra* note 18, at ¶ B6.03[6].

33. See *infra* text accompanying notes 52-54. Moreover, section 1248's "deemed dividend" treatment of all or a part of a U.S. shareholder's gain from the sale of a CFC's stock actually provides a tax benefit to a U.S. corporate shareholder of the CFC that owns at least 10% of the CFC's voting stock, because the deemed dividend will carry an indirect foreign tax credit under section 902 for a proportionate amount of the CFC's foreign taxes "deemed paid" by the U.S. corporate shareholder on account of the deemed dividend. In addition, realization of dividend income under section 1248 on the sale or liquidation of a CFC's stock often has the advantage of avoiding the foreign withholding tax imposed on actual dividends because gain on a sale of stock or liquidation of a corporation often is exempt from a foreign country's withholding tax. Thus, a corporate shareholder often prefers dividend treatment under section 1248 to sale treatment, particularly in the absence of a capital gain preference for corporate taxpayers under current law, see GUSTAFSON, PERONI & PUGH, *supra* note 1, at 410-11, as well as possible U.S. source treatment of most gain, see I.R.C. § 865(a); *but see* I.R.C. § 865(f), (h)(10).

The foreign personal holding company (FPHC) provisions³⁴ are a second anti-deferral regime. They tax U.S. persons who are shareholders of an FPHC as if they had received current pro rata distributions of the company's undistributed foreign personal holding company income for the year.³⁵ However, a foreign corporation is not an FPHC unless initially 60% or more of its annual gross income is comprised of certain types of passive and personal service income.³⁶ This benchmark generally drops to 50% for years after the first year of qualification as an FPHC.³⁷ Thus, the FPHC provisions are generally avoided if the foreign corporation has predominantly active business income. Moreover, these provisions require that at some time during the tax year, more than 50% of the voting power or value of the foreign corporation's stock must have been owned, directly or indirectly, by five or fewer individuals who were U.S. citizens or residents.³⁸ This stock ownership requirement provides an easy path to avoidance of the FPHC provisions.³⁹

Yet another anti-deferral regime is found in the foreign investment company provisions.⁴⁰ If they apply, a U.S. shareholder who disposes of stock must treat any gain as ordinary to the extent of the shareholder's pro rata share of the foreign corporation's earnings and profits accumulated after 1962.⁴¹ Like section 1248, these provisions are a rather feeble attack on deferral because they only deal with the character of gain and not the time-value-of money advantage derived from deferral.⁴² Furthermore, they require that the foreign corporation be registered under the Investment Company Act of 1940 as either a management company or a

34. See I.R.C. §§ 551-558. For a detailed discussion of the FPHC provisions, see 1 KUNTZ & PERONI, *supra* note 18, at ¶ B2.06.

35. See I.R.C. § 551(b). Undistributed foreign personal holding company income is the taxable income of the FPHC subject to certain adjustments. See I.R.C. § 556(a). A U.S. shareholder increases its tax basis in the shares by the amount of the deemed dividend. See I.R.C. § 551(e).

36. See I.R.C. §§ 552(a)(1), 553(a).

37. See I.R.C. § 552(a)(1).

38. See I.R.C. § 552(a)(2).

39. In some circumstances, however, the FPHC provisions can have a surprisingly broad reach. For example, there are broad partner-to-partner attribution rules for purposes of the stock ownership requirement. Under these rules, an individual is considered to own the stock owned by his or her partners, even if the partner is a foreign person (provided that the U.S. individual otherwise owns, actually or constructively, some stock in the foreign corporation). See I.R.C. § 554(a)(1), (a)(2), (a)(5), (c)(2). Thus, if an investment partnership acquires control of a foreign corporation, the stock ownership requirement is met if any one of its partners is a U.S. individual, no matter how small the individual's partnership interest. The related person-dividend look-through rule in section 552(c) is very restricted in that it cross-references the same-country-related-person dividend exception in section 954(a)(1), (a)(5), and (c)(3) (requiring that the dividend be from a corporation organized in and with substantially all of its assets used in an active business in the same country). Accordingly, many foreign holding companies controlled by investment partnerships meet both the FPHC gross income and stock ownership tests and are FPHCs.

40. See I.R.C. §§ 1246-1247. For a detailed discussion of the foreign investment company provisions, see 1 KUNTZ & PERONI, *supra* note 18, at ¶ B2.07.

41. See I.R.C. § 1246(a).

42. See *infra* text accompanying notes 52-54.

unit investment trust or that it be primarily engaged in the business of investing, reinvesting, or trading in securities or commodities.⁴³ Corporations predominantly engaged in active commercial operations outside the securities or commodities business are not covered. Finally, the foreign investment company provisions are inapplicable unless at least 50% of the vote or value of the foreign corporation's stock is owned by U.S. persons.⁴⁴ This provides a ready escape from the foreign investment company provisions.⁴⁵

A final anti-deferral regime is found in the passive foreign investment company (PFIC) provisions.⁴⁶ Generally speaking, this regime attacks deferral through a complex offsetting interest charge mechanism applied at the shareholder level.⁴⁷ It is quite broad in coverage in two important respects—its anti-deferral mechanism applies to any U.S. person owning stock in a foreign corporation that meets the definition of a PFIC, no matter how small that shareholder's ownership interest in the corporation, and the definition of a PFIC does not depend on any degree of concentrated ownership by U.S. persons of stock in the corporation. The PFIC regime, however, is inapplicable to foreign corporations predominantly engaged in active business operations because it applies only if a corporation's annual gross income is at least 75% passive or at least 50% of the average of the corporation's assets held during the year produced passive income or were held for the production of passive income.⁴⁸ Moreover, a foreign corporation that meets the definitions of both a CFC and a PFIC is not treated as a PFIC with respect to a U.S. person owning

43. See I.R.C. § 1246(b)(2).

44. See I.R.C. § 1246(b).

45. See 2 ISENBERGH, *supra* note 12, at 43:3. Offshore funds generally are sold to U.S. institutional investors (not U.S. individuals) and foreign persons. These funds typically try to avoid registration under the Investment Company Act of 1940. So-called master-feeder structures (either partnerships or business trusts formed under Massachusetts, New Hampshire, or Delaware law that are taxable as partnerships) have been popular in recent years and may have a regulated investment company as a domestic feeder fund and an offshore investment fund as a foreign feeder fund. The foreign investment company provisions are rarely a serious issue under this structure.

46. See I.R.C. §§ 1291-1297; see generally Thomas D. Fuller, *The Pfickle Finger of Fate: Many Questions, Few Answers*, 81 TAX NOTES 879 (1998). For a detailed discussion of the PFIC provisions, see 1 KUNTZ & PERONI, *supra* note 18, at ¶ B2.08.

47. See I.R.C. § 1291(a); see also GUSTAFSON, PERONI & PUGH, *supra* note 1, at 429-30. There are also elective alternatives in the form of a pass-through regime for a qualified electing fund (QEF), see I.R.C. § 1293, and a mark-to-market regime, see I.R.C. § 1296.

48. See I.R.C. § 1297(a). The PFIC rules are a frequent issue in U.S.-managed offshore portfolio or direct investment fund structures. There often are one or more U.S. individuals serving as partners in a general partnership that holds a 20% carried interest in the fund. These individuals benefit from capital gain treatment and therefore want to be able to make a QEF election so that the character of the fund's capital gains flows through to the U.S. individual investors. Tax-exempt partners generally are indifferent after temporary regulations promulgated in 1998. See Temp. Treas. Reg. § 1.1291-1T(e) (1998). Non-U.S. managed funds are reluctant to commit to provide the fund-level information necessary to make a QEF election, but will do so if they are marketing the fund to U.S. individual investors eligible for a preferential tax rate on capital gains. Obtaining entity-level information is a potential problem whenever an anti-deferral regime requires current inclusion by a U.S. shareholder of the income of a non-U.S.-controlled foreign corporation and is exacerbated when the shareholder owns only a small interest in the corporation.

stock in the corporation who meets the definition of a 10% or more "United States shareholder" in section 951(b), thus eliminating this overlap between the CFC and PFIC regimes and weakening the strength of the PFIC regime as an anti-deferral mechanism.⁴⁹

As demonstrated by the preceding discussion, the Internal Revenue Code's anti-deferral provisions can be readily circumvented by making certain that the CFC has substantial active business income or that its U.S. ownership is kept below applicable thresholds. In short, the anti-deferral regimes are substantially avoidable barriers to achieving deferral of U.S. tax on foreign business and investment income of foreign corporations controlled by U.S. shareholders.⁵⁰

This deferral of U.S. tax on foreign source income of a foreign corporation controlled by U.S. taxpayers provides an incentive for U.S. taxpayers to carry on business and hold investments in low-tax countries through CFCs.⁵¹ The following example is one approach to demonstrating the operation of this incentive:

Assume that U.S. Corp., taxed under section 11 at 35%, earns \$100 of taxable income from branch operations in a foreign country which imposes a 10% income tax but no branch profits tax or divi-

49. See I.R.C. § 1297(e) (1998) (added by Pub. L. No. 105-34, § 1175, 111 Stat. 788, 990-93 (1997)).

50. See generally GUSTAFSON, PERONI & PUGH, *supra* note 1, at 355-41; STAFF OF JOINT COMM. ON TAX'N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1021-22 (Comm. Print 1987) [hereinafter EXPLANATION OF THE 1986 ACT].

51. See U.S. TREAS. DEP'T, INTERNATIONAL TAX REFORM: AN INTERIM REPORT 7 (Jan. 1993) [hereinafter U.S. TREAS. DEP'T, INTERIM REP.]. In overall terms, the deferral subsidy may be quite large. To be specific, the tax expenditures chapter of the Clinton Administration's 1999 fiscal year budget estimated that the fiscal 1999 revenue loss from deferral would be \$2.6 billion, and that, as a result, deferral would rank as the 29th largest of 115 fiscal 1999 tax expenditures. See *Tax Expenditures Chapter from the President's Fiscal 1999 Budget*, 78 TAX NOTES 911, 912, 925-27 (1998). Some commentators have disputed this, however. They have argued that if deferral were eliminated, CFC losses would become deductible by U.S. shareholders and, in addition, the excess foreign tax credits of many U.S. corporations would become usable against current U.S. tax on CFC income. They assert that as a result of these two developments, little revenue would be gained from ending deferral. See Frisch, *supra* note 3, at 585-86; LaBrenda Garrett-Nelson, *The Future of Deferral*, in TAXING AMERICA 239 (Karen B. Brown & Mary Louise Fellows eds., 1996); Oosterhuis & Cutrone, *supra* note 3, at 767-68; Shay, *supra* note 3, at 1061; U.S. TREAS. DEP'T, INTERIM REP., *supra*, at 10; see also Kathleen Matthews, *How Should Clinton Handle International Tax Issues?*, 57 TAX NOTES 985, 986 (1992); *Roundtable Discussion—International Taxation: D. Kevin Dolan, Stephen E. Shay, and David R. Tillinghast*, ABA Sec. of Tax'n Newsletter, Fall 1993, at 8. Under this view, the preceding revenue loss estimate may be substantially overstated. Nevertheless, any restriction on the ability electively to defer income or take losses into account currently may be presumed to raise revenue. But regardless of how this empirical question is resolved, the deferral privilege clearly encourages U.S. taxpayers to carry on business operations through CFCs in low-tax foreign countries if the taxpayers anticipate that they will not be in an excess foreign tax credit status indefinitely and that the foreign operations will be profitable. Thus, those who are primarily concerned with capital export neutrality (defined *infra* note 59) will favor ending deferral regardless of whether the revenue consequence to the Treasury is a large gain, a small gain or a loss. See Reuven S. Avi-Yonah, *More on U.S. Notice 98-11 and the Logic of Subpart F*, 16 TAX NOTES INT'L 1943 (1998); Shay, *supra* note 3, at 1061, 1063.

dend withholding tax.⁵² U.S. Corp. would currently incur a net 25% U.S. tax (35% U.S. tax less a section 901 direct foreign tax credit for the 10% foreign tax).

But if U.S. Corp. carries on its foreign operations through a wholly owned foreign subsidiary, and if the anti-deferral provisions are inapplicable, the 25% net U.S. tax (35% U.S. tax minus a section 902 indirect foreign tax credit) on the subsidiary's \$100 of taxable income is deferred until the subsidiary's income (grossed up under section 78) is distributed to U.S. Corp. or until U.S. Corp. sells the subsidiary's stock. During the deferral period, U.S. Corp. has the interest-free use of the \$25 of deferred tax and is, therefore, commonly described as the beneficiary of a \$25 interest-free loan from the U.S. Treasury.⁵³ The following table shows two ways of illustrating the value of this benefit:⁵⁴

Table 1

Deferral Period	U.S. Corp.'s Total Avoided Interest Expense on \$25 (10% After-Tax Interest Rate)	U.S. Corp.'s Year 1 Cost of \$25 Deferred Tax (10% Discount Rate)
5 years	\$ 15.26	\$15.52
20 years	\$143.19	\$ 3.72

Although the preceding interest-free-loan analysis is the usual method for illustrating the effect of deferral, it is arguably more accurate to describe deferral as a system by which U.S. shareholders compel the Treasury to invest in their CFCs. To illustrate this point, assume again that U.S. Corp., a 35% bracket U.S. taxpayer, is the sole shareholder of a CFC operating in a foreign country that imposes a 10% income tax but no dividend withholding tax. The CFC earns \$100 of net business profits on the last day of year one but does not distribute this amount until the end of year two. If the CFC were a branch or a domestic corporation, the U.S. Treasury would be entitled to a \$25 net tax for year one (35% U.S. tax minus a section 901 direct credit for the 10% foreign tax). But under the non-heroic assumption that the U.S. anti-deferral regimes are avoided, the CFC is free to invest this \$25 during year two as part of the \$90 year one revenue that it retains after paying the \$10 year one foreign tax. If the CFC loses half of this \$90 and distributes only \$45 to U.S. Corp. at the close of year two, the distribution will be grossed up under section 78 to \$55 (\$45 distribution of all remaining earnings + \$10 previously paid foreign tax). A 25% U.S. tax thereon in the amount of \$13.75

52. If a branch profits tax or dividend withholding tax were imposed, it would likely result in a Section 901 direct credit as an "in lieu of" tax under Section 903. Thus, to simplify this and succeeding examples, we assume that the foreign country does not impose these taxes.

53. See GUSTAFSON, PERONI & PUGH, *supra* note 1, at 337; 1 ISENBERGH, *supra* note 12, at 1:22.; see also Green, *supra* note 3, at 34 (1993).

54. See generally JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & DEBORAH A. GEIER, FEDERAL INCOME TAX: DOCTRINE STRUCTURE AND POLICY 411-15 (1995).

(after application of the foreign tax credit) will be paid to the U.S. Treasury. Because of the CFC's year two loss, the Treasury's tax collection has been cut from \$25 to \$13.75 (i.e., the Treasury has shared in the CFC's loss just like an equity investor). The Treasury's tax collection, however, is \$13.75 instead of the \$12.50 (one-half of \$25) that one would intuitively expect in view of the fact that one-half of the Treasury's \$25 "investment" was lost during year two. How do we account for the extra \$1.25 collected by the Treasury? This is exactly equal to the Treasury's \$12.50 year two loss multiplied by the 10% foreign tax rate. In other words, the Treasury has effectively realized a \$1.25 foreign tax saving just as any non-governmental equity investor would if it deducted a \$12.50 investment loss from income otherwise taxable at a 10% rate.

Of course, if the CFC doubled its money to \$180 during year two (a \$90 gain), paid a \$9 foreign tax on the gain at the end of year two and then distributed \$171 (\$180 - \$9) to U.S. Corp., the distribution would be grossed up to \$190 (\$171 + \$10 + \$9) and the U.S. Treasury would collect a net 25% tax of \$47.50 instead of \$25 (i.e., the Treasury would take a share of the CFC's year two profit just like an equity investor). But in this gain scenario, why is the U.S. tax only \$47.50 instead of \$50? The reason is that when the \$25 that was the Treasury's share of the CFC's year one retained profits doubled to \$50, thus producing a \$25 gain for the Treasury, the foreign government took 10% (\$2.50) of this gain as tax, just as if the Treasury were a nongovernmental investor. This left the Treasury with a net gain of \$22.50, which, when added to the Treasury's initial \$25 "investment," yielded \$47.50—the amount of the Treasury's year two tax collection. As the preceding gain and loss scenarios both illustrate, instead of viewing deferral as providing U.S. shareholders with an interest-free loan, it is arguably better to think of deferral as a means by which U.S. shareholders force the U.S. Treasury to provide equity capital for their CFCs.

There is also an alternative approach for analyzing deferral that draws on an insight commonly used in analyzing consumption tax regimes. This insight holds that if tax rates remain constant, allowing a deduction for the cost of an investment but then taxing all returns thereon (including recovery of basis or principal) is generally equivalent to disallowing a deduction for the investment's cost but then excluding all returns thereon from the tax base.⁵⁵ When this insight is applied to CFCs, it teaches that deferral of tax on a CFC's retained income (which is equivalent to al-

55. See, e.g., William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1126, 1150 (1974); J. Clifton Fleming, Jr., *The Deceptively Disparate Treatment of Business and Investment Interest Expense Under a Cash-Flow Consumption Tax and a Schanz-Haig-Simons Income Tax*, 3 FLA. TAX REV. 544, 552-54 (1997); U.S. TREASURY DEP'T, BLUEPRINTS FOR BASIC TAX REFORM 123 (1977). However, for a discussion of the conditions that must exist for these equivalent results to occur, see ABA Sec. of Tax'n Comm. on Simplification, *Complexity and the Personal Consumption Tax*, 35 TAX LAW. 415, 418, 425 (1982); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1601-02 (1979); Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549, 551-52 (1985); Alvin C.

lowing a present deduction for the cost of investments made by the CFC out of that income) effectively treats the CFC as if a current U.S. tax were paid on the retained income but the CFC were then allowed a U.S. tax exemption for all returns from investing its after-tax retained income.

To demonstrate this proposition, assume, as above, that U.S. Corp., a 35% bracket U.S. taxpayer, has a wholly owned CFC which earns \$100 of net income from operations in a foreign country imposing a 10% income tax and no dividend withholding tax and that none of the U.S. anti-deferral provisions apply. All of the CFC's year one earnings occur at year-end and are distributed by the CFC to U.S. Corp. at the close of year two. During the twelve-month deferral period, the CFC invests its \$90 of retained earnings (after payment of the \$10 foreign tax) at a 10% per annum pre-tax rate of return. The investment earns \$9 ($\$90 \times .10$) and at the close of year two, the CFC pays a \$0.90 foreign tax thereon and distributes \$98.10 ($\$90 + \$9 - \0.90) to U.S. Corp. This amount is grossed up to \$109 under section 78 ($\$98.10 + \$10 + \0.90), a 25% U.S. tax in the amount of \$27.25 is paid thereon after credit for the foreign tax ($\$109 \times .25 = \27.25) and U.S. Corp. has \$70.85 left ($\98.10 distribution - \$27.25 U.S. tax).

Now assume a radically different U.S. tax regime in which there is no deferral of the 35% U.S. tax on the CFC's business profits but there is also no U.S. tax on earnings produced by the CFC's investment of those profits, not even when the earnings are distributed to U.S. Corp. as dividends. Under this regime, the CFC's \$100 of business profits will bear a full 35% combined U.S. and foreign tax at the end of year one (10% foreign tax plus 25% U.S. tax after crediting the foreign tax). The CFC will then have only \$65 to invest at 10% during year two. The CFC will earn \$6.50 on this amount, pay a 10% foreign tax of \$0.65, pay no U.S. tax and have \$70.85 left for distribution to U.S. Corp. at the end of year two ($\$65$ principal + \$6.50 earnings - \$0.65 foreign tax). Under the parameters of our assumed tax regime, no U.S. tax will be due on the distribution and U.S. Corp. will wind up with \$70.85. This is exactly the same as U.S. Corp's ending amount when we assumed above that the applicable U.S. taxing regime deferred U.S. tax on the CFC's income until it was repatriated, but then taxed both the business profits and the investment earnings thereon. In other words, the existing U.S. deferral regime reaches the same result as the hypothetical regime under which the CFC's retained business profits are currently taxed, but there is never a U.S. tax on the CFC's earnings from investing those profits.

Thus, if U.S. tax on CFC income is deferred until the income is distributed to U.S. shareholders, the CFC is effectively permitted to receive a return on investments of those earnings during the deferral period that is free of U.S. tax forever. This means that deferral creates an exemption

Warren, Jr., *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1 (1996).

regime for the investment return on a CFC's retained earnings.⁵⁶ It also means that with respect to a CFC's retained earnings, deferral allows the CFC to function for its U.S. shareholders as if it were a section 103 tax exempt bond fund.⁵⁷ But unlike the section 103 exemption, the effective exemption for the investment return on the CFC's retained earnings does not inure to the benefit of a U.S. state or local government. Instead, the exemption is captured by the CFC's U.S. shareholders. Moreover, as discussed above, the earnings yield an equity-based instead of a fixed income-based return.⁵⁸

Regardless of which of the preceding analytical approaches is used to describe deferral (an interest-free loan, a device to make the U.S. Treasury a forced equity investor or a regime for achieving tax-free reinvestment of retained earnings), the deferral privilege is clearly a substantial tax incentive that is not made available for earnings from domestic operations. Thus, many tax academicians view it as inappropriate encouragement for U.S. taxpayers to locate operations abroad (i.e., as a violation of the capital export neutrality norm).⁵⁹ By contrast, corporate executives and their professional advisers generally regard deferral as necessary to make U.S. businesses competitive in low-tax foreign markets against foreign multinationals whose home countries permit either deferral or exemption for foreign source income (i.e., as compelled by the capital import neutrality norm).⁶⁰ Still other observers regard deferral as re-

56. Under an exemption regime, the United States would impose no tax on foreign source income, even when it is repatriated. Thus, the only applicable tax would be the tax imposed by the foreign jurisdiction. See generally GUSTAFSON, PERONI & PUGH, *supra* note 1, at 14-17, 223.

