

9-1-1978

Special Vehicles for Operating Abroad: An Overview of U.S. Tax Planning Alternatives

Robert F. Hudson Jr.

Follow this and additional works at: <http://repository.law.miami.edu/umialr>

Recommended Citation

Robert F. Hudson Jr., *Special Vehicles for Operating Abroad: An Overview of U.S. Tax Planning Alternatives*, 10 U. Miami Inter-Am. L. Rev. 299 (1978)

Available at: <http://repository.law.miami.edu/umialr/vol10/iss2/2>

This Article is brought to you for free and open access by Institutional Repository. It has been accepted for inclusion in University of Miami Inter-American Law Review by an authorized administrator of Institutional Repository. For more information, please contact library@law.miami.edu.

SPECIAL CORPORATIONS FOR OPERATING ABROAD — AN OVERVIEW OF U.S. TAX PLANNING ALTERNATIVES

ROBERT F. HUDSON, JR.*

When a U.S.-based business expands into the international arena, a number of unique corporate vehicles and tax planning opportunities arise which are not available to a purely domestic enterprise. This article will review four types of special corporations: the Domestic International Sales Corporation, the Western Hemisphere Trade Corporation, the Possessions Company, and the Controlled Foreign Corporation, including their alternative applications and their related limitations.

The activities encompassed by the opportunities to be discussed can include exporting, importing, licensing, services, leasing, manufacturing, and similar commercial operations. However, the focus will be on a U.S.-based company engaged in these businesses abroad; the U.S. tax consequences of a foreign entity conducting these enterprises within the United States will not be addressed. The format of this review will be an analysis of the alternative vehicles, with a discussion of their applications and limitations contained thereunder. An outline of the topics covered under each section is set forth for reference purposes.

- I. DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)
 - A. In General
 - B. DISC Qualification Requirements
 1. *Initial Requirements*
 2. *Operating Requirements*
 3. *Qualified Export Receipts*
 4. *Qualified Export Assets*
 - (a) *In General*
 - (b) *Export Property*
 - (c) *Producer's Loans*
 - (d) *Operating Assets*
 - (e) *Accounts Receivable*
 - (f) *Working Capital and U.S. Bank Deposits*
 - (g) *Investments in Certain Foreign Corporations*
 - (i) *Foreign International Sales Corporation*
 - (ii) *Real Property Holding Company*
 - (iii) *Associated Foreign Corporation*
 - (h) *Eximbank, FCIA and PEFCO Obligations*
 - C. Determination of DISC Profits: Intercompany Pricing Rules
 1. *Export Promotion Expenses*
 2. *Strategies for Grouping DISC Transactions*

*LL.M., (Tax) New York University (1972); J.D., University of Florida (1971); B.S.B.A., (Economics) University of Florida; Member Florida and New York Bars and the Inter-American Bar Association; Associated with the law firm of Arky, Freed, Stearns, Watson & Greer (Miami, Florida). Mr. Hudson is a frequent lecturer on international tax subjects, having specialized in this area in both New York and Miami.

D. Deferred Taxation of DISC Income to DISC Shareholders

1. *In General*
2. *Incremental Rule of 1976 Tax Reform Act*
 - (a) *In General*
 - (b) *Liberalizing Aspects*
 - (c) *Affirmative Use of Small DISC Exemption from Incremental*

Rule

3. *Additional Changes in the DISC Provisions Under the 1976 Tax Reform Act*

4. *Multiple DISCs and the Recapture Deferral Period*

E. Summary of Uses of DISCs

1. *Exporting*
2. *Leasing*
3. *Services*
 - (a) *In General*
 - (b) *"Related and Subsidiary" Services*
 - (c) *Engineering and Architectural Services*
 - (d) *DISC Management Services*
 - (e) *Impact of Services on the Incremental Rule*
4. *Licensing*
5. *Manufacturing*
6. *Importing*

F. Legislative Outlook for DISC Repeal

II. POSSESSIONS CORPORATIONS

A. Introduction

B. Qualification Requirements for Possessions Corporations

1. *In General*
2. *Domestic Corporate Status*
3. *Possessions Source Income*
4. *Active Trade or Business Income*
5. *Non-DISC Status*
6. *Affirmative Election*

C. The PC Tax Credit

1. *In General*
2. *Determination of the PC Tax Credit*
 - (a) *Taxable Income from Active Conduct of a Possession, Trade or*

Business

- (b) *Qualified Possession Source Investment Income*
- (c) *Amount of the PC Tax Credit*
3. *Interrelationship with Regular Foreign Tax Credits*
4. *Recapture of Overall Foreign Losses*

D. Taxability of PC Shareholders

1. *Dividends Received Deductions*
2. *Foreign Tax Credits Allowable to PC Shareholders*
 - (a) *Direct Foreign Tax Credits*
 - (b) *The Deemed Paid Foreign Tax Credit*

E. Relevant Puerto Rican Law

F. Summary of Uses of Possessions Companies

1. *Exporting*
2. *Leasing and Licensing*
3. *Services*
4. *Manufacturing*
5. *Importing*

G. Legislative Outlook for Possessions Companies

III. WESTERN HEMISPHERE TRADE CORPORATION

A. Background

1. *Current Status*
2. *Original Benefits and Uses*
3. *Qualification Requirements and Tax Characteristics*
 - (a) *Western Hemisphere Business Test*
 - (b) *95% Foreign Source Income Test*
 - (c) *90% Active Business Tests*
4. *The WHTC Phase-Out*

B. Current Planning Opportunities

1. *Alternative to DISC*
2. *Obtaining Maximum Period of Use of WHTC Rates*

IV. CONTROLLED FOREIGN CORPORATIONS

A. Introduction

1. *Basic U.S. Tax Treatment of U.S. vs. Foreign Companies: The Deferral Concept*

2. *Uses and Abuses of Foreign Corporations*
3. *Limits on Deferral: CFC Overview*

B. Definition of Controlled Foreign Corporations

1. *In General*
2. *Decontrol of a CFC*

C. Income Attributed to CFC Shareholders

1. *In General*
2. *Foreign Base Company Income*
 - (a) *Foreign Personal Holding Company Income*
 - (b) *Foreign Base Company Sales Income*
 - (c) *Foreign Base Company Service Income*
 - (d) *Foreign Base Company Shipping Income*
 - (e) *Exclusions and Adjustments to Foreign Base Company Income*
 - (i) *No Tax Avoidance Motive*
 - (ii) *10% and 70% Tests*
 - (iii) *Allowance of Deductions*

3. *Insurance of U.S. Risks*

4. *International Boycotts and Illegal Bribes*

5. *Withdrawal of Previously Excluded Subpart F Income from Less Developed Countries or Shipping Operations*

6. *Investments in United States Property*

7. *Exceptions and Limitations on Subpart F Income*

8. *Mechanics of Subpart F Attribution*

- D. Other Restrictions on Passive Income
 - 1. *Foreign Personal Holding Company Provisions*
 - 2. *Foreign Investment Companies*
- E. Sale or Liquidation of Controlled Foreign Corporations
- F. Tax Consequences of Forming a CFC
- G. Summary of Uses of CFCs
 - 1. *Exporting*
 - 2. *Leasing*
 - 3. *Licensing*
 - 4. *Services*
 - 5. *Manufacturing*
 - 6. *Importing*
- H. Legislative Outlook for CFC Deferral

V. SUMMARY

- A. Exporting
- B. Leasing
- C. Licensing
- D. Services
- E. Manufacturing
- F. Importing

I. DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)

A. In General

In 1971, Congress provided U.S. exporters with new tax incentives to encourage certain export related activities.¹ A deferral of up to one-half of the tax on export profits is accorded to a special type of corporation, the Domestic International Sales Corporation, commonly referred to as a "DISC". To achieve this deferral, the DISC itself is exempted from U.S. tax, while approximately one-half of its profits are taxed to the DISC's shareholders on an annual basis even if not distributed. The remaining DISC profits are not taxed to the shareholders until actually distributed, or until a shareholder disposes of his DISC stock, or the corporation ceases to qualify as a DISC.

B. DISC Qualification Requirements

1. *Initial Requirements.* The formalities of creating a DISC are minimal.² To initially qualify, the entity must meet the following requisites: (a) A domestic corporation incorporated under the laws of any state or the District of Columbia;³ (b) only one class of stock;⁴ (c) a minimum capital of \$2,500 on each day of the taxable year;⁵ (d) files an election to be treated as a

1. Revenue Act of 1971 (Pub. L. No. 92-178.) § 501, 85 Stat. 535 (1971). See generally, §§ 991-997 of the Internal Revenue Code of 1954, as amended [All section references herein shall be to the Internal Revenue Code of 1954 as amended unless otherwise indicated.]

2. See generally, § 992 (a)(1) & Treas. Reg. § 1.992-1(a).

3. § 992(a)(1); Treas. Reg. § 1.992-1(a)(1).

4. § 992(a)(1)(C); Treas. Reg. § 1.992-1(d)(1).

5. *Id.*

DISC within a specified time period;⁶ (e) maintains a bank account on each day of the taxable year;⁷ (f) maintains separate books and records;⁸ and (g) must not be an ineligible corporation (a tax-exempt entity, personal holding company, bank or similar financial institution, insurance company, mutual fund, or Subchapter S corporation).⁹

There is no requirement that the DISC have employees or separate facilities of its own.¹⁰ In effect, a DISC may be a mere "paper" corporation whose function is to provide a convenient bookkeeping mechanism for isolating export profits of a larger sales enterprise, such as a parent manufacturing or distributing corporation. The viability of this relationship is reinforced by favorable rules for determining the transfer price on sales by a related supplier to a DISC.¹¹ The DISC tax deferral benefits are equally available, however, to an enterprise which deals only with unrelated parties.

2. *Operating Requirements.* After a corporation has met the initial DISC requirements, it must meet two operating tests pertaining to the character of its business: (a) at least 95% of its gross receipts must consist of "qualified export receipts"¹² and (b) at least 95% of its assets must be "qualified export assets."¹³ While the assets test must be met only at the close of the taxable year, the gross receipts test is applied to the taxable year as a whole.¹⁴ If a DISC inadvertently fails to satisfy either, or both, of these tests, the potential disqualification may be cured by a means of a distribution of the non-qualified assets and/or the taxable income attributable to non-qualified receipts, as the case may be, if the failure is due to "reasonable cause".¹⁵

3. *Qualified Export Receipts.* Generally, "qualified export receipts" consist of the following types of income:¹⁶

(a) Receipts from the sale or other disposition of "export property" (generally inventory produced in the United States, by someone other than the DISC, for export abroad);

(b) receipts from the leasing of export property which is used outside the United States;

(c) receipts for services which are related and subsidiary to any qualified sale, lease or other disposition of export property;

6. § 992(a)(1)(D); Treas. Reg. § 1.992-1(a)(5) & (1)(e).

7. Treas. Reg. § 1.992-1(a)(6) & (1)(i).

8. Treas. Reg. § 1.992-1(a)(7).

9. Treas. Reg. § 1.992-1(a)(8) & (1)(f).

10. Rev. Rul. 72-166, 1972-1 C.B. 220; *See generally*, DISC: A Handbook for Exporters (Published by the Treasury, 1972).

11. § 994; *See*, Part I. C. *supra*.

12. § 992(a)(1)(A); Treas. Reg. § 1.992-1(a)(2) & (2)(b).

13. § 992(a)(1)(B); Treas. Reg. § 1.992-1(a)(3).

14. Treas. Reg. § 1.992-1(c)(1).

15. § 992(c); Treas. Reg. § 1.992-3.

16. § 993(a)(1); Treas. Reg. § 1.993-1.

- (d) receipts from the sale or other disposition of "qualified export assets" (other than export property);
- (e) dividends from a related foreign export corporation;
- (f) interest on any obligation which is a "qualified export asset";
- (g) receipts for engineering or architectural services for construction projects located (or proposed for location) outside the United States; and
- (h) receipts for the performance of managerial services in furtherance of the production of other qualified export receipts of a DISC.

However, specifically excluded from the definition of qualified export receipts are:¹⁷ (a) Sales or rentals of property for ultimate use in the United States; (b) dispositions of products subsidized by the United States or an agency thereof; and (c) sales of property to the U.S. Government if the use of such property is required by law or regulation.

A DISC may earn its receipts from the foregoing qualified transactions not only as a principal, but also as a commission agent.¹⁸ The geographical source of a DISC's receipt of payment is immaterial; the test is a functional one, focusing on whether the income arises from a genuine "export transaction", to wit, one having its origin in the United States and its ultimate economic destination abroad. However, the Treasury has asserted that commissions constitute qualified export receipts only if the DISC acts as a commission agent on behalf of a U.S. seller rather than a foreign buyer.¹⁹ While this position is of very questionable validity, taxpayers are well advised to avoid confrontation with the Internal Revenue Service (IRS) on this issue simply by structuring their commission sales as being, in form at least, from the U.S. supplier rather than the foreign buyer.

4. *Qualified Export Assets.*

(a) *In General.* The assets of a DISC which constitute "qualified export assets" include the following:²⁰

- (i) "Export property";
- (ii) loans to U.S. manufacturers ("producer's loans");
- (iii) operating assets of the export business;
- (iv) receivables arising from export transactions;
- (v) working capital and deposits in U.S. banks;
- (vi) investments in certain foreign corporations; and
- (vii) Eximbank, FCIA, and PEFCO obligations.

Some of the more important aspects of these qualified export assets are reviewed below.

17. § 993(a)(2); Treas. Reg. § 1.993-1(j).

18. § 993(f); Treas. Reg. § 1.993-6(e).

19. Rev. Rul. 73-228, 1973-1 C.B. 362 & Rev. Rul. 76-338, 1976-2 C.B. 233 IRB 11.

20. § 993(b); Treas. Reg. § 1.993-2.

(b) *Export Property.* Generally, "export property" consists of property produced, grown, or extracted in the United States, by someone other than the DISC, and held for sale or rental use outside the United States.²¹ Foreign property may be incorporated into the export property only to the extent it represents not more than fifty percent of the export properties' fair market value.²² In addition, export property does not include (a) property leased to an affiliated company;²³ (b) intangibles such as patents, processes, copyrights, trademarks, and franchises (but not including films, records, or the like);²⁴ (c) certain natural resource products;²⁵ and (d) U.S. property designated as being in short supply.²⁶ Furthermore, a DISC is not allowed to manufacture its export property, although the property can be manufactured, grown, or extracted by a related enterprise.²⁷

(c) *Producer's Loans.* Another important concept among the qualified export assets is the "producer's loan". Such a loan is defined as one made by the DISC²⁸ out of its deferred profits to a U.S. producer of export property, regardless of whether affiliated with the DISC. The producer's loan is particularly beneficial, however, to an affiliated producer of the export property. That is, a parent-producer, by creating a DISC, can obtain a tax deferral on up to one-half of the DISC export profits, while at the same time it can borrow these deferred pre-tax profits from the DISC. Thus, the parent-producer, rather than the U.S. government, has the benefit of the deferred tax dollars.

(d) *Operating Assets.* The DISC's operating facilities which will constitute qualified export assets are essentially those which are used in furtherance of generating qualified export receipts.²⁹ For example, since a DISC is not permitted to manufacture, facilities used in that activity do not constitute qualified export assets, while equipment used for packaging and minor assembling is qualified because that is an acceptable DISC activity.³⁰ Thus, the nature of the DISC's activity will determine the qualification status of both the receipts and the operating assets.

(e) *Accounts Receivable.* The primary asset utilized by DISCs for satisfying the assets test is accounts receivable.³¹ In essence, eligible accounts

21. § 993(c); Treas. Reg. § 1.993-3.

22. § 993(c)(1)(C); Treas. Reg. § 1.993-3(e).

23. § 993(c)(2)(A); Treas. Reg. § 1.993-3(f)(2).

24. § 993(c)(2)(B); Treas. Reg. § 1.993-3(f)(3).

25. § 993(c)(2)(C); Treas. Reg. § 1.993-3(g).

26. § 993(c)(3); Treas. Reg. § 1.993-3(i). Export property also excludes certain "export controlled products." § 993(c)(2)(D) & Treas. Reg. § 1.993-3(h).

27. § 993(c)(1)(A); Treas. Reg. § 1.993-3(c). A DISC will be considered to have manufactured its export property if either (a) the property is substantially transformed, (b) the operations are generally considered to constitute manufacturing, or (c) the value added to the property is at least 20% of the total cost of the property.

28. § 993(d); Treas. Reg. § 1.993-4.

29. § 993(b)(2); Treas. Reg. § 1.993-2(c).

