

1969

Subpart G Tax Incentives for Export Trade: A Technical Analysis of Tax Haven Operations

Alan S. Schenk

Jeffrey G. Balkin

Follow this and additional works at: <https://scholarship.law.umn.edu/mlr>



Part of the [Law Commons](#)

Recommended Citation

Schenk, Alan S. and Balkin, Jeffrey G., "Subpart G Tax Incentives for Export Trade: A Technical Analysis of Tax Haven Operations" (1969). *Minnesota Law Review*. 802.
<https://scholarship.law.umn.edu/mlr/802>

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Law Review collection by an authorized administrator of the Scholarship Repository. For more information, please contact lenzx009@umn.edu.

Subpart G Tax Incentives for Export Trade: A Technical Analysis of Tax Haven Operations

Alan S. Schenk*

Jeffrey G. Balkin**

I. INTRODUCTION

The balance of payments problem facing the United States has become increasingly troublesome since 1950. During the early postwar years, deficits in the capital transfers account caused by spiraling foreign aid, defense expenditures and outflow of private capital were offset by balance of trade surpluses created by West European purchases of United States goods.¹ In the 1950's, however, Western Europe began to compete effectively in international commerce and the balance of payments position began to attract concern.

One of the most significant governmental efforts to remedy this problem was the 1962 addition of "subpart F" and "subpart G" to the Internal Revenue Code.² A gap which had theretofore existed between the tax jurisdiction asserted by the United States over foreign corporations and nonresident aliens and that asserted by certain "tax haven" countries encouraged the transfer of investment capital abroad.³ United States resident corporations could avoid paying substantial amounts of United States income tax by conducting their foreign operations through a subsidiary established in a tax haven country. The tax legislation substantially closed this gap, but an important statutory exception was included to encourage export trade.

* Professor of Law, Wayne State University Law School.

** Member of the Michigan Bar.

1. The "balance of trade" is the excess of exports over imports. The United States, due to its highly industrialized and competitive economy, has consistently exported more goods and services than it has imported. See W. SALANT ET AL., *THE U.S. BALANCE OF PAYMENTS IN 1968* 15 (1968). The perennial balance of trade surplus has prevented the United States balance of payments position from degenerating to a critical stage.

2. INT. REV. CODE of 1954, §§ 951-72. [Unless otherwise designated, all further references to the INT. REV. CODE are to the 1954 Code].

3. Congressional adoption of these sweeping measures was prompted by high foreign interest rates as well as the "tax gap." Increased demand for capital abroad caused foreign interest rates to soar and it thus became more profitable to save in foreign banks. For an analysis of the private long-term capital outflows, see generally W. SALANT, *supra* note 1, ch. V.

Traditionally, the United States taxes its citizens and resident aliens on income derived anywhere in the world.⁴ Prior to 1962 the United States did not, however, impose its income tax on non-United States source income⁵ derived by corporations chartered in a foreign country. Many foreign countries, interested in attracting foreign capital, structured their tax laws to take advantage of the limited taxing jurisdiction asserted by the United States and other industrialized nations. These "tax haven" countries relinquished all power to tax foreign source income, whether derived by its citizens, nonresident aliens, domestic or foreign corporations. Bilateral tax treaties have further enhanced the investment appeal of these tax haven countries. A common income tax treaty provision⁶ requires the "source country"⁷ to relinquish part of its jurisdiction to tax income derived by a foreign enterprise in its country. This "source country" rule applies so long as the foreign enterprise does not have a fixed place of business in the source country and does not engage in substantial business activities there.⁸ United States taxpayers, in an effort to take advantage of this provision in United States income tax laws, created artificial business relationships with tax haven countries. This device enabled many taxpayers to permanently avoid United States ordinary income tax rates on income earned abroad. For example, a domestic corporation

4. INT. REV. CODE § 61 provides that ". . . gross income means all income from whatever source derived"

5. Foreign source income includes interest and dividends other than that "derived from sources within the United States," compensation for services performed without the United States, rentals and royalties from property located without the United States, income from the sale of real property located without the United States and "income derived from the purchase of personal property within the United States and its sale without the United States." INT. REV. CODE § 862(a).

6. See, e.g., Income Tax Treaty with Switzerland, May 24, 1951, 2 U.S.T. 1753, T.I.A.S. No. 2316.

7. INT. REV. CODE §§ 861-63 provide the rules for determining the source of income—whether from within the United States, from without the United States or partly within and partly without the United States.

8. Most income tax treaties include this "permanent establishment" concept. For example, under the Income Tax Treaty with Switzerland, May 24, 1951, 2 U.S.T. 1753, T.I.A.S. No. 2316, the term "permanent establishment" means a "branch, office, factory, workshop, warehouse or other fixed place of business, but does not include the casual and temporary use of merely storage facilities, nor does it include an agency unless the agent has and habitually exercises a general authority to negotiate and conclude contracts on behalf of an enterprise or has a stock of merchandise from which he regularly fills orders on its behalf." *Id.* at 1754.

would organize a foreign subsidiary in a tax haven country. The subsidiary would purchase goods from the United States parent and resell them in France, Germany or other foreign markets. Had this sales company been incorporated in the United States, it would have been taxed on the income derived from the foreign sales. Since the subsidiary was a foreign corporation, however, the United States did not tax its foreign source income. The tax haven country, by limiting its tax jurisdiction to income derived within the country, did not tax the French or German source income derived by its domestic corporations. So long as the foreign corporation did not maintain a fixed place of business or engage in substantial business activities in France or Germany, the source countries were limited by the bilateral treaty in the tax they could impose on this income. The foreign source income thus remained untaxed or, at the worst, was subject to low rates of tax in the source country and country of incorporation.

Subpart F, designed to eliminate the "tax haven" *modus operandi*, taxes certain foreign source income earned by "controlled foreign corporations" (CFC).⁹ The United States jurisdiction to tax this income attaches to the "United States shareholders"¹⁰ of the CFC. While it appears that subpart F eliminated tax deferral of foreign source income, the limitations and exceptions to subpart F treatment make future tax deferral possible. Subpart G, which encompasses the "export trade corporation" provisions,¹¹ is one of the statutory exceptions to subpart F treatment. Subpart G was designed to encourage export trade and thereby improve the United States balance of payments position. The qualifying export trade corporation must actively engage in the exportation of United States manufactured or produced goods or United States related services. These provisions have not been utilized by a significant number of taxpayers, due in part to the highly complex nature of these provisions and the limited tax benefits granted.

It is the purpose of this article to analyze in some detail the deceptively short provisions of subpart G and their interrelationship with the pertinent provisions of subpart F. Before embarking on a technical analysis of subpart G, however, consideration will be given to three non-tax factors affecting export incentives: policy arguments regarding tax deferral of foreign

9. See note 46 *infra* and accompanying text.

10. See note 45 *infra* and accompanying text.

11. INT. REV. CODE §§ 970-72.

source income; the GATT treaty, which affects the ability of a member nation to unilaterally stimulate export trade;¹² and the Foreign Direct Investor Controls, which may limit the tax deferral privilege granted by subpart G.¹³

II. NON-TAX FACTORS AFFECTING EXPORT INCENTIVES

A. POLICY REGARDING TAX DEFERRAL

A basic policy underlying the United States income tax system is that of tax equality:

[A]ll nationals with the same amount of income should be subjected to the same tax burden. Under an income tax system based on ability to pay or taxable capacity, the source or nature of the income—whether from one type of business or another, earned or unearned, from foreign or domestic sources—is irrelevant.¹⁴

Any income tax provision which grants tax preferences to a limited group of taxpayers is, then, inconsistent with this principle.

Some theorists advocate elimination of United States taxation of foreign source income. The most persistent argument favoring tax preferences for foreign source income is that "United States nationals are at a competitive disadvantage in foreign operations when their foreign source income is taxed at the regular United States tax rate."¹⁵ Other proponents favoring tax preferences for foreign source income contend that foreign investment involves greater financial risks and consequently deserves special tax rates. These arguments were quite persuasive during the post-World War II reconstruction period when the United States had the avowed foreign policy of rebuilding Western Europe. Some of these arguments are not, however, convincing during a period when the United States is experiencing a chronic balance of payments problem.¹⁶ In fact, if the tax laws are to be utilized to achieve economic and political objectives, a persuasive argument could be made favoring an *increase* in the tax rates on in-

12. General Agreement on Tariffs and Trade [hereinafter cited as GATT] was acceded to by President Truman in 1947 under the Protocol of Provisional Application, Proclamation No. 2761A, 3 C.F.R. 139 (1943-48 Comp.). For an extensive discussion of GATT, see G. CURZON, MULTILATERAL COMMERCIAL DIPLOMACY (1968).

13. The Foreign Direct Investor Controls were imposed by Exec. Order No. 11,387, 3 C.F.R. 90 (1968 Comp.).

14. E. OWENS, THE FOREIGN TAX CREDIT 572 (1961).

15. *Id.* The countervailing arguments are presented at 572-75. This argument assumes that the American foreign policy should or does promote the investment of United States capital abroad.

come derived from certain foreign investments.

One aspect of tax preferences utilized to achieve national economic goals is preferential tax treatment to induce private enterprise to expand export trade. The rationale is that the tax preference will lead to

the expansion of business of corporations already engaged in foreign trade and investment, and . . . [stimulate] interest among corporations which have not previously engaged in these activities. The purpose of the preferential tax treatment is to provide an incentive to, or to stimulate the growth of, a particular type of business activity. In short, a preferential tax rate for this purpose is a form of subsidy. The emphasis is on making foreign operations more attractive than domestic operations.¹⁷

If the United States Government decides to use the tax laws to achieve economic or foreign policy goals, instead of granting tax preferences on all foreign source income, the preferences should (1) be selective, (2) be approved by Congress and (3) aid in the accomplishment of these national goals. In addition, Congress should take into account the United States commitments under the General Agreement on Tariffs and Trade before it grants a direct or indirect subsidy for exports.

B. GENERAL AGREEMENT ON TARIFFS AND TRADE

In 1947 President Truman, relying on delegated executive power, acceded to the General Agreement on Tariffs and Trade (GATT) under the Protocol of Provisional Application.¹⁸ GATT is a multilateral agreement affecting major aspects of international commerce, coordinating its members' efforts to remove tariff and other trade barriers and thereby create a free flow of goods in international commerce. It has been utilized most effectively as the negotiating vehicle to effect multilateral reductions in tariffs. GATT's "most-favoured-nation" clause¹⁹ emphasizes the importance of any bilateral reduction in tariffs.

16. Tax incentives for foreign investment would encourage capital transfers abroad and increase any balance of payments deficits.

17. E. OWENS, *supra* note 14, at 577.

18. Proclamation No. 2761A, 3 C.F.R. 139 (1943-48 Comp.). For a discussion of the constitutionality of the President's action, see Note, *United States Participation in the General Agreement on Tariffs and Trade*, 61 COLUM. L. REV. 505 (1961). Congress has subsequently granted Presidential authority to expand the overseas markets for American products. In their grant of executive power, Congress has specifically provided that it is not legislatively approving President Truman's action in acceding to GATT. See 19 U.S.C. §§ 1351(a)(1) (A) & 1366 (1964).

19. GATT art. I.

The most-favoured-nation clause automatically converts the tariff reductions negotiated by any two member nations into tariff concessions applicable to all member nations. For example, if the United States agrees to reduce tariffs on wool imported from England, tariffs on such wool imported from other member nations must be reduced accordingly. Using a permissible exception to the most-favoured-nation treatment, a member may grant preferences or use other discriminatory devices where such action is necessary in order to improve the discriminating country's balance of payments position.²⁰ Even though the United States has experienced chronic balance of payments deficits, it has chosen not to rely on this exception to reduce imports and improve the balance of trade.

By prohibiting the export subsidization of manufactured products,²¹ GATT further limits a member nation's ability to unilaterally influence its balance of trade. A nonmember country having balance of payments problems might find it desirable to grant a direct subsidy to a domestic producer for any article exported. By correlating the subsidy with the world market price, the subsidizing nation enables the producer to lower its prices and thus increase the international demand for its products.²²

To comply with GATT commitments and to maintain the national policy opposing direct government interference in international commerce, the United States has consistently favored indirect methods of accomplishing economic and foreign policy goals. The export trade corporation provisions grant a tax deferral incentive for foreign corporations to increase their export trade. Congress has thus attempted to channel American capital into the business of exporting United States manufactured or produced goods or United States related services.