57. See I.R.C. § 103.

58. We speculate that the pre-tax equity based return for CFCs would be higher than for a comparable investment conducted through a foreign branch because deferral is elective (by making the choice to use a foreign business entity taxable for U.S. purposes as a corporation) and, to the extent the CFC engages in related-party transactions, there is an incentive at the margin to shift income to the lower-taxed entity. Because U.S. transfer pricing regulations acknowledge that a range of prices may be considered to be arm's length, see Treas. Reg. § 1.482-1(e), it is possible for such income shifting to occur without running afoul of the section 482 transfer pricing rules. Moreover, to the extent U.S. income that otherwise would be subject to current U.S. taxation is shifted to a CFC and is eligible for deferral, U.S. revenue loss will result.

59. See CHARLES I. KINGSON, *INTERNATIONAL TAXATION* 451-52 (1998); Reuven S. Avi-Yonah, *More on U.S. Notice 98-11 and the Logic of Subpart F*, 16 *TAX NOTES INT'L* 1943 (1998). Under capital export neutrality, a U.S. person should pay the same total (U.S. and foreign) tax on all income, regardless of whether the income is from U.S. or foreign sources; thus, capital export neutrality is aimed at reducing the influence of tax considerations on the decision whether to locate investments abroad or in the United States. See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 1, at 17; see also David P. Hariton, *Notice 98-11 Notwithstanding, What Should Be Done With Subpart F?*, 79 *TAX NOTES* 388 (1998).

60. See GUSTAFSON, PERONI & PUGH, *supra* note 1, at 335-38; KINGSON, *supra* note 59, at 452; H.R. REP. NO. 87-1447, at 57-58 (1962); see also Michael DeHoff, *Letter to the Editor*, 17 *TAX NOTES INT'L* 1318, 1321 (1998); Kenneth J. Kies, *Letter to the Editor*, 81 *TAX NOTES* 138 (1998); *Interview with Daniel M. Berman*, 76 *TAX NOTES* 1387, 1390 (1997). Under capital import neutrality, all firms operating in the same industry in a particular foreign country are taxed at the same level, regardless of whether those firms are owned by U.S. or foreign persons; thus, capital import neutrality is focused on the effect of U.S. tax rules on the competitiveness of U.S. persons (including U.S. multinational corpo-

quired to counterbalance elements of the Internal Revenue Code that discriminate against the foreign source income of U.S. taxpayers (e.g., foreign tax credit limitation, interest allocation rules)⁶¹ or as compelled by the principle of free trade.⁶²

Although this conflict of views seems unresolvable, the dramatic favoritism of foreign income over domestic income that results from the deferral privilege would seem to leave the defenders of deferral with the burden of empirically demonstrating that the privilege does no more than offset the tax burdens on foreign business operations listed immediately above. A mere recitation of those burdens should not be sufficient. Moreover, deferral advocates must recognize that they can hold to their position only if they ignore, or discount, certain anomalies in the U.S. deferral system that cause its benefits to be only loosely coordinated with the justifications advanced in favor of deferral and with other important policy considerations. To be specific:

1. Because the benefit of deferral increases to the degree that repatriation of CFC income is delayed, U.S. taxpayers that can afford to postpone repatriation are favored over those that cannot. None of the preceding pro-deferral rationales support this result.
2. Retention and reinvestment of earnings by the CFC are encouraged even though the CFC's U.S. shareholders might be able to invest its earnings in the United States at higher before-tax rates of return than are obtainable by the CFC.
3. Deferral is fully available without regard to whether the U.S. taxpayer has little competition in the foreign country (for example, a pharmaceutical company selling patent-protected drugs) or faces fierce competition.
4. Deferral is fully available even if the U.S. taxpayer's principal competitor in a particular foreign country is another U.S. taxpayer. The struggle in foreign markets between U.S. software manufacturers is an example of this case.
5. Deferral is fully available regardless of the degree to which the CFC's United States shareholders are, or are not, adversely affected by the foreign tax credit limitation, the interest allocation rules, and other elements of the U.S. tax system that proponents of deferral believe discriminate against foreign source income.
6. The availability of, and degree of benefit from, deferral is unrelated to whether the United States has a foreign policy or economic assist-

rations) operating in foreign markets. See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 1, at 17; see also Hariton, *supra* note 59.

61. See Treas. Reg. §§ 1.861-8, -10, -17; Temp. Treas. Reg. §§ 1.861-9T, -10T, -11T, -12T, -14T; see Cooper, Melcher & Stretch, *supra* note 31, at 886, 891; see also U.S. Treasury Dep't, Interim Rep., *supra* note 51, at 30-31; GARY CLYDE HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME 104, 134-36 (1992).

62. See, e.g., J.D. Foster, *On 'Logic' and Subpart F: Responses to Avi-Yonah and Hariton*, 80 TAX NOTES 259 (1998).

ance objective that is furthered by having the U.S. taxpayer operate in a particular country.

In short, making the case for the deferral privilege is not an easy task and it is not surprising that some regard the effort as unsuccessful. This skepticism has played a major role in the gradual legislative imposition of limitations on deferral.

III. LEGISLATIVE EVOLUTION OF ANTI-DEFERRAL PROVISIONS⁶³

A. ORIGINS OF THE DEFERRAL PRIVILEGE

The deferral privilege has been a part of our income tax system since its inception. Starting with the enactment of a corporate excise tax based on income in the Revenue Act of 1909, the United States has imposed tax on the worldwide income from all sources of a domestic corporation.⁶⁴ Foreign income of a non-U.S. corporation not connected with a U.S. business, however, has never been subject to U.S. entity-level taxation. Thus, U.S. persons conducting business or holding investments through a foreign corporation have been able to defer U.S. income tax on the corporation's earnings until they are distributed or the U.S. person sells his, her or its stock in the foreign corporation, absent statutory limitations on the deferral privilege.

B. EARLY ANTI-DEFERRAL MEASURES

1. Sections 367(a) and 482

The earliest anti-deferral measures were not provisions relating to the taxation of income earned by a foreign corporation, but were provisions intended to assure that income realized economically within the U.S. taxing jurisdiction would not escape U.S. taxation. These provisions were the predecessors to sections 367 and 482. The development of these rules, as well as the more traditional anti-deferral regimes discussed below, illustrates the difficulty of managing the deferral privilege in a coherent manner.

Section 367. In 1932, the predecessor to section 367(a) was enacted to prevent appreciated property from being transferred tax-free from the

63. For an overview of the historical development of the U.S. taxation of foreign business operations of U.S. multinationals (written from a pro-business perspective), see William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed*, 43 TAX NOTES 1379 (1989). Abbreviated discussions of the historical background of the anti-deferral rules may be found in AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION (PROPOSALS OF THE AMERICAN LAW INSTITUTE ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF THE FOREIGN INCOME OF UNITED STATES PERSONS) 171-77 (1978) [hereinafter ALI PROPOSALS] and in GUSTAFSON, PERONI & PUGH, *supra* note 1, at 335-40.

64. See Revenue Act of 1909, Pub. L. No. 61-5, § 38, 36 Stat. 11, 112-13 (1909). This pattern continued with adoption of the income tax in 1913. See Income Tax Act of 1913, Pub. L. No. 63-16, § II(G)(a), 38 Stat. 114, 172 (1913).

U.S. taxing jurisdiction.⁶⁵ Section 367(a) has become the principal guardian of the United States' taxing jurisdiction with respect to untaxed appreciation of tangible assets transferred by a U.S. person to a foreign corporation in connection with enumerated tax-free exchanges.

In the predecessor version of section 367, section 112(k) of the Revenue Act of 1932⁶⁶ provided that certain otherwise tax-free transfers of stock or securities involving foreign corporations were nonrecognition transactions only if the taxpayer established before the exchange or distribution occurred that the transaction was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes. A taxpayer established that the principal purpose of a transaction was not to avoid federal income taxes by obtaining a ruling from the IRS. The targeted abuse was a tax-free transfer of stock by a U.S. person to a Canadian corporation followed by a sale of the stock by the Canadian corporation that was not taxable in Canada. The Canadian corporation liquidated and repatriated the proceeds to the U.S. person without further tax.⁶⁷

In 1968, the Service issued guidelines, modified by subsequent revenue rulings and procedures, for when favorable private rulings ordinarily would be issued.⁶⁸ As a condition to obtaining a favorable ruling, the 1968 guidelines required the taxpayer to agree to include certain items in income (a "toll charge"). The toll charge generally reflected untaxed accumulated earnings and profits in the case of inbound transfers and the immediate potential earnings from liquid assets or the untaxed appreciation in passive investment assets and inventory in the case of outbound transfers.⁶⁹ The 1968 guidelines represented the first comprehensive statement of the policies that the IRS would apply in granting section 367 rulings.⁷⁰

65. See Revenue Act of 1932, Pub. L. No. 72-154, § 112(k), 47 Stat. 169, 198 (1932). For a review of current Section 367(a) and the policies underlying the rules, see Philip Tretiak, *Section 367(a) Transfers in 1998: All You Need To Know!*, 80 TAX NOTES 239 (1998).

66. Pub. L. No. 72-154, 47 Stat. 169 (1932).

67. In the accompanying committee reports, Congress expressed concern that taxpayers would transfer appreciated stock or securities to foreign corporations that would sell them and repatriate the proceeds without U.S. tax on any of the transactions. See H.R. REP. NO. 72-708, at 20 (1932); S. REP. NO. 72-665, at 26 (1932).

68. See Rev. Proc. 68-23, 1968-1 C.B. 821.

69. See *id.*

70. See James B. Sitrick, *Section 367 and Tax Avoidance: An Analysis of the Section 367 Guidelines*, 25 TAX L. REV. 429 (1970). The substance of the statutory language that became section 367 in the 1954 Code remained essentially unchanged until it was amended in 1971 to provide that the requisite ruling could be obtained after the exchange in the case of mere changes in the form of organization of a lower-tier foreign subsidiary. See Pub. L. No. 91-681, 84 Stat. 2065 (1971). In addition, contributions to capital by controlling shareholders and section 355 distributions were specified as transactions to which section 367 applied. See *id.* Contributions by noncontrolling shareholders were made subject to the Section 1491 excise tax. See *id.* The constructive exchange rule of section 367(c)(2) with respect to capital contributions was enacted in response to the decision in *Abegg Cresta Corp. v. Commissioner*, 50 T.C. 145 (1968), *aff'd on other grounds*, 429 F.2d 1209 (2d Cir. 1970), *cert. denied* 400 U.S. 1008 (1971). In *Abegg*, the Tax Court had held that section 367

The Tax Reform Act of 1976⁷¹ amended section 367 in significant procedural respects. In the case of outbound transactions, revised section 367(a) allowed taxpayers to file a ruling request up to 183 days after the transfer and expedited Tax Court review was provided in the event of an adverse determination. Section 367(b) provided that no ruling was required with respect to inbound and foreign-to-foreign transactions and tax-free treatment applied except as to transactions the IRS identified in regulations. Pursuant to this statutory authority, in 1977 the IRS issued temporary regulations that imposed a notification requirement and required taxpayers to include in income appropriate amounts (a "toll charge") to reflect realized gain with respect to certain transactions.⁷² Section 367 was significantly amended again in 1984, when the ruling requirement (a ruling that the "principal purpose" of a section 367(a) outbound transfer was not the avoidance of federal income tax) was replaced with objective standards derived from prior administrative ruling positions and the requirement of a ruling was eliminated.

As amended in 1984, the general rule of section 367(a) is that, for purposes of determining gain on the transfer of property, the foreign corporation will not be considered a corporation and the nonrecognition rules in question will not apply. This general rule is subject to statutory and regulatory exceptions. Except as provided in regulations, the general recognition rule of section 367(a)(1) does not apply to a transfer of stock or securities in a foreign corporation that is a party to the exchange or reorganization.⁷³ In addition, certain "outbound" (i.e., from a U.S. person to a foreign corporation) transfers of tangible assets used in the active conduct of a trade or business outside the United States and certain transfers of stock and securities are excepted from the general recognition rule.⁷⁴ Various categories of tainted assets, including intangible property, are not eligible for the "active trade or business" exception.⁷⁵ Section 367(d) provides special rules for outbound transfers of intangible property, which generally treat the property as sold for royalty payments contingent on the productivity, use or disposition of the intangible over its expected life.⁷⁶ Section 6038B requires that the IRS be notified of transfers

was not applicable to a transfer of securities by a nonresident alien to his wholly owned foreign corporation where stock in the transferee foreign corporation was not received in exchange. *Abegg* subsequently was overruled to the extent it held that section 351 would not apply to a transfer to a wholly owned corporation in the absence of issuance of additional stock. See *Lessinger v. Commissioner*, 85 T.C. 824, 835-36 (1985), *rev'd on other grounds*, 872 F.2d 519 (2d Cir. 1989).

71. See Pub. L. No. 94-455, § 1042, 90 Stat. 1520, 1634-35 (1976).

72. Temp. Treas. Reg. §§ 7.367(b)-1 through -13 (1977). The temporary regulations would be amended by Prop. Treas. Reg. §§ 7.367(b)-1 through -6.

73. See I.R.C. § 367(a)(2).

74. See *id.* at 367(a)(3).

75. In addition, in 1988, section 367(a)(5) was added to limit tax-free transfers of assets in outbound asset reorganizations. See Pub. L. No. 100-647, § 1006(e)(13)(A), 102 Stat. 3342, 3402 (1988).

76. As enacted in 1984, the deemed royalty under section 367(d) was U.S. source, substantially increasing the risk of double taxation. See Pub. L. No. 98-369, § 131(b), 98 Stat. 494, 663-64 (1984). The U.S. source rule was deleted in 1997. Pub. L. No. 105-34,

to foreign persons, and provides penalties for failing to comply.

Searching for coherence in Section 367. The section 367 “outbound” transfer rules differ according to whether intangible property, stock or securities or tangible personal property is being transferred to a foreign corporation. Transfers of tangible property for use in a trade or business outside the United States are the most favored, since they may be transferred in a tax-free transaction without the requirement of a gain recognition agreement. Transfers of intangible property to a foreign corporation for stock, with few exceptions, are taxable. Transfers of stock or securities are subject to rules that generally permit tax-free transfers provided that the transferring U.S. shareholder is a sufficiently small shareholder of the transferee foreign corporation or the shareholder enters into an agreement to recognize gain as of the time of the initial transfer if the transferee foreign corporation sells the transferred stock within a five-year period.⁷⁷ Transfers of stock in a domestic corporation generally are taxable if U.S. transferors own more than 50% of the transferee foreign corporation after the transaction. This latter rule was adopted to prevent U.S. parent corporations from expatriating to escape Subpart F.⁷⁸

The section 367 rules have been placed under stress by the adoption of the “check-the-box” entity classification regulations. For example, the tax-free transfer of stock in a foreign corporation in exchange for five percent or more of the stock in another foreign corporation generally requires a five-year gain recognition agreement.⁷⁹ If all of the stock in the foreign corporation is transferred, however, and the transferred for-

§ 1131(b)(4), 111 Stat. 788, 979 (1997). Before 1985, the IRS allowed intangible property to be transferred without a toll charge to a foreign corporation for foreign manufacturing or consumption. *See, e.g.*, Priv. Ltr. Rul. 84-04-026 (Oct. 21, 1983); Priv. Ltr. Rul. 84-05-004 (Sept. 29, 1983); Priv. Ltr. Rul. 84-05-113 (Nov. 4, 1983); *see also* Dittler Bros., Inc. v. Commissioner, 72 T.C. 896 (1979), *aff'd per curiam*, 642 F.2d 1211 (5th Cir. 1981).

77. The policies behind the stock transfer rules often are unclear. For example, why should a gain recognition agreement entered into by a five percent shareholder be triggered by a sale of transferred stock by a transferee foreign corporation if that shareholder would be taxed currently on the gain realized by the transferee foreign corporation under any of the Subpart F, foreign personal holding company or PFIC rules? The only potential reason to cause the gain on the initial transfer to be recognized would be to preserve U.S. source characterization of the unrecognized gain as of the time of the initial transfer to the transferee foreign corporation. The gain recognition agreement could provide that it would not be triggered if gain on the sale is taken into account under one of the anti-deferral regimes and the gain is treated as U.S. source up to the amount of unrecognized gain as of the date of the initial transfer.

78. The adoption of the section 956A excess passive asset rules in the 1993 Act caused many U.S. multinationals to consider changing the domicile of the parent company to a non-U.S. location. The most highly publicized of such transactions in this period was undertaken by the Helen of Troy Company, which merged with a subsidiary of a newly formed Bermuda company and transferred its non-U.S. subsidiaries to the new Bermuda parent. This provoked the IRS to issue I.R.S. Notice 94-46, 1994-1 C.B. 356, which proscribes tax-free treatment of an outbound transfer of stock in a domestic corporation in exchange for stock in a foreign corporation if U.S. transferors receive more than 50% of the voting power or value of the foreign transferee corporation in the exchange or if certain other conditions are not satisfied. Final regulations implementing and refining Notice 94-46 are at Treas. Reg. § 1.367(a)-3(c).

79. *See* Treas. Reg. § 1.367(a)-3(b).

foreign corporation changes its classification from an association to a pass-through entity (i.e., a disregarded entity), the transfer would be treated as a foreign-to-foreign transfer of assets and no gain recognition agreement would be required.⁸⁰ In this “check-the-box” case a subsequent sale of the transferred “stock” would be treated for U.S. income tax purposes as a sale of assets and might not be taxable by either the foreign country (e.g., if it had a “participation exemption” for gains from the sale of stock) or the United States (so long as the assets were used in the business and did not give rise to passive income). Ironically, this is a case where the outbound stock transfer (recast as an asset transfer) should be subject to a gain recognition requirement.⁸¹

The section 367 rules are an important part of the U.S. tax structure made necessary by the deferral subsidy. The evolution of these rules reflects an effort to balance preservation of the U.S. tax base and nonrecognition for legitimate business reorganizations. In the absence of a guiding tax policy principle on which to base a stable compromise, however, the Congress and the Treasury have tinkered continuously with the rules' structure.

Section 482. A significant impetus for adoption of the Subpart F regime in 1962 was the perception that U.S. companies were engaging in transfer pricing manipulations to earn profits in tax havens. Although it serves a broader purpose as well, Subpart F acts as a “backstop” to the section 482 transfer pricing rules.⁸²

In 1962, the House of Representatives passed an amendment to section 482 that would have provided for formula apportionment of income from the sale of tangible property, unless the taxpayer demonstrated that it used an “arm’s length price” or an alternative method that clearly reflected income.⁸³ The Conference Committee struck the provision but instructed the Treasury to consider section 482 and “explore the possibility of developing and promulgating regulations under this authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.”⁸⁴ This led to the issuance of proposed regulations under section 482 in 1965⁸⁵ and

80. See Rev. Rul. 67-274, 1967-2 C.B. 141; Treas. Reg. § 1.367(a)-3(a).

81. The example in the text also illustrates how U.S. tax rules, particularly as they relate to deferral of U.S. tax on income or gain earned by a foreign corporation, and foreign rules for taxing the same income or gain, increasingly may be “arbitraged.” See Rosenbloom, *supra* note 5; I.R.S. Notice 98-11, 1998-6 I.R.B. 18; *infra* text accompanying notes 161-170; see also I.R.S. Notice 98-5, 1998-3 I.R.B. 49. With respect to U.S. tax rules, the success of the arbitrage depends on the many exceptions to current taxation under the U.S. anti-deferral regimes. One response to tax “arbitrage” is to adopt a comprehensive income tax base. Minimizing the scope of tax deferral on income earned by a foreign corporation would be a significant step in this direction.

82. See Treas. Reg. § 1.482(e).

83. H.R. 10650, 87th Cong. § 6, reprinted in House Comm. on Ways and Means, 87th Cong., Legislative History of the Revenue Act of 1962 (Comm. Print 1967).

84. H.R. REP. NO. 87-2508, at 18-19 (1962).

85. See 30 Fed. Reg. 4256 (1965).

1966,⁸⁶ and the promulgation of final regulations in 1968.⁸⁷

In the 1960s, the focus of transfer pricing was on transfers of tangible property and services. In the early 1980s, however, the IRS addressed the efforts of U.S. pharmaceutical and electronics companies to take advantage of the section 936 tax subsidy for business profits earned in Puerto Rico to shift substantial amounts of income from intangibles, including patented drugs and high technology machines and manufacturing processes, to their section 936 subsidiaries operating in Puerto Rico.⁸⁸ In addition, similar strategies were used to maximize the benefits from deferral for income earned in low-tax manufacturing locations such as Ireland and Singapore.⁸⁹ In response, section 482 was amended in 1986 to require that income with respect to a transfer or license of intangible property be "commensurate with the income attributable to the intangible."⁹⁰ A corresponding amendment was made to section 367(d). Final regulations implementing these statutory changes were adopted in 1994. Although the U.S. transfer pricing rules have been materially strengthened (and bolstered by the section 6662 penalties for substantial valuation misstatements), the 1994 section 482 regulations acknowledge that there may be a range of arm's length transfer prices.⁹¹ In many cases the range may be material. Accordingly, even the improved U.S. transfer pricing regime leaves substantial scope for taking advantage of the deferral privilege.

2. Foreign Personal Holding Companies

In 1937, the use by U.S. individual taxpayers of foreign corporations to hold investments and thereby serve as "foreign incorporated pocket-books" triggered adoption of the foreign personal holding company (FPHC) rules.⁹² The FPHC anti-deferral regime requires a U.S. person

86. See 31 Fed. Reg. 10,394 (1966).

87. See 33 Fed. Reg. 5848 (1968).

88. See, e.g., *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), *aff'd in part, rev'd in part*, 856 F.2d. 855 (7th Cir. 1988); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987).

89. See, e.g., *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991); *Sundstrand Corp. v. Commissioner*, 96 T.C. 226 (1991).

90. Section 482 now reads as follows:

SECTION 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

I.R.C. § 482.

91. See *Treas. Reg. § 1.482-1(e)*.

92. See *Revenue Act of 1937*, Pub. L. No. 75-377, § 201, 50 Stat. 813, 818-24 (1937); *H.R. REP. NO. 75-1546*, at 15-16 (1937).

holding stock in the FPHC to include in income his, her or its share of essentially all of the FPHC's undistributed income for the year if there is concentrated ownership of the foreign corporation by five or fewer U.S. individuals and the foreign corporation earns threshold amounts of certain passive, personal services or rental income.⁹³

C. ADOPTION OF SUBPART F AND SUBSEQUENT AMENDMENTS

1. Background

In 1961, the Kennedy Administration recommended that the "tax deferral privilege" be ended for U.S. corporations and individuals "on their current share of the undistributed profits realized in that year by subsidiary [or closely held] corporations organized in economically advanced countries."⁹⁴ In essence, the original proposal outlined by the Kennedy Administration's submission to Congress would have included all of the income of foreign corporations operating in developed countries in the income of their U.S. shareholders.