30. See Footnote 27 *supra*, reference to the definition of "manufacturing".

31. Normally, accounts receivable comprise 70% of aggregate DISC assets. Feinschreiber, *Analysis of the DISC Report*, 2 Int'l Tax J. 301, 304 (1976).

receivable are those arising in the ordinary course of the DISC's operating activities.³² A DISC which acts as a commission agent of manufacturers or suppliers (related or otherwise) may acquire their receivables which arose from the sales, leases, etc., made through the DISC.³³

(f) *Working Capital and U.S. Bank Deposits.* The two categories of monetary assets which constitute qualified export assets are: (i) Money, bank deposits, and other similar temporary investments which are reasonably necessary to meet the working capital requirements of the DISC,³⁴ and (ii) certain amounts, other than reasonable working capital, if on deposit in the United States and if subsequently used to acquire other qualified export assets.³⁵ The second category of monetary assets is premised on the need to provide the DISC with time to convert cash inflows into qualified export assets, particularly near the close of a taxable year.³⁶

(g) *Investments in Certain Foreign Corporations.* Investment in any of three types of specially defined foreign corporations also constitutes qualified export assets:³⁷ (i) Foreign International Sales Corporation (FISC); (ii) Real Property Holding Company (RPHC); and (iii) Associated Foreign Corporation (AFC). It was anticipated that a DISC might find ownership in these particular types of companies a useful, or even necessary, adjunct to its exporting business. The dividends and interest from such corporations are qualified export receipts.³⁸ While the use of such foreign entities has been rather limited to date, their employment in the future may be increased as early DISCs search for new applications of their accumulated deferred profits and as exporters become aware of the extra benefits which may be obtained from their use. The nature, requirements, and benefits of these three entities are as follows:

(i) *Foreign International Sales Corporation.* A foreign corporation will qualify as a FISC if a DISC directly owns stock possessing more than half of its voting power, and it meets modified ninety-five percent assets and gross receipts tests.³⁹ The function of a FISC is, in effect, to act as a foreign sales arm for a DISC by marketing its products or providing related and subsidiary services. But a FISC may not be used for supplying engineering or architectural services or DISC managerial services which a DISC may provide.⁴⁰

A FISC may not only be useful from a business perspective, but it can also increase the amount of income eligible for deferral under the DISC

32. § 993(b)(3); Treas. Reg. § 1.993-2(d).

33. Treas. Reg. 1.993-2(d)(2).

34. § 993(b)(4); Treas. Reg. § 1.993-2(e).

35. § 993(b)(9); Treas. Reg. § 1.993-2(j).

36. Treas. Reg. § 1.993-2(j)(2) sets forth a special safe-haven test for determining whether the excess cash on hand at the close of the taxable year is a qualified export asset: this test does not require tracing of the excess cash to specific qualified export assets and, thus, amounts to an extension of time for meeting the 95% assets test.

37. § 993(b)(6) & § 993(e); Treas. Reg. § 1.993-2(g) fi § 1.993-5.

38. Treas. Reg. 1.993-1(f).

39. § 993(e)(1)(A)-(C); Treas. Reg. § 1.993-5(b)(1).

40. § 993(e)(1)(B); Treas. Reg. § 1.993-5(b)(ii).

program where the DISC is related to a U.S. producer or supplier. That is, by virtue of having an additional entity in the sales chain, the group will generally be justified in shifting additional, non-deferrable income from the U.S. producer or supplier to the FISC, as compensation for its portion of the marketing activity.⁴¹ This possibility emphasizes a key distinction between a DISC and a FISC, to wit, the FISC must have real operating substance to justify its earning any portion of the total sales profit,⁴² unlike a DISC which can be a mere "paper" company without any operating substance.

(ii) *Real Property Holding Company*. An RPHC is a foreign corporation, more than half of whose voting stock is owned by the DISC, and whose exclusive function is to hold title to foreign real property for the exclusive use of the DISC where the DISC itself may not hold title to the property under the law of the country in which such property is situated.⁴³ The RPHC may also perform activities with respect to such property (such as management, maintenance, and payment of taxes) which are ancillary to its function of holding title to the real property.⁴⁴

(iii) *Associated Foreign Corporation*. In order for a foreign corporation to constitute an AFC, the DISC must own, directly or indirectly, less than 10% of its voting stock and the ownership of such stock or securities must facilitate activities that produce qualified export receipts for the DISC.⁴⁵

(h). *Eximbank, FCIA and PEFCO Obligations*. Obligations issued, guaranteed, or insured, in whole or in part, by the export-import bank (Eximbank) or the Foreign Credit Insurance Association (FCIA) constitute qualified export assets.⁴⁶ However, as a practical matter, the Eximbank obligations are rarely available and the FCIA obligations have never been issued. On the other hand, the Private Export Funding Corporation (PEFCO) has issued numerous obligations that may be acquired by DISCs,⁴⁷ with the interest thereon constituting qualified export receipts.⁴⁸

C. Determination of DISC Profits: Intercompany Pricing Rules

One of the more important advantages of the DISC provisions is the special intercompany pricing rules which apply when a DISC exports the goods of an affiliated entity. In such a case, a DISC can earn the highest of the following three amounts on each export transaction conducted on behalf

41. This increased deferral benefit will not normally inure to an independent DISC because its entire profit is already subject to the potential 50% DISC deferral, unless the FISC operated principally within its country of incorporation such that the FISC's income did not constitute "foreign base company income" subject to deemed distribution to its parent DISC. (See Part IV(C)(2)(b) & (c), *supra*).

42. See, Treas. Reg. § 1.994-1(b) & Treas. Reg. § 1.482-1(c).

43. § 993(e)(2); Treas. Reg. § 1.993-5(c)(1).

44. Treas. Reg. § 1.993-5(c)(2).

45. § 993(e)(3); Treas. Reg. § 1.993-5(d).

46. § 993(b)(7); Treas. Reg. § 1.993-2(h).

47. § 993(b)(8); Treas. Reg. § 1.993-2(i); Rev. Rul. 75-564, 1975-2 C.B. 314, *as amended by* Announcement 76-31, 1976-11 IRB 35.

48. § 993(a)(1)(F); Treas. Reg. § 1.993-1(g).

of the related party:⁴⁹ (a) Half the total profit (the "50-50 method"); (b) 4% of gross receipts when the profit margin is at least 4% ("4% method"); and (c) all the profit where the profit margin is less than 4% (this being the net effect of the "4% method"). The usual impact of these rules is to lower the current U.S. tax rate on export profits from 48% to a maximum of 36% and possibly as low as 24% (ignoring the surtax exemption). The allocation of income to the DISC under these rules may not serve to cause a loss on the sale by the related supplier (the "no loss rule").⁵⁰

1. *Export Promotion Expenses.* When a DISC elects to use the foregoing "50-50 method" or the "4% method," it is also entitled to an additional profit equal to 10% of "export promotion expenses."⁵¹ The term "export promotion expenses" refers to selling expenses incurred by the DISC to further the exportation of U.S. products, including advertising, salaries, rentals, sales commissions, warehousing, depreciation of DISC assets, specified freight expenses, specified packaging costs, and specified design and labeling costs.⁵² Because the additional profit allocated to the DISC is only 10% of export promotion expenses, there is no incentive to maximize the amount of these expenses, nor to maximize the apportionment of these expenses to the DISC. However, once expenses are already attributable to DISC activities, additional profit is normally generated if these expenses qualify as "export promotion expenses."

2. *Strategies for Grouping DISC Transactions.* When a DISC elects to use one of the foregoing DISC safe-haven pricing rules, the particular method utilized is usually determined on a transaction-by-transaction basis.⁵³ Normally, the "50-50 method" should be used when the profit margin is at least 8%; the "4% method" should be used when the profit margin is between 4% and 8%; and when the profit margin is below 4%, the third rule is utilized, so that the DISC earns the entire profit under the no loss rule. However, at the annual election of the DISC, some or all of these pricing determinations may be made on the basis of groups consisting of products or product lines.⁵⁴

When the DISC sells products or product lines which have varying profit margins, the grouping alternatives can substantially effect the amount of profit that can be allocated to the DISC. In some instances, profit lines can be advantageously grouped so as to produce a larger profit allocation to the DISC than would result if each profit line was handled separately under a different safe-haven pricing rule. In other instances, however, combining transactions reduces the DISC benefits which would otherwise obtain under a separate product line approach.⁵⁵

49. § 994(a); Treas. Reg. § 1.994-1(a)(1).

50. Treas. Reg. § 1.994-1(c)(1).

51. § 994(a)(1) & (2); Treas. Reg. § 1.994-1(a)(1), (c)(2)(ii), & (c)(3)(ii).

52. § 994(c); Treas. Reg. § 1.994-1(f).

53. Treas. Reg. § 1.994-1(c)(7)(i).

54. *Id.*

55. See, Feinschreiber, *How to Aggregate DISC Sales to Make Most Effective Use of the Deferral*, 36 J. of Tax. 300 (1972).

In general, a DISC that has some product lines with a greater than 4% profit margin and others with a less than 4% profit margin should consider grouping these product lines. For example, if a DISC and its related supplier had one product line with a profit margin of 6% and another product line with a 3% profit margin (and the gross receipts for each product line are the same), the average profit margin allocable to the DISC utilizing the "4% method" under separate treatment would be only 3½% (*i.e.*, 4% for the 6% profit margin product and 3% for the 3% profit margin product). But if these two product lines are grouped together, the average profit margin allocable to the DISC can be raised to 4% since the average profit margin for the combined product lines becomes 4½% (*i.e.*, 6% plus 3%, or 9%, divided by 2 equals 4½%).

D. Deferred Taxation of DISC Income to DISC Shareholders

1. *In General.* As indicated above, a DISC is exempt from all Federal income taxes (including the minimum tax and the accumulated earnings tax) on its income.⁵⁶ However, the DISC income will be fully taxed to its shareholders at some time: partially on an annual basis (as a deemed dividend), and the balance when actually distributed or when certain events cause a termination of the deferral privilege (*e.g.*, termination of DISC status, sale or exchange of DISC stock, or liquidation of the DISC).⁵⁷ On an annual basis, each shareholder is treated as receiving a deemed dividend distribution equal to his pro rata share of the total of the following items:⁵⁸

(a) Gross receipts from "producer's loans" (thus, offsetting any interest deduction of the parent or affiliated supplier on such loans);

(b) gain on sales of non-qualified export assets previously transferred to the DISC in a tax-free transaction (but only to the extent of the transferor's unrecognized gain thereon);

(c) gain on sales of non-inventory property previously transferred to the DISC in a tax-free transaction (but only to the extent that the transferor did not recognize potential ordinary gain on that transfer);

(d) 50% of the taxable income attributable to military property;

(e) taxable income (up to current and accumulated earnings and profits) attributable to "base period export receipts";

(f) 50% of net taxable income (after deduction of any distributions under (a)-(e) above), plus any "international boycott amount" and any "bribe amount"; and

(g) foreign investments attributable to producer's loans.

56. § 991.

57. § 995; Treas. Reg. § 1.995-1; *See*, Bischel, *Proposed DISC Regs: Planning for Deemed and Actual Distributions in Qualified Years*, 38 J. of Tax. 178 (1973).

58. § 995(b)(1); Treas. Reg. § 1.995-2(a) (Does not reflect 1976 TRA changes.)

The above amounts are deemed received by the DISC's shareholders on the last day of the taxable year of the DISC in which the relevant income was derived.⁵⁹ As a result, when DISC shareholders are on a calendar tax year, DISC deferral benefits will generally be maximized where the DISC's taxable year is a fiscal year ending early in the calendar year, such that shareholders will not be required to pay tax on such deemed distributions until after the close of said calendar year.

Once the DISC shareholders have been taxed on a deemed distribution, they may subsequently receive actual distributions attributable to said income on a tax-free basis, while income attributable to the deferred (or non-taxed) DISC income will be subject to tax upon actual distribution or one of the triggering events mentioned above.⁶⁰ The DISC shareholders are generally entitled to an "indirect foreign tax credit" for the foreign taxes, if any, paid by the DISC to the extent attributable to the DISC's income deemed or actually distributed.⁶¹

2. Incremental Rule of 1976 Tax Reform Act.

(a) *In General.* The most important DISC change caused by the Tax Reform Act of 1976 (the "1976 TRA") is that DISC benefits now apply only to incremental income, *i.e.*, current DISC income that exceeds a specified base period amount. Congress determined that, as a policy matter, it was not appropriate to confer tax deferral benefits on those DISCs which only maintained their export activity at the same levels which they had attained in the past.⁶²

To achieve the foregoing objective, the 1976 TRA provided that all income deemed attributable to "base period gross receipts" was to be treated as being currently distributed (under item (e) above).⁶³ Thus, the only DISC income which would be subject to the 50% deferral benefit would be that taxable income in excess of the income deemed attributable to the base period gross receipts (plus the other specific items excluded from income deferral under (a)-(d) and (g) above).⁶⁴

(b) *Liberalizing Aspects.* The foregoing incremental concept is liberalized, however, in two important respects. First, the "base period gross receipts" is not equal to the average of the gross receipts during the four-year base period, but rather it is equal to only 67% of the four-year base period average.⁶⁵ As a result, even if a DISC only maintained its gross ex-

59. *Id.*

60. § 996(a)(1)(A); Treas. Reg. § 1.996-1(a)(1).

61. § 901(d); Treas. Reg. § 1.901-1(i).

62. *See generally*, S. Rep. No. 94-938, 94th Cong., 2d Sess. 291-302 (1976); General Explanation of the Tax Reform Act of 1976 prepared by Joint Committee on Taxation 290 (1976) [hereinafter cited as JCT Expl. 76 TRA].

63. § 995(b)(1)(E).

64. § 995(b)(1)(F). The 1976 TRA also contains rules regarding "Control Groups" and "Separation of DISC and its Trade or Business," so as to insure that taxpayers can not avoid the incremental rules simply by the creation of new DISCs or transferring a present DISC's business to a new entity. § 995(e)(8)-(10).

65. § 995(e)(3).

port receipts at a constant level over a period of years, its DISC deferral benefits will not, in fact, be limited to the "incremental" growth conceptually required, but instead will also be available with respect to the taxable income attributable to 33% of the true base period gross receipts.

The second key liberalizing aspect of this incremental rule is that the base period for taxable years beginning before 1980 consists of measuring the gross receipts earned by the DISC during taxable years 1972 through 1975.⁶⁶ This, in essence, is a "grandfather clause" of sorts since in a growing or new DISC enterprise, these years will generally be low receipt or zero receipt years. For taxable years beginning in 1980 and thereafter, the base period consists of taxable years beginning in the seventh through fourth calendar years preceding the current taxable year.⁶⁷ Since there is a significant time lag between the base period and the current taxable year, the DISC has additional time in which to increase its gross export receipts. If a DISC was not in existence during one of the taxable years that constitutes part of its base period, it is treated as having gross export receipts of zero for that year.⁶⁸ As a result, a DISC which is commenced in 1978 will be treated as having zero base period gross receipts until 1982, the first year in which 1978 will be part of the base period years and such a 1978 DISC will not be fully subject to the incremental rule until 1985, when the base period years will be 1978-1981.

Another important liberalizing element is that small DISCs are exempt entirely from this incremental DISC benefits rule. That is, DISCs with adjusted taxable income of \$100,000 or less for a taxable year are totally excluded from the requirement that base period income be deemed distributed.⁶⁹ This small DISC exemption is phased out on a two for one basis as a DISC's income increases from \$100,000 to \$150,000,⁷⁰ such that the small DISC exemption is eliminated completely in the case of a DISC with adjusted taxable income in excess of \$150,000. According to the data available to Congress when the 1976 TRA was passed, approximately half of all DISCs had taxable income below \$100,000 per year.⁷¹ In order to encourage small businesses to export, these DISCs were excluded from the new incremental rule.

(c) *Affirmative Use of Small DISC Exemption from Incremental Rule.* The small DISC exemption provides planning opportunities which should not be ignored. Under some circumstances, shareholders will obtain greater DISC deferral benefits where the amount of adjusted taxable income is specifically limited so as to obtain the benefit of this exemption. Because of the new incremental rule, putting the maximum amount of income into a DISC will not always produce the maximum amount of deferral.

66. § 995(e)(5)(A).

67. § 995(e)(5)(B).

68. § 995(e)(6).

69. § 995(f).

70. § 995(f)(2).

71. See "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1974 Annual Report," prepared by the Department of the Treasury (April, 1976).

If one visualizes a range of current DISC income from zero upward, it can be seen that increased current income yields increased deferral until the phase-out of the small DISC exemption becomes operative (*i.e.*, current DISC taxable income reaches \$100,000). Assuming the DISC had "base period gross receipts," additional current income then causes the deferral benefit to decrease until the current income level reaches \$150,000 (the point at which the small DISC exemption is phased out completely and the DISC is fully subject to the incremental rule).⁷² Thereafter, the deferral again increases as current income increases. However, current DISC income may have to increase by a substantial amount to bring the deferral back up to the maximum level which existed prior to income increasing beyond \$100,000.

This principle can be demonstrated by an example: If a DISC were to have an export gross receipts ratio of .40 (*i.e.*, adjusted base period export gross receipts are 40% of current export gross receipts) and the DISC is assumed to have adjusted taxable income of \$125,000, then, but for the small DISC exemption, \$50,000 of its \$125,000 adjusted taxable income would be deemed attributable to base period export gross receipts (*i.e.*, $.40 \times \$125,000 = \$50,000$), such that only \$75,000 of the \$125,000 taxable income would be eligible for the 50% deferral benefit. However, the small DISC exemption of \$50,000 (*i.e.*, 50% of \$100,000) eliminates the \$50,000 incremental distribution such that the entire \$125,000 of adjusted taxable income is eligible for the 50% deferral benefit. On the other hand, if the same DISC (*i.e.*, with an export gross receipts ratio of .40) were to have adjusted taxable income of \$150,000, its incremental distribution before the small DISC exemption would be \$60,000 (*i.e.*, $.40 \times \$150,000 = \$60,000$), but because adjusted taxable income is now at the complete phase-out point, there is no small DISC exemption to reduce this incremental distribution. As a result, only \$90,000 of the adjusted taxable income (*i.e.*, \$150,000 adjusted taxable income minus \$60,000 incremental distribution) is eligible for the 50% deferral, whereas when adjusted taxable income was \$125,000, the entire \$125,000 was eligible for the 50% deferral benefit. Thus, the deferral benefit would have decreased from \$62,500 to \$45,000. While the DISC deferral benefit will increase as this DISC income increases above \$150,000, the deferred DISC income would not again reach \$62,500 until the DISC has adjusted taxable income of \$208,333. As a result, there is no benefit under these assumptions and in fact, there is a detriment, to putting adjusted taxable income into the DISC in excess of \$125,000, unless it can exceed \$208,333.