C. FOREIGN DIRECT INVESTOR CONTROLS

A major factor in the United States' deteriorating balance of payments position has been the spiraling outflow of capital. Due to the gravity of the United States international monetary position, President Johnson issued an executive order²³ limiting the amount of capital which could be transferred or reinvested abroad. The tax deferral privilege granted by subpart G is con-

20. See *id.* at art. XII (1) exception to art. XI (1).

21. *Id.* at art. XVI.

22. See text accompanying notes 15-17 *supra*.

23. Exec. Order No. 11,387, 3 C.F.R. 90 (1968 Comp.).

ditioned upon the reinvestment of certain foreign source income in qualified foreign assets. The Foreign Direct Investor Controls (FDIC) limit new capital transfers abroad and reinvestment of foreign earnings and may thus directly limit the subpart G deferral privilege.

The American business community was not surprised when the President ordered the imposition of the Foreign Direct Investor Controls. In 1964, when the net annual capital outflow was reaching dangerous proportions and the international economic community was losing confidence in the stability of the United States dollar, government representatives met with many American business leaders and explained the extent to which the capital outflow was adversely affecting the balance of payments. These meetings resulted in an agreement between the Government and the business leaders to voluntarily reduce net capital transfers abroad. While the voluntary program succeeded in its goal of reducing the capital outflow in 1965 and 1966, this reduction did not materially improve the net United States balance of payments position,²⁴ thus necessitating imposition of the FDIC.

The Foreign Direct Investor Controls apply only to transferors who (1) qualify as United States "direct investors," and (2) engage in capital transfers which are deemed to adversely affect the United States balance of payments position.²⁵ The investment controls are imposed on direct investors who engage "in any transaction involving a direct or indirect transfer of capital to or within any foreign country or to any national thereof outside the United States."²⁶ A "direct investor" includes any United States person who, directly or indirectly, owns or ac-

24. Ironically, the participants in this voluntary program were later penalized for their altruistic efforts, because in many cases the annual limitations on capital transfers abroad are based upon the amount of capital transferred abroad during a "base period;" coincidentally, the "base period" is the calendar years 1965 and 1966. Foreign Direct Investment Regulations, tit. 15, ch. X, §§ 1000.101-.1301, 15 C.F.R. §§ 1000.101-.1301 (1968) [hereinafter cited as FDIR].

25. Exec. Order No. 11,387, 3 C.F.R. 90 (1968 Comp.). The executive order prohibits direct or indirect transfer of capital abroad, authorizes the Secretary of Commerce to require the repatriation of certain foreign earnings to the United States and gives the Secretary of Commerce power to implement this order. "Direct investors" are not, however, entirely prohibited from transferring capital abroad. For example, Canada was exempted from the investment controls. Restrictions are imposed, however, so that Canadian corporations may not be utilized to avoid the FDIC entirely. See FDIR § 1000.1102, 15 C.F.R. 1000.1102 (1968).

26. Exec. Order No. 11,387, 3 C.F.R. 90 (1968 Comp.).

quires at least a 10 percent interest in a foreign corporation, partnership or "affiliated foreign national."²⁷ The included capital transfers are designed to be so broad that ingenious schemes for indirect transfers will be included.

The FDIC restrictions vary according to the severity of the United States "payments deficit" with certain categories of foreign countries. The most severe limitations are placed on transfers to many of the industrialized nations of Western Europe. These nations are classified as Schedule C²⁸ countries. Moderate limitations are placed on capital transfers to Schedule B²⁹ countries which need capital imports in order to maintain their domestic economies. The most liberal provisions apply to Schedule A³⁰ countries designated by the President as "less developed countries."

The FDIC impose three major restrictions on the outflow of United States capital. They include (1) direct investment limitations, (2) mandatory repatriation of certain current foreign earnings and (3) mandatory reduction in certain liquid foreign assets.

1. *Direct Investment Limitations*

The direct investment limitations are based on both new capital transfers and the reinvestment of current earnings of "affiliated foreign nationals." For direct investors subject to the investment controls,³¹ the limitations, with a minimum of \$1,000,000 allowable positive direct investment, vary from severe limitations applicable to Schedule C countries to less

27. See FDIR § 1000.305, 15 C.F.R. § 1000.305 (1968), *amending* 33 Fed. Reg. 49 & 806 (1968).

28. FDIR § 1000.319(c), 15 C.F.R. § 1000.319 (1968). Schedule C countries, such as Germany, are those countries not included as Schedule A and Schedule B countries.

29. FDIR § 1000.319(b), 15 C.F.R. § 1000.319 (1968); FDIR § 1000.301(a)(1), 15 C.F.R. § 1000.301 (1968); FDIR § 1000.504(a)(2), 15 C.F.R. § 1000.504(a)(2) (1968). Schedule B countries include Japan, England and Australia.

30. FDIR § 1000.319(a), 15 C.F.R. § 1000.319(a) (1968); FDIR § 1000.504(a)(3), 15 C.F.R. § 1000.504(a)(3) (1968); FDIR § 1000.501(a)(1), 15 C.F.R. § 1000.501 (1968). See Presidential designation of less developed countries in Exec. Order No. 11,071, 3 C.F.R. 684 (1959-63 Comp.).

31. The FDIR have been in a constant state of flux since their inception in January 1968. No attempt will be made to indicate the provision in effect at the date of this article. Reference will merely be made to the FDIR section which applies. See FDIR §§ 1000.502 & 1000.503, 15 C.F.R. §§ 1000.502 & 1000.503 (1968), *as amended*.

restrictive limitations applicable to Schedule A less developed countries.³²

2. *Mandatory Repatriation of Earnings*

The limitations on direct investment abroad includes the reinvestment of current earnings of "affiliated foreign nationals." While the regulations previously required the direct investors to repatriate the current earnings of "affiliated foreign nationals" located in Schedule C countries, the current earnings are now combined with new capital transfers in computing the amount of allowable positive direct investment in each category of countries.³³

3. *Mandatory Reduction in Certain Liquid Foreign Assets*

To increase the capital inflow to the United States, the regulations require each "direct investor" to reduce its "liquid foreign balances" in foreign countries to certain prescribed levels.³⁴ This reduction is required even though the "affiliated foreign national" does not earn any income currently. The "liquid foreign balances" include liquid assets such as bank deposits, negotiable and nonnegotiable instruments and other short-term commercial papers.³⁵

The investment controls are intended to encourage direct investors to borrow abroad since raising capital in this manner does not adversely affect the United States balance of payments position. In fact, if the income derived from the use of this foreign capital is repatriated to the United States direct investors, it has a favorable effect upon the balance of payments.

The Foreign Direct Investor Controls were a "stop-gap" measure designed to reduce the United States balance of payments deficits. Subpart G was also designed to encourage American export trade and thereby improve our balance of payments position. It is interesting to note that the FDIC did not exempt transfers to qualified export trade corporations. In addition, the most stringent limitations on the exportation of capital applies to most of the industrialized nations of Western Europe—the United States' largest export market.

32. See FDIR §§ 1000.502 & 1000.504, 15 C.F.R. §§ 1000.502 & 1000.504 (1968), *as amended*.

33. *Id.*

34. FDIR § 1000.203, 15 C.F.R. § 1000.203 (1968), *as amended*.

35. FDIR § 1000.203(a), 15 C.F.R. § 1000.203(a) (1968), *as amended*.

The FDIC was not the only government program designed to reduce the level of capital exports. An excise tax³⁶ has been imposed on the transfer of stock or securities to a foreign partnership, trust, or corporation as paid in surplus or as a capital contribution. Congress assumed this excise tax would reduce an investor's net return, making domestic investments more attractive by comparison. Although most attempts to reduce the net capital outflow have focused on methods of reducing capital outflow, Congress has also sought to increase the capital inflow. For example, the Foreign Investor's Tax Act³⁷ was intended to encourage nonresident aliens and foreign corporations to invest in the U.S. stock and bond markets. This law separates the tax treatment of investment income "effectively connected" with the conduct of a trade or business in the United States³⁸ and investment income not "effectively connected" with such trade or business. A foreign investor, whether or not he is considered as being "engaged in a trade or business" in the United States, may now receive preferential tax treatment on passive income from United States investments which is not "effectively connected" with a trade or business in the United States. This preferential treatment applies to interest, dividends and gains derived from investments³⁹ made by (1) reinvesting profits which are not intended to be used in any United States trade or business or (2) transferring additional foreign capital into the United States stock or bond markets. This section of the article was designed to show the trend toward increasing United States controls in the area of international investments. Most, if not all, of these restrictions have been precipitated by the degenerating balance of payments position. Unless the United States takes serious steps independently or in conjunction with the International Monetary Fund to improve the long-term United States balance of payments equilibrium, the same or similar restrictions may be expected to continue in the future.

III. SUBPART F—CONTROLLED FOREIGN CORPORATIONS

Prior to 1962, United States citizens and domestic corpora-

36. INT. REV. CODE §§ 1491-94. The tax of 27.5 percent is imposed on the excess of the fair market value of the securities transferred over the transferor's adjusted tax basis.

37. Act of Nov. 13, 1966, Pub. L. No. 89-809, tit. I, 80 Stat. 1539.

38. See INT. REV. CODE §§ 871(a) & 871(b).

39. See INT. REV. CODE § 871(a). The statutory tax rates on inter-

tions could conduct their foreign operations through a corporation chartered in a "tax haven" country and thereby partially or totally exempt the foreign source income of such foreign corporation from United States and foreign income taxes.⁴⁰ Subpart F now protects United States tax jurisdiction by taxing foreign source income which is not sufficiently identified with the country of incorporation to merit tax equality with the other local income of that country. The "United States shareholder" of a "controlled foreign corporation" is taxed on this foreign source income even if the foreign corporation does not repatriate this income. Subpart F, in effect, treats this income as if it were repatriated to the United States shareholders.

Subpart G⁴¹ continues tax deferral for foreign source *export* income. Export income includes income derived from the export of United States manufactured and produced goods and from the rendition of qualifying services. These "export trade corporation" (ETC) provisions were designed to stimulate export trade and thus improve the United States balance of payments. Since subpart G defers otherwise currently taxable subpart F income, any analysis of subpart G requires an understanding of the subpart F structure and some of its technical terms.⁴²

Subject to limited exceptions and deferral privileges, subpart F requires each "United States shareholder" of a "controlled foreign corporation" to include in his gross income his share of the current (and sometimes previously deferred) subpart F income. The following three-step approach is helpful in computing the net amount of foreign source earnings which must be included in the United States shareholder's gross income for purposes of subpart F.

1. Which United States persons and foreign corporations are subject to subpart F treatment?
2. What foreign earnings are taxable to the United States shareholders?
3. What subpart F or subpart G exceptions or deferral priv-

est, dividends and other passive income are reduced, in many cases, by income tax treaties to which the United States is a party.

40. On the constitutionality of subpart F, see Horwich, *The Constitutionality of Subpart F of the Internal Revenue Code*, 19 U. MIAMI L. REV. 400 (1965).

41. INT. REV. CODE §§ 970-72.

42. In a subsequent section of this article, an in-depth analysis of some of the provisions of subpart F will be made. For a more comprehensive treatment of subpart F, see McDonald, *Controlled Foreign Corporations*, in SOUTHWESTERN LEGAL FOUNDATION FIFTH ANNUAL INSTITUTE ON PRIVATE INVESTMENT ABROAD 5 (1963).

ileges apply to reduce the foreign earnings computed in (2) above?

A. UNITED STATES SHAREHOLDERS OF A CONTROLLED FOREIGN CORPORATION

Section 951(a) requires each "United States shareholder" of a "controlled foreign corporation" (CFC) to include in his gross income the net foreign earnings computed under steps (2) and (3) above. The terms "United States shareholder" and "controlled foreign corporation" are interrelated. A "United States shareholder" is a "United States person"⁴³ who owns at least 10 percent of the voting stock⁴⁴ of a foreign corporation.⁴⁵ When "United States shareholders" own more than 50 percent of the voting stock of a foreign corporation, that corporation qualifies as a CFC.⁴⁶ Even if a United States person qualifies as a "United States shareholder" and he owns stock in a CFC, the United States shareholder is not subject to subpart F unless the foreign corporation qualified as a CFC for an uninterrupted period of at least 30 days within the tax year.⁴⁷ Once the foreign corporation meets the 30-day "control" requirement and otherwise qualifies as a CFC, subpart F only imposes United States income tax on the 10 percent or greater "United States shareholders." Thus

43. INT. REV. CODE § 957(d) defines the term "United States person" as a "citizen or resident of the United States, . . . a domestic partnership, . . . a domestic corporation," and domestic estates and trusts, except that a "United States person" does not include certain individual residents of Puerto Rico, the Virgin Islands, and other U.S. possessions. Compare INT. REV. CODE § 7701(a) (3) (definition of "United States person" for U.S. domestic tax purposes.)