The Kennedy Administration message indicated that it viewed deferral as a subsidy:

In some cases, this tax deferral has made possible indefinite postponement of the U.S. tax; and, in those countries where income taxes are lower than in the United States, the ability to defer the payment of U.S. tax by retaining income in the subsidiary companies provides a tax advantage for companies operating through overseas subsidiaries that is not available to companies operating solely in the United States.

To the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would otherwise be invested in the United States. Certainly since the post-war reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries.⁹⁵

93. Foreign personal holding income is defined in section 553. As mentioned in Part II of this Article, a foreign corporation is classified as a FPHC if in any tax year five or fewer persons who are U.S. citizens or residents own (directly or constructively through certain attribution rules) more than 50% of the corporation's stock (a "U.S. group") and more than 60% of the gross income of the corporation consists of passive income for purposes of the FPHC rules. If a foreign corporation is an FPHC, each U.S. shareholder (including a U.S. corporation or other entity) who holds stock on the last day of the tax year of the FPHC, or, if earlier, the last day of its tax year on which a U.S. group exists with respect to the FPHC, is required to include in gross income as a dividend such shareholder's pro rata portion of the undistributed income of the FPHC (whether or not the income is passive), even if no cash dividend is actually paid.

94. Message from the President of the United States Relative to Our Federal Tax System, April 20, 1961, *reprinted as* H.R. Doc. No. 87-140, at 6-7 (1961).

95. *Id.*

The Administration proposal met with extraordinary opposition from the U.S. business and legal community. The counsel for the Joint Committee on Internal Revenue Taxation testified that the Congress could not constitutionally tax shareholders on the undistributed income of foreign corporations, except in cases where such taxation was reasonably necessary to prevent evasion or avoidance of tax.⁹⁶ Congress declined to adopt legislation that would end deferral altogether.

In cutting back the scope of the President's original proposal, the Congress attempted to reach devices "designed to avoid either U.S. tax or tax imposed by the foreign country."⁹⁷ The House Committee on Ways and Means stated:

Your Committee's bill does not go as far as the President's recommendations. It does not eliminate tax deferral in the case of operating businesses owned by Americans which are located in the economically developed countries of the world. Testimony in hearings before your committee suggested that the location of investments in these countries is an important factor in stimulating American exports to the same areas. Moreover, it appeared that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax.⁹⁸

The Congress, then, chose to continue the deferral subsidy in the expectation that it would foster exports and preserve the competitiveness of American-owned businesses. The debate over deferral has continued in much the same vein over the succeeding 38 years.⁹⁹

96. See *Hearings before Committee on Ways and Means, on The Tax Recommendations of the President*, vol. 1, 311-313 (1961). The taxation of income under Subpart F has been held to be constitutional. *Garlock, Inc. v. Commissioner*, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974); *L.E. Whitlock Est. v. Commissioner*, 494 F.2d 1297 (10th Cir.), *cert. denied*, 419 U.S. 839 (1974).

97. H.R. REP. NO. 87-1447, at 58 (1962).

98. H.R. REP. NO. 87-1447, at 62 (1962). Although the Conference Committee adopted the Senate bill with modifications, the Senate bill followed the House bill with modifications.

99. As discussed later in this Article, in I.R.S. Notice 98-11, 1998-6 I.R.B. 18, the IRS appeared to argue for a view that Congress intended to curb all deferral except what was permitted under the Subpart F rules:

Subpart F was enacted by Congress to limit the deferral of U.S. taxation of certain income earned outside the United States by CFCs, which are foreign corporations controlled by United States shareholders. Limited deferral was retained after the enactment of subpart F to protect the competitiveness of CFCs doing business overseas. This limited deferral allows a CFC engaged in an active business, and located in a foreign country for appropriate economic reasons, to compete in a similar tax environment with non-U.S. owned corporations located in the same country.

Although the debate quickly becomes semantic, it is difficult to read the 1962 legislative history and conclude that Congress thought the general rule should be to tax income of a CFC currently and the exception was to allow deferral to continue. See N.Y. St. B. Ass'n Tax Sec., *supra* note 29, at 882.

2. *The Original Scope of Subpart F and Related Provisions*

a. Overview

The Subpart F regime enacted in 1962 is structurally the same as it is in the law today, except that the statute included substantially broader exemptions and relief provisions that have been eliminated by subsequent legislation. Consequently, the reach of today's Subpart F anti-deferral provisions is greater than as originally enacted. For purposes of exposition, the following discussion focuses on four structural features of the U.S. Subpart F regime: the definition of a controlled foreign corporation (CFC), the scope of income included currently, the shareholders who must include the income and the nature of the taxing mechanism.

Definition of a CFC. The definition of a CFC relies on the presence of one or more 10% or greater U.S. shareholders. In other words, there must be a relatively small control group. This feature of the U.S. rules is significant in that Subpart F effectively does not reach foreign corporations whose shares are listed on U.S. stock exchanges so long as there is not a control group comprised of 10% U.S. shareholders. Accordingly, a number of multinationals that formerly had U.S. parent companies have opportunistically adopted non-U.S. parent structures at least in part to escape the reach of Subpart F over their foreign operations.¹⁰⁰

Transactional approach to current taxation. Only certain income of the CFC is taxed currently to its U.S. shareholders. This so-called transactional approach may be contrasted with the entity approach of the FPHC rules described above, the PFIC rules described below and certain controlled foreign company regimes in other countries whereby all of the income of the foreign corporation is taxed to the shareholders resident in the relevant country. The transactional approach requires a separate accounting for Subpart F income and adds enormous complexity to a CFC regime. The scope of Subpart F income and the investment in U.S. property rules are discussed below.

Definition of shareholders that must include income currently. Only 10% or greater U.S. shareholders are taxed currently on their share of Subpart F income or increased investment in U.S. property. This restriction on the affected taxpayers essentially excludes portfolio investments, other than through an FPHC or, as discussed below, a foreign investment company or a passive foreign investment company, from the scope of the anti-deferral rules. However, the transactional approach to defining the income subject to current taxation, described above, requires that the affected shareholders have access to rather detailed financial information regarding the foreign corporation. Shareholders with interests below a certain shareholding threshold (Congress identified 10% as the appropriate level) would often be unable to obtain this information from the corporation and would be unable to compute their includible amounts.

100. See, e.g., ADT Ltd., Form S-4 (Apr. 2, 1997) (Bermuda corporation publicly traded on New York Stock Exchange acquires Tyco International Ltd. in taxable transaction).

Thus, an administrable CFC regime is compelled to excuse small shareholders.¹⁰¹

Method for including income. Finally, the method of Subpart F income inclusion is consistent with recognition of the foreign corporation as an entity for tax purposes. Although the income inclusion generally has characteristics of a dividend, in that the amount of the inclusion is limited to current earnings and profits, the statute does not use the term dividend.¹⁰² In very limited respects, Subpart F also has attributes of branch taxation in that the character of income carries through to a United States shareholder for personal holding company purposes.¹⁰³ There is no suggestion, however, that character flows through more generally. Most significantly, a CFC's losses do not carry through to a United States shareholder. Thus, Subpart F properly is viewed as adopting a shareholder rather than branch or pass-through model of taxation.

The following discussion describes the relevant Subpart F rules as initially enacted in greater detail in order to be able to delineate the scope of the changes in subsequent legislation.

b. The Subpart F Taxing Mechanism and the Base Company Income Rules

Definition of a CFC. Subpart F causes a United States shareholder in a CFC to include in income currently the shareholder's pro rata share of Subpart F income and increased investment in U.S. property. A CFC is any foreign corporation if, on any day of its tax year, more than 50% of (i) the total combined voting power of all classes of stock entitled to vote, or (ii) the total value of the stock in the corporation, is owned directly, indirectly or by attribution,¹⁰⁴ by United States shareholders.¹⁰⁵ A "United States shareholder" is defined to mean a United States person¹⁰⁶ that owns, directly, indirectly or by attribution, 10% or more of the total

101. The House Ways and Means Committee Report states that the 10% ownership "*de minimis* rule" prevents attribution of undistributed income to shareholders where their "interest is small and their influence on the corporation's policy is presumably negligible." H.R. REP. NO. 87-1447, at 59 (1962).

102. See I.R.C. § 952(c). By contrast to the designation of an FPHC inclusion and section 1248 gain as a "dividend" in sections 551(b) and 1248(a), respectively, section 951 simply provides that amounts are included in gross income. See I.R.C. § 951(a).

103. See Treas. Reg. § 1.951-1(a) (flush language). The Small Business Job Protection Act of 1996 amended Section 512(b) to apply a look-through rule to characterize certain Subpart F insurance income as unrelated business taxable income. See Pub. L. No. 104-188, § 1603, 110 Stat. 1755, 1835 (1996). The House Committee Report disavowed the position of one IRS private letter ruling that character flowed through a Subpart F income inclusion for unrelated business taxable income purposes. See H.R. REP. NO. 104-586, at 136 n.14 (1996).

104. The relevant indirect ownership and attribution rules are found in section 958(a) and 958(b), respectively. See I.R.C. § 958(a)-(b).

105. See I.R.C. § 957(a). The ownership test is dropped to 25% for purposes of taking into account Subpart F insurance income under section 953(a). See I.R.C. § 957(b).

106. "United States person" is defined in section 957(c) by cross-reference to section 7701(a)(30), with modifications that relate to corporations organized in certain U.S. possessions.

combined voting power of all classes of stock entitled to vote in a foreign corporation.¹⁰⁷

Subpart F income. The central elements of Subpart F income continue to be (i) foreign base company income,¹⁰⁸ and (ii) income from the insurance of U.S. risks.¹⁰⁹ Foreign base company income initially included, foreign personal holding company income and foreign base company sales and services income. Foreign personal holding company income includes most categories of what might be thought of as “passive” or investment income (unless the income is subject to a high foreign tax or certain other exceptions). Although “active” sales or services income generated in the CFC’s country of organization is not covered in Subpart F, “base company” sales and services income is subject to current inclusion (unless the income is subject to an exception).

“Foreign base company sales income” is defined to mean income, including gross profit from sales or commissions, derived from the purchase and sale of personal property, if the property is either purchased from or sold to a related person, the property is manufactured, produced, grown, or extracted *outside* the country in which the CFC is organized,¹¹⁰ and the property is sold for use, consumption, or disposition *outside* that country.¹¹¹ Foreign base company services income is income derived from the performance of services by the CFC for, or on behalf of, a related person outside the country of incorporation of the CFC.¹¹² Income derived in connection with services that are directly related to the sale of property by the CFC or its principal are excluded. The definition of “related person” includes individuals and entities that control or are controlled by the CFC (or are entities controlled by persons that control the CFC).¹¹³

Limitations on Subpart F income. As originally enacted, Subpart F had at least four provisions that excepted significant categories of income from the reach of the current inclusion rule. First, (i) certain active rents

107. See I.R.C. § 951(b). A United States person who owns less than 10% of the total combined voting power of all classes of stock of the CFC entitled to vote, directly or indirectly, or by attribution, is not taxed on the undistributed income of the CFC.

108. See I.R.C. § 952(a)(2).

109. The definition of insurance income was substantially broadened in 1986 and is no longer limited to the insurance of U.S. risks. See Pub. L. No. 99-514, § 1221(b)(1), 100 Stat. 2085, 2551 (1986). Because of the single-industry focus of the Subpart F insurance income rules, as well as their general difficulty and complexity, this Article does not discuss them in any detail. For a useful review of the rules’ policy and history, see Mary Gillmarten, *Active Financing Income—Back to the Future*, 27 TAX MGMT. INT’L J. 491 (1998).

110. See I.R.C. § 954(d)(1)(A). Property manufactured *by the CFC* is not included in foreign base company sales income.

111. See I.R.C. § 954(d)(1)(B).

112. See I.R.C. § 954(e); Treas. Reg. § 1.954-4.

113. “Control of a corporation” means ownership, directly or indirectly, of stock possessing more than 50% of either (i) the total voting power of all the stock entitled to vote, or (ii) the total value of all the stock of a corporation. To determine stock ownership, both the foreign entity look-through rules of section 958(a) and the constructive ownership rules of section 958(b) apply. In the case of a partnership, trust, or estate, “control” means that the CFC owns, directly or indirectly, more than 50% (by value) of the beneficial interests in the partnership, trust, or estate. I.R.C. § 954(d)(3).

and royalties from unrelated persons, (ii) certain dividends, interest, and gains derived from financing or insurance businesses, (iii) certain same country dividends, interest, rents, and royalties from related persons, and (iv) interest received by a bank from another bank, were excluded from the definition of foreign personal holding company income.¹¹⁴ Second, if less than 30% of a CFC's gross income would be treated as foreign base company income, then none of the CFC's income would be foreign base company income.¹¹⁵ Third, foreign base company income did not include an item of income if it was established to the satisfaction of the Treasury that the creation or organization of the CFC under the laws of the country where it was incorporated did not have the effect of a substantial reduction of income or similar taxes with respect to that income.¹¹⁶ Fourth, if certain minimum distributions were made to U.S. shareholders of the CFC, then a domestic corporate shareholder could elect to exclude from income its share of the CFC's Subpart F income.¹¹⁷

c. Related Anti-Deferral Provisions

Increased investment in U.S. property. The 1962 Revenue Act also adopted a "backstop" rule that would prevent a CFC from making certain investments in U.S. property that Congress believed could be equivalent to a dividend being paid to the CFC's shareholders.¹¹⁸ Generally, a United States shareholder is taxed on previously untaxed earnings of the CFC to the extent that the CFC increased its investments in U.S. property such as stock or debt of a related U.S. person or tangible property located in the United States. Exceptions from the definition of U.S. property were designed to allow normal commercial transactions with U.S. persons.

Ordinary income characterization of gain on the sale of CFC stock to the extent of untaxed earnings. In order to achieve "full U.S. taxation" of a CFC's earnings, a United States shareholder's gain on the sale of stock in a CFC is characterized as dividend income to the extent of the shareholder's share of untaxed post-1962 earnings accumulated during the shareholder's holding period. In Congress' view, these amounts should be taxed in effect as dividends.¹¹⁹

114. See I.R.C. §§ 954(c)(3), (c)(4) (1962). Among other effects of this exclusion was to permit foreign banks and securities firms that were CFCs to operate substantially free of the reach of Subpart F.

115. See I.R.C. § 954(b)(3)(A) (1962). As is the case today, if more than 70% of a CFC's gross income would be treated as foreign base company income, then all of the CFC's income would be foreign base company income. See I.R.C. § 954(b)(3)(B) (1962).

116. See I.R.C. § 954(b)(4) (1962).

117. See I.R.C. § 963 (1962).

118. See S. REP. NO. 87-1881, at 88 (1962). The House version of this provision also would have covered investments of earnings in "nonqualified property," including non-U.S. property not necessary for the active conduct of an active trade or business outside the United States. See H.R. REP. NO. 87-1447, at 63-65 (1962). This 1962 House bill precursor to the section 956A "excess passive asset" rule adopted in 1993 and repealed in 1996 (see *infra* text accompanying notes 151-156) was deleted by the Senate.

119. See S. Rep. No. 87-1881, at 107 (1962).

Foreign investment companies. The Congress was concerned about the deferral that an individual shareholder could achieve by investing in a foreign investment company instead of a regulated investment company that distributed 90% of its earnings for the year.¹²⁰ In order to reduce this disparity, section 1246 was adopted which caused gain on the sale of stock in a foreign investment company to be treated as ordinary income to the extent of the taxpayer's share of post-1962 earnings and profits. For this purpose, a foreign investment company generally was defined to mean a company that either was registered under the Investment Company Act of 1940 or that invested primarily in securities at a time when more than 50% of total voting power was owned, directly or indirectly, by U.S. persons.¹²¹

d. Observations

The effect of the definition of Subpart F income in 1962 was to reach not only most passive income, but also to include "active" sales and services income earned through a "base company" if a related person was involved in the transaction. The Senate Finance Committee Report observed that, as to passive income, "there is no competitive problem justifying postponement of the tax until the income is repatriated."¹²² The rationale as to base company sales and services income related to the separation of the sales or services activity to secure a lower rate of (foreign) tax. The investment in U.S. property income inclusion and section 1248 and section 1246 gain recharacterization rules provided an additional fence around deferral, but were far from comprehensive. Each of these rules later was expanded substantially.

The absence of a clear and principled anti-deferral policy, other than to strike an ad hoc balance between current income inclusion to achieve capital export tax neutrality and deferral to preserve competitiveness and capital import neutrality, is the source of much of the difficulty in applying Subpart F in new contexts and in formulating an appropriate legislative regime. The variation in Subpart F legislative developments subsequent to 1962 and, more recently, in administrative promulgations as well, highlight the absence of a controlling policy rationale.

D. ANTI-DEFERRAL LEGISLATIVE DEVELOPMENTS SINCE 1962

1. *Piecemeal Expansion of Subpart F: 1963-1984*

Although there were minor amendments to Subpart F in 1966 and 1969,¹²³ 1975 saw the first significant changes to the Subpart F regime. In

120. See S. REP. NO. 87-1881, at 101 (1962).

121. See I.R.C. § 1246(b).

122. S. REP. NO. 87-1881, at 83.

123. In 1966, section 952(b) was amended to permit Subpart F to include U.S. source income that was exempt or subject to a reduced rate of U.S. tax under an income tax treaty. See Pub. L. No. 89-809, § 104(j), 80 Stat. 1539, 1562 (1966). In 1969, section 954(b)(4) was amended to liberalize the exception for when the organization or creation of

1975, Congress repealed the minimum distribution exception to Subpart F¹²⁴ as well as the exception for Subpart F income reinvested in less-developed countries.¹²⁵ Congress also modified the Subpart F *de minimis* rule providing that a CFC would not have Subpart F income if less than 30% of the CFC's gross income was Subpart F income by reducing the threshold to 10% of the CFC's gross income.¹²⁶ A new category of Subpart F income, shipping income, was added to the foreign base company income.¹²⁷ The only modification in the 1975 legislation that reduced the scope of Subpart F was a limited exception from the foreign base company sales rules for agricultural commodities that were not produced in commercial and marketable quantities in the United States.¹²⁸ The expansion of Subpart F finally adopted was in response to, and far less expansive than, a Senate proposal to end deferral for all income of foreign subsidiaries of U.S. corporations.¹²⁹

In the Tax Reform Act of 1976 (1976 Act), Congress expanded exceptions to the definition of U.S. property in order to permit investment of CFC earnings in stock or debt of domestic corporations that were not related to the CFC and also to permit holding of properties for exploring, developing or transporting resources from or under U.S. continental shelf ocean waters.¹³⁰ In 1982, "foreign base company oil and gas related income" (FORI) was added to the definition of foreign base company income.¹³¹ Generally, under sections 954(a)(5) and 954(f), United States shareholders of a CFC are taxed on the foreign oil related income of the CFC from countries other than those in which the oil and gas is extracted or consumed. FORI includes income from processing, transportation, distribution and sales, and services. In 1984, Congress added related party factoring income to the definition of foreign personal holding company income.¹³²

2. *The Tax Reform Act of 1986: Expansion of Subpart F*

The Tax Reform Act of 1986 (1986 Act) substantially expanded the Subpart F anti-deferral regime by adding categories of Subpart F income and narrowing exceptions. Taking account of the expanded role of inter-

the CFC did not have the effect of a substantial reduction of income, war profits or other taxes to provide the exception if (i) the organization or creation of the CFC, or (ii) the effecting of a transaction through the CFC, did not have as one of its significant purposes a substantial reduction of income, war profits or other taxes. See Pub. L. No. 91-172, § 909(a), 83 Stat. 487, 718 (1969).

124. See Pub. L. No. 94-12, § 602(a), 89 Stat. 26, 58 (1975).

125. See Pub. L. No. 94-12, § 602(c), 89 Stat. 26, 58-60 (1975).

126. See Pub. L. No. 94-12, § 602(e), 89 Stat. 26, 64 (1975).

127. See Pub. L. No. 94-12, § 602(d)(1)(A), 89 Stat. 26, 60-61 (1975).

128. See Pub. L. No. 94-12, § 602(b), 89 Stat. 26, 58 (1975).

129. The amendment to the Senate bill to end deferral was added in a 73 to 24 floor vote. See 121 CONG. REC. 7498-7500 (1975).

130. See Pub. L. No. 94-455, § 1021(a), 90 Stat. 1520, 1618-19 (1976).

131. See Pub. L. No. 97-248, § 212(a), 96 Stat. 324, 451 (1982).

132. See Pub. L. No. 98-369, § 123(a), 98 Stat. 494, 644-46 (codified as amended at I.R.C. § 864(d) (1984)).

national portfolio investment, the 1986 Act also added the passive foreign investment company anti-deferral regime.