The DISC income range that should be avoided depends on the "export gross receipts ratio" (*i.e.*, adjusted base period export gross receipts divided by export gross receipts for the current taxable year). As a DISC's export gross receipts ratio increases (*i.e.*, it is not enjoying an increase in current annual export gross receipts), this computation of the income range to be

72. This assumes that the DISC has been in existence since prior to 1976 and therefore has "base period export gross receipts," such that a portion of the DISC's taxable income will be attributable to base period export gross receipts and, thus, subject to deemed distribution, but for the small DISC exemption.

avoided becomes more crucial. Once the ratio reaches 1.0, the DISC deferral benefit will be totally eliminated, absent availability of the small DISC exemption, since all of the current adjusted taxable income will be deemed attributable to the base period export gross receipts. As a result, when a DISC is in a declining market and current export gross receipts are equal to or less than the adjusted base period export gross receipts, the DISC should limit its adjusted taxable income to \$100,000 so that some DISC benefit (\$50,000) results. Without this DISC income limitation, the small DISC exemption is not available and the entire DISC income is deemed distributed under the incremental rule.

3. *Additional Changes in the DISC Provisions Under the Tax Reform Act of 1976.* For those readers who were familiar with the DISC provisions prior to the 1976 TRA, it is important to note that the incremental rules are not the only change in the DISC law resulting from that legislation (although the new incremental rules are of primary importance in terms of revenue impact and the number of companies affected). Other changes include denial of 50% of the DISC benefits for military sales,⁷³ new reorganization rules,⁷⁴ an increase in the recapture deferral period,⁷⁵ revised deficiency distribution procedures,⁷⁶ new bribe⁷⁷ and boycott rules,⁷⁸ transition rules for products now excluded from DISC benefits⁷⁹ and changes in the producer's loan rules that affect excluded property.⁸⁰ A discussion of these revisions is beyond the scope of this article, but taxpayers and their advisors should be aware that such changes have been made.

4. *Multiple DISCs and the Recapture Deferral Period.* Many DISCs which were created soon after the enactment of the DISC legislation in 1971 are now faced with the possibility that they may soon become disqualified by virtue of failing the 95% assets test because they have a diminishing number of uses for the substantial amount of accumulated deferred DISC income. The establishment of a FISC, the purchase of PEFCO obligations, the producer's loan (as well as traditional investment vehicles such as acquisition of receivables and export property), or the distribution of excess cash, may be utilized to delay or even prevent disqualification. Nonetheless, it may be prudent in some cases to establish one or more additional DISCs that can be held in reserve in the event that the present DISC becomes disqualified.

Multiple DISCs can be highly advantageous for purposes of maximizing the period over which the deferred income is recaptured following a DISC's disqualification, because the number of years of recapture depends

73. § 995(b)(1)(D).

74. § 995(g).

75. § 995(b)(2)(B).

76. § 992(c).

77. § 995(b)(1)(F)(iii).

78. § 995(b)(1)(F)(ii).

79. § 993(c)(2)(C).

80. § 993(d)(1)(C).

on the number of years the DISC was qualified.⁸¹ That is, following a DISC's disqualification, the deferred DISC income is recaptured over a period that is twice as long as the number of qualified years, but not more than 10 years.⁸² For example, if a DISC is qualified for a period of four years and in the fifth year becomes disqualified, its years of recapture will be years six through thirteen, *i.e.*, an eight year period. Because the DISC deferral period increases as the number of qualified years increases, it becomes advantageous to set up a reserve DISC well in advance of the expected disqualification of a present DISC. This reserve DISC should be fully active and thus meet all qualification requirements, although only a nominal amount of exports need be funneled through that DISC during this reserve function period.

The advantage of this strategy is illustrated by the following example: Suppose a company sets up its first DISC in 1978 and this DISC is expected to qualify for three years, 1978, 1979, and 1980, and to become disqualified in 1981. The company expected to set up a new DISC in 1982 that would qualify for 1982, 1983, and 1984 and become disqualified in 1985. The income in the second DISC would be recaptured in 1986 through 1989. However, if the second DISC is also set up in 1978 and used for a minor number of transactions, its disqualification date would not be accelerated. Assuming this reserve DISC qualifies in years 1978 through 1984 and disqualifies in 1985, its deferred income is recaptured in years 1986 through 1995, rather than through only 1991 (as would have been the case where it was not, in fact, set up until 1982). Thus, in this example, establishment of the reserve DISC before it is needed can extend the recapture period by four years.

E. Summary of Uses of DISCs

1. *Exporting.* Encouraging the export of U.S. products was the principal impetus behind the DISC legislation and thus the principal function of a DISC. The key limitation on what may be exported through a DISC emanates from the definition of "export property" (discussed at I.B.4.(b) *supra*). Since DISC was designed to encourage the export of U.S. products, it cannot be used as a vehicle for the importing and re-exporting of foreign products.

In considering the scope of the DISC's exporting activity, it is also important to note that the DISC cannot engage in manufacturing activity. The products which a DISC sells must be produced by someone else; in theory, only the marketing-sales profits are eligible for the DISC deferral benefits although the intercompany pricing rules may, in fact, permit an affiliated manufacturer to allocate a portion of its manufacturing profits to the DISC.

81. There is no advantage in setting up multiple DISCs insofar as the incremental rule is concerned since their gross receipts and taxable income will be aggregated for that purpose. § 995(e)(8).

82. § 995(b)(2)(B).

Within the constraints of the foregoing limitations, a DISC is free to export whatever other U.S. products it chooses. The fact that over 10,000 DISCs have already been formed and are now exporting a wide variety of products emphasizes the extensive possibilities found to date.⁸³

2. *Leasing.* Foreign leasing income can be earned by a DISC where the subject property constitutes qualified "export property," and, thus, the key restrictions on DISC leasing activity are essentially the same as those applicable to sales activities. However, using a DISC for leasing activity may not always be advantageous. Because of the availability of accelerated depreciation and the possibility of "leveraging" the initial purchase of the property to be leased, leasing may produce favorable "tax shelter" benefits during the early years of the lease (*i.e.*, the accelerated deductions generated by ownership of the leased property may exceed the level payment income realized in the early years of the lease). As a result, it may be more beneficial for a business enterprise to conduct its leasing activity through an entity with a higher effective tax rate so the excess deductions will have greater tax benefits. Moreover, if the leasing activity generates a foreign source loss, this loss will normally have an adverse impact on the DISC's foreign tax credit limitation. As a result, business enterprises should review their total tax picture carefully before placing their international leasing activities in the DISC.

3. *Services.*

(a) *In General.* There are three types of service income which qualify for the DISC deferral privilege: (i) Gross receipts for services which are "related and subsidiary to" any qualified sale, exchange, lease, rental, or other disposition of "export property;"⁸⁴ (ii) gross receipts for "engineering or architectural services for construction projects located (or proposed for location) outside the United States;"⁸⁵ and (iii) gross receipts for the performance of managerial services in furtherance of the production of other qualified export receipts of a DISC.⁸⁶

(b) *"Related and Subsidiary" Services.* For most DISCs, "related and subsidiary" services are the most important category since they are the type of service which can be most readily performed by most business enterprises. Services are related and subsidiary, however, only if they pertain to a disposition of *export property* that generates qualified export receipts.⁸⁷ Thus, for example, services rendered in conjunction with producer's loans or the disposition of qualified operating assets, cannot qualify as related and subsidiary services even through other transactions involving those assets may in and of themselves produce qualified export receipts. While many

83. See, "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1976 Annual Report", prepared by the Department of the Treasury (April 13, 1978).

84. § 993(a)(1)(C); Treas. Reg. § 1.993-1(d).

85. § 993(a)(1)(G); Treas. Reg. § 1.993-1(h).

86. § 993(a)(1)(H); Treas. Reg. § 1.993-1(i).

87. § 993(a)(1)(C); Treas. Reg. § 1.993-1(d)(1).

DISCs think of related and subsidiary services in terms of their relation to sales, these services may also be performed in conjunction with qualified exchanges, leases, rentals, and other dispositions of export property.⁸⁸

The phrase "related and subsidiary" is a dual requirement, not a single test. Thus, services must be both "related" and "subsidiary" to produce DISC deferral benefits.⁸⁹ Services are considered to be "related services" if they are of a type "customarily and usually" furnished with the type of transaction giving rise to the qualified export receipts in that trade or business.⁹⁰ In order for the services to constitute "subsidiary services," their value must not be more than half of the total gross receipts from the services and the related sale or lease.⁹¹ Related and subsidiary services may be rendered within or without the United States.⁹²

(c) *Engineering and Architectural Services.* Engineering and architectural services on foreign construction projects (or proposed foreign projects) are qualified export receipts even if they are not related and subsidiary to the sale or lease of export property.⁹³ Foreign construction services such as feasibility studies, design, engineering, and construction supervision for projects located abroad or proposed for location abroad, except oil exploration, also qualify.⁹⁴

(d) *DISC Management Services.* Management services to DISCs, including staffing and operational services, also theoretically produce qualified export receipts.⁹⁵ However, the Treasury regulations interpreting this provision are so strict that the management services provision is virtually unused.⁹⁶ Thus, the principal service activities which may be conducted through a DISC are only those which are "related and subsidiary" to the basic export transaction and engineering and architectural services.

(e) *Impact of Services on the Incremental Rule.* Under the incremental rule discussed previously, DISC deferral benefits depend upon both export gross receipts and taxable income.⁹⁷ As a result, a DISC can normally increase its tax deferral by currently maximizing both of these items. Since revenues from eligible services are included in "export gross receipts" (as well as in qualified export receipts),⁹⁸ a DISC can increase its deferral benefits by including eligible services even though they produce no net taxable income. That is, if eligible services are included in the export gross

88. *Id.*

89. Treas. Reg. § 1.993-1(d)(3) & (d)(4).

90. Treas. Reg. § 1.993-1(d)(3)(i). "Related services" include warranty service, maintenance, repair, installation, transportation and insurance related to transportation; specifically excluded are financing or the obtaining of financing. Treas. Reg. § 1.993-1(d)(3).

91. Treas. Reg. § 1.993-1(d)(4)(i).

92. Treas. Reg. § 1.993-1(d)(1).

93. Treas. Reg. § 1.993-1(h)(1).

94. Treas. Reg. § 1.993-1(h)(3)-(h)(6).

95. § 993(a)(1)(H).

96. Treas. Reg. § 1.993-1(i).

97. § 995(e).

98. § 995(e)(4)(A).

receipts for the first time (whereas they had been excluded during the base period years), this will increase the denominator of the export gross receipts fraction and thereby decrease the portion of the taxable income that must be deemed distributed under the incremental rule.

4. *Licensing.* The term licensing normally implies the leasing of intangibles that constitute "intellectual property", *i.e.*, patents, inventions, models, designs, copyrights, secret formulas and processes, and similar property rights. However, as noted previously, this type of property is specifically excluded from the definition of export property,⁹⁹ and, as a result, income derived from the licensing or "leasing" of such intangibles will not produce qualified export receipts. Thus, licensing activity may not be conducted through a DISC.

5. *Manufacturing.* As discussed above, DISCs are not permitted to engage in manufacturing activity.¹⁰⁰ The products which a DISC exports must be produced by an entity other than the DISC. However, as also noted, when a DISC is affiliated with a U.S. manufacturer and elects the special safe-haven pricing rules, the DISC will be permitted to earn at least 50% of the combined taxable income and, in some cases, all of the total profit realized by the DISC and its related manufacturer.¹⁰¹ Thus, a U.S. manufacturer will be able to effectively shift a greater percentage of its manufacturing profit to the DISC than it would under the normal arms-length pricing rules generally applicable to transactions between related parties.

6. *Importing.* The DISC provisions have no applicability to importing transactions; nor does the United States tax law provide any incentives as such for importing. The act of importing generally does not in itself have tax consequences to the importer. Instead, the tax consequences arise when the importer sells the goods within the United States. If the importer and the foreign supplier are related parties, the tax results are more complex. Tax saving possibilities in this case will be discussed hereafter in connection with controlled foreign corporations.

F. Legislative Outlook for DISC Repeal.

On January 21, 1978, President Carter submitted legislative proposals that, among other "tax reforms," would phase-out the DISC tax benefits over a three-year period.¹⁰² This would be achieved by reducing the current deferral benefits otherwise available by one-third in 1979, two-thirds in 1980, and its elimination for 1981 and following years. Under the proposal, however, accumulated deferred DISC income of prior years would remain tax deferred as long as it continued to be invested in export related assets.

99. § 993(b)(2)(B).

100. § 993(c)(1)(A); Treas. Reg. § 1.993-3(c).

101. § 994(a); Treas. Reg. § 1.994-1(a)(1).

102. See, H.R. 12078, 95th Cong., 2d Sess. § 441 (1978) (submitted April 12, 1978, by Rep. Al Ullman at the request of the Administration.)

Thus, even if DISCs are phased-out, President Carter's proposal would continue to confer tax deferral benefits on that DISC income accumulated prior to the complete phase-out of the DISC provisions and, therefore, taxpayers still have a distinct incentive to utilize DISCs for exporting activity as long as possible.

The DISC provisions have been surrounded by controversy ever since their enactment in 1971, both within Congress and among the trading partners of the United States who have charged that the DISC benefits are in contravention of the GATT prohibitions on direct export subsidies.¹⁰³ It is likely that the DISC benefits will eventually be phased-out or further reduced, but the current unfavorable U.S. trade balance and other political factors suggest that these cut-backs are not imminent. In the meantime, most exporters have nothing to lose, and tax deferrals to gain, by setting-up or continuing their use of DISCs.

II. POSSESSIONS CORPORATIONS

A. Introduction

Since 1921, the United States tax law has contained provisions encouraging U.S. investment in the U.S. possessions. A domestic company which qualifies as a "possessions corporation" (PC) has some of the most favorable tax attributes of both domestic and foreign corporations such that it often ends up having more favorable tax treatment than either, to wit:

(1) A PC is not subject to current U.S. tax on its income derived from the active conduct of a trade or business within a possession (plus certain qualified investment income);¹⁰⁴

(2) under investment incentive programs established by the possessions, a PC generally will pay little or no tax to the possession for a period of 10 to 15 years;¹⁰⁵ and

(3) when the PC repatriates its earnings to U.S. corporate shareholders, they will be subject only to a small possession withholding tax¹⁰⁶ and U.S. tax only on the net dividends, after reducing for the dividends-received deduction (which may be equal to 100% of the dividend if the PC is at least 80% owned by a U.S. corporate shareholder).¹⁰⁷

Thus, a PC's current exemption from U.S. tax is not merely a deferral mechanism, but rather it can amount to a full exemption of the PC's earnings from U.S. tax when it is 80% or more owned by a U.S. corporation. The PC's only tax on qualified possession source income will be whatever

103. General Agreements on Tariffs and Trade, Art. XXI; See, 4 Tax Notes No. 12, at 19 (1976).

104. § 936(a).

105. See, e.g., Puerto Rico Industrial Incentive Act of 1963, as amended ("PRIIA") § 1.

106. Puerto Rican Income Tax Act ("PRITA") §§ 144(a), (b), 231(a)(1), as amended by Act 96, Laws of 1976.

107. § 243(a)(1), (a)(3), (b)(1)(C) & (b)(5), & § 1504(a).

current tax it is required to pay to the possession plus the possession's withholding (or "toll-gate") tax upon the repatriation of these earnings to its U.S. shareholders.¹⁰⁸

The foregoing consequences are in part the result of changes made by the Tax Reform Act of 1976 (the "1976 TRA"). Previously, a PC's earnings could not be repatriated to its U.S. parent tax-free until the PC was liquidated.¹⁰⁹ On the negative side, however, the 1976 TRA limited the scope of the benefits to exclude non-possessions income¹¹⁰ and curtailed the benefits to be derived from a PC's losses.¹¹¹

The advantage of using a PC includes not only its exemption from U.S. tax on qualified income, but also the absence of most restraints applicable to foreign corporations. For example, a transfer of assets in organizing the corporation and a tax-free liquidation do not require clearance from the Internal Revenue Service.¹¹² Similarly, provisions such as those dealing with the sale of patents to a foreign corporation may also make it advantageous to use a PC rather than a foreign corporation.¹¹³

The United States possessions are presently defined as including the Commonwealth of Puerto Rico, American Samoa, Guam, Johnston Island, Midway Islands, the Panama Canal Zone, and Wake Island; the U.S. Virgin Islands are excluded from this definition.¹¹⁴

The possessions each have their own local tax systems, including various tax incentive programs. Some possessions have their own tax laws (e.g., Puerto Rico) while others use the U.S. tax law, with some modifications, substituting the name of their possession in place of that of the United States (e.g., Guam).