44. Direct and indirect ownership of stock counts toward the required 10 percent interest. See constructive ownership rules of INT. REV. CODE § 958, *modifying* § 318. These constructive ownership rules are analyzed in a subsequent portion of this article dealing with the section 972 consolidation election.

45. A United States shareholder "means, with respect to any foreign corporation, a United States person . . . who owns . . . or is considered as owning . . . 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation." The United States shareholders are taxed even though the foreign source income is not repatriated in the form of dividends. INT. REV. CODE § 951(b).

46. A CFC is thus defined as "any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned . . . or is considered as owned . . . by United States shareholders on any day during the taxable year of such foreign corporation." INT. REV. CODE § 957(a).

47. INT. REV. CODE § 951(a) (1). A foreign corporation is a CFC for any day on which it meets the 50 percent ownership test. INT. REV. CODE § 957(a).

if the foreign corporation is owned equally by 11 or more⁴⁸ unrelated "United States persons," the corporation cannot qualify as a CFC and subpart F does not apply. Similarly, if a CFC is owned by six "United States shareholders," and a number of other "United States persons," only the "United States shareholders" are taxed. Since subpart G merely defers income otherwise subject to subpart F, if subpart F does not apply, a fortiori, subpart G does not apply.

B. FOREIGN EARNINGS TAXABLE TO THE UNITED STATES SHAREHOLDERS

Each United States shareholder of a CFC must include three categories of foreign earnings in his gross income: (a) his share of the CFC's subpart F income for that year;⁴⁹ (b) his share of previously deferred subpart F income which becomes subject to tax in the current year;⁵⁰ and (c) his share of the CFC's increase in earnings invested in United States property in such year.⁵¹ Each category of taxable foreign earnings needs further amplification.

1. *Current Subpart F Income*

Subpart F income includes foreign source income which, prior to 1962, was beyond the scope of the United States taxing jurisdiction. This income was either exempt from United States income tax or was subject to tax at the favorable capital gain rates. The broad categories of subpart F income are foreign base company income and income derived from the insurance of United States risks.⁵² Foreign base company income needs to be further divided into (1) foreign personal holding company

48. If a foreign corporation is owned equally by 11 "United States persons," each shareholder owns nine percent of that stock. Therefore, the shareholders would not qualify as "United States shareholders."

49. INT. REV. CODE § 951(a)(1)(A)(i). See the section 951(a)(2) limitation on the United States shareholder's pro rata share of subpart F income.

50. INT. REV. CODE § 951(a)(1)(A)(ii). See the section 951(a)(3) limitation on the United States shareholder's pro rata share of previously excluded subpart F income withdrawn from investments in less developed countries.

51. INT. REV. CODE § 951(a)(1)(B). See the section 951(a)(4) limitation on the United States shareholder's pro rata share of investment of earnings in United States property. See definition of "United States property" in INT. REV. CODE § 956(b).

52. See INT. REV. CODE §§ 952(a)(1), (2), 953 & 954.

income,⁵³ (2) foreign base company sales income⁵⁴ and (3) foreign base company services income.⁵⁵

Foreign personal holding company income includes, with certain modifications and adjustments, the same foreign income which is subject to the foreign personal holding company provisions.⁵⁶ The foreign personal holding company provisions are designed to prevent the use of foreign corporations as "pocket-books" to hold foreign investments.

Foreign base company sales income includes income from the purchase and resale of personal property where the property was purchased from, or sold to, a related person.⁵⁷ In addition, the personal property must have been manufactured, produced, grown or extracted outside the country in which the CFC was chartered, *and* the property must have been sold or "purchased for use, consumption, or disposition outside such foreign country."⁵⁸ For example, if a CFC purchases goods from an unrelated supplier and sells the goods to an unrelated buyer, the income derived from such sale would not qualify as foreign base company sales income. Even if the supplier or the consumer is related to the selling CFC, the income derived from the sale still is not foreign base company sales income unless the goods were manufactured, produced, grown or extracted outside the CFC's country of charter *and* are resold for use, consumption or disposition outside such country. These requirements reflect Congressional intent to prevent tax avoidance by United States shareholders who charter a foreign corporation in a country which has no business relationship to the production of that corporation's income.

Foreign base company services income is income derived from the performance of services "for or on behalf of any related person" if the services are performed outside the CFC's country of incorporation.⁵⁹ These requirements again stress the Congressional intent to tax foreign source income derived from re-

53. See INT. REV. CODE §§ 954(a)(1) & 954(c).

54. INT. REV. CODE §§ 954(a)(2) & 954(d).

55. INT. REV. CODE §§ 954(a)(3) & 954(e).

56. Compare INT. REV. CODE § 954 with § 553.

57. Such income includes profits, commissions and fees. See INT. REV. CODE § 954(d)(1).

58. INT. REV. CODE § 954(d)(1)(B).

59. Foreign base company services income includes income "derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services . . ." INT. REV. CODE § 954(e).

lated party transactions where the income is produced outside the country of incorporation.

Income derived from the insurance of United States risks was, prior to 1962, a source of tax avoidance. A foreign corporation was used to avoid United States income tax on income derived from reinsurance of policies written by United States insurance companies, or to funnel income derived from (1) the insurance of the health and lives of United States residents or (2) the insurance of property and business activity carried on in the United States. Subpart F attempts to close this tax loophole by including, as subpart F income, foreign earnings derived from the insurance of United States risks.⁶⁰

2. *Previously Deferred Subpart F Income*

United States income tax deferral is available for two categories of subpart F income. First, in order to divert American investment to aid the economic development of less developed countries (LDC), Congress granted a subpart F deferral privilege for dividends, interest and gains from the sale of qualified investments in these countries⁶¹ if this income is reinvested in qualified LDC investments. When the CFC's qualified LDC investments decline, each United States shareholder is taxed on his pro rata share of the reduction.⁶² Second, subpart G grants tax deferral for certain subpart F income. The qualifying export trade income (ETI) must be earned by a qualifying export trade corporation.⁶³ Previously deferred ETI becomes currently taxable to the United States shareholders when the CFC experiences a decline in qualified export trade assets.⁶⁴

3. *Increase in Earnings Invested in United States Property*

Each United States shareholder of a CFC must annually include in gross income his share of the CFC's "increase in earnings invested in United States property"⁶⁵ Previously, share-

60. INT. REV. CODE § 953.

61. See INT. REV. CODE § 954(b)(1).

62. INT. REV. CODE §§ 951(a)(1)(A)(ii) & 955.

63. INT. REV. CODE § 970(a).

64. Section 951(a)(1)(A)(ii) requires the United States shareholder to include in his gross income his share of the "corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year" The section 970(b) exclusion of previously deferred ETI is includible in the United States shareholder's gross income under section 951(a)(1)(A)(ii) to which section 955 applies.

65. INT. REV. CODE §§ 951(a)(1)(B) & 951(a)(4). For a detailed analysis, see Jenks, *Controlled Foreign Corporations Investment in*

holders of a foreign corporation could direct their corporation to invest earnings in "United States property" rather than pay a dividend and have the United States shareholders themselves invest in such property, thus utilizing the foreign corporation to avoid United States income taxes. Subpart F now taxes each United States shareholder on his share of the CFC's foreign earnings which are so invested.⁶⁶

C. DEFERRAL PRIVILEGES AND EXCEPTIONS TO SUBPART F TREATMENT

Since subpart F was designed to eliminate the tax avoidance made possible by conducting foreign operations through a corporation chartered in a tax haven country, Congress exempted United States shareholders from subpart F treatment where their CFC was not used for, nor did its foreign incorporation result in, substantially reducing United States and/or foreign income taxes.⁶⁷ Congress also granted tax deferral for subpart F income derived from investments which aid the economic development of less developed countries.⁶⁸ Finally, Congress granted deferral, in subpart G, of certain subpart F income where the business activity *improves* the United States balance of payments. Generally, subpart G was "intended to continue tax deferral in the case of corporations engaged in export trade . . . as an encouragement to export trade."⁶⁹

The exemptions from subpart F treatment and the deferral privilege applicable to income from qualified LDC investments will be discussed later in the article. The other deferral privilege,

United States Property: A New Dividend Concept, 21 TAX L. REV. 323 (1966).

66. See INT. REV. CODE § 956(b).

67. See exclusions and special rules in sections 954(b)(2), (3), (4) & 963.

68. INT. REV. CODE § 954(b)(1).

69. S. REP. NO. 1881, 87th Cong., 2d Sess. 91 (1962). The Treasury opposed this tax preference on the basis of the "economic penetration" doctrine. The rationale of the doctrine is that without substantial activity emanating from abroad, foreign source export income is merely disguised domestic source income. See Jenks, *The Export Trade Corporation: Orphan of the Storm*, 67 COLUM. L. REV. 1187, 1206 (1967). The influence of this doctrine is seen in § 971(c)(3) of subpart G, which requires the ETC to invest in *foreign situs* export facilities.

In the cases involving Western Hemisphere Trade Corporations, (W-HTC) the government argued that unless the W-HTC was engaged in substantial overseas activity emanating from abroad, the domestic corporation was not entitled to the special § 922 deduction. The Government consistently lost this argument in the courts. See *Commissioner v. Hammond Organ Export Corp.*, 327 F.2d 964 (7th Cir. 1964), *aff'g* 22 CCH Tax Ct. Mem. 426 (1963).

granted by subpart G, is the subject of the next section.

IV. SUBPART G—EXPORT TRADE CORPORATION PROVISIONS

A. A SUMMARY ANALYSIS OF EXPORT TRADE CORPORATION PROVISIONS

An “export trade corporation” (ETC) is a corporation chartered in a foreign country and engaged in the export of goods manufactured or produced in the United States and the furnishing of services related to such exported goods. While subpart F normally taxes the United States shareholders on the CFC's current subpart F income, the shareholders of a qualified ETC may defer subpart F income which qualifies as “export trade income” (ETI). This deferral privilege is granted so long as (1) the ETC engages in substantial export activity and (2) the deferrable income is reinvested in facilities and other assets which will help expand the export trade.

The code provision implementing the “substantial export activity” clause requires that, for the three-year period immediately preceding the close of the taxable year in question, the corporation must have earned 90 percent of its gross income from sources⁷⁰ outside of the United States and earned 75 percent of its gross income from the exportation of United States goods and services.⁷¹ “Export trade income” is income derived from the sale or rental of export property, commissions for services relating to export property, and interest income from certain obligations received in payment for the exported goods or services.⁷² To qualify, the vendee or lessee of the goods or services must be “unrelated” to the ETC.⁷³ There are three limitations to

70. INT. REV. CODE § 971(a)(1)(A). Treas. Reg. § 1.971(1)(a)(4) (1964) provides that the source rules of §§ 861-64 apply to the export trade corporation provisions.

71. INT. REV. CODE § 971(a). The 90 percent gross income requirement is reduced to 50 percent when the corporation exports agricultural products. INT. REV. CODE § 971(a)(2).

72. INT. REV. CODE §§ 971(b) & 971(e). For a more complete analysis of the categories of ETI, see Jenks, *supra* note 69, at 1194-95.

73. Section 954(d)(3) defines a related person as (1) a person who controls a controlled foreign corporation; (2) a person who is a corporation who is controlled by the foreign corporation; or (3) a person who “is a corporation which is controlled by the same person or persons which control the controlled foreign corporation.” For this purpose, control means “ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote.” INT. REV. CODE § 954(d)(3). Special indirect and constructive ownership rules are provided in section 958.

the export trade income deferral privilege. The two preliminary limitations are based on percentages of the gross export receipts and of the export promotion expenses.⁷⁴ The ETI, as limited, is then subject to an overall limitation based on the annual level of qualified "export trade assets."⁷⁵ Any current reduction in the level of export trade assets not only prevents deferral of current subpart F income but also triggers recognition of previously deferred ETI.⁷⁶ Export trade assets (ETA) include (1) an amount of working capital reasonably necessary for the production of export trade income, (2) inventory for use or consumption outside the United States, (3) facilities located outside the United States for the handling, storing, transporting and servicing of export property and (4) evidence of indebtedness resulting from the sale or service of export property.⁷⁷

Subpart G also permits United States shareholders to elect consolidation of a group of export trade corporations.⁷⁸ The United States shareholders may combine the export trade assets, the source and character of income and the total gross income of the group.⁷⁹ This consolidation will, in certain situations, increase the amount of deferrable export trade income.