Foreign personal holding company income. The definition of Subpart F foreign personal holding company income was amended to include (i) gains from sales of non-inventory property that is held for the production of passive income or that does not give rise to income, (ii) gains from commodities transactions (other than in the course of acting as a dealer), (iii) net foreign currency gains attributable to section 988 transactions (unless directly related to the business needs of the CFC), and (iv) income equivalent to interest, including commitment fees for loans actually made.¹³³ The "same country" exception for dividends and interest received from a related corporation organized in the same country was narrowed by requiring that the payor of dividends or interest have a substantial part of its assets used in its trade or business in the same foreign country and, in the case of interest, by denying the exception to the extent that the payment reduced the payor's Subpart F income.¹³⁴ Perhaps most significantly, the exception from foreign personal holding company income for interest, dividends, and gains from the sale or exchange of stock or securities derived in the conduct of a banking, finance, or other similar business, or derived from investments made by an insurance company of its ordinary and necessary unearned premiums or reserves, from unrelated persons, was repealed.¹³⁵ The repeal of the banking, financing and insurance exception essentially caused United States shareholders to be taxed currently on their share of a CFC's dividend and gain income from banking, securities or insurance businesses without regard to whether the income was directly related to their active business.¹³⁶ The Republican-controlled Senate Finance Committee articulated the following rationale for these changes:

The committee believes that deferral of U.S. tax on the income of U.S.-owned foreign corporations is generally appropriate until such income is repatriated or the stock of such foreign corporations is sold. However, the committee believes that a 10% or greater U.S. shareholder in a U.S.-controlled foreign corporation should not receive the benefits of deferral when a significant purpose of earning income through the foreign corporation is the avoidance of tax. Such a policy serves to limit the role that tax considerations play in the structuring of U.S. persons' operations and investments. Because movable income earned through a foreign corporation could often be earned through a domestic corporation instead, the committee believes that a major motivation of U.S. persons in earning certain kinds of income through foreign corporate vehicles often is the

133. See Pub. L. No. 99-514, § 1221(a), 100 Stat. 2085, 2549-51 (1986).

134. See *id.*

135. See *id.*

136. As discussed below, in the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998, Pub. L. No. 105-277, § 1005, 112 Stat 2681, 2681-890 (1998). Congress restored the exemption from Subpart F for certain active banking, financing and insurance income. See I.R.C. § 954(h) (1998).

tax benefit expected to be gained thereby. The committee believes that it is generally appropriate to impose current U.S. tax on easily movable income earned through a controlled foreign corporation, since there is likely to be limited economic reason for the U.S. person's use of [a] foreign corporation. The committee believes that by eliminating the U.S. tax benefits of such transactions, U.S. and foreign investment choices are placed on a more even footing, thus encouraging more efficient (rather than more tax-favored) uses of capital.¹³⁷

Insurance income. The definition of insurance income for purposes of Subpart F also was expanded to include *all* income attributable to the issuing of any insurance or annuity contract in respect of unrelated persons outside the insuring company's country of incorporation. This was a substantial expansion beyond the prior rule which only included income from the insurance or reinsurance of U.S. risks. The Democratic-controlled House Ways and Means Committee's rationale for the application of insurance rules to foreign as well as U.S. policies of insurance paralleled that of the Senate Finance Committee quoted above:

The committee believes that income from the insurance of risks outside the insurer's country of incorporation should be subject to current taxation regardless of whether the risks are located in the United States and regardless of whether the insured is a related person. Insurance income generally represents the type of inherently manipulable income at which Subpart F is aimed, since such income can frequently be routed through a corporation formed in any convenient jurisdiction. (Indeed, several countries promote themselves as jurisdictions for the formation of such corporations.) When a controlled foreign corporation insures risks outside of the country in which the corporation is organized, then it is appropriate to treat that income as if it has been routed through that jurisdiction primarily for tax reasons, regardless of whether the insured is a related or unrelated person. In all such cases, it is appropriate to impose current U.S. taxation under Subpart F.¹³⁸

Other foreign base company income changes. Foreign base company shipping income was expanded to include income derived from space or ocean activity.¹³⁹ The 1986 Act also reduced the *de minimis* threshold exclusion from foreign base company income and gross insurance income to the lesser of 5% of the CFC's gross income or \$1 million from 10% or less of the CFC's gross income.¹⁴⁰

The congressional rationale for the 1986 Act expansion of the Subpart F rules makes reference to neutrality, but the changes continued to be piecemeal and did not effect a capital export neutrality principle. The

137. S. REP. NO. 99-313, at 363 (1986).

138. H.R. REP. NO. 99-426, at 395 (1985).

139. See Pub. L. No. 99-514, § 1221(c)(2), 100 Stat. 2085, 2553 (1986). The 1986 Act also repealed the exemption from foreign base company shipping income for amounts reinvested in foreign base company shipping operations. See Pub. L. No. 99-514, § 1221(c)(1), 100 Stat. 2085, 2553 (1986).

140. See Pub. L. No. 99-514, § 1221(a), 100 Stat. 2085, 2549-51 (1986).

most coherent 1986 Act change to the anti-deferral rules, though flawed in important respects, was the adoption of the passive foreign investment company regime.

3. *The Tax Reform Act of 1986: Adoption of the Passive Foreign Investment Company (PFIC) Regime*

a. Overview

The enactment of the PFIC rules in the 1986 Act represented a sea change in the scope of the U.S. anti-deferral rules. The definition of a PFIC was intended to identify companies that were engaged in passive or portfolio investments, so there was little rationale to permit deferral. Targeted at investors in offshore investment funds structured to avoid existing anti-deferral rules, the PFIC regime implicitly recognized the substantially greater role of portfolio capital in U.S. international investment.¹⁴¹

For purposes of contrast with the Subpart F rules, we focus on the same four structural features of the U.S. PFIC regime discussed above in relation to Subpart F: the definition of a PFIC, the scope of income included currently, the shareholders who must include the income, and the nature of the taxing mechanism.

Definition of PFIC. Although ostensibly targeted at offshore investment funds, the PFIC rules have a far broader reach. The principal reason for the broad reach of the PFIC rules is the use of an asset test.¹⁴² The passive asset test proved extremely powerful as an indirect measure of the accumulated earnings deferred from even an *active* business.

Entity approach to taxation. Once a foreign corporation is determined to be a PFIC, the U.S. shareholder's entire share of income of the PFIC is subject to the rough economic equivalent of current taxation.

Definition of shareholders that must include income on a current basis (or its rough economic equivalent). All U.S. persons owning stock in a PFIC, regardless of how small their shareholding, are subject to the PFIC taxing rules.¹⁴³

Method for taxing income. The PFIC rules' taxing mechanism is to apply an interest charge in respect of all of the deferred income of the PFIC

141. See Stanley I. Rubinfeld & Jesse R. Rubin, *Passive Foreign Investment Companies: The Pentapus Become the Sextapus, or Does It?*, 36 TAX NOTES 199 (1987). U.S. portfolio investment rose from \$62 billion in 1980 to \$1.4 trillion in 1997. See U.S. Dep't of Commerce, *Survey of Current Business*, July, 1998, at D52.

142. For example, the asset test has been interpreted to treat all cash as a passive asset, whether or not it is working capital or otherwise held solely for use in the business. See I.R.S. Notice 88-22, 1988-1 C.B. 489, 490. The breadth of the PFIC rules triggered a legislative reaction, in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1121, 111 Stat. 788, 971 (1997), that excludes United States shareholders of a CFC from the scope of the PFIC rules. See I.R.C. § 1297(e), discussed *infra* text accompanying note 157. In effect, this amendment carved out a U.S. multinational's subsidiaries from the PFIC rules. The legislative change does not alter the asset test, however, so the PFIC rules may still apply to an investor in a foreign operating joint venture as well as to an investor in an offshore fund.

143. See I.R.C. §§ 1291(a)(1), 1293(a)(1), 1296(a) (1988).

unless the shareholder elects to include its share of the PFIC's earnings currently in income. Although defective in specific design, the interest charge represented a break-through approach to economically recapturing the deferral benefit. As an alternative, shareholders could elect to report income currently (subject to obtaining information from the PFIC). The interest charge taxing mechanism effectively permitted the PFIC rules to be applied to an extremely small U.S. shareholder interest because it does not require the shareholder to obtain information from the corporation.

The PFIC rules are widely viewed as a possible model for ending deferral altogether simply by changing the definition of a PFIC to include any foreign corporation in which a U.S. shareholder holds a material interest. Key elements of the rules, including 1988 technical changes, are outlined in the following paragraphs.

b. The 1986 PFIC Rules In Brief

Definition of a PFIC. A foreign corporation is a PFIC with respect to a U.S. shareholder if, for any tax year in which the U.S. shareholder holds shares, either (i) 75% or more of the gross income of the foreign corporation for the tax year is passive income; or (ii) the average fair market value of its assets during the tax year that produce passive income or that are held for the production of passive income is at least 50% of the average fair market value of all of the foreign corporation's assets for such year.¹⁴⁴ For this purpose, passive income means, in general, dividends, interest, royalties, rents (other than rents and royalties derived in the active conduct of a trade or business and from unrelated persons), annuities, and gains from the sale of assets that would produce such income, other than sale of inventory.¹⁴⁵ A foreign corporation could elect to apply the asset test using the average adjusted tax bases of assets (as determined for purposes of computing earnings and profits) during the tax year.¹⁴⁶

PFIC look-through rules. For purposes of the PFIC tests, if a foreign corporation owned directly or indirectly at least 25% by value of the stock of another corporation, the foreign corporation would be treated as owning its proportionate share of the assets of the other corporation, and as if it had received directly its proportionate share of the income of such other corporation.¹⁴⁷ The effect of this special provision with respect to the foreign corporation and its direct and indirect ownership of its subsidiaries is that the foreign corporation, for purposes of the income and assets tests described above, will be treated as owning directly its proportionate share of the assets of the subsidiaries and of receiving directly its proportionate share of each of those subsidiaries' income, if any,

144. See I.R.C. § 1296(a) (1988).

145. See I.R.C. § 1296(b)(1) (1988).

146. See I.R.C. § 1296(c) (flush language) (1988).

147. See I.R.C. § 1296(c) (1988).

so long as the foreign corporation owns, directly or indirectly, at least 25% by value of the particular foreign corporation's stock. Income of the foreign corporation's subsidiaries that does not constitute "passive income" will be treated as non-passive income of the foreign corporation for purposes of the PFIC tests. Significantly, if a foreign holding company is not a PFIC, after application of the look-through rules, a less than 50% U.S. shareholder would not be attributed ownership of stock in a lower-tier PFIC.

Once a PFIC, always a PFIC. Shares held, directly or indirectly under attribution rules, by a U.S. shareholder will be treated as stock in a PFIC if, at any time during the holding period of the U.S. shareholder with respect to such shares, the foreign corporation was a PFIC and the U.S. shareholder did not elect to recognize gain as of the last day of the last tax year for which the foreign corporation was a PFIC.¹⁴⁸

Taxation of a U.S. shareholder in a PFIC. If the foreign corporation were to be classified as a PFIC, a direct or indirect U.S. shareholder would be subject to an interest charge on taxes deemed deferred by her on actual or deemed receipt of certain "excess" dividend distributions by the foreign corporation and on recognition of gain on disposition of any shares of the U.S. shareholder (all of which distributions and gains would be taxable as ordinary income).¹⁴⁹ Alternatively, a U.S. shareholder could avoid the interest charge if the foreign corporation were to agree to comply with certain reporting requirements and the U.S. shareholder were to elect to be currently taxable on her pro rata share of the foreign corporation's earnings and profits (excluding net capital gain) and net capital gains for each year (at ordinary income and long-term capital gains rates, respectively), even if no distributions were received.¹⁵⁰

4. *The Expansion and Contraction of Subpart F (or Contraction and Expansion of Deferral) in the 1990s*

a. Legislative Developments

Following the 1992 election of President Clinton, and preceding the election in 1994 of a Republican-controlled House and Senate, the 1993 Act was the high water mark of anti-deferral legislation. In the Omnibus Budget Reconciliation Act of 1993,¹⁵¹ Congress adopted the excess passive asset rules of section 956A to restrict deferral of a CFC's untaxed accumulated earnings invested in passive assets.¹⁵² Under section 956A, a United States shareholder in a CFC had to include in income currently its pro rata share of excess passive assets (passive assets in excess of the 25% of the average amount of total assets held at the end of each quarter) to the extent of the lesser of its pro rata share of excess passive assets

148. See I.R.C. § 1297(b)(1) (1988).

149. See I.R.C. § 1291(a) (1988).

150. See I.R.C. § 1293 (1988).

151. Pub. L. No. 103-66, 107 Stat. 312, 416 (1993).

152. See H.R. Rep. No. 103-111, at 691-92 (1993).

or earnings and profits. Also adopted in 1993 was a substantial expansion of the investment in U.S. property taxing rules. Investments in U.S. property were to be measured quarterly instead of annually and no longer required an increased investment in U.S. property. Income inclusions were measured according to current or accumulated earnings and profits that were not previously taxed.

The excess passive asset rule essentially acted as a mechanical accumulated earnings tax mechanism, forcing a deemed repatriation when untaxed earnings were accumulated in the form of passive assets (whether U.S. or foreign) beyond a threshold amount and not reinvested in active business assets. Not only was the income on a passive asset taxed, the principal was included in income to the extent the threshold was exceeded and there were untaxed earnings of the CFC. There existed, briefly, a cap on deferral.¹⁵³

The direction set in the 1993 Act was reversed in the Small Business Job Protection Act of 1996¹⁵⁴ (1996 Act). Addressing a Republican-controlled Congress, the U.S. multinational community argued, and the Congress found, that the section 956A excess passive asset rule provided an incentive for CFCs to make investments in foreign assets they otherwise would not have acquired in order to avoid the income inclusion.¹⁵⁵ Section 956A was repealed for tax years after 1996.¹⁵⁶

Emboldened by their 1996 success, the U.S. multinational community turned to the next threat to deferral relating to investment of earnings in passive assets. Although the PFIC rules had a 50% passive asset test that generally would be difficult for an operating business to surpass, high-profit electronic and pharmaceutical CFCs with manufacturing operations in low-tax jurisdictions had accumulated substantial amounts of income, even to the point of having 50% passive assets. In the Taxpayer Relief Act of 1997 (1997 Act), Congress provided that a United States shareholder in a CFC would not be subject to the PFIC rules in respect of that investment.¹⁵⁷

The 1997 Act also included a one-year exception from Subpart F foreign personal holding company income for income earned by a CFC in the active conduct of an insurance, banking, financing or similar business.¹⁵⁸ The active banking and finance exception was vetoed by President Clinton using his new line item veto power, but the Line Item Veto Act was subsequently held to be unconstitutional.¹⁵⁹ Congress extended the active banking and finance exception for another year in 1998.¹⁶⁰ As

153. Indeed, the provision had elements in common with a proposal in the original 1962 House bill that was not adopted by the Senate or Conference. *See supra* note 118.

154. Pub. L. No. 104-188, 110 Stat. 1755 (1996).

155. *See* H.R. Rep. No. 104-586, at 129 (1996).

156. *See* Pub. L. No. 104-188, § 1501(a)(2), 110 Stat. 1755, 1825 (1996).

157. *See* Pub. L. No. 105-34, § 1121, 111 Stat. 788, 971 (1997).

158. *See* Pub. L. No. 105-34, § 1175, 111 Stat. 788, 990-93 (1997).

159. *See* *Clinton v. City of New York*, 118 S. Ct. 2091 (1998).

160. *See* Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998, Pub. L. No. 105-277, § 1005, 112 Stat. 2681 (1998). For a critique of this provision,

applied to U.S. multinationals (outside of the oil and shipping industries), the Subpart F rules were being returned to their 1975 configuration.

b. The Saga of I.R.S. Notice 98-11 and I.R.S. Notice 98-35

The adoption of the "check-the-box" entity classification rules effective January 1, 1997, created opportunities to "base-erode" foreign taxable income without triggering Subpart F income inclusions. A taxpayer could use debt to generate deductible payments between a CFC and a legal entity that is respected for foreign law purposes but disregarded for U.S. tax purposes. In the absence of a branch rule that applies to foreign personal holding income, this and similar arrangements may be used to reduce the foreign tax on income eligible for deferral. On January 16, 1998, the IRS issued I.R.S. Notice 98-11,¹⁶¹ announcing its intention to issue regulations under Subpart F to prevent the use of certain arrangements involving CFCs and "hybrid branches" to achieve this result. A hybrid branch is regarded as a branch for U.S. tax purposes, but as a separate entity (e.g., a corporation) for foreign tax purposes. On March 23, 1998, the IRS issued temporary and proposed regulations implementing Notice 98-11.¹⁶² The temporary regulations covered transactions involving hybrid branches and equivalent transactions involving partnerships under Subpart F. The proposed regulations, in addition to the provisions also contained in the temporary regulations, covered the treatment of a CFC's distributive share of income of a partnership in which a CFC is a partner.¹⁶³

Notice 98-11 and the subsequent regulations provoked a storm of comment, including criticism that the proposed rules were without support in the statute and therefore invalid.¹⁶⁴ In I.R.S. Notice 98-35,¹⁶⁵ the Treasury and the IRS announced their intention to withdraw the temporary regulations and proposed regulations issued on March 23, 1998, and withdrew Notice 98-11. Notice 98-35 also stated that proposed regulations on hybrid transactions will be adopted, but will not be finalized before January 1, 2000.¹⁶⁶

see Lee A. Sheppard, *The Bermuda Triangle and Other Voids of Taxation*, 80 TAX NOTES 430 (1998).

161. 1998-6 I.R.B. 18.

162. T.D. 8767, 1998-16 I.R.B. 4, 63 Fed. Reg. 14,613 (1998), which contained Temp. Treas. Reg. §§ 1.954-1T, -2T, -9T, and 301.7701-3T (1998).

163. See REG-104537-97, 1998-16 I.R.B. 21, 63 Fed. Reg. 14,669 (1998).

164. See, e.g., Cooper, Melcher & Stretch, *supra* note 31; Lee A. Sheppard, *Sweet Tax Nothings: Rethinking Treasury's Foreign Policy*, 79 TAX NOTES 145 (1998); see also David P. Hariton, *International Double Nontaxation: A Response to Stuart Leblang*, 80 TAX NOTES 403 (1998); Stuart E. Leblang, *International Double Nontaxation*, 80 TAX NOTES 255 (1998); Stuart E. Leblang, *International Double Nontaxation: Hariton Misses the Point*, 80 TAX NOTES 507 (1998).

165. See 1998-27 I.R.B. 35.

166. See *id.* at 36. When finalized, the proposed regulations will be effective for all payments made on or after June 19, 1998, under hybrid arrangements, except as provided under transition relief provisions. See *id.*

Notices 98-35 describes regulations substantially unchanged from those promulgated in March 1998. When certain conditions are present, the non-Subpart F income of a CFC, in the amount of a "hybrid branch payment," will be recharacterized as Subpart F income of the CFC.¹⁶⁷ The amount recharacterized as Subpart F income is the gross amount of the hybrid branch payment limited by the amount of the CFC's earnings and profits attributable to non-Subpart F income.¹⁶⁸ To the extent that the full amount required to be recharacterized under this provision cannot be recharacterized because it exceeds earnings and profits attributable to non-Subpart F income, there will be no requirement to carry such amounts back or forward to another year.¹⁶⁹ The conditions for application of the hybrid branch payment rule include:

- [(i)] The hybrid branch payment reduces the foreign tax of the payor;
- [(ii)] the hybrid branch payment would have been foreign personal holding company income if made between separate CFCs; and
- [(iii)] there is a significant disparity between the effective rate of tax on the payment in the hands of the payee and the hypothetical rate of tax that would have applied if the income had been taxed in the hands of the payor.¹⁷⁰

The Notice 98-11/98-35 debacle may be traced directly to the absence of a consensus regarding the policy underlying Subpart F and the resulting mishmash of statutory rules. The Treasury understood the potential of "hybrid branch" structures to reduce foreign tax on income eligible for deferral and was concerned that, if left unchecked, the proliferation of these structures would provide a strong tax inducement to move investment outside the United States. Reading the legislative history to imbue the statute with a "capital export neutrality" intent, the Treasury supplied the missing branch rule in its regulations. The resulting outcry reverberated throughout 1998. While we have doubts about the Treasury's reading of the legislative history of Subpart F, we believe that the Treasury's policy concerns relating to the hybrid branch structure are legitimate and illustrate some of the limitations of the current anti-deferral regimes.

E. OBSERVATIONS ON THE EVOLUTION OF U.S. ANTI-DEFERRAL REGIMES

The preceding review of the evolution of the principal elements of the U.S. anti-deferral regimes is instructive. Before 1962, the U.S. anti-deferral protections were limited and narrowly focused. Congress did not fully embrace the capital export neutrality principle at the time of the adoption of the Subpart F rules in 1962. The original proposal was cut back to require current inclusion of most passive income and to target practices (principally use of base companies in lower tax jurisdictions) that, even if

167. *See id.* at 35.

168. *See id.* at 36.

169. *See id.*

170. *Id.* at 35.

they related to active businesses, could artificially reduce the effective foreign tax to the extent that it could induce movement of investment abroad. Viewed in this light, the resulting Subpart F structure served a purpose much like that of section 367—namely, to protect the U.S. tax base.

The developments from 1962 through the 1993 Act generally further curtailed the scope of deferral. Indeed, deferral was effectively eliminated for passive income, shipping income, large categories of oil and gas income, and banking and financing income. The trend since 1996 has been to expand the deferral privilege, notably by repealing the excess passive asset rules, eliminating application of the PFIC rules to United States shareholders in a CFC and restoring an active banking, financing and insurance exception to the Subpart F foreign personal holding company rules.

While the policy trends in this evolution are not easily discerned, one trend has been inexorable—increased complexity and administrative burden. In addition, irrespective of one's policy preference, the application of the current anti-deferral rules is inconsistent across industries. It may be argued that this outcome is inevitable so long as there is no consensus regarding the appropriateness of the deferral privilege. The pass-through proposal discussed in Part IX would be less complex and more neutral across industries than current law.

IV. NON-U.S. CONTROLLED FOREIGN COMPANIES AND FOREIGN INVESTMENT FUND REGIMES

A. CONTROLLED FOREIGN COMPANY LEGISLATION

1. *Background*

In 1962, the United States was the first country to adopt controlled foreign corporation anti-deferral legislation. As Part III of this Article demonstrates, the objectives and design of the legislation were modified during the course of congressional consideration. Based in part on a capital export neutrality objective and in part on anti-abuse objectives, the product of this congressional compromise was a hybrid of both approaches.

A 1996 study by Working Party No. 2 of the Committee on Fiscal Affairs of the Organisation for Economic Co-Operation and Development (OECD) reports that, as of June, 1995, fourteen OECD member countries (including the United States) had adopted controlled foreign companies (CFC) legislation.¹⁷¹ The varied approaches of these OECD countries reflects the influence of the U.S. example and also signals an ambivalence toward adoption of capital export neutrality as the predominant objective without regard to an actual or deemed finding of tax

171. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, CONTROLLED FOREIGN COMPANY LEGISLATION 10 (OECD 1996) [hereinafter OECD, CFC REPORT].

abuse. The OECD's recent consideration of CFC legislation in the context of harmful tax competition, discussed below, suggests that the distinction between anti-abuse and capital export neutrality objectives can be overstated.

Protecting the domestic tax base. A country manifests its policy preference for capital export neutrality or capital import neutrality in the manner that it taxes foreign income. A country that favors the capital import neutrality principle adopts a territorial approach for taxing foreign income. A country that favors the capital export neutrality principle taxes worldwide income and allows an unlimited credit for foreign taxes.¹⁷² The method of taxing foreign income, however, is not determinative of whether a country adopts CFC legislation. France, for example, favors exemption of, or a reduced tax on, foreign income, but has adopted expansive CFC legislation. The crucial point is that a principal purpose of CFC legislation for most countries is to protect the domestic tax base by reducing the incentive to shift income-producing activity abroad. Indeed, the need to protect the domestic tax base is more pronounced for a country that does not tax foreign income than for a country that taxes foreign income and employs a foreign tax credit system.