B. Qualification Requirements for Possessions Corporations

1. *In General.* In order for a corporation to constitute a "possessions corporation," it must meet five basic requirements, as follows:

- (a) Domestic corporate status;¹¹⁵
- (b) eighty percent possession source income test;¹¹⁶

108. PRITA §§ 13 & 144(a) & (b).

109. § 246(a)(2)(B), prior to amendment by 76 TRA § 1051(f)(3).

110. § 931(a) & (b), prior to amendment by 76 TRA § 1051(c)(1).

111. § 904(f)(1).

112. § 367.

113. § 1249. On the other hand, a PC is treated like a foreign corporation for purposes of the accumulated earnings tax (§ 531), the minimum tax (§ 56) and the investment tax credit (§ 46). A PC will not constitute a Personal Holding Company (§ 541) or a Foreign Personal Holding Company (§ 551) since it must, by definition, be engaged in an active trade or business, although technically it is subject to these two provisions.

114. § 936(d)(1); cf. Treas. Reg. § 1.931-1(a). The office of International Tax Affairs of the U.S. Department of the Treasury has not yet determined whether the Panama Canal Zone will continue to constitute a U.S. possession for purposes of the PC Tax Credit now that the U.S.-Panama Treaty on the Canal Zone has been ratified by the U.S. Senate.

115. § 936(a)(1).

116. *Id.*

- (c) fifty percent active business test;¹¹⁷
- (d) non-DISC status;¹¹⁸ and
- (e) affirmative election.¹¹⁹

The foregoing basic requirements are subject to numerous definitional aspects and restrictions which bear further review for a complete understanding of the nature and scope of the possessions corporation benefits. A closer analysis therefore follows:

2. *Domestic Corporate Status.* While it is possible to do business in Puerto Rico through a U.S. corporation, a Puerto Rican corporation or a foreign corporation, only a U.S. corporation can qualify as a "possession corporation."¹²⁰ Thus, the corporation must be incorporated in one of the fifty states or the District of Columbia; a corporation formed with a possession will not be acceptable for this purpose.¹²¹ In addition, a qualifying entity must be a "corporation;" not a partnership, sole proprietorship, or trust.

Although a PC is a domestic corporation, an election to be a PC precludes it from joining in a consolidated return of an affiliated group.¹²² However, if during the PC's early years of operation it is expected to have start-up losses, the PC election can be deferred and it will be entitled to participate in the filing of the consolidated return, so as to permit its losses to be off-set against the income of other members of the affiliated group.¹²³

3. *Possessions Source Income.* In order for a PC to qualify, at least 80% of its gross income must be derived from sources within a possession.¹²⁴ There is no requirement for purposes of this 80% test that the income be derived from only one possession.¹²⁵ The possession source income test must be met for the three-year period immediately preceding the close of the subject taxable year, unless the PC was not in existence or did not conduct business in the possession for the entire three-year period, in which case the applicable test period is reduced accordingly.¹²⁶

4. *Active Trade or Business Income.* To qualify as a PC, at least 50% of the corporation's gross income must be derived from the active conduct of a

117. *Id.*

118. § 936(f).

119. § 936(a)(1) & (a)(1)(e).

120. § 936(a)(1).

121. § 7701(a)(4).

122. § 1504(b)(4); this explicit exclusion of a PC from a consolidated return is a change from pre-76 TRA law; the courts had previously determined that a PC could join in filing consolidated returns in years in which it had incurred losses, on the premise that it was not obtaining any benefits by virtue of being a PC in such years. *Burke Concrete Accessories, Inc.*, 56 T.C. 588 (1971) & Rev. Rul. 73-498, 1973-2 C.B. 316.

123. JCT Expl. 76 TRA *supra* note 62, at 275.

124. § 936(a)(1)(A).

125. *Cf.* § 936(d)(2)(A).

126. § 936(a)(1)(A).

trade or business within a possession.¹²⁷ This 50% active business test must be met over the same period of time used for the 80% source test.¹²⁸ This active business test is designed to insure that the PC tax benefits are not granted to passive holding companies. Nonetheless, if this test is satisfied, certain types of passive income can qualify for possessions corporation benefits.¹²⁹

5. *Non-DISC Status.* To constitute a qualified PC, the subject corporation may not be a DISC or former DISC; nor may it own stock in a DISC or a former DISC.¹³⁰ Thus, DISC status and PC status are incompatible. Ownership of a DISC by a PC is prohibited because it would result in exemption of the export income both at the DISC level and at the shareholder-PC level (although, if a PC conducts an export business from within a possession, the entire export profit will be exempt from U.S. tax in any event).

6. *Affirmative Election.* A corporation will not constitute a PC unless it makes an affirmative election on IRS Form 5712 within 90 days after the beginning of its taxable year. The election of PC status is irrevocable for a 10-year period, unless the IRS consents to revocation.¹³¹

C. The PC Tax Credit.

1. *In General.* A PC is theoretically subject to United States tax on its worldwide income, and, thus, the PC's qualified possession income is not exempt from U.S. income tax as such.¹³² Instead, a PC is entitled to a special tax credit (the "PC Tax Credit") equal to the amount of U.S. tax that would otherwise be imposed upon the "qualified possession income."¹³³ Since only a PC's qualified possession income is subject to this special tax credit, the net effect is that a PC's non-qualified income is fully subject to U.S. tax on a current basis.

A very important aspect of the PC Tax Credit is that it applies to qualified possessions income regardless of whether any taxes are imposed on this income by a possession or a foreign government.¹³⁴ As a result, this type of tax credit (sometimes known as a "tax-sparing credit") is more favorable than the normal U.S. foreign tax credit which only permits an offset of U.S.

127. § 936(a)(1)(B); See, *Ramey Investment Co.*, 26 TCM 17 (1967); thus, Section 936 requires substantial economic penetration of a possession, unlike the WHTC requirements of § 921 discussed at Part III. (A)(3) *supra*.

128. § 936(a)(1)(B).

129. See § 936(d)(2).

130. § 936(f).

131. § 936(e)(2); Legislative Committee Reports contemplated that consent will be given only in cases of substantial hardship where no tax avoidance can result from revocation, taking into account changes in business conditions. S. Rep. No. 94-938, *supra* note 62, at 281.

132. See generally, *Griggs, Operating in Puerto Rico in the Section 936 Era*, 32 Tax L. Rev. 239 (1977).

133. § 936(a)(1), "Qualified possession income" is not a defined term as such under the Internal Revenue Code, but is used as a term of convenience herein. The elements which actually comprise such income are defined at II. (C)(2) *supra*.

134. JCT Expl. 76 TRA *supra* note 62, at 274.

taxes by the amount of foreign taxes paid on the subject foreign income. To avoid a double tax benefit though, the corollary to the PC's tax-sparing credit is that the PC is not entitled to an additional foreign tax credit or deduction for taxes actually paid on the income eligible for the PC tax credit.¹³⁵ The net effect of all of this is, of course, that eligible possession income is only exempt from U.S. tax; the United States does not insure that such income will also be exempt from possessions or foreign taxes.

2. *Determination of the PC Tax Credit.* The PC Tax Credit, in effect, permits an elimination of the U.S. income tax which would otherwise be applicable to certain eligible PC income. The two types of income eligible for this exclusion from U.S. income tax are as follows: (a) Taxable income which is both (i) from non-U.S. sources, and (ii) from the active conduct of a trade or business within a U.S. possession;¹³⁶ and (b) "qualified possession source investment income. (QPSII)."¹³⁷

All PC income that does not fall within either of these two categories is fully subject to current U.S. taxation. Because these two categories of eligible income are at the heart of the current PC tax benefit, a closer examination of their scope is necessary.

(a) *Taxable Income from Active Conduct of a Possession Trade or Business.* At first reading this category of eligible income appears to be the same type of income which the PC must have in order to meet the 80% source test, discussed at II(B)(3) *supra*. However, there are several important differences, to wit, the 80% source test focuses on "gross income" and whether such gross income is "derived from sources *within a possession*,"¹³⁸ whereas this categorization is based on "taxable income", that is, "from sources *without the United States*" and "from the active conduct of a trade or business within a possession."¹³⁹ Thus, for purposes of the PC Tax Credit, eligible "possession taxable income" technically need not be from "possession sources" as such (although, if a PC persisted in earning non-possession source income, it might then flunk the 80% source test). The practical effect of this source distinction, though, is to protect a PC from inadvertently losing the benefits of the PC Tax Credit when occasionally the income technically constitutes non-possession source income (*e.g.*, because title to property passed outside of the possession), even though it was, in fact, earned by the possession-based PC business. Furthermore, this distinction is of little real difference, since a PC has no incentive to derive income from non-possession activity, because unless it can be attributed to the active possession business, it will not be eligible for the PC Tax Credit.

Unfortunately, the 1976 TRA has perpetuated a trap for the unwary which existed under prior law. Income payments received in the United States are not treated as foreign source income for purposes of the PC Tax

135. § 936(c).

136. § 936(a)(1).

137. § 936(a)(1) & (d)(2).

138. § 936(a)(1)(A).

139. § 936(a)(1).

Credit, even when the amounts, in fact, constitute foreign source income and otherwise qualify as eligible possessions income.¹⁴⁰ Thus, the PC exclusion mechanism continues to have a high blunder potential for the casually advised, since the form of the collection procedure is crucial.

(b) *Qualified Possession Source Investment Income.* In order for income to constitute Qualified Possession Source Investment Income (QPSII), all of the following requirements must be satisfied:¹⁴¹

(i) The income must be from sources within a possession;

(ii) the PC must actively conduct a trade or business in the particular possession from which the income is derived;

(iii) the gross income must be from investments in assets in that possession, for use therein;

(iv) the original funds which subsequently generate the investment income must have been derived from the active conduct of a trade or business in that possession or from a prior qualified investment; and

(v) the PC must establish compliance with the third and fourth requirements above to the satisfaction of the IRS.

The principal feature of the foregoing requirements is that investment income must be derived from the same possession in which the PC is actively engaged in the conduct of a trade or business. This requirement eliminates the opportunity which existed under prior law for a PC to avoid U.S. tax on non-possession sourced passive income (although there is a "grandfather clause" which includes within QPSII, any passive income from non-U.S. sources earned prior to October 1, 1976).¹⁴² Unlike the active business source test, this "particular possession" requirement for QPSII is stricter than the 80% source test for qualification purposes, since the latter only requires that 80% of the gross income be from "sources within a possession of the United States," not from just one possession.¹⁴³

The requirement that funds be invested in assets within the particular possession "for use therein" apparently requires a tracing concept since the legislative committee reports state that "funds placed with an intermediary (such as a bank located in the possession) are to be treated as invested in that possession only if it can be shown that the intermediary did not reinvest the funds outside the possession."¹⁴⁴ Seemingly, this requirement places a burden on the PC of verifying the use of funds which are invested in what would otherwise appear to be possession assets, such as stock or securities in Puerto Rico corporations. Interest paid by one PC to another PC operating

140. § 936(b).

141. § 936(d)(2).

142. 1976 TRA § 1051(i)(1), Pub. Law 94-455 § 1051(i)(1).

143. Although QPSII must be derived from the same possession in which the PC business is conducted, it is not necessary that said business otherwise produce taxable income during that year. JCT Expl. 76 TRA *supra* note 62, at 276.

144. JCT Expl. 76 TRA *supra* note 62, at 276; Temporary Treas. Reg. § 7.936-1 (adopted 12/27/76 by T.D. 7452).

in the same possession can qualify as eligible QPSII to the recipient where the PCs are unrelated.¹⁴⁵

(c) *Amount of the PC Tax Credit.* The amount of the PC Tax Credit is equal to the portion of the U.S. income tax that is attributable to the two types of possession derived taxable income described above. In determining said taxable income, the eligible gross income is reduced by the applicable deductions that are allocated or apportioned thereto, which is generally determined under the regular U.S. allocation and apportionment rules.¹⁴⁶ However, the legislative committee reports also contain a special rule which will reduce eligible taxable income when the PC has a current overall loss from non-qualifying sourced income.¹⁴⁷

The PC Tax Credit is based only on the amount of regular U.S. income tax which otherwise would be imposed on the eligible possession derived income. The PC Tax Credit does not provide for a credit against four special taxes to which the PC might also be subject, as follows: (i) The minimum tax on tax preference items;¹⁴⁸ (ii) the accumulated earnings' tax;¹⁴⁹ (iii) the personal holding company tax;¹⁵⁰ and (iv) the tax on recoveries of a foreign expropriation loss.¹⁵¹ However, unless the PC had non-eligible gross income, it is unlikely that the PC would be subject to any of these special U.S. taxes.¹⁵²

3. *Interrelationship with Regular Foreign Tax Credits.* As indicated above, a PC cannot obtain the benefit of both the PC Tax Credit and the regular foreign tax credit on the same income.¹⁵³ In addition, foreign or possession income taxes cannot be deducted in computing the PC's taxable income.¹⁵⁴

The prohibition on using the regular foreign tax credit appears to apply only when the foreign or possession tax is paid or accrued on eligible possession taxable income, which is taken into account in computing the PC Tax Credit, and therefore, the inference is that this prohibition does not apply to foreign or possession taxes on income *ineligible for the PC Tax*

145. S. Rep. No. 94-938, *supra* note 62, at 280. However, conceptually, there is no reason why this rule should not also apply where the PCs are related, since the issue should be solely one of whether the funds were derived from investments within the possessions.

146. Treas. Reg. § 1.861-8(a).

147. JCT Expl. 76 TRA *supra* note 62, at 275. When a PC incurs a current overall loss, it reduces both U.S. source and eligible possessions derived income proportionately for purposes of determining the amount of eligible, taxable income on which the PC Tax Credit is to be based.

148. § 936(a)(2)(A).

149. § 936(a)(2)(B).

150. § 936(a)(2)(C).

151. § 936(a)(2)(E).

152. The minimum tax is not applicable to eligible possession derived income. (§ 58(g)(1) Treas. Reg. § 1.58-7(a)); nor is the accumulated earnings tax (§ 936(g); § 535(a); Treas. Reg. § 1.535-1); and a PC should not ever be subject to the Personal Holding Company tax so long as it continues to qualify as a PC, since, by definition, it must be engaged in an active trade or business.

153. § 936(c).

154. *Id.*

Credit.¹⁵⁵ Thus, for example, foreign or possession taxes paid on income from investments outside the possession are presumably eligible for the regular foreign tax credit.

Since the new PC Tax Credit is separate from the regular foreign tax credit, the limitations applicable to the regular foreign tax credit do not apply to the PC Tax Credit.¹⁵⁶ In addition, income that qualifies for the PC Tax Credit is not taken into account in determining this regular foreign tax credit limitation.¹⁵⁷

4. *Recapture of Overall Foreign Losses.* As previously noted, a PC's current overall loss from foreign sources must be used to reduce proportionately, the PC's income from U.S. sources (if any) and qualifying possession derived income.¹⁵⁸ However, if the PC previously had an overall foreign loss that was not offset by these items of income or if it had an overall foreign loss prior to electing PC status, these prior foreign losses must be recaptured in later years when the PC derives possession source income.¹⁵⁹ Thus, the PC Tax Credit may be reduced by prior, as well as current, overall foreign losses.

The overall foreign loss is computed for the entire consolidated group, and, accordingly, there is no recapture in absence of such an overall foreign loss for the group even though a member corporation individually had such a loss and the member subsequently leaves the group (e.g., the member elects PC status).¹⁶⁰

D. Taxability of PC Shareholders

1. *Dividends Received Deductions.* Prior to the 1976 TRA, a corporate shareholder could not obtain a tax-free repatriation of the PC's earnings until the PC was liquidated. The dividends paid by a PC to a domestic corporation, however, are now entitled to the dividend received deduction.¹⁶¹ Thus, 85% or 100% of the dividends from a PC will be free of U.S. tax to a corporate recipient, depending upon whether the corporate shareholder owns less than, or 80% or more, respectively, of the PC's stock.¹⁶² However, the elimination of the prior lock-in effect prompted the government of Puerto Rico to impose a withholding tax (or "tollgate tax") equal to ten percent of

155. While not explicit, the Legislative Committee Reports also support this inference. See, e.g., JCT Expl. 1976 TRA *supra* note 62, at 276. Moreover, this statutory phrasing might support the position that a PC may elect not to utilize the PC Tax Credit and instead utilize the regular Foreign Tax Credit in cases where the PC's effective foreign and possession tax rate is in excess of effective U.S. tax rate on the eligible income; although this circumstance is highly unlikely to arise where the PC is deriving its income from possession sources.

156. S. Rep. No. 94-938, *supra* note 62, at 281; JCT Expl. 1976 TRA *supra* note 62, at 276.

157. § 904(b)(4).

158. § 904(f); JCT Expl. 1976 TRA *supra* note 62, at 275-276.

159. *Id.*

160. JCT Expl. 1976 TRA *supra* note 62, at 240.

161. § 243(a) & (b)(1)(C). The dividends received deduction applies to dividends paid out of pre-1976 TRA income, as well as post-1976 TRA income.