B. A DETAILED ANALYSIS OF THE EXPORT TRADE CORPORATION PROVISIONS

1. *Export Trade Corporation Activity*

An ETC is defined by reference to the source⁸⁰ and character⁸¹ of its gross income: the CFC must derive at least 90 percent

74. INT. REV. CODE § 970(a)(1)(A), (B). An ETC can reduce its ETI which is FBCI by the lesser of (1) 1½ times its export promotion expenses, INT. REV. CODE § 970(a)(1)(A), or (2) 10 percent of the ETC's gross export receipts, INT. REV. CODE § 970(a)(1)(B).

75. INT. REV. CODE § 970(a)(2).

76. INT. REV. CODE § 970(b).

77. INT. REV. CODE § 971(c). See also Treas. Reg. § 1.971-1(c)(5) (1964). The evidence of indebtedness must be written and must be executed by an unrelated person.

78. INT. REV. CODE § 972. See text accompanying notes 201-23 *infra*, which explains the consolidation election and the interrelation between this election and other Code provisions.

79. See Treas. Reg. § 1.972-1(a)(1)(i) (1964).

80. To satisfy the "source of income" requirement, INT. REV. CODE § 971(a)(1)(A) provides that "90 percent or more of the gross income for the 3-year period immediately preceding the close of the taxable year [must be] derived from sources without the United States." This "source" concept was borrowed from the Western Hemisphere Trade Corporation provisions. See INT. REV. CODE § 921.

81. Section 971(a)(1)(B) provides that 75 percent of the gross in-

of its gross income from sources outside the United States and at least 75 percent of its gross income from exporting United States goods and services. Sales or service income qualifies as ETI only if the purchaser of the goods or the recipient of the services is "unrelated"⁸² to the ETC.

The qualifying percentages of the source and character of gross income must be met for a three-year period immediately preceding the close of the taxable year in question.⁸³ The following example illustrates the scope of the three-year provision. Assume a CFC was organized in 1964. In that year, the CFC's operating results were as follows:

	1964 Operations
Total Gross Income (G.I.)	\$100,000—100% of total G.I.
Income from Non-U.S. Sources	95,000— 95% of total G.I.
Export Trade Income	90,000— 90% of total G.I.

For 1964, the CFC derived over 90 percent of its gross income from non-United States sources and over 75 percent of its gross income from exporting United States goods and services. The CFC therefore qualifies as an ETC in 1964.

In 1965, the CFC's operating results were as follows:

	1965 Operations	1964 Operations	Cumulative Totals and %
Total Gross Income	\$100,000 (100%)	\$100,000	\$200,000 (100%)
Income from Non-U.S. Sources	80,000 (80%)	95,000	175,000 (87½%)
Export Trade Income	70,000 (70%)	90,000	160,000 (80%)

While over 75 percent of the CFC's cumulative gross income for the first two years of operation constituted export trade income, less than 90 percent of its cumulative total gross income was from non-United States sources. Therefore, for 1965, the CFC

come for the three-year period must be export trade income. This 75 percent requirement is reduced to 50 percent if the ETI is derived from the exportation of domestic agricultural products. See INT. REV. CODE § 971(a)(2).

82. Section 971(f) defines "unrelated person" as "a person other than a related person as defined in section 954(d)(3)." See note 73 *supra* for an explanation of section 954(d)(3).

83. INT. REV. CODE §§ 971(a)(1)(A), (B) & 971(a)(2). Treas. Reg. § 1.971-1(a)(2) (1964) provides that the three-year qualifying period

is the 3-year period ending with the close of the controlled foreign corporation's current taxable year, or such part of such 3-year period as occurs on and after the beginning of the corporation's first taxable year beginning after December 31, 1962, whichever period is shorter.

does *not* qualify as an ETC.

In 1966, the CFC's operating results were as follows:

	1966 Operations	1965 Operations	1964 Operations	Cumulative Totals and %
Total Gross Income	\$100,000 (100%)	\$100,000	\$100,000	\$300,000 (100%)
Income from Non-U.S. Sources	95,000 (95%)	80,000	95,000	270,000 (90%)
Export Trade Income	65,000 (65%)	70,000	90,000	225,000 (75%)

Looking only at the 1966 results, the CFC would not qualify as an export trade corporation since less than 75 percent of its gross income qualified as export trade income. Using the three-year average and cumulative percentages, however, the source and character requirements are met. Therefore, for 1966, the CFC qualifies as an ETC.

2. *Qualifying Export Trade Income*

Export trade income includes income derived from the sale of export property to unrelated persons for use, consumption or disposition outside the United States,⁸⁴ service income derived in connection with such sales or in connection with the installation or maintenance of such export property,⁸⁵ service income derived in connection with the use, by an unrelated party outside the United States, of intangible property owned by the seller of export property,⁸⁶ "income attributable to the use of export property . . . in the rendition of . . . services to an unrelated person"⁸⁷ and interest income derived from certain obligations received in payment for the exported goods or services.⁸⁸ Subpart G grants tax deferral only for one category of subpart F income—foreign base company income—if it also qualifies as export trade income.

84. The Treasury Regulations presume that property is sold for consumption, use or disposition in the "country of destination of the sale." Treas. Reg. § 1.971-1(b)(1)(i) (1964).

85. INT. REV. CODE § 971(b)(1).

86. INT. REV. CODE § 971(b)(2).

87. INT. REV. CODE § 971(b)(3). If the service income is "not solely attributable to the use of export property in the performance of such services" and no apportionment can be made based on dealings with other unrelated persons, then

such gross income shall be an amount which bears the same ratio to total gross income from the contract or arrangement as the cost of the export property . . . bears to the total costs and expenses attributable to the production of income under the contract or arrangement.

Treas. Reg. § 1.971-1(b)(1)(vi)(b) (1964).

88. INT. REV. CODE § 971(b)(4).

(a) ETI from Sales of Export Property

To qualify income as export trade income (ETI), the ETC must sell, service or rent "export property" for use, consumption or disposition outside the United States. Export property is defined as "any property or any interest in property manufactured, produced, grown, or extracted in the United States."⁸⁹ The property is generally deemed to have been manufactured or produced in the United States if the property is

substantially transformed in the United States prior to its export . . . or the operations conducted in the United States with respect to the property . . . are substantial in nature and are generally considered to constitute the manufacture or production of property⁹⁰

If no substantial transformation occurs subsequent to its original export from the United States, the property retains its character as "export property."⁹¹

A CFC may purchase from a foreign distributor *new* goods manufactured or produced in the United States, resell these goods abroad, and arguably qualify the income as ETI.⁹² It is questionable, however, whether a CFC could purchase similar *used* goods from a foreign owner, resell them abroad, and still so qualify the sale. The interpretation of subpart G, including the interpretation of "export property," should be consistent with the stated policy of encouraging export trade. Since subpart G

89. INT. REV. CODE § 971(e).

90. Treas. Reg. § 1.971-1(e)(1),(2) (1964). Treas. Reg. §§ 1.954-3(a)(4)(ii) (1963) & (iii) (1963), explaining the manufacture or production of property which does not give rise to foreign base company sales income, applies for purposes of determining which property qualifies as "export property" under INT. REV. CODE § 971(e). See Treas. Reg. § 1.971-1(e) (1964).

91. See Treas. Reg. §§ 1.954-3(a)(4)(ii), (iii) (1963) & 1.971-1(e) (1964).

92. A literal reading of the Code would lead to the conclusion that such sales would give rise to ETI. Section 971(b) defines ETI as including income from the "sale to an unrelated person . . . of export property" and section 971(e) defines export property as "any property . . . manufactured, produced, grown or extracted in the United States." In addition, the Regulations define ETI as income derived by a CFC from "the sale of export property . . . which it purchases, if the sale is made to an unrelated person . . ." Treas. Reg. § 1.971-1(b)(1)(i) (emphasis added). The Code and Regulations do not seem to limit ETI to the initial export sale (sale from U.S. manufacturer to foreign distributor), but merely require that the purchased "export property" be sold for use, etc. outside the United States. It is still arguable that subpart G was designed to cover only the original export sale and not the resales abroad.

was designed to aid the United States balance of payments position, "export property" should include property, the sale or lease of which will improve the United States balance of trade. The purchase abroad of *used* United States manufactured or produced equipment for resale or lease abroad seems to have too indirect a relation to the United States balance of trade to come within this policy.⁹³ A counterargument based on statutory interpretation could, however, be advanced. Since the Code defines "export property" as "*any* property . . . manufactured, produced, grown, or extracted in the United States,"⁹⁴ both new and used property would seem to be included.

(b) ETI Derived from the Rendition of Services

For service income to qualify as ETI, the service must relate to export property sold to unrelated persons.⁹⁵ The service income qualifies whether the underlying export property was sold by the CFC or by another party. The vendor of the export *property* need not be the CFC and the vendee of the *services* may be a related party. The only requisite is that the vendee of the export *property* be an unrelated person.⁹⁶

Income qualifies as foreign base company services income where the services are performed *outside* the CFC's country of incorporation and are performed for, or on behalf of, a related party. If an ETC performs services in connection with export property sold by the related person and the performance of such services constitutes a material term of the contract, or if the ETC is not capable of performing the services without the assistance of the "control" person, then the services will be deemed performed for or on behalf of a related party.⁹⁷ If the related person merely assures the vendee that the services will be performed, the income derived from rendition of such services will not constitute service income performed for or on behalf of a related person.⁹⁸

93. While the purchase of such *used* equipment in Germany for resale in Brazil might encourage the purchase of more United States equipment by the German seller, this result is too speculative.

94. INT. REV. CODE § 971(e) (emphasis added).

95. Example 1 of Treas. Reg. § 1.971-1(b)(1)(ii) (1964) indicates that a CFC derives ETI from a sales commission even though the CFC does not take title to the "export property."

96. See INT. REV. CODE § 971(b).

97. See Treas. Reg. § 1.954-4(b) (1964).

98. *Id.*

3. *Limitations on Deferrable ETI*

The ETC provisions permit deferral of subpart F foreign base company income which qualifies as export trade income. Under subpart G, the otherwise deferrable export trade income must be reduced by the lesser of (1) a percentage of the ETC's gross export receipts⁹⁹ or (2) a percentage of the ETC's export promotion expenses,¹⁰⁰ and is then subject to an overall limitation based on the amount of ETI reinvested in qualified export trade assets.¹⁰¹ The gross export receipts and promotion expense limitations provide a statutory guarantee that the ETC is engaging in substantial export activity. The underlying rationale is that a corporation's business activity is directly related to the level of its business expenses and its gross receipts. The export promotion expense limitation guarantees that the corporation is actively engaged in and aggressively promoting the sale of United States products abroad. It also provides some assurance that a sham foreign corporation will not obtain this tax deferral privilege. The overall limitation encourages expansion of export operations by restricting deferral of current ETI and accelerating recognition of previously deferred ETI if the ETC does not utilize its export profits to expand such operations.

99. The ETI deferral may not exceed an amount equal to 10 percent of the gross receipts from the sales of export property plus 10 percent of the gross fees from services performed on export property with respect to which the corporation derives ETI which constitutes FBICI. INT. REV. CODE § 970(a)(1)(B).

100. The ETI deferral may not exceed "1½ times so much of the export promotion expenses . . . as is properly allocable to" ETI which constitutes foreign base company income. INT. REV. CODE § 970(a)(1)(A). For this purpose, export promotion expenses include all amounts directly related to, and a ratable part of amounts indirectly related to, the production of ETI which constitutes FBICI. "No expense incurred within the United States shall be treated as an export promotion expense . . . unless at least 90 percent . . ." of that category of export promotion expenses was incurred outside the United States. INT. REV. CODE § 971(d). The categories of expenses include salaries, rental expense, depreciation and other ordinary and necessary expenses relating to the production or collection of export trade income.

101. In no event may the deferrable ETI "exceed an amount which bears the same ratio to the increase in the investments in export trade assets" as the ETI which constitutes FBICI bears to the entire ETI of such corporation. INT. REV. CODE § 970(a)(2). Assume an ETC currently earns \$300 of ETI of which \$200 constitutes FBICI. Based on the overall limitation, the United States shareholders may defer the \$200 of ETI which constitutes FBICI only if the ETC invests the entire \$300 of ETI in qualified ETA.

4. *Qualifying Export Trade Assets*

Because the overall limitation to the subpart G deferral privilege is based on the increase in the level of ETA, it is essential to understand which corporate assets qualify as ETA. The four basic categories of ETA are (1) working capital, (2) inventory, (3) facilities located outside the United States and (4) evidences of indebtedness. To qualify, these assets must bear a direct and necessary relationship to the production of export trade income.