Protecting against tax competition. In 1996, the Ministers of OECD countries adopted a communique directing the OECD to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998."¹⁷³

In 1998, the OECD released its report on harmful tax competition, in which it examined the issue of tax competition among countries in the context of an increasingly global economic system. It enunciated factors to identify tax havens and harmful preferential tax regimes and made recommendations to counteract harmful tax competition.¹⁷⁴ The first recommendation of the report reads:

Recommendation concerning Controlled Foreign Corporations (CFC) or equivalent rules: that countries that do not have such rules consider adopting them and that countries that have such rules ensure that they apply in a fashion consistent with the desirability of curbing harmful tax practices.¹⁷⁵

The report observed that CFC rules may apply in situations which do not involve harmful tax competition as defined in the report, but stated: "It is recognized that countries retain their rights to use such rules in such situations."¹⁷⁶

172. For a discussion of how the capital export neutrality criterion is applied in relation to the taxation of foreign source income, see *supra* note 59 and GUSTAFSON, PERONI & PUGH, *supra* note 1, at 16-18, 335-38; Shay, *supra* note 3, at 1044-46.

173. This communique is quoted in ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 6 (OECD 1998) [hereinafter OECD, HARMFUL TAX COMPETITION].

174. See *id.* at Chs. 2 & 3.

175. See *id.* at 40-41.

176. *Id.* at 41.

It is instructive to review the kinds of CFC rules that have been adopted by other OECD countries.

2. *Other Countries' Approaches to CFC Legislation*

The OECD's CFC Report, which drew on Professor Brian J. Arnold's comparative analysis of CFC regimes,¹⁷⁷ focused on certain characteristics of CFC rules, including the definition of a CFC, whether the country in question relied on a transactional or "target country" approach (or a combination of the two), the type of income attributed to the taxpayer, the taxpayers to whom income is attributed, and the nature of exemptions (for entities or income) from the rules. The legislative approaches for some of the fourteen countries studied in the OECD Report are summarized in the table attached as Appendix A.

One difference between CFC regimes relates to whether a target country list is relied on or whether the CFC analysis is based on a transactional or entity analysis. The United States utilizes a transactional approach. Since we do not recommend a change to a target country list approach, the following discussion focuses on three issues affecting a transactional CFC regime: how the CFC is defined, the character of the CFC's income that is attributed and the shareholders to whom income is attributed.

Definition of CFC. In all of the countries reviewed, CFCs are defined to be a foreign entity over which domestic taxpayers have substantial influence. Of these countries, the lowest threshold for application of the CFC rules is that of France which applies its CFC regime to a foreign corporation if a French company owns directly or indirectly 10% or more in shares or has an investment in shares of 150 million French francs, whichever is less.¹⁷⁸ In most other cases, 50% control is required. As discussed below, however, a number of countries have adopted foreign investment fund (FIF) regimes, analogous to the U.S. PFIC rules, that apply to companies not controlled by residents.

In determining control, another important difference among approaches is whether control is required to be held by a small control group. In Australia, Canada and New Zealand, as well as the United States, either the control group is small (five or fewer persons) or the persons counted have material holdings (e.g., 10%). In Germany, Japan, and the United Kingdom, however, there are no minimum shareholding thresholds in determining whether resident shareholders own more than 50%, in the aggregate, of the foreign corporation.

Resident shareholders to whom income is attributed. Generally, there is a 10% ownership threshold for income to be attributable to a shareholder in the CFC.¹⁷⁹ The threshold may be lower if the shareholder is part of a

177. BRIAN J. ARNOLD, *THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS: AN INTERNATIONAL COMPARISON I* (Canadian Tax Foundation 1986).

178. See OECD, *CFC REPORT*, *supra* note 171, at 127.

179. See, e.g., France, New Zealand.

control group.¹⁸⁰ Application to the less than 10% shareholder is more common as an element of the FIF regimes.

CFC income attributed to domestic taxpayers. In most CFC regimes studied in the OECD CFC Report, the income subject to attribution is analyzed on a transactional basis and consists of passive income, certain related party or domestic income from sales or services and insurance income.¹⁸¹ Some countries treat all income of a CFC as tainted, but rely on exemptions to carve out active income.¹⁸² New Zealand is the most expansive. If the requisite control is found, all of the CFC's income is included in the income of a New Zealand shareholder owning 10% or more of the income interests in the CFC. Although New Zealand employs a list of countries to which the CFC rules do not apply, the list is small and they all are high-tax countries.¹⁸³

3. Observations

The proposals set forth in this Article reflect an effort to define a practical taxing regime for which capital export neutrality is the predominant objective. Although no country has adopted as strict an anti-deferral system as proposed in Part IX of this Article, all of the material elements of the proposed anti-deferral system may be found in at least one other country's CFC regime.

B. FOREIGN INVESTMENT FUND LEGISLATION

The United States also is not alone in adopting anti-deferral legislation relating to offshore investment companies. Although we have not undertaken a survey of such legislation, we are aware that Germany and Australia have such regimes. The following discussion outlines the German foreign investment fund (FIF) taxation rules as a basis for comparison with the U.S. PFIC rules.¹⁸⁴

A FIF is a fund governed by non-German (foreign) law invested directly or indirectly in securities, securitized loans, cash deposits or real property under the principle of risk diversification. The taxation rules apply to the interests in a FIF, which will qualify as a foreign investment unit (FIU). For tax purposes, FIUs are categorized as follows:

- (i) Registered Units;
- (ii) Units with respect to which a Tax Representative has been appointed (Tax Representative Units); and

180. See, e.g., Australia, Canada.

181. See, e.g., Australia, Canada.

182. See, e.g., France, Japan and United Kingdom.

183. In the United States, all the income of a CFC is treated as tainted base company income if 70% or more of the CFC's income is foreign base company income. See I.R.C. § 954(b)(3)(B).

184. The description of the German rules is based on a paper prepared by Friedhelm Jacob. See Friedhelm Jacob, Taxation of Income From Foreign Investment Units under the German Foreign Investment Act (Dec. 5, 1997) (unpublished manuscript, on file with authors). Mr. Jacob is a partner in the German law firm of Hengeler Mueller Weitzel Wirtz.

(iii) Other Units.

Registered Units are FIUs (i) registered for public distribution with the German Federal Banking Supervisory Authority or (ii) traded on a German stock exchange (but which are not distributed by way of public offering and with respect to which a Tax Representative¹⁸⁵ has been appointed).¹⁸⁶ Profit distributions on Registered Units are taxable to a German investor as dividends (if the investor is an individual who holds the FIUs as a non-business asset) or as business income (in all other cases). Realized but undistributed profits of the FIF are deemed distributed at the end of the fund's financial year and are taxable to an investor as dividend income. In addition, certain accrued profits will be taxed as dividends or business income, respectively, upon sale or redemption of the FIUs. However, the investor's pro rata share of the fund's capital gains is tax-exempt if the investor is an individual and holds the FIU as a non-business asset.

Tax Representative Units are FIUs that are not Registered Units but that meet certain requirements. A Tax Representative has to be appointed with respect to the FIUs. In addition, certain documentation requirements have to be met that entail the calculation of interim profits on a daily basis. Profit distributions on Tax Representative Units and realized profits of the fund are taxable to the German investors as dividends. Unlike Registered Units, no exemption applies to capital gains, which therefore are taxed to the German investors at ordinary rates.

Other Units are units that do not qualify as Registered Units or as Tax Representative Units. These Other Units are subject to an extremely onerous tax regime. The income derived from Other Units is determined by adding 90% of their appreciation in value during the calendar year (but not less than 10% of the redemption price last computed for the calendar year) to the distributions actually made by the FIF. Thus, tax will be imposed on the unrealized gains of the FIF, which, in addition, are deemed to be at least 10% per annum of the redemption price. If Other Units are redeemed or otherwise disposed of, 20% of the sales proceeds is deemed income taxable at regular rates. Like the PFIC interest-charge rules, the rules for Other Units discourage investment in a FIF that does not issue Registered Units or Tax Representative Units.

The German FIF rules generally are comparable to the PFIC rules except in one respect. The principal difference is that the use of an asset test has swept far more than just investment companies into the PFIC net. Like the PFIC rules, however, the German FIF regime applies to a German resident shareholder no matter how small his, her or its shareholding interest in the FIF. All of the income of the FIF is taxed (except realized

185. A Tax Representative is a German resident who is authorized to represent the Fund before the German tax authorities and in the German tax courts.

186. In addition, the FIF has to fulfill notification and publication requirements and certain data relevant for German tax purposes has to be reported to the investors. The redemption value of the FIUs and certain profits accrued by the FIF have to be computed and published on a daily basis.

capital gains in the case of a holder of Registered Units) as dividends or ordinary income.

V. THE MERITS OF DEVELOPING AN APPROACH TO ENDING THE DEFERRAL SUBSIDY

Even those who believe that the deferral subsidy is appropriate should recognize that legislation eliminating deferral is not an unreasonable possibility.¹⁸⁷ Accordingly, it seems appropriate to think seriously about the preferred technical approach for ending deferral, even though the policy controversy concerning the desirability of deferral probably cannot be resolved. Furthermore, deferral is a topic that has long been on the reform agenda. There has been extensive and continuous debate since 1961 (when President Kennedy proposed to end deferral for most CFCs). Consequently, deferral advocates can participate in the present discussion without concern that the mere development of a technical position would likely be the event causing repeal of deferral. In addition, without articulating with some clarity the design of a system for ending deferral, it is not possible to accurately evaluate the costs and benefits of ending deferral and the transition costs of moving to the new system for taxing income earned by U.S. persons through foreign corporations.

VI. CRITERIA FOR DEVELOPING AN ANTI-DEFERRAL APPROACH AND AN EXPLANATION FOR PATHS NOT TAKEN

There are several ways to impose current U.S. tax on the foreign income of CFCs, thereby ending the deferral subsidy. For example, an entity level tax (collected from the U.S. shareholders) could be currently levied on CFC income. Alternatively, if a U.S. corporation has at least 80% ownership of the CFC, the U.S. corporation could be required to file a consolidated return with the CFC. Finally, a pass-through regime could be imposed which requires U.S. shareholders to currently include their shares of CFC income.

Choosing among these approaches and then designing a specific regime under the chosen approach requires appropriate criteria. We suggest the following. First, the Internal Revenue Code's foreign tax provisions are already dauntingly complex. Thus, an anti-deferral regime should at least be as simple as possible and, in a best-case scenario, should contribute to reducing complexity.¹⁸⁸

187. See LaBrenda Garrett-Nelson, *The Future of Deferral*, in *TAXING AMERICA* 239 (Karen B. Brown & Mary Louise Fellows eds., 1996). Indeed, the demand by some taxpayers to loosen the Subpart F deferral limitations because they are too complicated, see Ryan J. Donmoyer, *Multinationals Beg U.S. Senate Finance Committee to Simplify International Laws*, 18 *TAX NOTES INT'L* 1103 (1999), can be readily converted into a demand to eliminate complexity by totally repealing deferral through the imposition of a pass-through regime on CFCs. See *infra* Part IX.

188. For discussion of the possible simplification consequences of ending deferral, see Charles I. Kingson, *Taxing the Future*, 51 *TAX L. REV.* 641, 659-60 (1996).

Second, if deferral is an evil that requires correction, the evil consists of a tax subsidy, illustrated in Part II of this Article, that affirmatively encourages U.S. taxpayers to carry on business operations and investments in low-tax foreign countries instead of in the United States. This subsidy is present whether the foreign income is active or passive. Thus, there seems to be no need for differential treatment of active and passive income in a comprehensive anti-deferral regime.¹⁸⁹ Indeed, developing a single approach to both types of income should promote the goal of simplicity.

The third criterion is similar to the second. Since the deferral evil exists with respect to all foreign source income that is, *in fact*, earned by a CFC in a low-tax jurisdiction, an anti-deferral regime has no need for distinctions such as between CFC income that can readily be shifted to low-tax jurisdictions and CFC income that is difficult to shift,¹⁹⁰ between CFC income earned in the CFC's country of incorporation and CFC income earned in another country,¹⁹¹ between CFC income earned from related party transactions and CFC income earned from independent parties¹⁹² and between manufacturing and service income.¹⁹³ In short, an anti-deferral regime should reach all CFC income and should not leave residual areas of deferral to be gamed by well-advised taxpayers.

Fourth, the purpose of an anti-deferral regime is fully served by taking away the economic benefit of deferral; there is no need to impose punitive consequences in addition. Furthermore, if U.S. shareholders were faced with a punitive anti-deferral regime they could always avoid it by conducting foreign operations through a foreign branch or pass-through entity. These considerations suggest that to the extent that a CFC's foreign source income would have received preferential treatment under the Code's capital gains provisions if earned through a foreign branch or pass-through entity, the same preferential treatment should be available to CFC income taxed under an anti-deferral system. Similarly, when CFCs suffer net operating losses that would have been available to the CFC's owners if it were a branch or pass-through entity, those losses should be currently available to the CFC's U.S. shareholders. In addition, it is sufficient if foreign corporate earnings that are realized and recognized under existing general tax principles are taxed currently. The formulation of an appropriate anti-deferral regime should not require sig-

189. See I.R.C. §§ 553, 954, 1297 (providing such treatment under current law). There is no valid capital import neutrality or competitiveness argument justifying deferral with respect to a passive investment.

190. The Subpart F income inclusions are sometimes described as focused on items that can be readily shifted to low-tax countries. See, e.g., N.Y. St. Bar Ass'n Tax Sec., *supra* note 29, at 882; *Treasury's Daniel Berman Reflects on Past and Future Int'l Tax Law*, 76 TAX NOTES 1387, 1388 (1997); EXPLANATION OF THE 1986 ACT, *supra* note 50, at 963-65.

191. See I.R.C. § 954(d)(1)(B), (e)(1)(B) (making such a distinction under current law).

192. See I.R.C. § 954(d)(1), (e)(1)(A) (making such a distinction under current law).

193. See *Treas. Reg.* § 1.954-3(a)(4) (acknowledging that the Code's present CFC provisions do not reach manufacturing income, whereas those provisions clearly apply to income from resales of purchased personal property (I.R.C. § 954(d)(1)) and from performing services (I.R.C. § 954(e))).

nificant changes to the realization principle (however ill-advised that principle may be from a tax policy point of view). Finally, these considerations also indicate that an anti-deferral regime should employ tax rates that reflect the tax rates of the CFC's U.S. owners.

When the preceding criteria are applied to an anti-deferral regime that works by levying a current tax on the CFC,¹⁹⁴ the outcome is doubtful. First, because the CFC is a foreign taxpayer and because the income that is the object of such a tax is foreign-source, the tax could not be collected from the CFC either practically or under prevailing international taxation norms.¹⁹⁵ Instead, it would be necessary to collect from each U.S. shareholder his, her, or its pro rata share of the tax imposed on the CFC. Furthermore, the last of the preceding criteria would require the use of shareholder rates in computing the tax borne by each U.S. shareholder. In short, to make an entity-level tax workable and consistent with the criteria described above, the tax has to be effectively transformed from an entity-level tax into a pass-through regime. This suggests that the solution to the deferral problem lies in taxing CFC shareholders on a pass-through basis.¹⁹⁶

Before we embrace the pass-through approach, however, we should at least acknowledge the possibility of attacking deferral through mandatory consolidated reporting.¹⁹⁷ The deferral subsidy would be eliminated to the extent that CFC income was currently taxed on a consolidated return filed with a U.S. corporate parent. Furthermore, the CFC's income would be taxed at the U.S. shareholder's rate, any capital gain characterization of the CFC's income would be preserved, CFC losses would be currently available to the U.S. parent, and no distinction would be made between active and passive income and other classes of income, all in accordance with the design criteria developed above. Nevertheless, an anti-deferral regime limited to consolidated return reporting by any CFC and its 80%,¹⁹⁸ or greater, U.S. corporate parent is highly problematic. To be specific, this approach would violate the third of the preceding criteria by leaving deferral intact for all CFCs that lack an 80% U.S. corporate parent. A large residual area of deferral would be preserved, and

194. For possible models, see Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 *TAX LAW.* 229, 267-77 (1998); U.S. TREAS. DEP'T, *INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE* 39-60 (1992) [hereinafter U.S. TREAS. DEP'T, *INTEGRATION REP.*].

195. See Hugh J. Ault, *Comparative Income Taxation: A Structural Analysis* 371-73 (1997); ALI PROPOSALS, *supra* note 63, at 6; see also U.S. TREAS. DEP'T, *INTERIM REP.*, *supra* note 51, at 49.

196. Of course, the difficulties in preventing the shares of business income from being manipulated for tax purposes mean that pass-through taxation is not without problems. See George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 *SMU L. REV.* 125, 139-58 (1997). But the absence of entity-level taxation as a realistic alternative regime for CFCs makes the problems of pass-through taxation more tolerable than they are in a purely domestic context.

197. See Bhansali, *supra* note 3; Green, *supra* note 3, at 78.

198. See I.R.C. §§ 1501, 1504(a).

this would remain the case even if the stock ownership threshold for mandatory consolidation were dropped as low as 50%.¹⁹⁹ Stated differently, this cure would have only a modest impact on the disease.

It should also be noted that a commentator has recently suggested limiting deferral by repealing Subpart F with respect to active business foreign income and replacing it with a system under which a CFC's United States shareholders would be taxed annually on a deemed minimum distribution of the CFC's income for the year.²⁰⁰ The proposal is somewhat complex, but there is no need to describe the details here. It is sufficient to say that if (1) the proposal's formula for calculating the minimum deemed distribution produced an amount exactly equal to that which would be included in the United States shareholders' incomes if the CFC were a pass-through entity; (2) the character of the CFC's income, deductions, and credits were preserved in the hands of the United States shareholders; and (3) CFC losses were available to the United States shareholders, this proposal would amount to a *de facto* pass-through regime. If, however, the deemed distribution was less than the amount currently taxable under a pass-through approach, then the deferral benefit would be preserved *pro tanto*, and that is precisely what this particular proposal envisions.²⁰¹

Moreover, this recent proposal would violate the second of the preceding criteria by requiring a distinction between active and passive income,²⁰² and the fourth by apparently declining to preserve the character of CFC income that is deemed distributed to the United States shareholders,²⁰³ and by apparently failing to permit the pass-through of CFC losses.²⁰⁴ Finally, because the proposal would continue the Subpart F regime with respect to most foreign personal holding company income,²⁰⁵ it would do little to simplify the law.

In contrast to the approach of levying a current U.S. tax on the CFC, to the mandatory consolidated reporting regime and to the mandatory minimum distribution system, a pass-through approach would fare well under the four criteria described above. It would not distinguish between various classes of income, the capital gains preference would apply, net operating losses would be currently available to U.S. shareholders, the CFC's income would be taxed at its U.S. shareholders' rates, and most CFCs would be covered by the system. It has, however, generally been thought impractical to impose a pass-through tax regime on publicly traded cor-

199. This was Bhansali's proposal. See Bhansali, *supra* note 3, at 1410. To deal with the residual area of deferral, he advocated that a CFC's minority shareholders be taxed on their shares of CFC income pursuant to a pass-through regime. See *id.* at 1414-15.

200. See Stuart E. Leblang, *Deferred Gratification: A More Rational Approach for Taxing Multinationals*, 81 TAX NOTES 1413 (1998).

201. See *id.* at 1419, 1421.

202. See *id.* at 1417-18.

203. See *id.* at 1423-24.

204. See *id.* at 1417-18, 1423-24.

205. See *id.* at 1417-18, 1422-24.

porations.²⁰⁶ Thus, some other approach may be needed for the small universe of publicly-traded CFCs. But because pass-through taxation is the anti-deferral approach that best satisfies our design criteria, we shall use it as a benchmark for evaluating the alternative proposals that follow and for constructing our preferred approach.

VII. THE WRONG WAY TO END DEFERRAL FOR CFCS— AN EXPANDED SUBPART F REGIME

The present CFC provisions require each U.S. person owning at least a 10% interest in a CFC (a “United States shareholder,” as defined in section 951(b)) to currently include his, her, or its pro rata share of certain narrowly-defined categories of CFC income with respect to which deferral was viewed as unduly egregious. The major income categories, and the exceptions that narrow them, are:

1. *Insurance income.*²⁰⁷

There is an exception for insuring or reinsuring risks in the CFC’s country of incorporation.²⁰⁸

2. *Foreign personal holding company income*²⁰⁹—i.e., “interest”²¹⁰ (including OID,²¹¹ interest equivalent items²¹² and “related person factoring income”²¹³), royalties, rents, annuities, net gains from sales of passive investment property,²¹⁴ net gains from commodities transactions,²¹⁵ and net foreign currency gains from section 988 transactions.²¹⁶ Although the foreign personal holding company income category seems broadly inclu-

206. See U.S. TREAS. DEP’T, INTEGRATION REP., *supra* note 194, at 33-35.

207. See I.R.C. §§ 952(a)(1), 953.

208. See I.R.C. § 953(a)(1) (prior to amendment by the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681 (1998) [hereinafter 1998 Act]. Section 1005(b) of the 1998 Act effectively expanded this exception to include the insuring and reinsuring of certain foreign cross-border risks and to provide that income covered by this exception is not foreign base company services income. See I.R.C. § 953(a), (e), 954(e)(2) (as amended in 1998). The 1998 Act also provided that insurance company investment income related to insuring or reinsuring these foreign cross-border risks is generally excluded from foreign personal holding company income and from foreign base company services income. See I.R.C. § 954(i), (c)(1)(B)(i), (e)(2) (as amended in 1998). These provisions of the 1998 Act however, are applicable only to tax years beginning in 1999, i.e., affected taxpayers can take advantage of the provisions for only one year.

209. See I.R.C. §§ 952(a)(2), 954(a)(1). The 1998 Act amended the Internal Revenue Code to provide that foreign income from the active conduct of a banking, financing, or similar business is generally neither foreign personal holding company income nor foreign base company services income. See I.R.C. § 954(h), (c)(1)(B)(i), (e)(2) (as amended in 1998). These amendments, however, are applicable only to tax years beginning in 1999; i.e., affected taxpayers can take advantage of the amendments for only one year. See generally LaBrenda Garrett-Nelson, *Good Subpart F News for Finance and Credit Companies*, 81 TAX NOTES 901 (1998).