162. *Id.*

the dividends paid, so as to discourage PCs from repatriating their earnings to their U.S. corporate shareholders.¹⁶³

Individual shareholders of a PC are unable to utilize the dividend received deduction and thus, these shareholders are subject to an additional level of taxation when the PC's earnings are repatriated.¹⁶⁴

2. Foreign Tax Credits Allowable to PC Shareholders

(a) *Direct Foreign Tax Credits.* Since the 1976 TRA now provides that a corporate shareholder may take a dividends received deduction on distributions from PCs, the 1976 TRA added a provision disallowing a credit or a deduction for any income taxes paid by a corporate shareholder to a possession or foreign country with respect to the repatriation of these earnings.¹⁶⁵ Thus, a corporate shareholder can not take a foreign tax credit for the ten percent tollgate tax paid to Puerto Rico on the dividends received from a PC there in. This foreign tax credit disallowance provision also applies in the case of a tax-free liquidation of a PC.¹⁶⁶

In addition, as the tax law presently reads, this foreign tax credit disallowance provision also applies to individual shareholders, which inappropriately exposes individual shareholders to double taxation since individuals are not entitled to the mitigating benefits of the dividends received deduction. This result was apparently due to an unintentional oversight, and is slated to be corrected by the Technical Corrections Act of 1978, passed by the House of Representatives and now pending before the Senate.¹⁶⁷

(b) *The Deemed Paid Foreign Tax Credit.* Because corporate shareholders have now been provided with the benefits of the dividends received deduction, the 1976 TRA also repealed the provision which permitted a corporate shareholder, a "Deemed Paid Foreign Tax Credit" with respect to those foreign or possession taxes paid by the PC.¹⁶⁸ Individual shareholders were never permitted this benefit.

E. Relevant Puerto Rican Law

Puerto Rico is the largest situs of PCs due to the size of its economy and its liberal tax-holiday policy. Puerto Rico exempts from Puerto Rican income tax numerous activities, including many manufacturing and processing operations and specified Puerto Rican investments.¹⁶⁹ This exempt in-

163. PRITA §§ 144(a), (b) & § 231(a)(1).

164. *But see*, Rev. Rul. 73-493, 1973-2 C.B. 294, providing that where an individual obtains no benefit from PC status, he may retroactively terminate the PC election. Moreover, see discussion at II. (D)(2)(a), *supra*, regarding legislative proposal that individuals, unlike corporations, will be permitted the benefits of the regular Foreign Tax Credit since they are not permitted to take the dividend received deduction.

165. § 901(g).

166. *Id.*

167. Technical Corrections Act of 1978 ("H.R. 6715") § 2(v)(1)(A), amending § 901(g)(1); S. Rep. No. 95-745, 95th Cong. 2d Sess. at II. (A)(22)(a) (April 19, 1978).

168. § 902(d)(5) repealed by 1976 TRA § 1033(a).

169. PRIIA.

come is referred to as "industrial development income." The exemption period depends on the situs of operations. The minimum period of exemption is 10 years and the period may be "stretched" upon the PC's election to deduct a percentage of income qualifying for exemption each year. PCs are not taxed on income from sources outside Puerto Rico.¹⁷⁰ Therefore, foreign investment income escapes Puerto Rican taxation (although now subject to U.S. income tax). Any Puerto Rican source income of a non-Puerto Rican corporation which is not eligible for exemption is taxed at corporate rates ranging from 22% to 45%.¹⁷¹

When a PC pays dividends to a non-resident U.S. corporate shareholder, Puerto Rico imposes a 10% withholding ("tollgate") tax if the dividends are paid out of industrial development income or other specifically exempted Puerto Rican income.¹⁷² On the other hand, if the dividends are paid from non-Puerto Rican source income, there is no withholding tax.¹⁷³

When a PC pays dividends to a U.S. citizen not resident in Puerto Rico, the non-Puerto Rican source dividends are exempt from withholding,¹⁷⁴ but other Puerto Rican source dividends are taxable at progressive Puerto Rican individual rates.¹⁷⁵ The normal 20% withholding tax on such dividends is credited against the progressive tax due and may result in a refund.¹⁷⁶ Under certain circumstances liquidating distributions to individuals may also be subject to Puerto Rican tax.¹⁷⁷

Puerto Rico is currently considering revisions in its tax structure, including a reduction of the tax-holiday benefits, but also reductions in the tollgate tax on dividends repatriated to the U.S. While it is expected that these proposals will undergo further revisions prior to their final enactment, taxpayers are well advised to check the status of same prior to setting up a PC in Puerto Rico.

F. Summary of Uses of Possessions Companies

The scope of the uses for which a PC may be advantageously employed is, in effect, defined by the PC qualifications requirements and the PC Tax Credit parameters. That is, a PC will generally be limited to conducting an active trade or business within a possession and deriving its income from sources within that possession.¹⁷⁸ The PC no longer will be a useful vehicle for acting, in part, as a passive investment-holding company, beyond investing unneeded accumulated earnings in certain qualified investments within the possession in which it operates.

170. PRITA § 231(c).

171. PRITA § 13.

172. PRITA § § 144(a), (b) & 231(a)(1).

173. PRITA § 231(c).

174. PRITA § 116(a)(1).

175. PRITA § 11.

176. PRITA § 32 & § 143(a).

177. 13 L.P.R.A. § 252(c) & PRITA § § 112(b)(6), (i) & 115(c).

178. § 936.

Within the context of an active trade or business, the activities which can be conducted through a PC (from a U.S. tax perspective) are only limited by the requirement that it derive at least 80% of its income from possession sources. Thus, for example, a PC can not be used as a base company for performing extensive service activity outside the possessions since this income would be treated as non-possession source income. Similarly, leasing activity could be conducted through a PC only if the leased property was located within a possession, since the source of leasing income depends on the location where the leased property is used. This same principle applies to the licensing of intangibles such as patents, processes and the like.

The type of business in which a PC may engage is effectively determined by the possession's criteria for obtaining a tax exemption (or "tax-holiday") as well as the U.S. tax requisites, since such a tax-holiday is usually a material factor in an enterprise's decision regarding new business operations in a possession. As noted above, Puerto Rico presently provides tax-holidays for numerous activities, including many manufacturing and processing operations, although the general preference is for labor intensive industries. Because these provisions are currently being revised, businesses should ascertain their exact status before proceeding with new plans for operations in Puerto Rico.

A summary of the usefulness (from a U.S. tax perspective) of a PC for some of the more common commercial activities is as follows:

1. *Exporting.* A PC may be used for exporting both U.S. and non-U.S. products so long as the income is from sources within a possession (*i.e.*, title to the goods passes from the PC exporter to the foreign buyer within the possession). Moreover, because a PC is not subject to the Subpart F rules (discussed in Part IV, *infra*), a PC may acquire products from a related U.S. supplier for resale either within or without the possession. Thus, the PC may act as a "foreign base sales company." However, unlike a DISC, the transfer price for products between the related supplier and the PC must be based on an arm's length price and the PC must, in fact, be a substantive company with its own employees and facilities in order for it to justify its earning a slice of the export sales profit.

2. *Leasing and Licensing.* As noted above, a PC may engage in these activities so long as the property being leased or licensed is used within the possession; if it is not, then the income from such activities will be from sources outside the possession, and therefore, will not be counted for purposes of the PC qualification requisite that 80% of a PC's income be from possession sources.

3. *Services.* Like leasing and licensing, this activity may be carried on by a PC if the services are performed within a possession; if not conducted within a possession, then again, this will not constitute possession source income.

4. *Manufacturing.* The conduct of manufacturing or processing operations within a possession are the classic activities for which a PC is em-

ployed, particularly when the operation is labor intensive. The profits from exporting the resulting products to points outside the possession are also exempt from U.S. tax.

5. *Importing.* A PC could be used for importing products which it then re-exports or sells within the possession in which it is based. This is another form of foreign base company sales activity which is exempt from the Subpart F rules so long as the PC is a substantive company which can justify earning its slice of the re-export profit.

G. Legislative Outlook for Possessions Companies

Prior to the enactment of the 1976 TRA, consideration was given to repealing the U.S. tax benefits accorded PCs. Puerto Rico mounted a strong counter-attack to these proposals, with the ultimate results being the adjustments described above. However, the committee reports have provided that the Department of the Treasury is to submit an annual report to Congress regarding the operations of PCs and the effects of the changes made by the 1976 TRA.¹⁷⁹ Among other things, the annual report is to include an analysis of the revenue effects of the PC tax benefits, as well as the effects on investment and employment in the possessions. The first annual report, commencing with calendar year 1976, is to be submitted to Congress by June 30, 1978; as of this writing, the annual report has not yet been submitted. Until Congress receives several of these annual reports, it is not likely that it will take further action to revise substantially or eliminate the PC tax benefits. It is noteworthy that President Carter's January 21, 1978, tax reform proposals did not include any recommendations regarding the curtailment or elimination of PC tax benefits, while he has recommended phase-out of the DISC and CFC deferral benefits.

III. WESTERN HEMISPHERE TRADE CORPORATION

A. Background

1. *Current Status.* The Western Hemisphere Trade Corporation (WHTC) provisions have been part of the U.S. tax law for thirty-six years, but they will soon be a footnote in U.S. tax history, joining other such past incentive entities as the Export Trade Corporation and the China Trade Act Corporation. The WHTC benefits are being phased-out over a four year period, with all benefits being eliminated for taxable years beginning after December 31, 1979.¹⁸⁰

As a result, WHTCs will soon be relevant only in emphasizing that the U.S. tax law applicable to the international arena is one of continuing transition. However, because a permanent tax rate reduction of 5% and 2% may be obtained for income earned by a WHTC during taxable years beginning in 1978 and 1979, respectively, the WHTC may still have vitality in a limited number of circumstances which merits a brief review of the WHTC and the planning opportunities that still exist.

¹⁷⁹ JCT Expl. 1976 TRA *supra* note 62, at 277-278.

¹⁸⁰ § 922(b).

2. *Original Benefits and Uses.* The WHTC provisions were originally enacted in 1942 (then known as a "Pan American Trade Corporation") in order to aid U.S. companies actively engaged in business in Central or South America since such companies frequently had to compete in those areas with foreign corporations which were subject to lower taxes.¹⁸¹ However, because foreign corporations have usually been a preferable vehicle for operating within Latin America, WHTCs have been used primarily for exporting goods from the United States. Theoretically, both direct business activities and exporting may still be conducted through a WHTC at the present time.

Under prior law, companies which qualified as WHTCs were entitled to a deduction which could reduce their applicable U.S. corporate tax rate to as much as 14 percentage points below the applicable rate for other domestic corporations, such that a WHTC was not subject to Federal income tax in excess of 34%.¹⁸²

3. *Qualification Requirements and Tax Characteristics.* In order for a domestic corporation to qualify as a WHTC, it has to meet three basic requirements, as follows:

(a) *Western Hemisphere Businesses Test.* All business (other than incidental purchases) must be done within the Western Hemisphere, *i.e.*, countries in North, Central or South America, or in the West Indies (excluding Bermuda, the Falkland Islands, Antarctica and the high seas).¹⁸³ Although 95% of a WHTC's income must be from non-U.S. sources, a WHTC's business could often be based within the United States, since, in the case of tangible personal property sales, the source of income is normally the place where title passes, rather than the origin of the goods or the place from which the transaction is handled.¹⁸⁴

(b) *95% Foreign Source Income Test.* At least 95% of the WHTC's gross income for the prior three year period must be derived from sources outside the United States.¹⁸⁵ While a WHTC can conduct an exporting business from the United States so long as title to the goods passes outside of the United States, it cannot act as a commission agent through a U.S. office since commission income is service income whose source is the place where the services are performed.¹⁸⁶

(c) *90% Active Business Tests.* At least 90% of the WHTC's income for the above period has to be derived from the active conduct of a trade or

181. S. Rep. No. 1613, 77th Cong. 2d Sess. (1942).

182. § 922(a). The § 922 deduction was actually equal to taxable income multiplied by 14 over the normal tax and surtax rates (*i.e.*, as much as 48). Thus, the benefit was less than 14 percentage points deduction if the corporation was not in the 48% tax bracket.

183. § 921; Treas. Reg. § 1.921-1(a)(1); *cf.* Rev. Rul. 55-372, 1955-1 C.B. 339.

184. *Cf.* § 861(a)(6) & § 862(a)(6).

185. § 921(1).

186. *Cf.* § 861(a)(3) & 862(a)(3).

business.¹⁸⁷ Unlike a Possessions Corporation, there is no requirement for economic penetration into a non-U.S. Western Hemisphere country; it is sufficient to do business with, rather than within, non-U.S. Western Hemisphere countries. While a WHTC need not have employees of its own, this will (unlike a DISC) affect the profit which the WHTC can justify earning.¹⁸⁸

To qualify as a WHTC, the corporation must also attach to its corporate tax return a statement claiming that status, and set forth facts which substantiate its qualification.¹⁸⁹

In addition to the foregoing qualification requirements, tax characteristics of a WHTC which bear noting include the following: (i) Taxable on worldwide income;¹⁹⁰ (ii) unlike a foreign subsidiary, no advance IRS ruling is required to form a WHTC;¹⁹¹ (iii) dividends paid by WHTC are eligible for the 85% or 100% dividends received deduction;¹⁹² (iv) WHTC is eligible for inclusion in a U.S. consolidated return, although numerous technical problems exist;¹⁹³ (v) WHTC is eligible for the foreign tax credit but WHTC benefits generally reduce to nil as foreign tax rate (besides which a WHTC engaged in exporting is rarely subject to foreign taxes, and so is of little practical use);¹⁹⁴ (vi) various "foreign" provisions are not applicable; (vii) WHTC is subject to accumulated earnings tax and minimum income tax;¹⁹⁵ and (viii) WHTC can normally be liquidated tax-free into U.S. corporate parent.¹⁹⁶

4. *The WHTC Phase-Out.* The 1976 TRA committee reports set forth five reasons for eliminating the WHTC provisions:¹⁹⁷

(a) It is more equitable to tax all foreign source income at the same rate;

(b) to the extent export incentives are needed, DISC is more appropriate;

(c) higher Western Hemisphere country taxes have reduced or even eliminated WHTC benefits;

(d) profits of related U.S. manufacturers have been artificially shifted to WHTCs; and

187. § 921(2).

188. *Frank v. International Canadian Corp.*, 308 F.2d 520 (9th Cir. 1962); *A. P. Green Export Co. v. United States*, 284 F.2d 383 (Ct. Cl. 1960); *Babson Bros. Export Co.*, TCM 1963-144 (1963).

189. Treas. Reg. § 1.921-1(c).

190. *Cf.* 922.

191. *Cf.* § 367.

192. § 243.

193. § 1504(b); Rev. Rul. 58-56, 1958-1 C.B. 335, *amplifying* Rev. Rul. 56-316, 1956-2 C.B. 597; Rev. Rul. 58-168, 1958-2 C.B. 430.

194. § 901; *See*, Rev. Rul. 58-618, 1958-2 C.B. 430.

195. § 531 & § 56.

196. § 332.

197. JCT Expl. 76 TRA *supra* note 62, at 279; S. Rep. No. 94-938, *supra* note 62, at 283.

(e) WHTCs have been abused through their use for non-Western Hemisphere products sold in the Western Hemisphere.

WHTCs are being phased-out over a four-year period. The tax rate reduction, which was originally 14%, is being decreased annually, as the table below reflects.¹⁹⁸

Taxable Year Beginning In	Tax Rate Reduction	Effective Tax Rate
1975	14	34
1976	11	37
1977	8	40
1978	5	43
1979	2	46
1980	0	48

The figures for the tax rate reduction and the effective tax rate assume that the surtax exemption is inapplicable.¹⁹⁹

B. Current Planning Opportunities

1. *Alternative to DISC.*

Because the WHTC benefit is a permanent tax rate reduction, while the DISC benefit is only a tax deferral, under certain circumstances the present WHTC benefit may be preferable to the present DISC benefit. This is particularly true where the DISC has existed for a number of years and its benefits are being reduced by the new DISC incremental base period rule.

In addition, the effect of current exports on the DISC's future base period gross receipts should be taken into account. For instance, if 1978 exports are made through a DISC, these exports will be in the DISC's base for 1982 through 1985 and may reduce DISC benefits in those years. Therefore, the long term benefit may be maximized by foregoing the DISC tax benefit in the current year (and using the WHTC instead) when the present value of future savings that result from lower base period receipts exceeds the current year DISC advantage. Thus, an enterprise may maximize future DISC deferral benefits and still obtain current benefits by using the WHTC for present exports. Alternatively, the DISC might be used only to the extent of the small DISC exemption from the new incremental rule,²⁰⁰ with the remainder of the enterprise's exports being handled through a WHTC. This technique is most likely to be of advantage where the DISC has operated in prior years.

In addition, DISC benefits are limited in the case of military property exports and are precluded altogether for transactions involving boycott participation.²⁰¹ On the other hand, no such limitations apply if a WHTC is used for these transactions.

198. § 922(b).

199. See Note 182, *supra*.

200. See discussion at I(D)(2)(c), *supra*.

201. § 995(b)(1)(D) & (F)(ii) & (iii).