(a) Four Categories of Export Trade Assets

(1) Working Capital

Working capital of a CFC is the excess of its current assets over its current liabilities.¹⁰² While the amount of working capital must not be more than is reasonably necessary for the production of ETI, the guidelines used to determine reasonableness are flexible and somewhat subjective.¹⁰³ The amount of the working capital, furthermore, may vary according to the method of inventory pricing¹⁰⁴ and the method of financing current operations. The subjective nature of this category of export trade assets makes it adaptable to tax planning; that is, planning the annual level of ETA.

In determining working capital which is reasonably necessary for the production of export trade income, the anticipated future needs of the business will be taken into account to the extent that such needs relate to the year of the controlled foreign corporation following the applicable determination date¹⁰⁵

Since working capital is the excess of current assets over

102. Liabilities which mature in one year or less are treated as current liabilities. Treas. Reg. § 1.971-1(c) (2) (1964).

103. A determination of the amount of working capital of a controlled foreign corporation which is reasonably necessary for the production of export trade income will depend upon the nature and volume of the activities of the controlled foreign corporation which produce export trade income as they exist on the applicable determination date.

Treas. Reg. § 1.971-1(c) (2) (1964).

104. Under the F.I.F.O. method of inventory valuation, the first goods purchased are presumed to be the first goods sold. The inventory valuation, thus, reflects the cost of the most recently acquired inventory. In times of inflation, this inventory cost will be high. In contrast, under the L.I.F.O. method the last goods purchased are presumed to be the first goods sold. If a company maintains a steady level of inventory, the inventory valuation will remain low even during inflation. The valuation will be the cost of the original inventory.

105. Treas. Reg. § 1.971-1(c) (2) (1964). The "anticipated future needs relating to a later period will not be taken into account unless it is clearly established that such needs are reasonably related to the

current liabilities, the method of financing current operations can have a significant effect on the level of working capital. The potential for tax planning is greater where the corporation is thinly capitalized and is forced to borrow in order to purchase inventory, to finance sales and to pay current operating expenses. Assume the ETC begins operations with working capital of zero:

Current Assets	
Cash for operating expenses	\$100.00
Inventory	100.00
	<u>\$200.00</u>
Less Current Liabilities	
Current Loans Payable	200.00
Net Working Capital	<u>\$.00</u>

In the first year of operations, the ETC profits generate \$150.00 cash which is used to repay part of the current liabilities. The net working capital will increase by \$150.00:

Current Assets	
Cash	\$100.00
Inventory	100.00
	<u>\$200.00</u>
Less Current Liabilities	
Current Loans Payable	50.00
Net Working Capital	<u>\$150.00</u>

In contrast, if the ETC financed its initial operations with \$200 of equity capital, the profits would increase "working capital" only if the export activities were expanded.¹⁰⁶

If an asset qualifies as working capital, but also qualifies as inventory or evidence of indebtedness, it will be considered to be working capital so long as it is "reasonably necessary" for the

production of export trade income as of the applicable determination date." *Id.*

106. Assume the cash for current expenses, for inventory and for the financing of current sales was provided by equity capital. Working capital would then be:

Current Assets	
Cash	\$200.00
Inventory	100.00
	<u>\$300.00</u>
No Current Liabilities	<u>—0—</u>
Net Working Capital	<u>\$300.00</u>

Unless the corporation used the \$150.00 cash which the profits generated to finance increased export inventory or increased export sales, there would be no increase in net working capital. Part of the deferral privilege would be lost unless the \$150.00 cash was invested in another category of qualified ETA. See ETA limitation in INT. REV. CODE § 970(a)(2).

production of export trade income.¹⁰⁷ Any part of such asset which does not qualify as working capital because it exceeds the reasonable necessity standard can still be considered inventory or evidence of indebtedness.

(2) Inventory

The second major category of export trade assets is "inventory of export property held for use, consumption, or disposition outside the United States."¹⁰⁸ While the physical situs of property is not determinative, to qualify as export property any property physically located in the United States on the determination date "must have been acquired by the controlled foreign corporation with a clear intent that it would dispose of the property for use, consumption, or disposition outside the United States."¹⁰⁹

(3) Facilities Located Outside the United States

Export trade assets include "facilities located outside the United States for the storage, handling, transportation, packaging, or servicing of export property."¹¹⁰ Any facilities used to change the form of export property do not qualify.¹¹¹

(4) Evidence of Indebtedness

The last category of ETA includes evidence of indebtedness executed by persons unrelated to the ETC in connection with purchases of export property for use, consumption or disposition

107. Treas. Reg. § 1.971-1(c) (6) (1964).

108. INT. REV. CODE § 971(c) (2). Treas. Reg. § 1.971-1(c) (3) (1964) provides that the determination of items includible in inventory is to be made according to the rules applicable to domestic corporations. See Treas. Reg. § 1.471 (1960).

109. Treas. Reg. § 1.971-1(c) (3) (1964). There is a presumption that such property was export property if, during the "year following the applicable determination date," such property was actually exported for use, consumption or disposition outside the United States. . . . On the other hand, the indefinite warehousing of export property in the United States by the controlled foreign corporation, or the subsequent sale [in the United States] will evidence a lack of intent by such corporation on the applicable determination date to hold such property for use, consumption, or disposition outside the United States.

110. INT. REV. CODE § 971(c) (3).

111. Treas. Reg. § 1.971-1(c) (4) (i) (b) (1964). This regulation also provides that "a facility in which property is manufactured or produced, even though export property is used or consumed in the production or becomes a component part of the manufactured article, will not qualify as an export trade asset."

outside the United States, or in connection with payment for certain services.¹¹² "Evidence of indebtedness" includes a note, an installment sales contract, a time bill of exchange evidencing a sale on credit or similar written instruments.¹¹³

(b) Controlling the Level of Export Trade Assets

(1) Setting up the ETC

To maximize the potential subpart G deferral income, the annual increase in the level of ETA must be carefully planned. The annual increase must keep pace with the current deferrable ETI; otherwise the United States shareholders must include part or all of the current and previously deferred ETI in gross income.

Tax planning at the formative stage of an ETC may substantially affect the future ETI deferral privilege. If the ETC starts exporting operations by purchasing needed ETA with *equity* capital, the first year's increase in the level of qualified ETA will be substantial. The overall limitation to the deferral privilege is based on this increase in ETA. Therefore, in the first year, when most new companies suffer losses from operations, this deferral potential will not be utilized. Since the unused deferral potential is not carried over to subsequent taxable years, it is permanently lost. In contrast, if the ETA were purchased by the use of *debt* financing with the liabilities reducing the cost of these assets, the net first-year increase in the level of ETA would be minimal. In the later profitable years, repayment of these loans out of profits or equity capital would increase the level of qualified ETA.

(2) Transfers to Controlled Foreign Corporations

The increases in the annual level of qualified ETA may come, at least in part, from United States shareholders' transfers to their CFC. If the transfer involves appreciated property, income is realized.¹¹⁴ To avoid tax recognition of this gain, the United States shareholders must comply with the nonrecognition provi-

112. INT. REV. CODE § 971(c)(4).

113. Treas. Reg. § 1.971-1(c)(5) (1964). Evidence of indebtedness, for the purpose of INT. REV. CODE § 971(c)(4), does not include "[r]eceptivables which arise out of the delivery of export property, or the performance of services, which are evidenced by . . . documents created by the unilateral act of a creditor."

114. See INT. REV. CODE § 1001.

sions of the Code¹¹⁵ and also obtain a Treasury acknowledgment that the transfer was not contemplated in order to avoid United States income taxes.¹¹⁶ In view of the fact that the sale of inventory and the lease of equipment are major sources of qualified ETI,¹¹⁷ it is interesting to note that the section 367 advance ruling guidelines¹¹⁸ preclude nonrecognition treatment for transfers of inventory or "lease" property to foreign corporations.¹¹⁹ If the ETC needs current increases in ETA, instead of transferring property in a nonrecognition transaction so that the value to the ETC would be the transferor's basis,¹²⁰ the United States shareholder could recognize the gain,¹²¹ thus increasing the ETA valuation to its fair market value.¹²² This procedure will alter the current increase in the level of qualified ETA. The future export promotion expense limitation¹²³ will be affected by the taxability of the transfer of depreciable property, the method of depreciation uti-

115. A foreign corporation is not considered a "corporation" for the purposes of sections 332, 351, 354, 355, 356 or 361 of the Code "unless, before such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." INT. REV. CODE § 367.

116. INT. REV. CODE § 351 permits nonrecognition of gain on the transfer of appreciated property to a controlled corporation. The transferors must own 80 percent of the stock of such corporation after the transfer. Even if the transferors receive a favorable section 367 ruling, permitting the CFC to be treated as a "corporation" under section 351, the transferors will not receive tax-free treatment under this section unless, after such transfer, such persons are in control of the CFC. Unlike the "more than 50 percent" ownership requirements of section 957, control under section 351 is defined as "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." INT. REV. CODE § 368(c).

117. INT. REV. CODE §§ 971(b)(1), (3). See also Treas. Reg. §§ 1.971-1(b)(1)(i), (v) (1964).

118. Rev. Rul. 68-23, 1968 INT. REV. BULL. No. 22, at 33.

119. The Government seems justified in requiring the recognition of income on the transfer of inventory, and perhaps even on the transfer of equipment to be leased. If it were not for this requirement, the transferor might, in the future, transfer inventory to a CFC under the guise of a "contribution to capital."

120. INT. REV. CODE § 362(a).

121. INT. REV. CODE §§ 1001-02. The gain would be measured by the difference between the fair market value of the property transferred and its adjusted basis to the transferor.

122. The section 1012 cost basis would be the fair market value of the property received.

123. Section 970(a)(1)(A) provides a specific limitation on the amount of deferrable export trade income. This limitation is measured by 1½ times so much of the export promotion expenses allocable to the ETI which constitutes foreign base company income. See note 100 *supra*.

lized¹²⁴ and the useful life and salvage value of the transferred property.¹²⁵ When the Internal Revenue Service reviews applications for section 367 rulings, it seems certain that special scrutiny will be given to proposed transfers of property which possess tax shifting or tax avoidance potential.

(3) 75-Day and One-Year Election

Subpart G provides a statutory aid in planning the annual level of ETA.¹²⁶ Although the United States shareholder generally determines the year-end level of ETA at the close of the taxable year, he may elect to defer determination of the year-end level of ETA until (1) 75 days after or (2) one year after the close of the taxable year. When investments in qualified ETA are made within 75 days or one year after the close of the year, this election may increase the deferrable income. The United States shareholder can make the 75-day election with respect to (1) only export trade assets which are qualified export facilities, or (2) only export trade assets which are not qualified export facilities or (3) both.¹²⁷ A 75-day election under (2) or (3) above precludes the one-year election available only for qualified export facilities.¹²⁸ When the United States shareholder is required to file a return before the close of the election period such shareholder may estimate the level of ETA as of the close of such election period.

(4) Use of Debt to Control Level of ETA

The method of financing working capital has a direct bearing on the annual level of qualified working capital.¹²⁹ The method of acquiring fixed assets which qualify as ETA may also have a direct bearing on the annual level of ETA.

There are three major methods of acquiring fixed assets. The export trade corporation may (1) purchase the property for

124. See Treas. Reg. § 1.167(b) (1960).

125. The determination of the useful life and salvage value of an asset is subjective. For some depreciable property, there may be a wide area of good faith differences of opinion. It is this type of property which may be the subject of tax planning. See also Treas. Reg. §§ 1.167(a)-1(b), (c) (1964).

126. INT. REV. CODE § 970(c) (4).

127. Treas. Reg. § 1.970-2(a) (2) (1964). Section 971(c) (3) facilities are "facilities located outside the United States for the storage, handling, transportation, packaging, or servicing of export property"

128. See Treas. Reg. §§ 1.970-2(a) (2), (3) (1964).

129. See notes 102-07 *supra*.

cash, (2) acquire the property in a tax-free section 351 transfer or (3) purchase the property on credit.¹³⁰

The first alternative, purchasing for cash, does not offer any exceptional planning opportunities. If qualified property is purchased, the cash paid increases the current level of ETA.