210. See I.R.C. § 954(c)(1)(A).

211. See Treas. Reg. § 1.954-2(a)(4)(i).

212. See I.R.C. § 954(c)(1)(E).

213. I.R.C. § 864(d).

214. See I.R.C. § 954(c)(1)(B).

215. See I.R.C. § 954(c)(1)(C).

216. See I.R.C. § 954(c)(1)(D).

sive, it has the following important exceptions that would be targets of an anti-deferral initiative.

i) *Export financing interest exception*: export financing interest derived in the conduct of a banking business.²¹⁷ This exception, however, is inapplicable to related person factoring income.²¹⁸

ii) *Related corporation/same country dividends and interest exception*: dividends and interest received from a related corporation which is incorporated in the same country as the CFC and which uses a substantial part of its assets in its trade or business located in that country.²¹⁹ This exception is, however, inapplicable to interest to the extent that the interest reduces the payor's Subpart F income or creates or increases an earnings and profits deficit which, under section 952(c), may reduce the Subpart F income of the payor or another CFC.²²⁰ In addition, this exception is inapplicable to section 881(c) portfolio interest,²²¹ and to related person factoring income.²²² Finally, this exception does not apply to dividends on any stock attributable to earnings and profits accumulated during any period in which the CFC did not directly hold the stock or did not indirectly hold the stock through a chain of one or more same-country subsidiaries.²²³

iii) *Related person factoring income/same country exception*: this is similar to the related corporation/same country dividend and interest exception, discussed above.²²⁴

iv) *Related corporation/same country rents and royalties exception*: rents and royalties received from a related corporation for the use of, or privilege of using, property within the CFC's country of incorporation.²²⁵ This exception is inapplicable to rents and royalties to the extent that they reduce the payor's Subpart F income²²⁶ or create or increase an earnings and profits deficit which, under section 952(c), may reduce the Subpart F income of the payor or of another CFC.²²⁷

v) *Active business/unrelated person rents and royalties exception*: rents and royalties received in the active conduct of a trade or business from an unrelated person.²²⁸

vi) *Net gains from sales of business property exception*: the excess of gains over losses from sales of tangible depreciable personal property, real property, and intangibles used by the CFC in a business for the pro-

217. See I.R.C. § 904(d)(2)(G).

218. See I.R.C. § 864(d)(5)(A)(iii).

219. See I.R.C. § 954(c)(3)(A)(i).

220. See I.R.C. § 954(c)(3)(B).

221. See I.R.C. § 881(c)(5)(A)(iii).

222. See I.R.C. § 864(d)(5)(A)(iv).

223. See I.R.C. § 954(c)(3)(C).

224. See I.R.C. § 864(d)(7).

225. See I.R.C. § 954(c)(3)(A)(ii).

226. See I.R.C. § 954(c)(3)(B).

227. *Id.*

228. See I.R.C. § 954(c)(2)(A); Treas. Reg. § 1.954-2(b)(6); see also GUSTAFSON, PERONI & PUGH, *supra* note 1, at 376.

duction of income other than rents or royalties (except for active business/unrelated person rents or royalties referred to in section 954(c)(2)(A)).²²⁹

vii) *Net gains from sales of dealer property and inventory exception*: net gains from the sale of section 1221(1) property.²³⁰

viii) *Property dealer transactions exception*: most income, gains, deductions, and losses from all transactions of a CFC that is a regular dealer in property if the transactions are entered into in the ordinary course of the dealer business.²³¹

ix) *Commodities hedging transactions exception*: net gains from bona fide commodities hedging transactions reasonably necessary to the conduct of a commodities business.²³²

x) *Commodities business net gains exception*: commodities sales net gains which are active business net gains of a CFC substantially all the business of which is as an active producer, processor, merchant, or handler of commodities.²³³

xi) *Commodities business foreign currency gains and losses exception*: commodities transactions gains and losses which are foreign currency gains and losses attributable to section 988 transactions.²³⁴

xii) *Business related net foreign currency gains exception*: other foreign currency net gains from section 988 transactions directly related to the CFC's business needs.²³⁵

3. *Foreign base company sales income*—i.e., profits, commissions, fees, and other income earned in connection with:

i) Sales of personal property.²³⁶

ii) Purchases of personal property on behalf of a related person.²³⁷

iii) Foreign milling of unprocessed softwood timber cut in the United States.²³⁸

The principal exceptions to this category of income are:

i) *Manufactured property exception*: sales of property manufactured by the CFC²³⁹ except softwood timber cut in the United States and milled abroad by the CFC.²⁴⁰

229. I.R.C. § 954(c)(1)(A), (B), (c)(2)(A); Treas. Reg. § 1.954-2(e)(1)(i)(A), (C), (e)(2)(i), (e)(3)(ii)-(iv).

230. I.R.C. § 954(c)(1)(B) (last sentence); Treas. Reg. § 1.954-2(e)(1)(ii).

231. See I.R.C. § 954(c)(2)(C).

232. See I.R.C. § 954(c)(1)(C)(i).

233. See I.R.C. § 954(c)(1)(C)(ii).

234. See I.R.C. § 954(c)(1)(C)(iii).

235. See I.R.C. § 954(c)(1)(D).

236. See I.R.C. § 954(d)(1) (first paragraph).

237. See *id.*

238. See I.R.C. § 954(d)(4).

239. See Treas. Reg. § 1.954-3(a)(4); Eric T. Laity, *The Foreign Base Company Sales Income of Controlled Foreign Corporations*, 31 CORNELL INT'L L.J. 93, 107 (1998) [hereinafter Laity, *Foreign Base Company Sales Income*]; Adess, Angus & Villmow, *supra* note 23, at 936-37.

240. See I.R.C. § 954(d)(4); Laity, *Foreign Base Company Sales Income*, *supra* note 239, at 127-28.

ii) *Unrelated party exception*: purchases and sales of personal property where all parties are unrelated to the CFC,²⁴¹ sales of personal property on behalf of unrelated persons²⁴² and purchases of personal property on behalf of unrelated persons.²⁴³ But this exception is inapplicable where the sold property is unprocessed softwood timber cut in the United States.²⁴⁴

iii) *Same country production exception*: purchases and sales of personal property, sales of personal property on behalf of another, and purchases of personal property on behalf of another where the property in question is manufactured, produced, grown, or extracted in the CFC's country of incorporation.²⁴⁵ This exception does not apply to unprocessed softwood timber cut in the United States and milled in the CFC's country of incorporation.²⁴⁶

iv) *Same country use exception*: purchases and sales of personal property, sales of personal property on behalf of another, and purchases of personal property on behalf of another where the property in question is to be used, consumed, or disposed of in the CFC's country of incorporation.²⁴⁷ This exception does not apply to sales of unprocessed softwood timber cut in the United States and sales or purchases of such timber milled outside the United States.²⁴⁸

v) *Noncompetitive agricultural commodities exception*: purchases and sales of personal property, sales of personal property on behalf of another, and purchases of personal property on behalf of another where the property in question is an agricultural commodity not grown in the United States in commercially marketable quantities.²⁴⁹

4. *Foreign base company services income*—i.e., compensation earned by a CFC “in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services.”²⁵⁰

The principal exceptions to this category of income are:

i) *Unrelated person exception*: compensation for services rendered to or on behalf of an unrelated person.²⁵¹

ii) *Same country exception*: compensation for services rendered in the CFC's country of incorporation.²⁵²

241. See I.R.C. § 954(d)(1).

242. See *id.*

243. See *id.*

244. See I.R.C. § 954(d)(4).

245. See I.R.C. § 954(d)(1)(A); Laity, *Foreign Base Company Sales Income*, *supra* note 239, at 129-30.

246. See I.R.C. § 954(d)(4).

247. See I.R.C. § 954(d)(1)(B).

248. See I.R.C. § 954(d)(4).

249. See I.R.C. § 954(d)(1) (last flush paragraph).

250. I.R.C. § 954(e)(1) (first paragraph).

251. See I.R.C. § 954(e)(1)(A).

252. See I.R.C. § 954(e)(1)(B).

iii) *Sales related services*: compensation for presale services directly related to the CFC's sale "of property manufactured, produced, grown, or extracted by it"²⁵³ and compensation for services directly related to an offer or attempt to sell such property.²⁵⁴

Deferral would be substantially curtailed by repealing the same country, manufactured property, and unrelated person exceptions described above, and deferral would be virtually eliminated by repealing all exceptions described above.²⁵⁵ Moreover, either of these alternatives would achieve the reduction or elimination of deferral without creating any new statutory structure; both alternatives would make use of the familiar constructive dividend structure of section 951(a) but would substantially broaden the items that are included in constructive dividend treatment. Furthermore, they would deal with both active income and passive income (at least to the extent that passive income is included in foreign personal holding company income) without creating complex differentials in the treatment of these two categories. Finally, both of these alternatives would serve the goal of simplification by permitting the repeal of sections 956 and 1248.²⁵⁶

But this approach would have several unattractive features. First, it would leave the various Subpart F income categories and the section 954(b)(5) deduction allocation rules in place. Second, the indirect foreign tax credit in section 960 for foreign income tax paid by the CFC would not be available to individual shareholders unless they elect to be taxed as corporations on their CFC constructive dividends.²⁵⁷ Third, the complexities of the indirect foreign tax credit provisions in sections 960 and 902 would be preserved as the rules for passing foreign taxes paid by the CFC through to the CFC shareholders. Fourth, the character of the passed-through income items would generally not be preserved.²⁵⁸ This is important with respect to long-term capital gains passed through to individual shareholders principally because of the rate preference for those gains. It will also be important to corporate shareholders if a corporate capital gain preference is adopted. Even if this does not happen, corporations may find capital gains advantageous because they absorb otherwise nondeductible capital losses.

Finally, CFC losses are not passed through to shareholders under the present CFC provisions.²⁵⁹ Instead, CFC losses are carried forward as earnings and profits deficits and used to reduce Subpart F income in subsequent years (subject to the section 952(c)(2) recharacterization rule), but only Subpart F income produced by the same class of activity as the class of activity that gave rise to the loss. All of this substantially reduces

253. I.R.C. § 954(e)(2)(A).

254. See I.R.C. § 954(e)(2)(B).

255. See Green, *supra* note 3, at 75-77.

256. See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 51, at 48.

257. See I.R.C. §§ 960, 962.

258. Treas. Reg. § 1.951-1(a).

259. See Treas. Reg. §§ 1.954-1(c)(1)(ii), -2(e)(1)(iii).

the value of CFC losses to CFC shareholders by deferring the economic benefit of the losses. This distortion would be preserved by an anti-deferral regime that relies on the current Subpart F framework.²⁶⁰

In short, curtailing or ending deferral for CFCs by expanding the definition of Subpart F income would result in a very complex anti-deferral regime with unsatisfactory limitations on pass-through treatment for the CFC's United States shareholders.

Recently, a commentator has proposed curtailing deferral by adding a "low-tax-kick-in" to Subpart F.²⁶¹ Under this proposal, all CFC income that is deferred under current Subpart F would lose the deferral benefit if it were not currently taxed in a foreign jurisdiction at 90% or more of the section 11 rate.²⁶² Although the details have not been elaborated, this proposal would seem to retain much of the current Subpart F structure and, therefore, be subject to the criticisms directed above at the proposal to end deferral by repealing the Subpart F income exceptions. Furthermore, the "low-tax-kick-in" proposal assumes that objections to the deferral subsidy will vanish if deferred income is taxed abroad at 90% of the U.S. rate but not at a lower foreign rate, say 85% of the U.S. rate. It seems highly doubtful that a precise determination can be made regarding the foreign rate point at which the deferral advantage becomes insignificant and, more importantly, it seems doubtful that the effort is worth the trouble. Indeed, the author of the "low-tax-kick-in proposal" is certainly aware of these criticisms because he offered the proposal as a second-best alternative to his preferred approach of terminating deferral altogether.²⁶³

VIII. ANOTHER SUBOPTIMAL WAY TO END DEFERRAL— THE ROSTENKOWSKI-GRADISON BILL

The Rostenkowski-Gradison bill was introduced in the House in 1992 as H.R. 5270,²⁶⁴ but it died at the end of the session.²⁶⁵ It would have

260. See Shay, *supra* note 3, at 1061.

261. Reuven S. Avi-Yonah, *The Logic of Subpart F: A Comparative Perspective*, 79 TAX NOTES 1775 (1998) [hereinafter Avi-Yonah, *Logic of Subpart F*]; see also Albertina M. Fernandez, Jacqueline B. Manasterli, Amy Hamilton & Kathleen Matthews, *IRS, GW Hold Annual International Tax Institute*, 81 TAX NOTES 1467, 1474-76 (1998); U.S. TREAS. DEP'T, INTERIM REP., *supra* note 51, at 12. For a different critique of Professor Avi-Yonah's proposal, see David P. Hariton, *The 'Logic' of Subpart F: Response to Prof. Avi-Yonah*, 79 TAX NOTES 1778 (1998). Professor Avi-Yonah, in turn, responds to this critique in Reuven S. Avi-Yonah, *More on U.S. Notice 98-11 and the Logic of Subpart F*, 16 TAX NOTES INT'L 1943 (1998).

262. See Avi-Yonah, *Logic of Subpart F, supra* note 261, at 1777.

263. See *id.* at 1777 n.20.; see also STAFF OF JOINT COMM. ON TAX'N, 102D CONG., 2D SESS., EXPLANATION OF H.R. 5270 (FOREIGN INCOME TAX RATIONALIZATION AND SIMPLIFICATION ACT OF 1992) (Comm. Print 1992) [hereinafter RATIONALIZATION AND SIMPLIFICATION ACT].

264. H.R. 5270, 102d Cong., 2d Sess. (1992). For analyses of H.R. 5270, see U.S. TREAS. DEP'T, INTERIM REP., *supra* note 51, at 48; RATIONALIZATION AND SIMPLIFICATION ACT, *supra* note 263.

265. See generally Barbara Kirchheimer, *Foreign Tax Bill Floats in a Sea of Lukewarm Reviews*, 55 TAX NOTES 1303 (1992); Ian K. Loudon, *Rosty, Gradison Introduce Sweeping*

ended deferral by treating all of a CFC's earnings and profits as Subpart F income. The exclusion in present section 952(b), regarding U.S. source income effectively connected with a U.S. trade or business of the CFC, would have been continued, however.

This approach would have accomplished substantial simplification by eliminating the present Subpart F income categories and the exceptions thereto. However, the constructive dividend structure of section 951(a) would have been continued. Thus, the character of CFC income taxed to CFC shareholders generally would not have been preserved. Furthermore, the complexities of the indirect foreign tax credit provisions in sections 960 and 902 would have continued to govern the pass-through to domestic corporate CFC shareholders of foreign taxes paid by CFCs. Also, the section 960 indirect foreign tax credit would have continued to be unavailable to individual shareholders unless they elected to be taxed as corporations on their CFC constructive dividends. Finally, CFC losses would have continued to be carried forward as earnings and profits deficits of the CFC instead of being passed through to CFC shareholders. However, there would have been a repeal of the rule specifying that a deficit can be used to absorb only Subpart F income produced by the same activity that gave rise to the loss. This modification would have made the loss carryforward rule slightly less onerous and complex.

In summary, the Rostenkowski-Gradison Bill was an improvement on the expanded Subpart F approach described above in that it would have eliminated the intricate Subpart F income categories and the exceptions thereto. Nevertheless, considerable complexity would have remained, the character of CFC income would not have been passed through to CFC shareholders, and CFC losses would not have been passed through to CFC shareholders. The latter two of these consequences seem inconsistent with a regime that currently taxes CFC shareholders on their pro rata portions of CFC income.

IX. THE RIGHT WAY TO END DEFERRAL—TREATMENT OF THE FOREIGN CORPORATION AS A PASS-THROUGH ENTITY WITH RESPECT TO ITS U.S. SHAREHOLDERS²⁶⁶

A. INTRODUCTION

As discussed above in Parts II and III of this Article, the complex array of anti-deferral regimes of current law represents an uneasy and impractical compromise between completely ending deferral of U.S. tax on income earned by U.S. persons through foreign corporations and allowing such deferral without limitation. Congress has made numerous revisions

Foreign Tax Simplification Bill, 55 TAX NOTES 1161 (1992); Joanna Richardson, *Gains From Foreign Tax Bill Not Worth Losses, Witnesses Charge*, 56 TAX NOTES 397 (1992); John Turro, *OECD Ambassadors Protest Foreign Tax Bill*, 56 TAX NOTES 554 (1992).

266. Part IX of this Article is drawn in part from an earlier article by Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 986-94 (1997).

to the anti-deferral regimes over the years and has changed directions several times in terms of strengthening or weakening those regimes. These revisions have only made the U.S. international tax system more complex without significantly eliminating the problems caused by the deferral privilege. The end product of this legislative ineffectiveness is a highly complicated set of statutory provisions that leaves the deferral subsidy largely intact, thus encouraging U.S. taxpayers to shift their operations abroad to low-tax foreign jurisdictions, but requiring that a taxpayer navigate through a number of anti-deferral hurdles to obtain that result. Moreover, the current rules make deferral elective for the well-advised U.S. taxpayer and create traps for the unwary in the case of other U.S. taxpayers, thus undermining taxpayer confidence in the fairness and efficiency of the tax system.²⁶⁷ One could well argue that the current system is more complicated, susceptible of tax abuse, and economically inefficient than a "theoretically pure" territorial system of taxing foreign source income, which would exclude foreign source income from U.S. taxation but not allow the deduction of any foreign source losses nor allow any credit for foreign taxes.²⁶⁸

B. DESCRIPTION OF THE PASS-THROUGH PROPOSAL

Given the inherent problems with the expanded Subpart F approach for curtailing deferral by CFCs (detailed above in Part VII of this Article) and with the Rostenkowski-Gradison approach for eliminating deferral outlined above in Part VIII, a more effective method for ending deferral would be to treat each U.S. person²⁶⁹ (including a U.S. multinational corporation) owning stock in a foreign corporation (regardless of whether the foreign corporation is a CFC as defined in section 957) as if that shareholder directly earned his, her, or its pro rata share of the foreign

267. As numerous other commentators have noted, the elective nature of the deferral privilege has been fortified and made more explicit by the Treasury Department's adoption of the "check-the-box" entity classification system. See T.D. 8697, 1997-1 C.B. 215. Under the check-the-box classification system, U.S. persons operating abroad through foreign entities (other than *per se* foreign corporations) are more readily able to elect whether to obtain deferral of U.S. tax on their foreign source income by electing whether to have the foreign entities treated as corporations or partnerships (or disregarded as an entity separate from its owner in the case of an entity with a single owner) for tax purposes. See, e.g., Avi-Yonah, *End Deferral*, *supra* note 3; Michael L. Schler, *Initial Thoughts on the Proposed "Check-the-Box" Regulations*, 71 TAX NOTES 1679 (1996). For example, a U.S. taxpayer is likely to elect partnership or branch (i.e., disregarded entity) status for a subsidiary engaged in foreign operations that are generating losses, or for a subsidiary operating in a high-tax foreign country because the U.S. taxpayer can use the foreign tax credit to offset both the U.S. tax on the subsidiary's foreign source income and the U.S. tax on other low-taxed foreign source income earned by the U.S. taxpayer in other countries. (The latter planning strategy works only when the high-taxed and low-taxed foreign source income falls within the same basket limitation category in section 904(d)(1). See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 1, at 293-94, 301, 471-72.) In addition, a U.S. taxpayer is likely to elect partnership or branch status for foreign subsidiaries in situations where flow-through status will circumvent certain restrictions and limitations on the foreign tax credit under current law. See Schler, *supra*, at 1687.

268. The articulation of this argument will itself, however, require a separate full article.

269. See I.R.C. § 7701(a)(30).

corporation's gross income and expenses. Under this pass-through approach, each U.S. person owning stock in the foreign corporation would be required to currently include a pro rata share of such income or expense in computing his, her, or its own U.S. tax liability. Thus, deferral would be ended with respect to the U.S. shareholders' full shares of all of the foreign corporation's income, not merely certain categories of income earned by CFCs described in section 957 (as is true under Subpart F of current law). In addition, each U.S. person owning stock in a foreign corporation would be attributed his, her, or its share of the foreign taxes paid by the corporation during the year and could claim a direct credit for those taxes, to the extent they are creditable taxes under section 901 or section 903 and subject to the limitations in section 904.

Under this pass-through regime, a U.S. person owning stock in a foreign corporation would be allowed to reduce his, her, or its taxable income by a pro rata share of the foreign corporation's losses.²⁷⁰ This feature of the proposed pass-through regime would remove the bias that exists under current law against use of the corporate form in international start-up situations where significant deductions in excess of income in the early years of a venture are anticipated.

Other important features of this pass-through regime include the following:

1. The character of the foreign corporation's items of income and expense would flow through to the U.S. shareholders under principles similar to those developed under section 702(b) of Subchapter K and 1366(b) of Subchapter S. Thus, the character distortion caused by Subpart F's constructive dividend approach to curtailing deferral (under which all Subpart F income attributed to a U.S. shareholder is treated as ordinary income) would be avoided with this pass-through regime.

2. To determine each U.S. shareholder's pro rata share of the foreign corporation's income, losses, and foreign taxes, pass-through rules similar to those developed under Subchapter K would apply in modified form. All such allocations would have to survive the "substantial economic effect" test of section 704(b).²⁷¹

Alternatively, one could adopt a principle for determining a U.S. shareholder's pro rata share of the foreign corporation's income, expenses, and taxes that does not allow contractual special allocations of such items to be determinative (notwithstanding their passing muster under the section 704(b) regulations). Under this alternative approach, a U.S. share-

270. In the case of tiered structures of corporations, look-through rules may be needed to the extent that section 958 does not solve the problem.