2. *Obtaining Maximum Period of Use of WHTC Rates.*

The tax rate applicable to a WHTC depends upon when the corporation's taxable year commences.²⁰² For instance, if a WHTC's taxable year began on December 1, 1977, (and therefore ends on November 30, 1978), the 1977 rates apply to that entire taxable year. Thus, a WHTC will obtain a longer period of use of the WHTC benefits if its taxable year ends late in the calendar year. In the case of a WHTC being set up currently, it can maximize the benefits of the 1978 and 1979 WHTC tax rates by adopting a fiscal year of November 30th. The 1978 WHTC rates will apply to both the short year ending on November 30, 1978, and the full tax year ending November 30, 1979, while the 1979 WHTC rates will apply to the tax year ending on November 30, 1980. In this way it will be able to obtain the WHTC benefits for a period of over two and one-half years from the date of this writing, rather than only one and one-half if a December 31st year is utilized.

IV. CONTROLLED FOREIGN CORPORATIONS

A. Introduction

1. *Basic U. S. Tax Treatment of United States vs. Foreign Companies: The Deferral Concept.* A United States corporation is generally taxed on its worldwide income.²⁰³ Thus, if a U.S. company operates abroad through an unincorporated branch, the foreign income earned by that branch will be subject to U.S. tax currently. On the other hand, foreign corporations normally are only subject to U.S. tax on the income they derive from United States sources;²⁰⁴ they are not subject to U.S. tax on their foreign source income, unless that foreign income is treated as, in effect, being derived from a U.S. trade or business (and thus being more akin to U.S. source, rather than foreign source income).²⁰⁵

Because foreign corporations are not usually subject to U.S. tax on their foreign source income, U.S. businesses frequently find it advantageous to segregate their non-U.S. activities in a foreign corporation, particularly if the foreign country taxes business income at a lower rate than the United States.²⁰⁶ By using this structure, no U.S. tax normally need be paid until the foreign corporation's earnings are "repatriated" in the form of dividends or a liquidating distribution, or until the U.S. shareholders sell their stock in the foreign corporation. As a result, U.S. taxes on these foreign earnings are generally deferred. Deferral of U.S. taxes enables the foreign corporation to use and profit from the money that would have otherwise been paid to the U.S. Government. In addition, deferral enables repatriation to be timed to

202. § 922(b).

203. § 61(a).

204. § 881 & § 882.

205. § 882(b)(2).

206. Branch operations, however, are not without their advantages, including: (a) Current deduction of losses, including depletion deduction; (b) avoidance of excess foreign tax credits where foreign country imposes a withholding tax on dividends but not on repatriation of branch profits; (c) can be included in consolidated U.S. tax return; and (d) no requirement of prior IRS approval to avoid taxing of gain of assets transferred.

derive maximum U.S. tax benefits for the U.S. shareholders, *e.g.*, cause repatriation in years when U.S. shareholders have offsetting losses, low income years or other factors. As a result, tax deferral is a widely desired objective.

2. *Uses and Abuses of Foreign Corporations.* When a U.S. enterprise has operations in a foreign country which taxes those profits at a lower rate than the United States, use of a foreign corporation to conduct those activities will generally be advisable. However, when the foreign corporation and its U.S. affiliate(s) are engaged in several aspects of a single enterprise (*e.g.*, if the foreign corporation is a sales subsidiary of a U.S. manufacturer), their intercompany transactions take on a special significance since the foreign corporation's share of the enterprise's worldwide income is not generally subject to current U.S. tax. Thus, the Internal Revenue Service will scrutinize these intercompany transactions carefully to insure that profits properly attributable to the U.S. operation are not being artificially shifted to the foreign corporation.²⁰⁷

The unjustified shifting of U.S. profits to an otherwise bona fide foreign operating entity is not the only abuse in which foreign corporations have been employed. U.S. taxpayers have, at times, created artificial relationships and activities based on deferring or avoiding taxes in situations where the structure has no business or economic purpose in and of itself. For example, a U.S. manufacturer or supplier which normally sold its products directly to foreign buyers, instead set up a foreign base company in a low or no tax haven country (such as Panama, Bermuda or the Cayman Islands) and then, as a matter of form, structured its foreign sales as if the U.S. products were first sold to the foreign base company and thereafter sold by that entity to the foreign buyers. The result of this structure, if left unchallenged, would enable the U.S. seller to, in effect, siphon a portion of the profits which would otherwise have been earned by the U.S. company (and subjected to U.S. tax), to the foreign base company where they would not be subject to current U.S. taxation. Foreign corporations were also employed to avoid U.S. taxes on portfolio or other passive investment income, to create deductions for their affiliates or shareholders, and for other, more esoteric manipulations.

207. The IRS has a number of principles in its arsenal to insure that such arrangements are not obtaining undeserved U.S. tax benefits: (a) § 482 which requires inter-company transactions to be conducted on an arms-length basis; (b) "assignment of income" principles emanating from the landmark decision in *Lucas v. Earl*, 281 U.S. 111 (1930); (c) "form v. substance" and the "step transaction doctrine" and § 446(b) (accounting method must "clearly reflect income"); *see, e.g.*, *Asiatic Petroleum Co. v. Comm'r*, 79 F. 2d 234 (2d Cir. 1935) and *Hay v. Comm'r*, 145 F. 2d 1001 (4th Cir. 1944); *Bischel, Tax Allocations Concerning Inter-Company Pricing Transactions in Foreign Operations: A Reappraisal*, 13 Va. J. Int'l. L. 490 (1973).

3. *Limits of Deferral: CFC Overview.* As early as 1937, Congress enacted legislation to remedy some of the foregoing abuses,²⁰⁸ but the main restrictions on deferral were placed in the tax code by the Revenue Act of 1962. This principal set of rules dealing with Controlled Foreign Corporations (CFC), commonly referred to as the "Subpart F" provisions, limits the number of situations in which deferral benefits can be obtained through the use of a CFC.²⁰⁹

To achieve these restrictions on deferral, the Subpart F rules treat certain U.S. shareholders as if they have received a current distribution of certain types of specified income ("Subpart F income") from their CFC, even though no actual distribution is made to them.²¹⁰ Thus, certain U.S. shareholders of CFCs will be subject to current U.S. taxation and lose the benefits of deferral to the extent their CFC has Subpart F income (or engages in certain other specified transactions).

The subsequent sections examine those situations in which deferral can still take place and those in which it cannot. However, in reviewing the Subpart F provisions, it should be kept in mind that these rules do not change the traditional U.S. tax pattern for foreign corporations under which foreign source income of the foreign corporation is not normally taxed by the United States. Instead, the Subpart F provisions (like the Foreign Personal Holding Company rules discussed hereafter) remedy the abusive situations by subjecting the CFC's U.S. shareholders to U.S. tax, rather than attempting to tax the foreign corporation itself.²¹¹

It should also be noted that while the Subpart F rules address many (although not all) tax-haven activities, the scope of these rules goes beyond tax-havens, applying to many normal business operations conducted abroad.

B. Definition of Controlled Foreign Corporations

1. *In General.* The threshold question under the Subpart F rules is whether a foreign corporation does, in fact, constitute a "controlled foreign corporation;" if it is not, then the Subpart F rules are inapplicable. CFCs are defined as those foreign corporations in which "United States shareholders" own more than 50% of the voting stock on any day of the taxable year.²¹²

208. The Foreign Personal Holding Company provisions (§§ 551-558); See discussion Part IV(D)(1), *supra*.

209. Subpart F (§§ 951-964) of Part III, Subchapter N of the Internal Revenue Code of 1954, as amended.

210. § 951(a)(1)(A).

211. This approach sidesteps several problems, to wit: (a) it is questionable whether CFCs could be taxed directly under International Law; (b) the CFC may have some foreign shareholders, as well as U.S. shareholders, so it is more appropriate to tax the allocable CFC income at the shareholder level; (c) administrative problems, *e.g.*, filing of returns and collection of the tax are more readily solved by making the U.S. shareholders directly liable; and (d) shareholder level taxation provides greater uniformity since it avoids variations in tax treatment accorded foreign corporations under the numerous U.S. income tax treaties.

212. § 957(a); Treas. Reg. § 1.957-1.

A "United States shareholder" is a "United States person" (a U.S. citizen or resident, a domestic partnership or corporation, or a non-foreign trust or estate)²¹³ who owns 10% or more of the foreign corporation's total combined voting power.²¹⁴ For these purposes, stock ownership includes stock held indirectly and constructively, as well as that owned directly.

The definition of United States shareholder serves two important functions: (a) Only 10% U.S. shareholders are counted in determining if the foreign corporation is owned more than 50% by U.S. shareholders,²¹⁵ and (b) only 10% U.S. shareholders are subject to the deemed distribution rules of Subpart F.²¹⁶ For this latter purpose, only stock owned directly or indirectly through foreign entities is considered (*i.e.*, certain constructively owned stock is ignored), such that a U.S. person may be counted for purposes of the CFC 50% ownership test, yet not be subject to tax under the Subpart F rules.²¹⁷

It should be noted that because of this definition of U.S. shareholder, it is possible for a foreign corporation to be wholly owned by U.S. persons without becoming a CFC. For example, if a foreign corporation's voting stock is equally divided among eleven or more unrelated U.S. persons, none of them will constitute "U.S. shareholders" since none would own 10% or more of its voting stock. Thus, the CFC ownership rules not only require that more than 50% of the CFC's voting power be in U.S. hands, but also that it be concentrated in a limited number of U.S. persons.

The determination of whether a foreign corporation constitutes a CFC must be made on the basis of the foregoing requisites on each day of the taxable year;²¹⁸ if it is a CFC for only part of the year, the amount taxable to its U.S. shareholders is appropriately reduced;²¹⁹ and, if the CFC period is less than 30 consecutive days, none of its income is attributable to its U.S. shareholders.²²⁰

There are two basic exceptions to the foregoing rules. First, a CFC does not include a corporation which is both organized and doing business in the Commonwealth of Puerto Rico or a U.S. possession.²²¹ Second, in situations involving the "insurance of U.S. risks," ownership of more than 25% (rather than 50%) of combined voting power by U.S. shareholders will suffice to classify the foreign corporation as a CFC.²²²

2. Decontrol of a CFC. A number of U.S. companies have attempted to decontrol their CFCs and thereby avoid Subpart F. One of the techniques

213. § 7701(a)(30); § 957(d).

214. § 951(b); Treas. Reg. § 1.951-1(g).

215. § 957(a).

216. § 951(a)(1).

217. § 958(a) & (b).

218. § 957(a).

219. § 951(a)(1) & (2).

220. § 951(a)(1)

221. § 957(c).

222. § 957(b). *See*, discussion of "Insurance of U.S. Risks" at IV(c)(3), *supra*.

employed to this end, is the issuance of voting preferred stock to unrelated entities, usually foreign corporations.²²³ Under this method, the U.S. parent parts with little actual ownership of the CFC because the preferred stock has relatively little value compared with its voting power. Of the five decided cases on this issue, only one has concluded that the taxpayer, in fact, relinquished sufficient control to avoid CFC status.²²⁴ One key aspect of demonstrating decontrol is to show that the unrelated directors comprise at least 50% of the board and participate actively in its decisions. Any control by U.S. owners over the foreign directors will adversely affect the decontrol efforts.²²⁵

C. Income Attributed to CFC Shareholders

1. *In General.* When a foreign corporation constitutes a CFC, there are ten different types of income or transactions which will be taxed to its U.S. shareholders as a deemed dividend. These types of income or transactions are as follows:

- (a) Foreign Personal Holding Company Income;²²⁶
- (b) Foreign Base Company Sales Income;²²⁷
- (c) Foreign Base Company Service Income;²²⁸
- (d) Foreign Base Company Shipping Income;²²⁹
- (e) income from the insurance of U.S. Risks;²³⁰
- (f) income earned during participation in or cooperation with an International Boycott;²³¹
- (g) amount equal to illegal foreign bribes and kickbacks;²³²
- (h) withdrawals of Subpart F income previously excluded because invested in less-developed countries;²³³
- (i) withdrawals of Subpart F income previously excluded because invested in foreign base company shipping operations;²³⁴ and

223. See, Bailey, *Using Voting Preferred Stock to Avoid CFC Status*, 2 Int'l Tax J. 101 (1976).

224. CCA, Inc. v. Comm'r, 64 T.C. 137 (1975); *contra*: Koehring Co. v. United States, 40 AFTR Second 77-5213 (E.D. WIS. 1977); Estate of Weiskopf v. Comm'r, 538 F. 2d 317 (2d Cir. 1976), *cert. denied*, —U.S.—(1977), *aff'g* 64 T.C. 78 (1975); Kraus v. Comm'r, 490 F. 2d 898 (2d Cir. 1974), *aff'g* 59 T.C. 681 (1973); and Garlock v. Comm'r, 489 F. 2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974), *aff'g* 58 T.C. 423 (1972).

225. Treas. Reg. § 1.957-1(c), example 2.

226. § 954(c).

227. § 954(d).

228. § 954(e).

229. § 954(f).

230. § 953.

231. § 952(a)(3) & § 999.

232. § 952(a)(4).

233. § 951(a)(1)(A)(ii).

234. § 951(a)(1)(A)(iii).

(j) amount equal to increase in earnings invested in U.S. property.²³⁵

Although the term "Subpart F income" is often used to refer to all of the above, technically, only the first seven of the above classes of income constitute "Subpart F income," as that term is defined under the Internal Revenue Code, while the last three are simply separate components of the amount which may be attributed to a CFC's U.S. shareholders under the Subpart F rules.²³⁶ In addition, the first four classes of income listed above together constitute "Foreign Base Company Income."²³⁷ This category of income will normally be the most relevant for the majority of taxpayers. Each of the above classes of income is examined below.

2. Foreign Base Company Income.

(a) *Foreign Personal Holding Company Income.* This classification of Subpart F income consists of various forms of "passive income," including dividends, interest, rents, royalties, securities gains, and the like.²³⁸ Normally, these items of income are received by reason of an investment of funds or ownership of property rather than the conduct of an active trade or business. Congress reasoned that these passive items usually could be received directly by the U.S. shareholders, rather than by the CFC, and thus use of the CFC as a recipient was considered to be a tax avoidance device. While there is some overlap between the Foreign Personal Holding Company rules (discussed hereafter) and the treatment of passive income as an item of Subpart F income, its inclusion under the CFC rules gives it broader application since it then applies to corporate, as well as individual, U.S. shareholders and it eliminates the need for finding that at least 60% of the foreign corporation's income is derived from passive income (as is the case with a FPHC).²³⁹

(b) *Foreign Base Company Sales Income.* This category of income comprises one of the classic abuses which instigated the Subpart F legislation. While this category encompasses four types of transactions,²⁴⁰ the most typical target was the U.S. company selling its own products through a tax-haven corporation to foreign purchasers outside the tax-haven. Thus, the foreign corporation acted as a "base" company although little, if any, business activity was conducted within that jurisdiction; the base country was selected primarily for its lack of applicable income taxes.

Specifically, the foreign base company sales income rules apply only when a "related person" is involved in either the purchase or sale of the property. That is, when the related person is:²⁴¹

235. § 951(a)(1)(B).

236. § 952(a).

237. § 954(a).

238. § 954(c)(1).

239. § 552(a).

240. § 954(d)(1).

241. *Id.*; "related person" is defined in § 954(d)(3).

(i) The person from whom the CFC purchases the property which is sold by the CFC (relationship of the CFC to the ultimate buyer is irrelevant);

(ii) the person on whose behalf the CFC sells the property (again, relationship to buyer is irrelevant);

(iii) the person to whom the CFC sells the property which the CFC has purchased (relationship to the original supplier is irrelevant); or

(iv) the person on whose behalf the CFC purchases the property (again, relationship to the supplier is irrelevant; in this one case, no sale of the property by the CFC is required, as presumably it applies where a related CFC receives commissions as a purchasing agent).

Thus, this foreign base company sales income classification does not apply to the income of tax-haven trading companies which deal only with unrelated companies in their buying and selling transactions. However, unless such a tax-haven trading company has substance, *i.e.*, staff and facilities of its own, it probably would be considered to be acting "on behalf of" any related U.S. entity or person who is, in fact, conducting the trading activity.

Tainted income arises from the foregoing transactions only where the property in question is (i) manufactured, produced, grown or extracted outside the country of incorporation of the CFC,²⁴² or (ii) sold (or purchased) for use, consumption, or disposition outside such foreign country.²⁴³ Thus, for example, where a CFC acquires property produced within its country of incorporation and resells it to a related party, it will not constitute tainted income; the result would be otherwise if the acquired property was from sources outside the CFC's country of incorporation. Similarly, this classification does not apply to sales of goods (purchased from a related party) that are to be used in the tax-haven country.

A further exception arises with respect to property acquired from a related party when the CFC converts or substantially transforms the purchased product.²⁴⁴ Thus, manufacturing income of a CFC is generally excluded from this categorization, unless the CFC's sales of the manufactured property are regularly made to a "branch" in another foreign country.²⁴⁵ A final exclusion applies when a CFC derives income from sales or purchases of commodities, wherever grown, so long as such commodities are not grown in the U.S. in commercially marketable quantities.²⁴⁶

(c) *Foreign Base Company Service Income.* As in the case of foreign base company sales income, the purpose of this classification is again to

242. § 954(d)(1)(A).

243. § 954(d)(1)(B).