An ETC may acquire qualified ETA as a result of a section 351 transfer from a United States shareholder. When a foreign corporation is involved, a favorable section 367 ruling¹³¹ is a prerequisite to section 351 treatment. The ETA level will increase in the year of acquisition by the amount of the transferor's adjusted basis,¹³² assuming the property is not mortgaged, but, for depreciable property, will decrease in subsequent years by the amount of the annual depreciation allowance.¹³³ In contrast, if the section 351 property is mortgaged by the ETC for an amount equal to or exceeding¹³⁴ its adjusted basis, the level of ETA would neither increase nor decrease. If the adjusted basis of the asset exceeds the liability, the excess will be includible as ETA.¹³⁵ If the mortgage permits acceleration of principal payments, the opportunity to control the level of ETA is even greater. The Treasury Regulations provide a safeguard against excessive manipulation of the level of ETA by the use of debt financing by specifying that the creation of a current liability or specific charge on property

principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investments in export trade assets shall be taken into account in such a manner as to properly reflect the controlled foreign corporation's investments in export trade assets One of the factors that will be

130. The other methods of acquiring fixed assets include the donation of property (especially where a country or local government is trying to encourage manufacturing in a particular area), tax-free exchanges under either section 1031 or 1032, and tax-free acquisitions as part of a reorganization.

131. A favorable ruling must be obtained from the Government before the section 351 transfer is made or the Government may disallow the section 351 tax-free treatment.

132. The section 1012 basis is cost. The cost of property purchased for cash is the amount of cash paid or payable.

133. Section 1016(a) requires that the adjusted basis of property be reduced by the annual depreciation allowed and resulting in a tax benefit, but not less than the amount allowable.

134. Assuming the liability is deemed to be a valid liability and not one incurred to artificially alter the level of qualified ETA, the amount of the liability would reduce the adjusted basis. See also INT. REV. CODE § 357(c).

135. For example, assume the adjusted basis of the ETA is \$10,000 and the qualified liability is \$4,000. The value of the ETA, for purposes of computing the annual level of ETA, would be \$6,000.

considered in making such a determination with respect to a loan is whether the loan is from a related person¹³⁶

Mortgagors usually impose a penalty for the privilege of accelerating principal payments.¹³⁷ The absence of such a penalty clause, however, may influence the Commissioner to disregard the liability for purposes of computing the ETA level.

Regardless of whether purchased property is unsecured, secured by a purchase money security interest or secured by a mortgage, any provision permitting deviation from the payment terms will be subject to the Regulations' caveat regarding artificial alteration of the level of liabilities.¹³⁸ The United States shareholders are thus limited in their ability to manipulate the level of ETA to coincide with the level of qualified ETI.

(5) Foreign Direct Investor Controls (FDIC)

The FDIC and the economic justification for the imposition of foreign investment controls has been previously explored.¹³⁹ It should be noted that any measure which limits an ETC's freedom to increase its ETA may also limit its ability to defer export trade income. In this respect, any measure restricting capital expansion abroad reduces the tax deferral benefits which the ETC legislation was designed to provide.

5. Consolidation of Export Trade Corporations

Subpart G authorizes United States shareholders to consolidate a "chain" of export trade corporations.¹⁴⁰ The "chain" concept, used in subpart F to characterize some foreign corporations as CFC's and to subject their United States shareholders to subpart F treatment, is the device used by subpart G to grant the same shareholders some tax benefits.¹⁴¹

The ETI deferral granted by subpart G, as discussed previously,¹⁴² may not exceed the lesser of the export promotion ex-

136. Treas. Reg. § 1.970-1(d)(1)(iii) (1966).

137. This penalty is designed to compensate the mortgagor for the loss of future interest payments.

138. Treas. Reg. § 1.970-1(d)(iii) (1966).

139. See text accompanying notes 23-36 *supra*.

140. INT. REV. CODE § 972.

141. The Government may indirectly benefit from the consolidation election. The shareholder consolidation of the related foreign corporations' operations may ease the Government's administrative burden of auditing the United States shareholders' tax returns and fit the pieces of the foreign operation "jigsaw puzzle" together.

142. See notes 99-101 *supra*.

pense, gross receipts or reinvestment of earnings limitations. One ETC in the "chain" may have export promotion expenses far exceeding the statutory minimum, so that the ETI deferral privilege would not be restricted. Another "link" in the "chain" may have qualified ETI exceeding the export promotion expense limitation. Using the consolidation election, United States shareholders may combine both the ETI and export promotion expenses of the member ETC's and thereby minimize the section 970(a) deferral limitations. The consolidation election may also affect the section 970(b) income recognition resulting from a current reduction in the level of qualified ETA. In a subsequent section of this article, this consolidation election will be analyzed in more depth. The complex statutory structure and its attendant limited application becomes apparent only by interrelating the provisions of subpart G with the pertinent provisions of subpart F.

V. INTERRELATIONSHIP BETWEEN SUBPARTS F AND G

As discussed previously, subpart F requires United States shareholders of controlled foreign corporations (CFC) to include in gross income their pro rata share of the CFC's (1) current subpart F income, (2) previously deferred subpart F income which becomes subject to tax in the current year and (3) increases in earnings invested in United States property.¹⁴³ The export trade corporation (ETC) provisions of subpart G enable United States shareholders to defer (but not permanently exclude) subpart F income which qualifies as export trade income (ETI). The United States shareholders must recognize this previously deferred ETI when the export trade corporation reduces its export activity; that is, when it decreases its investment in qualified export trade assets (ETA).¹⁴⁴

It is only the net subpart F income after the exclusions and modifications permitted under subpart F that is subject to the preferential treatment of subpart G. A meaningful analysis of the scope and impact of subpart G cannot be complete without understanding the relation between these subpart G provisions and the subpart F exclusions and modifications.

143. See INT. REV. CODE § 951(a)(1). See generally text accompanying notes 40-69 *supra*.

144. INT. REV. CODE § 970(b).

A. METHODS TO DEFER OR AVOID SUBPART F INCOME

There are six statutory methods by which United States shareholders may defer or avoid all or part of the otherwise currently taxable subpart F income.¹⁴⁵ The first five methods are granted under subpart F and the sixth is granted under subpart G. These provisions are (1) the exclusion for certain shipping income, (2) the 30-70 percent rule, (3) the "not availed of to reduce taxes" exception, (4) the minimum distribution exception, (5) the less developed country (LDC) exception and (6) the ETC provisions.

145. In addition to these statutory methods of excluding or deferring recognition of subpart F income, a foreign corporation may tailor its foreign operations to avoid subparts F and G treatment entirely. The following examples are illustrative.

Subparts F and G apply to income classified as subpart F income, that is, foreign base company income (FBCI) and income from the insurance of U.S. risks. INT. REV. CODE § 952(a). If foreign source income does not come within these two categories, it is not generally subject to subparts F and G treatment (see exception relating to the 30-70 percent rule discussed at text accompanying notes 150-52 *infra*). Foreign source income derived from manufacturing operations is neither FBCI nor income derived from the insurance of United States risks. Using the 30-70 percent rule, where over 70 percent of a CFC's gross income is derived from manufacturing operations, no part of such gross income will constitute subpart F income. The United States shareholders are thus not required to include any current CFC income in their gross income for United States tax purposes. A CFC engaged in manufacturing may limit subpart F treatment by establishing selling branches in the countries of destination of the products. In this way, the manufacturing entity incorporated in country A would sell to branch B in country B and the branch B would resell to buyers in country B. Where the sales operations are conducted through separate branches of a CFC and the location of the branch outside the country of incorporation of the CFC has "substantially the same effect as if such branch . . . were a wholly owned subsidiary corporation deriving" foreign base company sales income then, for purposes of computing the amount of foreign base company sales income, such branches are treated as wholly-owned subsidiaries of the CFC. See INT. REV. CODE § 954(d)(2). The "branch" rule, combined with the 30-70 percent rule, may enable the United States shareholders to avoid part or all of the subpart F treatment. Treas. Reg. §§ 1.954-3(b)(2)(e) (1963), 1.954-1(b)(3)(viii) (1964). Assume a CFC is incorporated in, and manufactures in, Country A. It sells some of its goods in country A and the remainder to its branches in countries B and C. If the branches come within the section 954(d)(2) branch rule, they are treated as wholly owned subsidiaries of the CFC. The manufacturing phase of the corporation will be treated as a separate corporation. So long as more than 70 percent of the gross income from the manufacturing arm of the corporation is derived from the sale of the manufactured product, then under the 30-70 percent rule of section 954(d)(2) less than 30 percent of its gross income will constitute FBCI. Therefore no part of its gross income is treated as foreign base company sales income. See Treas. Reg. § 1.954-1(d)(4) (1964) and accompanying example.

Subparts F and G also incorporate priorities for the application of the statutory exceptions and deferral privileges listed above. The exceptions that relate to the "characterization" of foreign income as subpart F income must be applied first. The first three exceptions fall within this group. Once this is determined, the "minimum distribution" exclusion must be applied. The statute supports this treatment by requiring each United States shareholder, except as provided in section 963,¹⁴⁶ to include in gross income his share of current subpart F income. The gross subpart F income must, therefore, be computed first and the "minimum distribution" exclusion then applied to exclude otherwise currently taxable subpart F income. The LDC deferral privilege is then available to reduce the subpart F income as modified by the first two steps. The subpart G deferral privilege may be used only to defer this "net" subpart F income.¹⁴⁷

1. *The Exclusion of Certain Shipping Income*

Income realized by a controlled foreign corporation from the use, or hiring or leasing for use, of vessels or aircraft in foreign commerce does not constitute foreign base company income (FBCI). Income derived from the performance of services directly related to the use of such vessel or aircraft is likewise excluded.¹⁴⁸ "Foreign commerce" is broadly defined as including the transportation of persons or property (1) between ports or airports in the United States (or a United States possession) and a foreign country or (2) between ports or airports in the same or different foreign countries. If a substantial part of the CFC's income is derived from this excludable shipping income the total gross income may, under the 30-70 percent rule, be exempt from subpart F treatment. Since the subpart G deferral privilege applies only to the FBCI which qualifies as export trade income, when a CFC has no FBCI subpart G cannot apply.

2. *The 30-70 Percent Rule*

Subpart F provides arbitrary rules regarding the amount of foreign base company income which is subject to subpart F

146. INT. REV. CODE § 951(a)(1)(A)(i).

147. The section 970(a)(1) subpart G reduction applies only to "subpart F income (determined without regard to this subpart) . . ."

148. INT. REV. CODE § 954(b)(2).

treatment.¹⁴⁹ If less than 30 percent of the CFC's gross income constitutes FBICI, then *none* of the gross income is treated as foreign base company income.¹⁵⁰ On the other side of the spectrum, if more than 70 percent of the gross income constitutes FBICI, then *all* of the gross income is considered FBICI.¹⁵¹ If between 30 and 70 percent of the gross income qualifies as FBICI, then the actual amount of FBICI, after applying the other exclusions and deferral privileges, is treated as subpart F income. If under the 30 percent rule no part of the gross income is FBICI, then subpart G has no application. When the 70 percent rule converts all gross income to FBICI, the subpart G deferral privilege applies to that portion of the FBICI which constitutes export trade income.

The subpart G consolidation election¹⁵² enables qualified ETC's to combine, for purposes of subpart G, such items as FBICI and non-subpart F income. Combining the election to consolidate and the 30-70 percent rule, the United States shareholders may keep the consolidated FBICI below the 30 or 70 percent levels.

3. *Foreign Corporations not Availed of to Reduce Taxes*

Congress intended, in subpart F, to eliminate wholesale tax avoidance by United States shareholders who conducted their foreign operations through "tax haven" countries. The Code therefore provides that foreign income derived by a CFC may be exempt from subpart F treatment if the United States shareholders satisfy the Government that the creation or organization of the CFC "does not have the effect of substantial reduction of income . . . or similar taxes."¹⁵³ United States shareholders may avoid subpart F treatment when their CFC is incorporated in the country of (1) destination of its goods and/or (2) rendition of its services.¹⁵⁴

Even if the foreign corporation is not incorporated in the country of destination of the goods or the rendition of services, the income may still be excluded from the category of foreign

149. Subpart F income includes income from insurance of United States risks. INT. REV. CODE § 952(a) (1). This category of subpart F income is not within the 30-70 percent rule.

150. INT. REV. CODE § 954(b) (3) (A).

151. INT. REV. CODE § 954(b) (3) (B). This provision is subject to the exclusions and special rules of sections 954(b) (1), (2), (4) & (5).

152. INT. REV. CODE § 972.

153. INT. REV. CODE § 954(b) (4).

154. INT. REV. CODE § 954(d) (1) (A), (B).

base company income. To qualify for this exclusion, the CFC's effective foreign tax rate must be comparable to the effective rate which would be payable if the foreign corporation were incorporated in and subject to tax: (1) for "sales income," in the country of destination of the property sold or in the country of manufacture, production or growth of the property sold, or (2) for "service income," in the country where the services were performed.¹⁵⁵ The effective foreign tax rate is considered "comparable" if the rate equals at least 90 percent of, or not more than five percentage points lower than, the lowest effective tax rate in the applicable country under (1) or (2) above.¹⁵⁶ While these 90 percent and five percentage point standards are significant criteria, they are neither exclusive nor determinative.