271. Simplification and reform of the allocation rules in Subchapter K are needed without regard to whether this pass-through proposal is ever enacted into law. The tax abuses and economic inefficiencies fostered by the allocation rules in Subchapter K have been the subject of extensive commentary. See, e.g., Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990); Kwall, *supra* note 194, at 232, 248-53, 268-70. Moreover, the American Law Institute will soon release a draft of its study of those rules and its proposals for their reform. In any event, a detailed discussion of the Subchapter K allocation rules is beyond the scope of this Article.

holder's pro rata share of the foreign corporation's income, expenses, and taxes would correspond to the shareholder's economic interest in the corporation. In determining the U.S. shareholder's economic interest in the foreign corporation, one could look primarily at three factors: (1) the shareholder's voting rights in the corporation; (2) the shareholder's right to participate in current earnings and accumulated surplus; and (3) the shareholder's right to share in the corporation's net assets on liquidation.²⁷² There are, however, two major problems with this alternative approach for determining a U.S. shareholder's share of the foreign corporation's items of income, expense, and taxes. First, in a case where there are multiple classes of stock with differing voting rights, dividend rights, and liquidation preferences, it may be very difficult, as a practical matter, for the U.S. shareholder to determine his, her or its economic interest in the foreign corporation. Second, by ignoring special allocations if a foreign corporation is used to conduct the foreign business, but continuing to respect such allocations if a partnership or LLC is used, the same choice of entity distortions induced by the special allocation rules in the partnership area under current law would be perpetuated by our pass-through proposal.

3. Basis adjustments similar to those in both section 705 of Subchapter K and section 1367 of Subchapter S would apply to prevent double taxation of the foreign corporation's earnings when they are distributed to a U.S. shareholder or a U.S. shareholder sells the corporation's stock. Thus, for example, items of income that flow through to the U.S. shareholders would increase those shareholders' bases in their stock in the foreign corporation, and deductions or losses flowing through to the U.S. shareholders would reduce their stock bases. Distributions to the U.S. shareholders would reduce their bases in the corporation's stock.

4. Any losses flowing through from the foreign corporation to a U.S. person owning stock in the corporation would be limited to the extent of the U.S. shareholder's basis in the corporation's stock and the U.S. shareholder's basis in any loans to the foreign corporation. This loss limitation rule is analogous to the section 704(d) limit on the deduction of partnership losses and the section 1366(d)(1)(A) limit on the deduction of S corporation losses.²⁷³

272. These are the factors looked at by the IRS and the courts in determining whether a shareholder is entitled to exchange treatment on a corporate redemption under section 302(b)(1) by reason of the redemption resulting in a meaningful reduction in the shareholder's proportionate interest in the corporation. *See, e.g.,* *Roebing v. Commissioner*, 77 T.C. 16, 30 (1981); Rev. Rul. 76-364, 1976-2 C.B. 91; Rev. Rul. 76-385, 1976-2 C.B. 92; Rev. Rul. 78-401, 1978-2 C.B. 127. *See generally* BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 9.05[3] (6th ed. 1994).

273. Under this pass-through proposal, a decision would have to be made concerning whether the Subchapter K approach to treatment of entity-level liabilities to third parties will be followed. In other words, should a U.S. shareholder be allowed to include a pro rata share of the foreign corporation's liabilities in his, her, or its adjusted basis in the stock for purposes of the limitation on a shareholder's deduction of losses flowing through from the corporation and the taxability of dividend distributions to the shareholder? If so, this

5. Distributions from the foreign corporation would be tax-free to the extent of the shareholder's basis in the corporation's stock. Any distributions in excess of stock basis would be treated as gain from the sale of the corporation's stock.²⁷⁴

Suppose that the U.S. person owning stock in the foreign corporation does not have sufficient information to determine his, her, or its pro rata share of the corporation's income, either because the shareholder owns a small percentage of stock in a closely held foreign corporation that is otherwise owned by uncooperative foreign persons or the shareholder owns a small percentage of stock in a publicly traded foreign corporation that is indifferent to the information needs of shareholders under U.S. tax law. As a practical matter, how would such a U.S. person determine his, her, or its pro rata share of the foreign corporation's income and expenses? What accommodations can be made in the pass-through regime to reflect these compliance concerns?

If the foreign corporation's stock is publicly traded, the U.S. person could be provided with a mark-to-market election similar to the one provided in section 1296 of current law with respect to passive foreign investment companies. The mechanics of this mark-to-market approach would be similar to those in section 1296.

Alternatively, if the U.S. person owns a less than 10% stock interest in the voting power of a foreign corporation the stock of which is not publicly traded, the U.S. shareholder could be allowed to base the amount of the current inclusion on generally available financial information of the corporation, with adjustments to reflect U.S. tax accounting principles for certain "material items" that could be "reasonably identified" by the U.S. person.²⁷⁵ The reason that we would limit this alternative reporting approach to less than 10% shareholders is that, as a practical matter, a U.S. person owning 10% or more of the voting power of a foreign corporation should have sufficient economic clout to obtain the necessary information concerning the foreign corporation's income and deductions to report under the general pass-through approach.²⁷⁶ In determining whether a

pass-through proposal would place great pressure on the liability allocation rules in Subchapter K and would require that those rules be carefully reexamined and reformulated. Alternatively, a more sound approach might be to adopt the Subchapter S model here and not allow the U.S. shareholder to include a pro rata share of the foreign corporation's liabilities to third parties in the stock basis for loss limitation purposes. *See* I.R.C. § 1366(d) (allowing a shareholder of an S corporation to deduct losses flowing through from the corporation only to the extent of the shareholder's basis in the S corporation stock and in any indebtedness of the S corporation to the shareholder). However, this latter approach would perpetuate a choice of entity bias in favor of the partnership form of conducting a foreign business if the business is expected to incur losses and will be financed with third-party debt incurred by the entity.

274. *Cf.* I.R.C. §§ 301(c)(3), 1368(b)(2).

275. *See* Shay, *supra* note 3, at 1061.

276. This premise is consistent with the assumption underlying both the indirect credit provisions in sections 902 and 960 and the look-through rules used for foreign tax credit limitation purposes in sections 904(d)(3) and 904(d)(4) that 10% or more U.S. shareholders in foreign corporations are able to obtain detailed information concerning a foreign corporation's income, deductions, and foreign taxes.

U.S. person is a 10% or more shareholder in the foreign corporation for this purpose, a modified version of the foreign entity indirect ownership and constructive ownership rules in section 958 would apply.

We recognize, however, that there may be a number of situations where the less than 10% U.S. shareholders of a nonpublicly traded foreign corporation do not possess sufficient financial information concerning the foreign corporation to properly report their income under the pass-through method, even as modified to use financial accounting information. Accordingly, it may be appropriate to use a modified version of the approach taken in section 1291 of the current law PFIC provisions—namely, allow such less than 10% U.S. shareholders to defer U.S. tax on their shares of the foreign corporation's income but recapture the benefits of deferral by imposing an interest charge when the U.S. shareholder receives an extraordinary distribution (i.e., an "excess distribution") from the corporation or the U.S. shareholder sells the foreign corporation's stock. However, in calculating that interest charge on the benefit of deferral, we would not use the straight-line accrual calculation method of section 1291, which calculates the interest charge by allocating the taxpayer's income realized at the time of an excess distribution or sale of the PFIC's stock over the shareholder's entire holding period for the stock on a ratable or straight-line basis. We would not use that method because it assumes more tax deferral than would occur if income had been earned at a constant rate (i.e., it "front-loads" the deferred income) and thus probably over-compensates for the benefits of deferral in most cases.²⁷⁷ Instead, we would calculate the interest charge by using economic accrual and assuming that the undistributed income had been earned at a constant rate.

C. SIMPLIFICATION AND OTHER BENEFITS OF THE PASS-THROUGH PROPOSAL

Adoption of this pass-through method for ending deferral by U.S. persons earning foreign source income through foreign corporations should result in significant simplification and reform of various international tax provisions of the Code. First, the detailed rules in sections 952 through 954 (and the regulations promulgated thereunder) defining the various types of Subpart F income (and the exceptions thereto) would be unnecessary and would be repealed. As discussed earlier in this Article, there is little policy justification for the lines drawn in the Subpart F regime of current law between acceptable and unacceptable deferral opportunities. Accordingly, our pass-through proposal would end deferral completely without regard to the type of income earned by the foreign corporation.

Second, the definitions of "United States shareholder" in section 951(b) and "controlled foreign corporation" in section 957 would be un-

277. See Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45, 65, 67 (1996); see also, e.g., 3 ISENBERGH, *supra* note 12, at ¶ 44.16.

necessary in a pass-through regime that ends deferral completely for U.S. persons owning stock in foreign corporations and would be repealed. Under the proposed pass-through regime, all U.S. persons owning stock in a foreign corporation would be required to include their pro rata shares of the corporation's income and deductions on their own returns, regardless of the level of U.S. ownership of the foreign corporation. Our theory is that the deferral incentive for income earned through foreign corporations is no more justifiable for 1% U.S. shareholders in a foreign corporation than it is for 25% U.S. shareholders. One reason for drawing the line at 10%—the presumed lack of power to compel dividend distributions by the foreign corporation when the shareholder owns less than 10%—does not withstand scrutiny. A 1% owner of a partnership interest may not be able to force distributions by the entity; yet, U.S. tax law requires the partner to report his, her, or its distributive share of the partnership's net income and leaves the partner with the burden of solving any liquidity problem by negotiating an appropriate distribution provision in the partnership agreement. There is, however, a genuine concern regarding whether the 1% shareholder can obtain sufficient information to make an accurate return under the pass-through approach, and we have dealt with that concern by providing an alternative reporting method for under 10% shareholders of non-publicly traded foreign corporations.²⁷⁸ Note that the foreign entity indirect ownership rules in section 958(a), and the constructive ownership rules in section 958(b) would be simplified and retained only for purposes of the special reporting method for less than 10% U.S. shareholders outlined above.

Third, the policy rationales underlying sections 956 and 1248 would no longer be valid in a pass-through regime ending deferral completely for U.S. persons owning stock in a foreign corporation. Accordingly, both of those complicated provisions could be repealed. In addition to this simplification benefit, unrepatriated low-taxed foreign earnings would no longer be "trapped" in foreign corporation solution. Today, literally many corporations have millions of dollars of unrepatriated earnings that are reinvested outside the United States to take advantage of the deferral incentive.²⁷⁹ In certain cases, the consequence of the deferral incentive is a tax-induced distortion of the decision of where to invest these funds.

278. See *supra* text accompanying notes 275-277.

279. See *infra* text accompanying notes 310-311. For example, Intel Corporation's 1997 annual report on Form 10-K reports that it has not paid U.S. income taxes on \$1.5 billion of undistributed earnings for certain non-U.S. subsidiaries and intends to reinvest these earnings indefinitely in operations outside the United States. A few examples from other 1998 annual reports indicate that U.S. taxes have not been paid on \$2.4 billion of earnings from Lucent Technologies' foreign subsidiaries and \$6.7 billion of earnings from Procter & Gamble's foreign subsidiaries. Not all unrepatriated earnings are being held offshore to defer tax. The 1998 annual report for the Hewlett-Packard Company, for example, reports that the company has not paid U.S. taxes on \$7.1 billion of foreign subsidiaries' unrepatriated earnings but goes on to state that if these earnings were distributed foreign tax credits should become available to offset the resulting U.S. tax.

Fourth, the indirect foreign tax credit provisions in sections 902 and 960 would be repealed, at least with respect to post-enactment earnings of foreign corporations. Each U.S. person owning stock in the foreign corporation (including a U.S. individual) would obtain a direct credit for his, her, or its pro rata shares of the creditable foreign taxes paid by the corporation; thus, no indirect credit would be necessary. This change also would permit repeal of the election in section 962 for an individual shareholder of a controlled foreign corporation to be taxed as a corporation. Moreover, adoption of our pass-through proposal should permit substantial simplification of the foreign tax credit limitation rules in section 904.

Fifth, if this pass-through proposal were adopted, the passive foreign investment company provisions, the foreign personal holding company provisions and the foreign investment company provisions of current law would no longer be necessary and could be repealed. Moreover, the personal holding company tax provisions and accumulated earnings tax provisions could be amended to exempt foreign corporations from their reach. Instead of six overlapping and ineffective anti-deferral regimes, only one anti-deferral regime would remain—the pass-through regime which ends deferral entirely for U.S. persons earning income through foreign corporations.

Sixth, the number of outbound transfer pricing disputes under section 482 should be significantly reduced, thereby lowering taxpayer compliance costs and IRS administration costs.²⁸⁰ The deferral subsidy encourages U.S. multinational corporations to use intercompany pricing to shift profits to their controlled foreign corporations operating in tax haven jurisdictions. This pass-through proposal would make such shifts an ineffective tax planning strategy since the profits would be subject to a current U.S. tax in the hands of the U.S. multinational owning stock in the foreign corporation.

Seventh, repeal of deferral should significantly reduce pressure on the section 367 rules, which in part serve as a backstop to the current anti-deferral regimes in the Code. Thus, repeal of deferral through the adoption of this pass-through proposal should permit substantial simplification of those increasingly complex and incoherent rules.²⁸¹

Eighth, repeal of deferral would permit adoption of the worldwide fungibility method of interest allocation for U.S. multinationals and their U.S. and foreign affiliates.²⁸² This approach to interest allocation would both simplify the international tax rules and improve economic efficiency

280. See Shay, *supra* note 3, at 1062.

281. See *id.*

282. Ending deferral would offset one of the major arguments against adoption of the worldwide fungibility method of interest allocation—namely, that worldwide fungibility is not appropriate when the foreign income of a U.S. multinational group is not subject to current U.S. tax by reason of the deferral privilege because it allows a double tax benefit to the U.S. parent corporation (i.e., deferral of U.S. tax on the foreign income of its foreign subsidiaries and a deduction for interest expense allocable to such income). See U.S. TREAS. DEP'T, INTERIM REP., *supra* note 51, at 38 n.89.

by reducing the effect of tax considerations in the financing decisions of U.S. multinational corporations and their affiliates.²⁸³ By contrast, the so-called “water’s edge fungibility” interest allocation approach of current law causes a U.S. multinational corporation to borrow through its foreign subsidiaries (and thereby reduce the amount of interest expense allocable to the U.S. parent’s foreign source income), even when borrowing through a U.S. financing subsidiary would be less costly from a nontax perspective.²⁸⁴

Finally, adoption of this anti-deferral proposal should greatly reduce the significance of tax considerations in a U.S. person’s choice of an entity to conduct international business and investment activities because all foreign business entities, whether corporations, partnerships or branches, would be taxed under a pass-through approach.

D. PROBLEMS WITH THE PASS-THROUGH PROPOSAL

There are a number of problems with this pass-through proposal for ending deferral, which would require further analysis before this proposal were enacted.²⁸⁵ First and foremost, as discussed below in Part X of this Article, adoption of this proposal would involve complicated transition issues, which would require either the retention of many of the provisions of current law with respect to pre-enactment foreign corporate earnings (e.g., sections 902, 960, and 1248) or the adoption of other alternative transitional approaches (each of which has its own problems). Second, as the Subchapter K provisions of current law demonstrate, rules for allocating the source and character of the income and expenses of a pass-through entity to its owners are complex in operation. Adoption of this proposal would undoubtedly put great pressure on those allocation rules and raise many new issues concerning their application.²⁸⁶

However, whatever added complexity would be caused by extension of pass-through rules to all U.S. persons owning stock in foreign corporations is outweighed by the simplification benefits achieved by the proposal, as discussed above. In any event, with the adoption of the explicitly elective, check-the-box entity classification system, a substantial extension of the application of the pass-through rules to U.S. persons owning interests in foreign entities is inevitable since more U.S. taxpayers are likely to be operating abroad through foreign entities that will be classified as partnerships or “tax nothings” for federal tax purposes, even

283. *See id.* at 36-39.

284. *See id.* at 38.

285. In addition to those problems raised in the text, some commentators, including one of the authors of this Article, *see Peroni, supra* note 266, at 989 n.36, believe that adoption of this pass-through proposal might require renegotiation of existing U.S. income tax treaties in order to avoid a “treaty override” problem. However, the other two authors of this Article believe that the pass-through proposal is consistent with existing U.S. tax treaties. *See OECD, HARMFUL TAX COMPETITION, supra* note 173, at 122. In any event, we believe that the United States should seek to develop an international consensus for repealing tax deferral on the foreign income of CFCs.

286. *See Peroni, supra* note 266, at 992-93.

though those entities provide limited liability for investors. Thus, adoption of the check-the-box entity classification system should necessarily provoke a rethinking and redesign of the Subchapter K allocation rules. These rules were largely designed for a different era, not an era in which partnership flow-through treatment for a variety of different types of business organization (including the limited liability company) have become widely used for both domestic and foreign activities.²⁸⁷

E. NARROWER VERSION OF PASS-THROUGH PROPOSAL THAT WOULD APPLY ONLY TO "UNITED STATES SHAREHOLDERS" OF CONTROLLED FOREIGN CORPORATIONS

Alternatively, a narrower version of this proposal could be adopted, which would require only United States shareholders (as defined in section 951(b)) of a controlled foreign corporation (CFC) (as defined in section 957) to report their pro rata shares of the CFC's income and deductions on their own returns.²⁸⁸ This narrower version would achieve a substantial expansion of the reach of the anti-deferral rules, but at a lesser cost in terms of administrative difficulties.

Under this narrower version of the anti-deferral proposal:

1. Each United States shareholder of the CFC would be required to currently include a pro rata share of the CFC's income and expense items in computing his/her/its own U.S. tax liability.

2. Each United States shareholder of the CFC would be attributed his/her/its share of the foreign taxes paid by the CFC during the year and could claim a direct credit for those taxes to the extent they are creditable taxes under section 901 or section 903 (subject to the limit in section 904).

3. Under this pass-through regime, a United States shareholder of a CFC (including a U.S. multinational corporation) would be allowed to reduce its taxable income by its pro rata share of the CFC's losses.

4. The character of the CFC's items of income and expense would flow through to the United States shareholders under rules similar to those developed under sections 702(b) and 1366(b).

5. To determine each United States shareholder's pro rata share of the CFC's income, losses, and foreign taxes, pass-through rules similar to those developed under Subchapter K would apply in modified form. As discussed above, any allocations of the CFC's income, losses, and foreign taxes would have to meet the substantial economic effect test of section 704(b) and the regulations thereunder.

6. Basis adjustments similar to those in sections 705 and 1367 would apply to prevent double taxation of the CFC's earnings when they are distributed as a dividend or the CFC's stock is sold.

7. Any losses flowing through from the CFC to the United States shareholder would be limited to the extent of the United States share-

287. *See id.* at 993.

288. *See id.* at 989-92.

holder's basis in the CFC's stock and the United States shareholder's basis in loans to the CFC.

8. Distributions from the CFC would be tax-free to the extent of the United States shareholder's basis in the CFC's stock, and any excess would be treated as gain from the sale of the CFC's stock.

9. The current law definitions of "United States shareholder" in section 951(b) and "controlled foreign corporation" in section 957 would be retained. The direct, indirect, and constructive ownership rules of section 958 would also be retained, although some modification of the constructive ownership rules might be desirable (e.g., expanding the family attribution rules to include attribution of stock from siblings).

10. To allow elimination of the indirect credit rules for United States shareholders of foreign corporations that are not CFCs, a U.S. person owning at least 10% of the voting power of a foreign corporation that is not a CFC would be allowed to elect current inclusion treatment with respect to the foreign corporation and obtain a direct credit for its pro rata share of the foreign taxes paid by the foreign corporation. Thus, if no election were made, a 10-percent-or-more United States shareholder of a foreign corporation that is not a CFC or passive foreign investment company could continue to defer U.S. tax on the foreign corporation's earnings, but the price of continued deferral would be no foreign tax credit for any foreign taxes paid by the foreign corporation. To prevent self-selection problems, a United States shareholder's election with respect to any particular foreign corporation would be revocable only with the consent of the IRS.

11. With respect to a U.S. person owning stock (no matter how small the ownership interest) in a foreign corporation that is not a CFC but that earns primarily passive income, one anti-deferral regime would apply and that regime would be patterned after the passive foreign investment company provisions of current law. However, to simplify those rules, current inclusion of the passive foreign investment company's income could be made mandatory. The complex rules relating to the interest charge on excess distributions and the various elective rules in section 1291(d) of current law could be repealed.²⁸⁹

If the U.S. person owning shares in the passive foreign investment company does not have sufficient information to determine his/her/its pro rata share of the passive foreign investment company's income, that U.S. person could be allowed to base the amount of the current inclusion on generally available financial information of the passive foreign investment company (as adjusted to reflect U.S. tax accounting principles for certain "material items" that could be "reasonably identified" by the U.S. person).²⁹⁰ Alternatively, if the passive foreign investment company's

289. See Avi-Yonah, *supra* note 3, at 223; Michael J. McIntyre, *Collecting Current Tax From U.S.-Resident Individuals and U.S.-Based MNEs on Income Earned Through Foreign Entities*, 11 TAX NOTES INT'L 440, 444-45 (1995).

290. See Shay, *supra* note 3, at 1061.

stock is marketable stock, the U.S. person could be provided with a market-to-market election similar to the one in section 1296 of current law. In the event that the foreign corporation's stock is not marketable and the U.S. person owning stock in the corporation does not possess sufficient information to properly report under the pass-through method, our modified version of the section 1291 "interest-charge" method for recapturing the benefits of deferral would be used here.²⁹¹

This narrower version of the pass-through proposal would still have many of the simplification benefits achieved by the broader version of the anti-deferral proposal discussed above, including repeal of the detailed Subpart F income definitional rules in sections 952 through 954, the indirect credit provisions in sections 902 and 960, and the foreign personal holding company and foreign investment company regimes. However, this narrower version would lose some significant simplification benefits of the broader anti-deferral proposal by retaining some of the definitional complexities of the current law Subpart F and passive foreign investment company regimes (e.g., the definitions of a controlled foreign corporation in section 957 and a passive foreign investment company in a modified version of section 1297).

This narrower version of the pass-through proposal also would be much less effective in ending the deferral subsidy because it would generally continue to allow deferral of U.S. tax on active foreign business income by U.S. persons owning less than a 10% stock interest in a CFC and by U.S. persons owning stock in foreign corporations that are not CFCs as defined in section 957. It also would continue to allow deferral of U.S. tax on foreign passive income by U.S. persons owning stock in foreign corporations that are neither CFCs nor passive foreign investment companies. Thus, this narrower version would continue to place a premium on tax planning maneuvers that structure the stock ownership of U.S. persons in a foreign corporation in such a way as to avoid "United States shareholder" status for the shareholder under section 951(b), "controlled foreign corporation" status for the corporation under section 957, or "passive foreign investment company" status for the corporation under section 1297.