244. Treas. Reg. § 1.954-3(a)(2) & (4). A CFC would be considered to have manufactured a product if its conversion costs are more than 20% of the cost of goods sold. Treas. Reg. § 1.954-3(a)(4)(iii).

245. § 954(d)(2).

246. § 954(d)(1).

deny tax deferral when a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax for the segregated service income. Specifically, this category applies when certain enumerated services are performed outside the CFC's country of incorporation for or on behalf of any related person, or when the CFC obtains "substantial assistance" from a related U.S. party.²⁴⁷ Enumerated services include the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services.²⁴⁸ This taint applies notwithstanding the fact that compensation for the services is received from an unrelated third party.²⁴⁹

(d) *Foreign Base Company Shipping Income.* This classification consists of income from shipping and aircraft operations. Unlike foreign base company sales and service income, the prohibited activity need not be conducted in conjunction with related parties. Specifically, this classification includes income with respect to any vessel or aircraft derived from, or in connection with its (i) use (covers actual operator); (ii) hiring or leasing for use (covers owner or charterer which rents the vessel to another for use); (iii) performance of services directly related to the use (covers operating or managing agent); (iv) the sale or exchange of a vessel or aircraft; and (v) dividends and interest gains from sale of a foreign corporation and the distributive share of a partnership's income to the extent such items are attributable to foreign base company shipping income.²⁵⁰

Income is excluded from this categorization, however, to the extent that the profits of such CFCs are reinvested in qualified shipping operations.²⁵¹ In addition, this categorization does not include shipping income derived from the operation of a vessel between two points within the foreign country in which the vessel or airplane is registered and in which the corporation owning the vessel or airplane is incorporated.²⁵²

(e) *Exclusions and Adjustments to Foreign Base Company Income.*

(i) *No Tax Avoidance Motive.* Items of income which otherwise constitute foreign base company income will be excluded from that classification when it can be established to the satisfaction of the Treasury that neither (a) the creation (or acquisition) of the CFC under the laws of the particular foreign country, nor (b) the use of the CFC for the particular

247. § 954(e). Services are considered "performed for, or on behalf of", any related person when: (a) The services are paid for, directly or indirectly, by the related person; (b) whether or not paid, services relieve related party from obligation to perform services (unless the obligation amounts to no more than a mere guarantee of the services to be performed by the CFC; (c) services rendered constitute a material term or condition of a sale by a related person; and (d) substantial assistance contributing to the performance of such services has been furnished by a related person or persons. Treas. Reg. § 1.954-4(b).

248. § 954(e); Treas. Reg. § 1.954-4(a).

249. Treas. Reg. § 1.954-4(b).

250. § 254(f).

251. § 254(b)(2).

252. § 954(b)(7).

transaction, has as one of its significant purposes a substantial reduction of income or similar taxes.²⁵³ This test must be met on an item-by-item income basis.²⁵⁴

(ii) *10% and 70% Tests.* If foreign base company income, before deductions and before the exclusion for reinvested shipping income, is less than 10% of gross income, the CFC will be treated as having no foreign base company income.²⁵⁵ On the other hand, if such income is more than 70% of gross income, then all of the CFC's income will be treated as foreign base company income.²⁵⁶ These tests are applied separately to the foreign base company income of each CFC within an affiliated group.²⁵⁷ If the percentage is between 10% and 70%, the actual amount is treated as foreign base company income.²⁵⁸

(iii) *Allowance of Deductions.* Since only the net income provides the measure of the tax on U.S. shareholders, foreign base company income is reduced by the expenses and other deductions properly attributable to it, including expenses, losses, taxes, and other deductions.²⁵⁹ Deductions are first allocated to the categories of gross income to which they relate, while those deductions that cannot be so allocated are thereafter apportioned among all income items or categories, except that no deduction can be allocated to an item or category to which it clearly does not relate.²⁶⁰ In the event foreign base company income exceeds 70% of gross income, all deductions are taken into account since all of the income will be taken into account.

3. *Insurance of U.S. Risks.* Income from insurance of U.S. risks consists of income derived by a CFC from premiums (or other consideration) for reinsurance of, or the issuing of, insurance or annuity contracts on property in, or on residents of, the United States.²⁶¹ (This category also includes income derived from arrangements between a CFC and another foreign corporation whereby the latter holds insurance involving U.S. risks for the former and the former holds insurance not involving such risks for the latter).²⁶²

These provisions are intended to prevent domestic insurance companies from avoiding underwriting gains by reinsuring their policies abroad or placing the initial policy with a foreign insurance company controlled by them.

The income from insurance of U.S. risks, which is included under this category, is that income which would be taxed in the United States if it were income of a domestic insurance company.²⁶³ However, none of this income

253. § 954(b)(4).

254. *Id.*

255. § 954(b)(3)(A). Under pre-1976 law, a "less than 30%" rule applied.

256. § 954(b)(3)(B).

257. Treas. Reg. § 1.954-1(d).

258. § 951(a)(1)(A).

259. § 954(b)(5).

260. Treas. Reg. §§ 1.952-2(b), 1.953-4(a), & § 1.861-8.

261. § 953(a)(1)(A).

262. § 953(a)(1)(B).

263. § 953(a)(2).

will be included as Subpart F income if premiums on such risks are 5% or less of the total premiums received by the CFC.²⁶⁴

Because of these provisions, there is little U.S. tax advantage to operating a CFC as a foreign insurance company solely for the purpose of insuring U.S. risks. A CFC may, however, still be quite advantageous for the purpose of insuring foreign risks so long as it does not constitute Foreign Base Company Service Income.

4. *International Boycotts and Illegal Bribes.* To the extent that a CFC's earnings are attributable to operations in connection with which there was an agreement to participate in or cooperate with an international boycott, those earnings will be deemed distributed to the CFC's U.S. shareholders and subjected to current U.S. tax.²⁶⁵

Deferral of tax for U.S. shareholders of CFCs is also ended for the amount of illegal payments, kickbacks, or other unlawful payments to an official, employee, or agent of a foreign government made after November 3, 1976.²⁶⁶ Such amounts are deemed immediately distributed as a taxable dividend. This deemed distribution does not reduce the CFC's earnings and profits, unlike the usual case involving deemed distributions under Subpart F.²⁶⁷

5. *Withdrawal of Previously Excluded Subpart F Income from Less Developed Countries or Shipping Operations.* Prior to the enactment of the Tax Reduction Act of 1975, the Subpart F rules provided that a CFC's U.S. shareholders would not be subject to tax on that foreign base company income which was invested in "less developed country corporations."²⁶⁸ In addition, dividends or interest received from such companies, plus the net gain on sales of such stock, were excluded from foreign base company income, up to the amount of the increase (if any) in such investments for the year.²⁶⁹

This deferral privilege for reinvestment of foreign base company income in less developed country corporations was repealed by the Tax Reduction Act of 1975, for taxable years beginning in 1976 or thereafter. However, foreign base company income previously reinvested in such companies will continue to be deferred until the CFC withdraws the investment, for example, by the sale or exchange of the stock in the less developed country corporation.²⁷⁰

A similar rule applies in the case of amounts withdrawn from the CFC's qualified foreign base company shipping operations.²⁷¹

264. § 953(a); Treas. Reg. § 1.953-1(b).

265. § 952(a)(3).

266. § 952(a)(4); JCT Expl. 76 TRA *supra* note 62, at 289.

267. *Id.*

268. § 955(b) (prior to Tax Reduction Act of 1975).

269. *Id.*

270. § 951(a)(1)(A)(ii); § 955(a)(3) (prior to Tax Reduction Act of 1975).

271. § 951(a)(1)(A)(iii); § 955(a).

272. § 951(a)(1)(B); § 956(a).

6. *Investments in United States Property.* U.S. shareholders of CFC's are taxed on their pro rata share of the CFC's "increase in earnings invested in United States property."²⁷² In substance, such shareholders are being taxed on foreign source earnings brought back to the United States on the theory that such returned earnings are substantially the same as a dividend.

The measure of this deemed dividend is the amount (if any) by which a CFC's earnings invested in U.S. property at year end exceed the earnings so invested at the beginning of the year.²⁷³ "United States property" generally includes the following property acquired or developed for use in the United States after 1962:²⁷⁴ (a) Tangible property located in the United States; (b) stock of a domestic corporation (but see iv below); (c) an obligation of a U.S. person; and (d) a right to use in the United States a patent, copyright, design, secret formula, process or any other similar property right. Excluded from this definition of "U.S. property" are the following items:²⁷⁵ (i) U.S. bank deposits; (ii) export property; (iii) receivables from a U.S. person arising in the ordinary course of business from the sale or processing of property; (iv) stock or obligations of a domestic corporation which is neither a U.S. shareholder of the CFC, nor a domestic corporation in which a U.S. shareholder of the CFC has a 25% voting interest; and (v) movable drilling rigs.

If a CFC facilitates a loan to, or borrowing by, a U.S. shareholder, the CFC is to be considered as having made a loan to (or acquired an obligation of) the U.S. shareholder and thus as having made an investment in U.S. property.²⁷⁶

It should be noted that the U.S. shareholder is taxed on his pro rata share of an increase in investment in U.S. property, without regard to the source of the earnings of the CFC that made the increase possible.

7. *Exceptions and Limitations on Subpart F Income.* Subpart F income does not include any item of income from sources within the United States which is derived from or effectively connected to, the conduct of a trade or business within the United States (unless such item is entitled to an exemption or reduced rate under a U.S. income tax treaty).²⁷⁷ Thus, if a CFC earns income within the United States which is fully subject to U.S. tax, it will not again be subject to tax under the deemed distribution rules of Subpart F.

The Subpart F income of a CFC for any taxable year is limited to the earnings and profits of such corporation for that year.²⁷⁸ In addition, the current earnings and profits are reduced by the net deficits in earnings and profits for prior taxable years, beginning in 1960.²⁷⁹ Furthermore, a CFC's

273. § 956(a)(1).

274. § 956(b)(1).

275. § 956(b)(2).

276. § 956(c); Rev. Rul. 76-192, 1976-1 C.B. 205.

277. § 952(b).

278. § 952(c); Treas. Reg. § 1.952-1(c).

279. *Id.*

earnings and profits may be reduced by deficits of other foreign corporations in the same chain of ownership.²⁸⁰

8. *Mechanics of Subpart F Attribution.* Each U.S. shareholder of a CFC is required to report annually his pro rata share of the CFC's net Subpart F income (including the CFC's withdrawal of previously excluded Subpart F income and its increase in earnings invested in U.S. property) which remains undistributed at year end. A basic feature of this mechanism is that the U.S. shareholder is taxed directly on the CFC's income, whether the stock of such CFC is held directly or is owned indirectly through other foreign entities.²⁸²

Because the purpose of Subpart F is to require the U.S. shareholder to report his share of the CFC's *undistributed* income, the amount imputed to him excludes any amounts actually distributed during the taxable year.²⁸³ Computation of the amount of income attributable to a U.S. shareholder is based not only on the shareholder's percentage of stock interest, but also on the portion of the year during which the foreign corporation constituted a CFC.²⁸⁴ Thus, if the foreign corporation was a CFC for only six months during the taxable year, then only half of its otherwise attributable income is taxed to the U.S. shareholders.

To the extent that undistributed income is taxed to the U.S. shareholder, his basis for his CFC stock is increased as though the imputed distribution had been reinvested by him.²⁸⁵ Subsequent distributions of these previously taxed amounts are received tax-free²⁸⁶ and the basis of the CFC stock is then reduced.²⁸⁷ If the CFC pays foreign taxes, a U.S. shareholder that is a domestic corporation is entitled to a foreign tax credit which can offset the current U.S. tax on the undistributed income.²⁸⁸ Since U.S. shareholders, who are individuals, are not entitled to the benefits of this indirect foreign tax credit provision, a special rule permits such individual shareholders of a CFC to achieve similar results by making a special election.²⁸⁹

As indicated above, there is no further U.S. taxation when previously taxed income is actually distributed by the CFC.²⁹⁰ Moreover, an order of distribution is established which causes previously taxed income to be deemed the first income which is distributed by a CFC.²⁹¹ Thus, only after a

280. § 952(d); deficit corporation need not be a CFC; rule limited to deficits of current year; blocked foreign income is also eliminated from earnings and profits. § 964(b).

281. § 951(a).

282. § 958.

283. 951(a)(1) & (a)(2).

284. § 951(a)(1) & (a)(2); Treas. Reg. § 1.951-1(b).

285. § 961(a).

286. § 959.

287. § 961(b).

288. § 960(a); Treas. Reg. § 1.960-1.

289. § 962.

290. § 959(a) & (b).

291. § 959(c).

CFC has distributed all of the previously taxed income would further actual distributions be treated as dividends resulting in ordinary income tax.

D. Other Restrictions on Passive Income

1. *Foreign Personal Holding Company Provisions.* In 1937, the Foreign Personal Holding Company provisions were enacted to prevent the use of foreign corporations for owning portfolio investments (sometimes referred to as "offshore incorporated pocketbooks").²⁹² These provisions affect only closely-held foreign corporations whose income is predominately derived from passive investments. They do not affect widely-held foreign corporations or widely-held U.S. parent companies with foreign subsidiaries with investment income (although as seen above, such subsidiaries may constitute CFCs under the Subpart F provisions). When the Foreign Personal Holding Company (FPHC) provisions overlap with the CFC rules, the FPHC rules take precedence and the U.S. shareholders will not be subject to a double imputation of income.²⁹³

In order for a foreign corporation to constitute a FPHC, *more than 50% in value* of the corporation's outstanding stock must be owned, directly or indirectly, by *not more than five individuals* who are citizens or residents of the United States.²⁹⁴ The second requisite is that at least 60% of its gross income for the taxable year be "foreign personal holding company income,"²⁹⁵ which is defined to include the following categories of income:²⁹⁶ (a) Dividends, interest, and royalties; (b) the excess of gains over losses from sales of stocks, securities, and commodity future contracts; (c) income from an estate or trust, or from the sale from an interest therein; (d) income from certain personal service contracts; (e) compensation for the use of corporate property by a 25% or more shareholder; and (f) rents, if they constitute less than 50% of gross income. Once a foreign corporation has been classified as a FPHC, this annual gross income requirement drops to 50%.²⁹⁷

Like the CFC rules, U.S. shareholders are taxed on their proportionate share of the foregoing income items which are not distributed prior to the end of the taxable year.²⁹⁸ If the FPHC distributes its income to its shareholders, the FPHC provisions have no application. To the extent a U.S. shareholder is taxed on undistributed income, such income is treated as if it had been reinvested by the shareholder in the FPHC.²⁹⁹ However, unlike the CFC rules, the U.S. shareholder may be subject to further tax when the FPHC makes an actual distribution of this previously taxed income.³⁰⁰

292. § 551-558.

293. § 951(d).

294. § 552(a)(2). Because of the constructive ownership rules (§ 554), stock in a foreign corporation owned by another closely held company may be attributed to its individual shareholders.

295. § 552(a)(1).

296. § 553(a).

297. § 552(a)(1).

298. § 551(a) & (b).

299. § 551(e).

300. § 556 & § 561.

It should be noted that the stock ownership test for a FPHC is narrower than that for a CFC. In the case of a FPHC, more than 50% of stock *value* must be owned by *not more than five individuals*, whereas, in the case of a CFC, it is required only that more than 50% of *voting* stock power be owned by U.S. shareholders, with *no limit on the number of shareholders* who might comprise this more than 50% ownership (other than the requisite that only 10% U.S. shareholders be taken into account). Thus, for example, if ten U.S. individuals have equal 10% shareholdings, the company will not constitute a FPHC, since five or fewer shareholders do not own *more than* 50% of the corporation stock; any five shareholders only own 50%. On the other hand, such a company would constitute a CFC, since more than 50% (in fact, 100%) of its stock would be owned by "U.S. shareholders." This limitation on the FPHC rules had, in the past, led to the growth of "foreign investment companies," discussed hereafter.

2. *Foreign Investment Companies.* Foreign Investment Companies (FIC) were similar in form and function to the closely held FPHC. Although widely-held, FICs were also owned primarily by domestic shareholders as an investment vehicle for the tax-free accumulation of foreign source income. That is, the FIC would be based in a tax-haven country which imposed little or no tax and it would be simultaneously exempt from U.S. tax because its income was derived from foreign sources. When the U.S. shareholder subsequently sold his stock in the FIC, he would usually realize capital gain. Thus, the FIC shareholder not only obtained the benefits of deferral of U.S. tax on the income accumulated by the FIC, but he was also able to, in effect, convert this ordinary income into capital gain upon the disposition of his FIC stock.

Congress responded to this abuse in the Revenue Act of 1962 by providing, in general, for ordinary income treatment when the U.S. shareholder of a FIC sold or exchanged his stock.³⁰¹ Thus, unlike the CFC and FPHC rules, this FIC provision does not attack the deferral of income, but rather prevents its recharacterization upon its effective realization. Specifically, a U.S. shareholder will realize ordinary income on the sale or redemption of his stock in a FIC to the extent of his ratable share of the earning accumulated by the FIC after 1962 and during which period he held his stock.³⁰² The burden of establishing his "ratable share" is on the shareholder and if he fails to prove this figure, the entire gain will be ordinary income.³⁰³ Similarly, the ordinary income potential of such "tainted stock" will survive a gift of the stock, a tax-free exchange of the stock, and the death of the holder of such stock.³⁰⁴

As an alternative to the above treatment, a FIC registered under the Investment Company Act of 1940 was permitted to make an election by the end of 1962 to distribute 90% of its ordinary income currently and for their

301. § 1246.