The "not availed of" exception applies to each item of income which would otherwise constitute FBCI. If a small portion of the CFC's gross income is excluded by virtue of this exception, it may have a significant impact on subpart F treatment. For example, if this exception omits one percent of the FBCI and reduces FBCI to 29 percent of total gross income, then under the 30-70 percent rule discussed above, no part of the gross income will constitute FBCI.¹⁵⁷ Likewise, if the "not availed of" exception reduces FBCI from 70 percent to 69 percent of total gross income, the 30-70 percent rule would treat 69 percent, rather than 100 percent, as FBCI.

4. *Minimum Distribution*

Each United States shareholder of a controlled foreign corporation (CFC) must include in his gross income, except as provided in section 963, his pro rata share of the corporation's subpart F income for the year in question.¹⁵⁸ The section 963 mini-

155. Treas. Reg. § 1.954-1(b)(3)(iii) (1964).

156. *Id.* In computing the effective foreign tax rate, it is assumed that all the corporate income was derived from sources within such country, that the corporation was created and organized there and that the income was effectively connected with the operation of the business there through a permanent establishment. The Regulations provide some guidance for the computation of this hypothetical tax. *Id.* Treas. Reg. § 1.954-1(b)(3)(v) (1964).

157. The CFC may still have income from insurance of United States risks subject to subpart F treatment. See INT. REV. CODE § 954(a)(1).

158. INT. REV. CODE § 951(a)(1)(A)(i). To utilize the minimum distribution exclusion, the corporate United States shareholders must comply with the election procedure set out in the Regulations. See Treas. Reg. § 1.963-1(c)(2) (1964) and text accompanying note 169 *infra*.

imum distribution exception, applicable only to *corporate* United States shareholders, reduces the section 951(a)(1)(A)(i) inclusion to zero. A CFC is deemed to have made a minimum distribution if the combination of (1) the effective foreign tax rate, plus (2) the United States tax rate on the dividend distribution, closely approximates the amount of United States corporate income tax which would have been payable if the CFC operated abroad through a United States corporation. The "minimum distribution" exception thus exempts current subpart F income where the CFC has not utilized its foreign incorporation to avoid United States and/or foreign income taxes. The Code provides combinations of effective foreign tax rates, plus minimum dividend distributions which produce qualified minimum distributions.¹⁵⁹

Subparts F and G provide independent rules on the current taxation of previously deferred subpart F income.¹⁶⁰ When a CFC, in one year, makes a qualified minimum distribution and earns deferrable export trade income, it is essential that the corporate United States shareholder determine whether the exclusion or deferral provision takes priority.¹⁶¹ The Regulations pro-

159. INT. REV. CODE § 963(b). Where the combination of the effective foreign tax rate and the United States tax rate on the dividend distributions equals 43 percent total effective tax rate (for years after 1964), this combination qualifies as a minimum distribution. INT. REV. CODE § 963(b)(3). The total effective tax rate must be 47 percent for taxable years within the tax surcharge period. See INT. REV. CODE § 963(b)(1).

160. Previously deferred income from qualified LDC investments becomes currently taxable to the United States shareholders when this income is withdrawn from investments in less developed countries. INT. REV. CODE § 955. Section 970(b) provides for the current taxation of export trade income which was previously deferred by virtue of subpart G.

161. If subpart F grants the deferral, such previously deferred subpart F income is later taxable to the United States shareholders only in accordance with the provisions of subpart F or section 1248. On sale or disposition other than by liquidation (and except for section 1248(d)), section 1248 requires the United States shareholder of a CFC to recognize as dividend income any gain attributable to the post-1962 earnings and profits of such CFC.

Subpart F income previously deferred by virtue of subpart G becomes taxable to the United States shareholders when the CFC experiences a reduction in qualified export trade assets (INT. REV. CODE § 970(b)) or when the stock of such CFC is sold (INT. REV. CODE § 1248). For example, assume a CFC qualifies as an export trade corporation. If all prior subpart F income has been deferred by virtue of a subpart F exclusion, a subsequent reduction in export trade assets which would otherwise precipitate the recognition of previously deferred subpart F income will not have that effect.

vide that the subpart F income of a CFC which is excluded from the gross income of a United States shareholder by reason of the receipt of a minimum distribution will not be considered to be excluded under the section 954(b) (1) "less developed country" provision or the section 970(a) export trade corporation provision.¹⁶² The Regulations make the only reasonable interpretation of the relationship between the minimum distribution exclusion under subpart F and the export trade corporation (ETC) deferral privilege granted by subpart G. The minimum distribution exclusion should and does preempt any deferral privilege available under subpart G. A contrary interpretation—that the ETC de-

162. See text accompanying notes 146 & 147 *supra*. See Treas. Reg. § 1.963-1(a) (3) (1964). The following example assumes that the Regulations are correct; that is, the section 963 exclusion preempts the section 970(a) deferral privilege. Assume that a CFC, organized in 1965, also qualifies as an ETC. Assume the effective foreign tax rate is 30 percent. The results of operations, the export trade asset (ETA) level and the corporate distributions are as follows:

	1965	1966
December 31 ETA level	\$100,000	\$85,000
Subpart F income (100 percent is ETI)	50,000	10,000
Current earnings and profits	50,000	10,000
Minimum distributions	42,000	9,000
Potential § 970(a) reduction for qualified ETI, subject to § 970(a) limitations (assumed arbitrary limitation for 1965)	40,000	-0-

For 1965, there was a qualified minimum distribution of \$42,000: the combination of the 30 percent effective foreign tax rate plus the United States income tax on the \$42,000 dividend income equals at least 43 percent total effective tax rate. The minimum distribution would eliminate the section 951(a) (1) (A) (i) subpart F income inclusion. Therefore, even though the subpart F income otherwise qualified for the section 970(a) deferral privilege, there would be no section 970(a) reduction.

For 1966, the minimum distribution would again wipe out the entire section 951(a) (1) (A) (i) inclusion. The United States shareholders would include \$9,000 in gross income as dividend income. Since there was no previously deferred ETI under section 970(a), the current reduction in ETA does not trigger recognition of ETI earned in prior years. For both years, even though the CFC met the ETC deferral requirements, the minimum distributions avoided the impact of subpart G. The priority of section 963 minimum distributions over the subpart G deferral privilege reaches the desired result.

The independence of the minimum distribution exclusion and the subpart G deferral privilege can be further emphasized by considering the tax results where the ETC has previously deferred ETI and, in a later year, makes a minimum distribution and also experiences a decline in ETA. In this later year, the corporate United States shareholders will, under section 301, have to report dividends equal to the amount distributed (limited to the earnings and profits of the CFC—see INT. REV. CODE §§ 312 & 316), and by virtue of sections 951(a) (1) (A) (ii) 2nd 970(b), also include in gross income, part of the previously deferred ETI.

ferral privilege preempts the minimum distribution exclusion—would lead to an absurd result.¹⁶³

The minimum distribution exclusion also preempts the deferral privilege available for certain income from qualified less developed country (LDC) investments.¹⁶⁴ If a CFC earns deferrable LDC investment income and also makes a qualified minimum distribution, the Regulations¹⁶⁵ presume that the minimum distribution eliminates all subpart F income and therefore the LDC income deferral is not utilized. Assume that the CFC experiences a decline in qualified LDC investments in the following year. In this situation, section 951(a)(1)(A)(ii) together with section 955(a)(3) requires that part or all of the section 954(b)(1) previously deferred LDC income be included in the United States shareholder's gross income. The prior year's LDC income is not covered because this income was not previously excluded from

163. The results of an interpretation that the subpart G deferral privilege preempts the minimum distribution exclusion, would be as follows:

In 1965, the section 970(a) ETI deferral privilege would reduce the section 951(a)(1)(A)(i) inclusion by \$40,000. The minimum distribution would reduce the section 951(a)(1)(A)(i) inclusion by the remaining \$10,000 of subpart F income. The United States shareholders would still include \$42,000 distribution in gross income as dividend income.

In 1966, the reduction in qualified ETA would preclude any subpart G deferral privilege. Subject to the section 970(b) limitations, section 951(a)(1)(A)(ii) demands that the previously deferred ETI, \$40,000, be includible in the United States shareholders' gross income. This section 951(a)(1)(A)(ii) inclusion is limited to the *lesser* of:

- | | |
|--|----------|
| 1. ETI previously deferred under § 970(a) | \$40,000 |
| 2. Current earnings and profits (without reduction for current distributions) plus post-1962 earnings and profits (\$8,000 undistributed 1965 earnings and profits plus \$10,000 current earnings and profits) | 18,000 |
| 3. Current reduction in qualified ETA | 15,000 |

For 1966, the United States shareholders would include \$18,000 in their gross income. Due to the minimum distribution, the section 951(a)(1)(A)(i) inclusion would be zero. The section 951(a)(1)(A)(ii) inclusion for previously deferred ETI would be \$15,000 and the section 301 dividend income resulting from the minimum distribution would be \$3,000. (The dividend income would be limited by section 316 to the remaining current and accumulated earnings and profits. The \$8,000 accumulated earnings and profits and \$10,000 current earnings and profits have already been reduced by the \$15,000 section 951(a)(1)(A)(ii) inclusion.) Therefore, for 1966, when the CFC met the minimum distribution requirements, the total subpart F income would be taxable to the United States shareholders. This result seems totally out of harmony with the intent of subparts F and G.

164. See INT. REV. CODE § 954(b)(1) & Treas. Reg. § 1.963-1(a)(3) (1964).

165. Treas. Reg. § 1.963-1(a)(3) (1964).

the FBCI under section 954(b)(1),¹⁶⁶ but rather under the minimum distribution exclusion.

A minimum distribution excludes only current subpart F income, not previously deferred income which is recognized in the current year. Section 963(a) provides that when a CFC makes a minimum distribution, "no amount shall be included in gross income under section 951(a)(1)(A)(i) . . ." (emphasis added). When sections 955(a)(3) or 970(b) trigger recognition of previously deferred subpart F income, such income is includible in the United States shareholder's gross income under section 951(a)(1)(A)(ii). Therefore, since the minimum distribution excludes only section 951(a)(1)(A)(i) subpart F income, and previously deferred income becomes currently taxable to the United States shareholder under section 951(a)(1)(A)(ii), the corporate United States shareholders cannot, by making a minimum distribution, exclude previously deferred subpart F income.

To assure adherence to subpart C's goal of continued expansion of export trade as an aid to the balance of payments position, the deferral privilege is conditioned upon the reinvestment of ETI in qualified export trade assets. Repatriation of earnings, considered to be capital imports, also aid the United States balance of payments. It would be the exceptional case where the United States shareholders of a CFC which makes a minimum distribution would also qualify for the ETI deferral privilege. An ETC's minimum distribution will generally be a distribution of export trade income. Unless the ETC converts nonqualifying assets into qualified ETA, the distribution will reduce the qualified ETA and part or all of the previously deferred ETI will become currently taxable to the United States shareholders.¹⁶⁷

Each corporate "United States shareholder" of a CFC may elect the minimum distribution.¹⁶⁸ This "per shareholder elec-

166. INT. REV. CODE § 954(a)(1)(A).

167. See INT. REV. CODE §§ 970(b) & 951(a)(1)(A)(ii). The Foreign Direct Investor Controls, Exec. Order No. 11,387, 3 C.F.R. 90 (1968 Comp.), requiring mandatory repatriation of certain foreign profits, further reduces the practical benefit of the ETI deferral privilege. It is curious that the most stringent repatriation requirement is imposed on Western European countries—the United States' largest export market.

168. Treas. Reg. § 1.963-1(a)(1) (1964) provides that "a corporate United States shareholder may exclude from its gross income the subpart F income of a controlled foreign corporation if for the taxable year such shareholder elects such exclusion . . ." (emphasis added). In contrast, see section 333(c) which requires corporate and/or non-corporate shareholders owning at least 80 percent of voting stock to make the section 333 election before any shareholder can claim the

tion" is consistent with the policy of exempting from subpart F treatment any United States shareholder who is not utilizing the CFC to avoid United States and/or foreign income taxes.