Finally, many of the problems with the broader version of the pass-through proposal discussed above would apply to this narrower version as well. However, this narrower version would avoid some of the potential administrative difficulties with applying the pass-through regime to relatively small stock interests of U.S. persons in foreign corporations, particularly non-U.S.-controlled foreign corporations.

291. See *supra* text accompanying note 277.

F. ANOTHER NARROWER VERSION OF THE PASS-THROUGH PROPOSAL

Yet another possible version of this anti-deferral proposal would apply the pass-through regime to any U.S. person owning stock in a foreign corporation that meets the definition of a CFC in section 957 (with perhaps a broadening of that definition). This proposal would retain a modified version of the passive foreign investment company provisions (similar to the one discussed above) to deal with abuses involving deferral of passive income earned through foreign corporations that are not CFCs. This narrower version of the anti-deferral proposal is preferable to the broader version only if one accepts the underlying rationale of Subpart F that deferral should be ended only with respect to U.S. shareholders who have the power to force a dividend distribution (i.e., those U.S. persons owning 10% or more of the voting stock of a foreign corporation that is more than 50% owned by such shareholders).

X. TRANSITION ISSUES

A. EFFECT OF THE PASS-THROUGH PROPOSAL IN THE ABSENCE OF TRANSITION RELIEF

If the pass-through proposal were adopted without transition relief, presumably the rules governing a change in status from a corporation to a partnership would apply. Under current law, the corporation would be deemed to liquidate and the shareholders deemed to contribute the assets to a partnership.²⁹² Assuming that the controlled foreign corporation were owned directly by an 80% (by vote and value) domestic corporate shareholder, the deemed liquidation would be a taxable disposition of the CFC stock unless the shareholder elected to include the all earnings and profits amount in income.²⁹³ If the shareholder were not a corporation or owned less than 80% of the CFC stock by vote and value, the deemed liquidation would be a taxable disposition of the CFC stock.²⁹⁴ Accordingly, in the absence of statutory transition relief, shareholders in foreign corporations deemed by the proposal to change to a pass-through entity would recognize deferred earnings in a section 332 liquidation or all unrealized gain in a taxable disposition.²⁹⁵ The pass-through entity would obtain a fair market value basis in the assets deemed contributed back to

292. See Rev. Rul. 63-107, 1963-1 C.B. 71; see also Tech. Adv. Mem. 96-18-003 (Jan. 17, 1996); Prop. Treas. Reg. § 301.7701-3(g)(1)(ii) (1997).

293. See I.R.C. §§ 332, 337; Temp. Treas. Reg. § 7.367(b)-5. If the domestic corporation does not include the all earnings and profits amount, the foreign corporation will not be considered a corporation for purposes of section 332 and the domestic corporation will be taxable on the gain realized. The carryover rules for assets and corporate attributes (sections 334 and 381) will continue to apply.

294. See I.R.C. § 331.

295. Section 1248 would apply to a United States shareholder's taxable disposition of CFC stock and recharacterize the gain as a dividend income to the extent of untaxed earnings and profits accumulated during the period the shareholder was a United States shareholder and the foreign corporation was a CFC.

the pass-through entity, or, in the case of a section 332 liquidation, a carryover basis.

The following discussion identifies and evaluates possible alternative transition rules, ranging from the maximum windfall for taxpayers that have untaxed deferred income to "no transition."

B. ALTERNATIVE TRANSITION RULES

Maximum transition relief. If the pass-through proposal were adopted, the most generous transition for an 80% U.S. corporate shareholder would be to permit the change in classification of the CFC to a pass-through entity without requiring taxation of untaxed accumulated earnings and allowing the pass-through entity to take a carryover basis in the former CFC's assets. An analogous level of transition relief for a U.S. shareholder other than an 80% corporate shareholder would be to provide exemption from tax on liquidation gain, exemption from Subpart F or other U.S. income inclusion of entity-level gain, and carryover basis for assets transferred. This would not only forgive tax on pre-change earnings, but also give the U.S. taxpayer the benefit of tax basis in assets that have been acquired with pre-tax dollars.²⁹⁶

There is precedent for such extreme generosity in transition. In 1984, in order to persuade exporters to support a change from the domestic international sales corporation (DISC) tax regime²⁹⁷ to the foreign sales corporation (FSC) regime,²⁹⁸ in the face of a challenge by several European trading partners that the DISC was an illegal export subsidy under the General Agreement on Tariffs and Trade (GATT), the deferred earnings of a DISC were exempted from taxation.²⁹⁹ Arguments in support of the DISC transition relief were not stated explicitly in the legislative history, but implicitly included that the change in the targeted incentive was being forced on exporters by the government's desire to comply with the GATT and terminate a contentious trade dispute. In addition, the FSC regime provided for an exemption system and exemption of the DISC deferred earnings from tax avoided the need to maintain DISC rules for earnings that would have continued to be deferred. Finally, the argument was made that the deferred DISC earnings likely would never have been taxed and, therefore, the transition relief was not as generous as it appeared.

It is arguable, however, that the DISC history is not a controlling precedent regarding the elimination of deferral because unlike the DISC provisions, deferral is not a targeted subsidy consciously intended by gov-

296. This policy issue was identified by Charles Kingson in connection with analyzing the appropriate "toll charge" for an inbound corporate liquidation. See Charles I. Kingson, *The Theory and Practice of Section 367*, 37th N.Y.U. INST. ON FED. TAX'N 22-1, 22-7 to 22-30 (1979).

297. See I.R.C. §§ 991-997.

298. See I.R.C. §§ 921-927.

299. See Pub. L. No. 98-369, § 805(b)(2), 98 Stat. 494, 1001-02 (1984).

ernment to induce reliance.³⁰⁰ Arguably it is more like an advantageous tax rate that can be raised without transition relief.

Minimum transition relief. Although relief from all income recognition (without basis adjustment) clearly is too generous a form of transition, triggering realization of more than the amount of deferred earnings and profits goes too far in the other direction. If, as discussed above, the baseline objective is to move to current inclusion in income of previously realized foreign corporate earnings, it would not seem appropriate to require realization of corporate-level unrealized appreciation (i.e., goodwill and other assets).³⁰¹ Accordingly, a transition rule that did not compel recognition of unrealized gains but that required inclusion of an all earnings and profits amount and section 332 carryover treatment for assets in what otherwise would be a section 331 liquidation case would seem appropriate at a minimum.

Alternative transition proposals. It would be possible to fashion transition relief that falls between current inclusion of all untaxed earnings and exemption of untaxed earnings. One approach would be to permit a taxpayer to reduce basis in depreciable and certain other property, under principles of section 1017, in lieu of current inclusion of pre-change earnings. Another approach would be to spread inclusion of pre-change earnings over multiple years in a manner similar to section 481 treatment of accounting method changes.

The following discussion identifies the standards that might be employed to evaluate the preceding, and other, approaches to transition relief.

C. STANDARDS FOR EVALUATING CLAIMS FOR TRANSITION RELIEF

Transition relief in tax legislation is and always will be a political exercise. Nonetheless, it is desirable to attempt to apply objective standards in considering transition claims or face erosion in public respect for the tax system if transition relief is perceived as an unprincipled pork-barrel giveaway.³⁰² Ronald Pearlman observes that transition relief may pertain to pre- or post-change behavior.³⁰³ This discussion is addressed solely to the effect of the proposal on pre-change actions.³⁰⁴

300. See *supra* text accompanying notes 59-62.

301. It also would not be necessary to require realization of appreciation in PFIC stock that has been the subject of a QEF election or that is subject to the PFIC interest charge or mark-to-market rules.

302. See Ronald Pearlman, *Transition Issues in Moving to a Consumption Tax*, reprinted in AM. B. ASS'N TAX SEC., A COMPREHENSIVE ANALYSIS OF CURRENT TAX PROPOSALS 22 (1998). Pearlman cites the adverse publicity from the Philadelphia Inquirer's reporting of the hundreds of transition rules included in the Tax Reform Act of 1986. See Donald L. Barlett & James B. Steele, *A Historic Hotel and Its Quest for a Tax Cut*, PHILADELPHIA INQUIREY, Sept. 26, 1988 at A-10; Donald L. Barlett & James B. Steele, *The Tax Break Sweepstakes: Who Wins Round 2?*, PHILADELPHIA INQUIRER, Sept. 25, 1988, at A-1.

303. See Pearlman, *supra* note 302, at 22-23.

304. The pass-through proposal may have a significant wealth effect on U.S. taxpayers affected by the proposal. These effects may be addressed by ameliorating the transition to

Reliance-based claims for relief. Transition relief historically has not been granted for rate changes, but is common in relation to tax base changes that narrow or repeal taxpayer-favorable provisions of existing law. A common basis for claiming transition relief is reliance. The reliance claim essentially is that the government should not penalize taxpayers who have been induced to undertake a specific action or investment by a tax incentive provision.³⁰⁵ The claim is strongest for targeted tax incentive provisions.

There is an irony in assessing reliance claims in relation to the deferral issue, namely, that most proponents of deferral insist that the location of their investments is not tax-motivated. In such a circumstance, it could be argued that transition relief is not appropriate for pre-change earnings. If deferral is analyzed as an incentive, however, a reliance claim could be asserted if taxpayers demonstrated that they invested abroad in reliance on the incentive.

Moderating wealth effects. Not all commentators subscribe to the need or desirability of reliance-based transition relief, rejecting the analogy to a contractual relationship.³⁰⁶ Professor Michael Graetz would, however, take account of the magnitude of wealth effects³⁰⁷ and there likely would be substantial wealth effects from adoption of the pass-through proposal since the value of CFC assets would be decreased. There also would be windfall gain wealth effects if pre-change untaxed earnings were exempted from taxation altogether.³⁰⁸

Mitigating inefficiencies of tax uncertainty. As noted above, it may be argued that transition relief should depend on the magnitude of the change proposed and take account of the effect of tax law change on the risk premium for future investments. This argument for transition relief is strongest for targeted incentives. Others argue, however, that transition relief may disturb rather than correct a properly functioning market that takes risks of changes in the law into account.³⁰⁹

Evaluation. U.S. multinational corporations have billions of dollars of untaxed, unrepatriated earnings.³¹⁰ There is no accurate basis to gauge

the proposal through postponed effective dates or other measures. This Article does not discuss this aspect of transition.

305. See Pearlman, *supra* note 302, at 24.

306. See Michael J. Graetz, *Retroactivity Revisited*, 98 HARV. L. REV. 1820, 1823-24 (1985).

307. See *id.* at 1826.

308. Professor Graetz finds that neither fairness nor efficiency requires grandfathering of pre-change transactions or investments. Generally, he would favor phased-in or delayed effective dates. See *id.* For an argument, in response to Professor Graetz and others, that grandfathering is appropriate for incentive subsidy provisions, see Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129 (1996).

309. See Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 520, 550-52 (1986).

310. Office of Management and Budget estimates of the revenue from eliminating the deferral tax expenditure exceed \$2 billion annually. See OFFICE OF MANAGEMENT & BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT: ANALYTICAL PERSPECTIVES—FISCAL YEAR 1999 74 (1998).

the amount of unrealized gain United States shareholders of CFCs and other United States shareholders have in their holdings of foreign corporate stock. Without doubt, in the absence of transition relief, a pass-through based anti-deferral proposal would constitute one of the largest potential revenue raising measures available to an Administration or Congress.³¹¹ Any such proposal will be required to address claims by these shareholders for relief from current taxation.

The unmitigated constructive liquidation model, explained above, for determining the tax consequences of a change in classification from corporate to pass-through status is not appropriate for the transition to any of our proposed pass-through regimes because it would accelerate realization of appreciation in entity-level assets. If taxable U.S. shareholders in a foreign corporation were not required to include pre-change earnings in income, however, they would realize an unprecedented windfall if their foreign corporations were placed in a pass-through regime which allowed these corporations to continue with asset basis that represented untaxed (by the United States) earnings and profits.³¹² There is no tax policy merit to such a rule (that is not accomplished more efficiently by more modest relief) except as an explicitly political cost of reform.

We do not know the amount of additional U.S. taxes that would be due if undistributed pre-change earnings were included in income. If earnings were distributed to a corporate taxpayer and carried significant foreign tax credits, there may be no additional U.S. tax. It is likely, however, that there would be substantial additional federal and state tax due. Accordingly, we would favor a transition rule that permitted pre-change earnings to be included in income over a period of from three to five years (but no later than when transferred basis is utilized in the taxpayer's U.S. return).

XI. CONCLUSIONS

As this Article has demonstrated, design of an appropriate anti-deferral regime for taxing the foreign source income earned by U.S. persons through foreign corporations is an important and difficult issue in the international tax arena. Although a number of different approaches have been developed over the years and incorporated into U.S. law, dissatisfaction with the current rules is widespread, regardless of one's views of the appropriateness of the deferral privilege. We have concluded that the most effective method for achieving anti-deferral is the pass-through model—i.e., treating the foreign corporation as a pass-through entity with

311. Recent discussions of whether the repeal of deferral would raise or lose revenue either have assumed that pre-enactment earnings would not be taxed or have not discussed the issue. See, e.g., Frisch, *supra* note 3; Oosterhuis & Cutrone, *supra* note 3. Professor Saul Levmore has argued that unexpected use of retroactive taxation may provide a nondistortionary source of revenue. See Saul Levmore, *The Case for Retroactive Taxation*, 22 J. LEGAL STUD. 265, 273-78 (1993).

312. We assume that tax-exempt entities would not be adversely affected by the absence of exemption of pre-change earnings because a distribution of corporate earnings in liquidation would not give rise to unrelated business taxable income.

respect to its U.S. shareholders, with special rules for less than 10% shareholders in non-U.S.-controlled foreign corporations. Although this pass-through proposal does have some problems (including difficult transition issues), it best satisfies the optimal criteria for designing an appropriate anti-deferral mechanism discussed in Part VI of the Article. By writing this Article, we hope to provoke discussion and debate in the international tax community concerning the anti-deferral issue and the appropriateness of using our pass-through model as the mechanism for curtailing deferral.

APPENDIX A

Country	CFC Definition	Target Territory	Tainted Income	Exemptions From Income Attribution	Affected Taxpayers
Australia	(i) Five or fewer Australian residents (each owning at least 1 percent) control 50 percent or more of CFC at the end of the accounting period; (ii) owning less than 50 percent, five or fewer Australian residents effectively control CFC; or (iii) one Australian resident owns 40 percent or more of CFC, unless Commissioner satisfied that control is exercised by nonresidents holding some or all of the remaining interests. Constructive ownership rules apply.	List of designated comparable tax jurisdictions (non-target countries) with certain concession income carved out from exclusion.	If CFC is in unlisted (e.g. target) country, passive income and certain sales and service income are tainted income; if in listed country, only income from "eligible designated concession" is tainted. Certain other income, including certain trust income, is tainted regardless of exemption.	If tainted income is less than 5 percent of total (or, in listed country, tainted "eligible designated concession" income is less than 5 percent of total "eligible designated concession" income), the CFC carries on business through permanent establishment in its residence country, keeps its books on commercially acceptable standard and is in existence at the end of the year, no income attribution.	Every member of group that actually controls CFC at the end of the year (if at least 1 percent owned); if not a member of control group, must hold substantial interest (10 percent or more) of greater of voting rights or rights to dividends or distributions on winding up. Indirect and constructive ownership rules apply.
Canada	A controlled foreign affiliate is a foreign affiliate of a taxpayer resident in Canada more than 50 percent of whose voting shares are owned by (i) the taxpayer, (ii) the taxpayer and not more than 4 other Canadian residents, (iii) persons who do not deal at arm's length with the taxpayer, or (iv) the taxpayer and non-	None.	(i) Passive income and gains from passive property; (ii) services income if the amount paid is deductible in Canada by a person as to which the non-resident corporation is a CFC or person related to the CFC; (iii) income from the sale of property the cost of which is deductible by non-arm's length Canadians; (iv)	There are 3/4 exemptions from FAPI for: (i) property sold in Canada if created in CFC's country of residence or 90 percent or more of the CFC's revenue is from sales to unrelated persons; (ii) more than 90 percent of the CFC's gross premium income is from insurance of non-Canadian risks of arm's length persons; (iii)	Any Canadian person who owns not less than 1 percent of any class of the CFC at the end of the year and who, with related persons, owns not less than 10 percent of the shares of any class of the CFC and in respect of whom the CFC is a CFC.

Country	CFC Definition	Target Territory	Tainted Income	Exemptions From Income Attribution	Affected Taxpayers
Canada ctd.	arm's length person. A foreign affiliate of a Canadian resident taxpayer is a non-resident corporation in which the taxpayer owns at least 1 percent of a class of capital stock and the taxpayer and related persons own at least 10 percent of a class of capital stock (both under constructive ownership).		income from insurance or reinsurance of Canadian risks; (v) income from debt and lease obligations of residents of Canada; and income from an investment business carried on by a CFC.	income from debt or lease obligations if more than 90 percent of CFC's gross income from indebtedness is from arm's length non-residents. There also is a C\$ 5,000 <i>de minimis</i> standard.	
Denmark	A foreign corporation engaged "mainly" in financial activities (meaning more than 50 percent of the assets of the CFC are used in financial activities) if, at any time during an accounting period, a company resident in Denmark controls, directly or indirectly, more than 50 percent of the shares or voting power of the foreign corporation. No constructive ownership rules apply.	A country if the income tax rules "deviate substantially" from Danish company income tax rules. This is deemed to exist if: (i) the foreign tax is less than 75 percent of the tax that would have been paid had the CFC been resident in Denmark; (ii) the CFC has entered into an agreement with the foreign tax authorities regarding the tax rate or tax base; or (iii) the target territory applies different internal tax rules depending on where the parent company of the CFC is resident.	Income from financial activities (including interest, dividends, royalties, financial leasing, capital gains from disposal of shares in other securities).	None.	A Danish company which holds, directly or indirectly, more than 50 percent of the shares or controls more than 50 percent of the voting power of the CFC.

Country	CFC Definition	Target Territory	Tainted Income	Exemptions From Income Attribution	Affected Taxpayers
France	For structures established after September 30, 1992, a foreign corporation is a CFC if a French company directly or indirectly owns 10 percent or more or has an investment of FF 150 million, whichever is less, in shares.	If the foreign corporation is established in a "privileged" tax regime, meaning the actual foreign tax is less than 2/3 of the French tax that would have been paid by the CFC.	All income, as calculated under French law, is tainted income. (E.g., the French 95 percent participation exemption also is available to CFCs.)	No income is attributed if the CFC's operations do not have the principal effect of "localizing" profits in a country where it is subject to a privileged tax regime. This test is deemed to be satisfied if more than 50 percent of the CFC's revenue is from local manufacturing, sales or commercial service activities, or from the local purchases of goods or raw materials.	Any French corporation that directly or indirectly owns 10 percent or more or has an investment of FF 150 million or more in the CFC at the end of the year.
Germany	At the end of the foreign corporation's fiscal year, German resident shareholders (without minimum shareholdings) own more than 50 percent of voting rights or profit distribution rights of the foreign corporation. Indirect and constructive ownership rules apply.	Generally, the foreign tax on tainted income is less than 30 percent. There are special rules for determining the tax base. There is an unofficial list of target territories and other countries.	Generally, passive income, income from captive insurance and sales with related parties. Other than capital investment income, tainted income is treated as income from capital (treated as ordinary income under the German FIF rules) and dividends for treaty purposes.	No attribution if tainted income less than 10 percent of CFC's gross income, provided that total amount exempted with respect to any CFC or any German taxpayer (with respect to all CFCs in which it owns shares) does not exceed DM 120,000. Special rules for interests in 25 percent or more owned subsidiaries engaged in certain exempt activities.	Any German resident shareholder at end of the CFC's fiscal year. No minimum ownership or constructive ownership rules apply.
Japan	At the end of the foreign corporation's fiscal year,	Foreign tax is less than 25 percent. From April 1,	All income is tainted income.	No attribution for a CFC if: (i) the CFC's main	Any Japanese shareholder who holds, directly or

Country	CFC Definition	Target Territory	Tainted Income	Exemptions From Income Attribution	Affected Taxpayers
Japan ctd.	Japanese resident shareholders (without minimum shareholdings) own more than 50 percent of votes or shares of the foreign corporation. Indirect and constructive ownership rules apply.	1992, no official or unofficial list of target or non-target territories.		business is not to hold securities, licensing, or lease of vessels or aircraft, (ii) the CFC has fixed facilities necessary to conduct its business in the target territory, (iii) the CFC manages and controls its business in the target territory as an independent operating unit, and (iv) main business is more than 50 percent carried out in the target territory, or, if main business is wholesale banking, trust, securities, insurance, shipping or air transport, more than 50 percent of business income is from unrelated persons.	indirectly, 5 percent or more of the shares of the CFC at the end of the fiscal year. Constructive ownership rules apply.
New Zealand	At any time during an accounting period, (i) five or fewer New Zealand residents control more than 50 percent of the CFC (based on any of total paid-up capital, total nominal capital, entitlement to income, entitlement to value of net assets or total rights to vote in specified deci-	Since April 1, 1993, certain high-tax <i>non-target</i> countries identified.	All income of the CFC calculated as if CFC resident in New Zealand.	None.	Any taxpayer holding, directly or indirectly, 10 percent or more of income interests during the year (calculated on certain measurement dates and averaged). [A separate FIF regime may apply to less than 10 percent owners.] There are no constructive ownership provisions.

Country	CFC Definition	Target Territory	Tainted Income	Exemptions From Income Attribution	Affected Taxpayers
New Zealand ctd.	<p>sions); (ii) one person controls 40 percent or more of the CFC and no other single person controls at least as large a holding; (iii) a group of five or fewer residents have the power to control the exercise of shareholder decision making rights.</p>				
United Kingdom	<p>At any time during the foreign corporation's year, UK residents (with no minimum ownership threshold) hold more than 50 percent of votes, distributable income or value of assets on liquidation. Indirect and constructive ownership rules apply.</p>	<p>Foreign tax is less than 3/4 of UK tax payable had the foreign corporation been resident in the UK. White and grey lists are published.</p>	<p>All income other than capital gains.</p>	<p>If CFC is trading company, 50 percent of available profits less capital gains (under foreign law) distributed during accounting period or 18 months thereafter. If CFC not a trading company, must distribute 90 percent of taxable profits (under UK tax rules) less capital gains and foreign tax.</p>	<p>Corporations to which 10 percent or more of CFC's income is apportioned. Board of Inland Revenue has power to attribute income to domestic non-shareholder (e.g., creditor).</p>