302. § 1246(a)(1).

303. § 1246(a)(3).

304. § 1246(c).

shareholders to pay tax on capital gains, whether or not distributed.³⁰⁵ Most registered FICs employed this election, which results in substantially the same tax treatment applicable to a registered domestic investment company, and thereby eliminated the former tax advantages accorded FICs because of their foreign status.

The type of FIC covered by these provisions should not be confused with "offshore investment funds" which are owned primarily or solely by non-U.S. shareholders and which are formed for the purpose of investment in stock or securities of U.S. corporations. Because these off-shore funds are investment vehicles for bona fide foreign persons, and thereby provide sources of capital for U.S. businesses which might not otherwise be available, these vehicles are generally encouraged rather than prohibited, and, therefore, are not subjected to the foregoing FIC provisions.³⁰⁶

E. Sale or Liquidation of Controlled Foreign Corporations

The foregoing discussion of CFCs has focused on circumstances under which a U.S. shareholder may be taxed currently on its undistributed income. However, even in situations where the U.S. shareholder will not be subject to current U.S. tax from either the Subpart F deemed distributions or actual dividends, shareholders should be aware of the tax consequences which will obtain upon the sale or liquidation of a CFC.

Prior to 1962, the U.S. shareholders gain on the sale of stock in a CFC, on some redemptions of stock, and on a partial or complete liquidation of the CFC resulted, in most instances, in capital gain. Therefore, rather than repatriate the CFC's foreign earning in the form of dividends taxable as ordinary income, the CFC shareholders might allow the earnings to accumulate and then sell their stock or liquidate the CFC, thereby obtaining their profit as long-term capital gain. Thus, the deferral of U.S. tax on the accumulated foreign earnings evolved into a permanent exemption of the U.S. tax liability to the extent of the lower rate applicable to capital gains.

To discourage such deferral and recharacterization results, the Revenue Act of 1962 introduced provisions requiring the gain realized by certain U.S. shareholders of CFCs on the foregoing types of transactions to be treated as a dividend to the extent of the earnings and profits that were accumulated after 1962 and during the period the U.S. shareholder held his stock.³⁰⁷ In essence, the same approach used to curb the Foreign Investment Company benefits (discussed above) was employed for CFCs. This special rule applies only if at sometime during the five years preceding the transaction, the corporation constituted a "controlled foreign corporation" (as previously defined) and the U.S. shareholder owned (directly, indirectly or constructively) 10% or more of its voting power.³⁰⁸ Although the shareholder's 10% ownership must have coincided with the corporation's status as a CFC,

305. § 1247(a).

306. § 1246(b).

307. § 1248.

308. § 1248(a)(2).

neither of these conditions need be satisfied at the time when the gain is realized.

Like the Foreign Investment Company rules, unless the U.S. shareholder establishes the amount of post-1962 earnings and profits of the CFC during the period he held his stock, all gain from the sale or exchange is considered a dividend.³⁰⁹ In determining the amount of the CFC's earnings and profits during the applicable period, amounts that were previously included in the shareholder's gross income under the Subpart F provisions are excluded.³¹⁰

If the U.S. shareholder is a domestic corporation, it is entitled to a credit for foreign taxes paid by the CFC.³¹¹ However, this indirect foreign tax credit is not available to individual shareholders, but to alleviate the effect of *throwing the accumulated earnings into the individual shareholders ordinary income in a single year*, a special relief provision moderates this tax burden.³¹²

While the foregoing tax provision was enacted with the objective of putting taxpayers at a disadvantage, its effect can be the reverse for individuals where the CFC paid high foreign taxes. That is, because of the aforementioned special relief provision which serves to give individuals roughly the same benefits as the corporate indirect/foreign tax credit, this special individual tax credit benefit may be of greater importance than the capital gains rate, where the CFC paid substantial foreign taxes.

In summary, this recharacterization provision may be viewed as a backstop to the Subpart F rules discussed above. Taken together, and disregarding a variety of minor exceptions, these provisions require the principal U.S. shareholders of a CFC to report their pro rata share of its accumulated earnings as a dividend either (1) when the earnings are realized by the CFC, if they constitute Subpart F income; (2) when an actual distribution is made; or (3) when they sell or exchange their CFC stock or the CFC is liquidated.

F. Tax Consequences of Forming a CFC

The transfer of assets to a foreign corporation may be tax-free, but many such transactions are subject to U.S. tax, while others are tax-free only if the Internal Revenue Service issues a favorable ruling. An IRS ruling is generally required when the taxpayer wishes to transfer appreciated assets *on which gain would otherwise be realized but for the applicability of a non-recognition provision under the Internal Revenue Code.*³¹³ Transfers of cash

309. § 1248(h); Treas. Reg. § 1-1248-7.

310. § 1248(d)(1); Treas. Reg. § 1.1248-2(e)(3) & § 1.1248-3(e)(2). Additional exclusions from earnings and profits include: certain gains on sales made in the course of liquidation (§ 1248(d)(2)), U.S. source income of the CFC (§ 1248(d)(4)), less developed country corporation income accumulated pre-1976 or while the CFC itself was a less developed country corporation (§ 1248(d)(3)).

311. § 902.

312. § 1248(b); Treas. Reg. § 1.1248-4.

313. § 367.

or assets which have declined in value do not require an IRS ruling because they are not appreciated assets.

Generally a favorable IRS ruling will be issued (and tax-free treatment will be accorded) if the appreciated property being transferred will be used in the active conduct of a trade or business in the foreign country. However, a favorable ruling will not normally be issued for the transfer of passive income producing property. If a tax-free transfer of such property were permitted, the income realized on its subsequent disposition might escape U.S. tax, absent the applicability of the Subpart F rules. As a result, when such property is transferred, the Internal Revenue Service imposes a tax on the amount of gain that would have been realized if the transfer had been for a fair value consideration.³¹⁴

If a U.S. person attempts to transfer appreciated property to a foreign entity without the receipt of adequate consideration and without obtaining a prior ruling, an excise tax equal to thirty-five percent of the amount of untaxed appreciation is imposed.³¹⁵

G. Summary of Uses of CFCs

From a U.S. tax perspective, the uses of a CFC are limited only by the restrictions under the Subpart F and FPHC rules; a CFC may be employed, therefore, for any activity which does not produce such income. By contrast, the DISC, WHTC, and PC laws are enabling statutes which permit such companies to derive special benefits only when they meet specific criteria. This difference in perspective impacts on the uses to which a CFC may be committed.

A key point regarding permissible activities of a CFC is that if the foreign corporation does not, in fact, constitute a "CFC," then it is not subject to the Subpart F or FPHC rules (although in the case of certain widely-held foreign investment companies, restrictions may still apply). Thus, if the foreign corporation is widely-held (*i.e.*, at least eleven equal shareholders for CFC purposes or ten for FPHC purposes) by U.S. persons or its stock is at least 50% owned by unrelated foreign person(s), the foreign corporation may conduct its activities without regard to the CFC and FPHC restrictions. (These tests are more stringent in the case of a foreign-based insurance operation).

When a foreign corporation does constitute a CFC it will not be able to act as a passive investment holding company (*i.e.*, a FPHC). Instead, it will generally be limited to conducting an active trade or business within the country in which it is incorporated, insofar as activities in connection with related parties are concerned, *i.e.*, it will not be able to act as a base company for related party sales, service or, in some cases, manufacturing activity. This restriction is applicable principally when the CFC is part of the same integrated enterprise with its U.S. affiliates, *e.g.*, the CFC is in the sales or supply end of a chain of activities comprising a single enterprise.

314. Rev. Rul. 67-192, 1967-2 C.B. 140; Rev. Rul. 69-16, 1969-1 C.B. 103.

315. § 1491.

On the other hand, when the CFC deals only with unrelated parties in its sales, servicing or manufacturing activity and these operations are not, in fact, conducted on behalf of a related party, the CFC will be able to operate outside its country of incorporation. Thus, for example, if a U.S. trading company sets-up a foreign subsidiary in a tax-haven country to also act as a trading company (dealing only with unrelated parties), that activity theoretically would be acceptable so long as the foreign subsidiary operated independently of its U.S. parent and did not make its sales or purchases "for or on behalf of" its U.S. parent. In practice, however, it may be difficult for a CFC, which is engaged in the same business as an affiliated U.S. entity, to keep its operations separate and distinct from those of the U.S. affiliate(s) such that the potential for running afoul of the "for or on behalf of" rule remains high. Therefore, a CFC will generally be on more solid ground when it is engaged in a different trade or business than that of its U.S. affiliates.

Within the context of the foregoing restrictions, a CFC can conduct most any business activity it wishes. A summary of a CFC's usefulness, from a U.S. tax perspective, for the principal commercial activities follows:

1. *Exporting.* A CFC may purchase property from the U.S. or other parts of the world and re-export it to other destinations so long as it is dealing with (or acting on behalf of) unrelated parties. In other words, a CFC can act as an independent trader.

2. *Leasing.* The leasing of tangible personal property may be handled by a CFC if the leasing activity amounts to an independent, active trade or business;³¹⁶ if it is not, then it will constitute passive rental income under the "foreign personal holding company income" category of the Subpart F rules and therefore subject to current U.S. taxation. As a general rule, rents are considered to be derived from the active conduct of a trade or business if the lessor manufactures or produces the property that is leased or adds substantial value to leased property that has been acquired.³¹⁷ A similar result will obtain if the leasing requires active and substantial management and operational functions to be performed by the lessor. Rents received from a related party do not result in foreign base company income, if the leased property is used in the country in which the CFC is incorporated;³¹⁸ otherwise, such rental income is subject to current U.S. taxation. However, a further consideration in having a CFC conduct a leasing business is the problem of initially transferring the assets to be leased from the U.S. to the CFC; generally, this cannot be done on a tax-free basis.³¹⁹ In fact, if the property is acquired from a related party, any gain will normally be treated as ordinary income.³²⁰

316. Treas. Reg. § 1.954-2(d)(1)(i).

317. Treas. Reg. § 1.954-2(d)(1)(ii)(a)(1).

318. § 954(c)(4)(C).

319. § 367.

320. § 1239.

3. *Licensing.* The uses of a CFC discussed above with respect to the leasing of tangible personal property are generally equally applicable to the licensing of intangibles.

4. *Services.* A CFC may be used for conducting a service business either within or without its country of incorporation when dealing with an unrelated party and not acting on behalf of a related party; but, if the CFC provides services for or on behalf of any related person or receives substantial assistance from an affiliated U.S. party, the services must be rendered in its country of incorporation in order to avoid "foreign base company service income" classification.

5. *Manufacturing.* Generally, a CFC can be used for manufacturing or processing operations either within or without its country of incorporation without running afoul of the Subpart F rules. The exception arises when a CFC is engaged in manufacturing in one foreign country and regularly sells its products through a branch in another foreign country; the sales in the second country may constitute "foreign base company sales income" under the complex "branch rule" which treats the operations in the second country as a separate corporation.³²¹

6. *Importing.* The use of a CFC for importing activity is generally governed by the same rules applicable to exporting operations discussed above. However, if the CFC is selling products to buyers within the United States, it must insure that any affiliated U.S. entity (or any other person) does not assist the CFC in a fashion which could be deemed to constitute that U.S. affiliate (or other person) a dependant agent or otherwise the U.S. office of the CFC; if it was so attributed to the CFC, then the CFC may be considered to be engaged in a U.S. trade or business and thereby subject to U.S. tax on the income derived from U.S. sources.

H. Legislative Outlook for CFC Deferral

On January 21, 1978, President Carter submitted legislative proposals that would phase-out the "deferral" of earning of CFCs over a three year period. This would be achieved by treating an appropriate fraction (one-third in 1979, two-thirds in 1980, and the entire amount in 1981 and thereafter) of a CFC's gross income, deductions, and foreign taxes as having been earned or incurred directly by its U.S. shareholders. The earnings of a CFC would be taxed currently, whether or not they are paid to the U.S. shareholders as dividends. In effect, this proposal would use the same technique currently employed under the Subpart F provisions, except that the deemed distribution would now be of all CFC income, not just the specially defined types under the present Subpart F provisions. This proposal has engendered considerable debate, but at the time of this writing, it appears that it is not likely to be passed in the near future, although further reductions in the deferral benefits of CFCs will probably be enacted at some future date.

321. § 954(d)(2); Treas. Reg. § 1.954-3(b)(1)(i).

The Administration's proposals also include a provision which would define a CFC as a foreign company in which U.S. shareholders own more than 50% in *value* of its stock, rather than the present "more than 50% in *voting* stock" test. If this "value test" is enacted by Congress, the efforts of many U.S. taxpayers to "decontrol" their CFCs will be defeated. This proposal would seem to have a higher probability of passage in the not too distant future, as it has a greater equity appeal than the complete abolishment of CFC deferral benefits.

V. SUMMARY

When a U.S.-based enterprise considers expansion into the international arena, it may be able to avail itself of one of the special corporate vehicles described above. Through the use of these vehicles, it may be able to obtain more favorable U.S. tax results than available through a normal domestic entity.

The selection of a particular corporate entity will depend on numerous business and tax considerations, including the nature of the business activity involved, the location of the intended activity, the relationship of the proposed activity to those currently conducted by the U.S. enterprise and the like. However, certain generalities can be made regarding the usefulness of particular vehicles for a specified activity, as follows:

A. Exporting

Unless the taxpayers are prepared to move at least a portion of their operations outside of the United States, a DISC normally will be the most appropriate vehicle for the exporting of U.S. products. However, during the next two years there may be situations in which a WHTC will provide better results. (See, Part III.B.1., *supra.*) If taxpayers are willing to move their exporting operations outside the United States, the CFC may be employed to advantage so long as it is not buying from or selling to (or acting on behalf of) related parties, except where the destination or origin (as the case may be) of products is the CFC's country of incorporation. Alternatively, a PC may be used, in some cases with greater advantage, when the operation can be based within a U.S. possession or the Commonwealth of Puerto Rico, since a PC is not subject to the Subpart F rules and therefore may deal with related parties.

B. Leasing

This is an activity which often may be conducted through a normal U.S. entity to greater tax advantage because of the potential "shelter" benefits which may arise. If this is not the case under the particular circumstances, a DISC may be utilized if the property to be leased constitutes "export property." A PC may be used only if the property is to be leased within a possession or Puerto Rico. The use of a CFC for leasing has the initial hurdle that the transfer of appreciated property to a CFC will normally be taxable. In addition, the CFC's leasing activities must amount to an active trade or business and leases to related entities must be within the CFC's

country of incorporation; otherwise, the leasing income will be subject to full current U.S. tax and the advantage of using a foreign corporation will be lost. Within the next two years, a WHTC may be used for leasing activity within the Western Hemisphere, so long as the activity amounts to an active trade or business. However, a CFC will normally be a preferable vehicle (unless the property is leased to a related entity outside its country of incorporation) since the full deferral benefits are normally of greater advantage than the small permanent tax reduction accorded WHTCs over the next two years.

C. Licensing

A DISC may not be used for licensing since this involves the leasing of "intangibles" which are specifically excluded from the definition of "export property." A PC, CFC or WHTC may be used for licensing under the same circumstances they may be used for leasing, discussed above.

D. Services

A DISC may be used for only three types of services, to wit: (a) Services "related and subsidiary to" certain qualified export transactions; (b) engineering or architectural services for construction projects located outside the United States; and (c) DISC management services. A PC may be used, in essence, only for services performed within the U.S. possessions. However, a CFC may be used for engaging in a service business worldwide, except when performed for or on behalf of a related party, in which case they must be provided within the CFC's country of incorporation. During the next two years, a WHTC may also be employed for conducting a service business within the Western Hemisphere (outside the United States), but in most cases a CFC will be a more advantageous vehicle, unless the services are to be performed for or on behalf of a related entity outside the CFC's country of incorporation.

E. Manufacturing

A DISC may not be used for manufacturing activity other than minor packaging and labeling. When business considerations permit manufacturing and processing operations to be conducted within a U.S. possession through a PC, the tax benefits will generally include a U.S. tax exemption on both current and repatriated profits. These PC benefits are normally better than those which can be derived through the use of a CFC, although the latter may be used for manufacturing operations in most foreign countries while a PC's operations must be conducted in a U.S. possession. When a CFC is used for manufacturing operations, its profits are generally exempt from current tax, except to the extent it regularly sells its products to a branch located outside of its country of incorporation. While a WHTC may theoretically be used for manufacturing operations in the Western Hemisphere during the next two years, a CFC will usually produce greater tax benefits.

F. Importing

A DISC can not be used for importing activities. On the other hand, a PC, WHTC or CFC will generally *have the same uses for importing activity as described above with respect to exporting activity*, although such operations must be handled with greater care because of the potential for finding the existence of a U.S. trade or business.

The foregoing should provide the reader with some idea of the potential benefits and the alternative vehicles which may employed in the international context. Nonetheless, before businesses enter into this arena, they are well advised to consult with their own tax advisers as to the best means of *structuring* their international operations. The most preferable vehicle will depend on the particular facts and circumstances of each case, as the structure must be tailored to meet the specific needs and objectives of each enterprise.