Each corporate United States shareholder must make the election within the time prescribed for filing the return, receive a sufficient minimum distribution, and, by claiming the section 963 benefits in a return, consent to the section 963 regulations.¹⁶⁹ Even if the effective foreign tax rate is 43 percent or higher,¹⁷⁰ so that an actual dividend distribution is not required, the United States shareholder must still make the election and disclose the required information.¹⁷¹

If a corporate United States shareholder makes a "minimum distribution" in good faith and it is later determined that the distribution did not meet the section 963 requirements, the electing shareholder has two alternatives. It may still claim the subpart G deferral benefits which are otherwise available. It may also make a supplemental dividend distribution in the current year. This "deficiency distribution" relates back to the prior year and has the effect of retroactive compliance with section 963.¹⁷²

5. *Exclusion of Income from Investments in Less Developed Countries*

To foster the United States policy of aiding the economic development of less developed countries (LDC),¹⁷³ subpart F

benefits of such an election. The per-shareholder election is of limited practical importance. Even if the CFC has two classes of stock and a distribution is made to the shareholders of one class, the Commissioner may disallow such dividend allocation and allocate earnings and profits pro rata to each shareholder as though there were only one class of stock. See Treas. Reg. § 1.951-1(e)(3) (1965).

169. Treas. Reg. § 1.963-1(a)(2) (1964).

170. The effective foreign tax rate must be 47 percent for years within the tax surcharge period. See INT. REV. CODE § 963(b)(1).

171. See Rev. Rul. 68-522, 1968 INT. REV. BULL. No. 40, at 12, in which the Government limits the foreign tax credit benefits granted by the section 963 regulations to those dividend distributions which are required for the minimum distribution exclusion. Since the United States shareholders have elected to be bound by the section 963 regulations in effect at the time of election, the question may be posed whether the Treasury is exceeding its authority by retroactively modifying these regulations.

172. See Treas. Reg. § 1.963-6(a) (1964). This escape clause is available where the corporate United States shareholder, in good faith, erroneously calculates the required minimum distribution.

173. While this is the pronounced policy of the United States government, the Foreign Direct Investor Controls, the limited LDC excep-

excludes from the category of foreign base company income (FBCI) any dividends or interest received from qualified LDC investments and any gain from the sale thereof.¹⁷⁴ If the recipient CFC is an LDC corporation,¹⁷⁵ the United States shareholders remain currently taxable on any subpart F income the CFC derives from sales and/or service operations.¹⁷⁶

The "exclusion," which is actually a deferral privilege, is available only if the CFC reinvests the deferrable income in *qualified LDC investments*. In contrast, the United States shareholder may defer ETI only if the ETC reinvests such ETI in *qualified export trade assets (ETA)*. Whether the shareholders of an ETC can utilize both the deferral for passive LDC investment income and the ETI deferral depends upon (1) the annual level of qualified investment and (2) the mutual exclusiveness of "qualified LDC investments" and "qualified ETA."

(a) Qualified LDC Investments

Qualified LDC investments¹⁷⁷ include:

(A) stock of an [LDC] corporation^[178] held by the controlled

tion to the severe subpart F treatment, the limited United States program to insure foreign investment and the liberal income tax credit for taxes paid to LDC's probably do not motivate the reallocation of resources to less developed countries.

174. INT. REV. CODE § 954(b)(1).

175. If a CFC also qualifies as an LDC corporation, the United States shareholder that held stock in such corporation for at least 10 years may sell this stock and realize capital gain rather than ordinary income. See INT. REV. CODE § 1248(d)(3).

176. The subpart F exclusions and the ETI deferral privilege, if applicable, may reduce this subpart F income inclusion.

177. The Internal Revenue Code contains other "tax benefits" for foreign corporations operating in less developed countries. Sections 902(a)(2) and 902(b)(2) permit the corporate United States shareholders to use the "chicle" method of computing the foreign tax credit. This method allows such shareholders to use the foreign tax credit in part as a tax deduction and in part as a tax credit. It generally results in a greater tax benefit than if such shareholder were computing the tax credit on a dividend received from a non-LDC corporation. See generally E. OWENS, *THE FOREIGN TAX CREDIT* 104-06 (1961). Section 1248 ordinarily treats gain on the sale or other disposition of CFC stock as dividend income. An exception is granted for gain attributable to the earnings and profits of the LDC corporation where the United States shareholder owned such stock for at least 10 years. This provision in section 1248(d)(3) permits United States shareholders to realize capital gain on the sale of this LDC corporation stock. These token measures do not, however, provide any logical, systematic plan effectively to encourage investment in less developed countries or redirect investments from Western Europe to LDC's. They merely provide tax preferences for those corporations currently operating in LDC's.

178. An LDC corporation is "a foreign corporation which during the taxable year is engaged in the active conduct of one or more trades

foreign corporation [whether or not such (CFC) also qualifies as an (LDC)], but only if such [CFC] owns at least 10 percent of the total combined voting power of all classes of voting stock of the [LDC] corporation,

- (B) obligations of an [LDC] corporation, but only if the [CFC] owns at least 10 percent of such total combined voting power of the [LDC] corporate stock, and then only if, at the time of acquisition, such obligations have a maturity date of at least one year, and
- (C) obligations of a less developed country.¹⁷⁹

The annual changes in the level of qualified LDC investments limit the deferrable income. The annual change is measured by the level of qualified investments at the end of the current tax year less the level of qualified investments at the end of the preceding year.¹⁸⁰ For example, the calendar year 1969 change is measured by comparing the December 31, 1969, level with the December 31, 1968, level. The United States shareholder may elect to defer the year-end determination date for one year,¹⁸¹ so that newly qualified investments could be includible in the December 31, 1968, and December 31, 1970, ETA level. This election is beneficial where (1) a CFC has invest-

or businesses" and (1) derives at least 80 percent of its income from sources within LDC's, and (2) at least 80 percent of the value of its assets, on each day of the taxable year consists of

- (i) property used in such trades or business and located in less developed countries,
- (ii) money, and deposits with persons carrying on the banking business,
- (iii) stock, and obligations which, at the time of their acquisition, have a maturity of one year or more, of any other less developed country corporation.
- (iv) an obligation of a less developed country,
- (v) an investment which is required because of restrictions imposed by a less developed country, and
- (vi) property, under section 956(b)(2), [which is not "United States property."]

INT. REV. CODE § 955(c)(1).

For the purpose of determining the 80 percent asset requirement, the value of the assets are their actual value without reduction for any liabilities. In the absence of proof to the contrary, the value of each asset is deemed to be its adjusted basis for tax purposes. The value of accounts receivable is treated specially and is deemed to be the face value. See Treas. Reg. § 1.955-5(d) (1963).

179. INT. REV. CODE § 955(b)(1). To constitute a qualified LDC investment, the qualifying property must be held by the United States shareholder for at least six months. See Treas. Reg. § 1.955-2(b) (1963). The 10 percent stock ownership requirement may be satisfied only with stock owned directly by the CFC. See Treas. Reg. § 1.955-2(b)(2) (1963). For this purpose, the section 958 constructive ownership rules do not apply. The qualifying property must also be owned directly by the CFC. See Treas. Reg. § 1.955-2(a) (1963).

180. Treas. Reg. §§ 1.954-1(b)(1) (1964) & 1.954-5(a) (1964).

181. See INT. REV. CODE §§ 954(b)(1) & 955(a)(2). The election

ments in a country which, within the succeeding taxable year, is designated as an LDC¹⁸² or (2) a CFC experiences a temporary decline in qualified LDC investments.¹⁸³

A current reduction in the level of qualified LDC investments not only prevents deferral of such current subpart F income, but also triggers recognition of previously deferred income from these investments.¹⁸⁴ The level of qualified LDC investments may vary with the method of asset valuation employed. The qualified property must be included at its adjusted basis for tax purposes reduced by any liability to which it is subject.¹⁸⁵ To prevent United States shareholders from manipulating the level of qualified LDC investments, the Regulations prohibit reducing the adjusted basis of a qualified asset by the amount of any liability which was incurred or used to artificially increase or decrease the level of qualified investment.¹⁸⁶

(b) Qualified Export Trade Assets

Qualified ETA consists of working capital, inventory, facilities located outside the United States and evidences of indebtedness.¹⁸⁷ It is unlikely that any qualified LDC invest-

under Treas. Reg. § 1.954-5(b) (1964), granted by Treas. Reg. § 1.955-3(a) (1963), is binding for all subsequent years. The Commissioner may consent to a change in the election.

182. The most likely candidates for qualification as new LDC's are the emerging nations of Africa.

183. For example, a temporary decline in qualified LDC investments may occur if the CFC sells qualified stock during the current tax year and has not reinvested the proceeds in other qualified investments before the end of the year.

184. INT. REV. CODE § 955(a)(1). Generally, the United States shareholder must include in its gross income the current reduction in the level of qualified LDC investments, but not exceeding the lesser of: (1) the sum of the post-1962 accumulated earnings and profits plus current earnings and profits computed without regard to any current distributions, or (2) the sum of the section 954(b)(1) prior exclusions for income from qualified LDC investments, less such deferred income which was previously withdrawn from investment in LDC's. See INT. REV. CODE § 955(a)(1)-(2); Treas. Reg. § 1.955-1(b) (1965). Earnings and profits for the purpose of (1) above do not include: (1) section 951(a) inclusions in gross income, other than current section 951(a)(1)(A)(ii) or section 951(a)(1)(B) inclusions, or (2) amounts (even if not distributed) which are currently or were previously included in gross income of such United States shareholder under section 551(b). See Treas. Reg. § 1.955-1(b)(2)(ii) (1965).

185. INT. REV. CODE § 955(b)(5). The qualifying liability must be a specific charge against the property and must not exceed the adjusted basis of the property. See Treas. Reg. § 1.955-2(d)(1) (1963).

186. Treas. Reg. § 1.955-2(d)(2) (1963).

187. For a detailed analysis, see text accompanying notes 111-22 *supra*.

ments could satisfy the ETA requirements. Three categories of qualified ETA, (1) inventory, (2) evidences of indebtedness and (3) facilities located outside the United States, could rarely meet the qualified LDC investment requirements. Qualified "inventory" includes only "export property" held for use, consumption or disposition outside the United States. A CFC would not export stocks or obligations and, therefore, could not qualify these investments as export property.¹⁸⁸ Qualified "evidences of indebtedness" include instruments executed by unrelated persons as payment for export property or certain exported services. Only in the extreme case where the ETC sells goods or renders services to an LDC government agency and that agency makes payment with an obligation of the LDC might the ETC argue that the obligations constituted qualified LDC investments. "Facilities located outside the United States" are neither stock or obligations of an LDC corporation nor obligations of the less developed country itself and, therefore, could not constitute qualified LDC investments. There remains only the category of working capital which may qualify as an LDC investment. It is possible but probably not practical for an ETC to invest part of its working capital in qualified LDC investments. For example, since working capital includes capital needed for the entire year following the determination date,¹⁸⁹ the ETC may temporarily invest, in LDC obligations, the portion of working capital needed only for seasonal demands.

The prior discussion has centered on the question of whether qualified ETA could also qualify as LDC investments. There remains the possibility that an ETC could invest excess funds, not currently needed to increase the level of qualified ETA, in qualified LDC investments.¹⁹⁰ If such investments were made,

188. Generally, "export property" is property manufactured or produced in the United States. Stock or obligations of a corporation and obligations of a nation do not fit within that definition.

189. Treas. Reg. § 1.971-1(c) (2) (1964).

190. There remains the theoretical possibility that an export trade corporation could also qualify as an LDC corporation. If an ETC does not qualify as an LDC corporation, the United States shareholders (see section 1248(a)(2)) must include previously deferred ETI in gross income when the ETC experiences a decline in its level of qualified ETA or when the United States shareholders sell their stock in the ETC. Congress closed a previous loophole by providing that when a United States shareholder sells or exchanges his CFC stock, gain attributable to his pro rata share of post-1962 earnings and profits is taxed as dividend income (see section 1248(a)). If an ETC can also qualify as an LDC corporation, the United States shareholders can avoid dividend

the passive income from such investments would be subject to the section 954(b)(1) exclusion.

B. THE ELECTION TO CONSOLIDATE

Where United States shareholders have pyramided control of export trade corporations through a multi-tier system of corporate ownership, subpart G authorizes the electing shareholders of the "top-tier" corporation to consolidate certain aspects of the multi-corporate operations. The United States shareholders may recompute the per-ETC limitations to the ETI deferral privilege. The consolidation election, once made, is binding for succeeding years. The benefits of the subpart G consolidation are available only if the electing United States shareholders own, directly or constructively, more than 50 percent of the voting stock of the top-tier ETC.¹⁹¹ In addition, each qualifying ETC within the consolidating "chain" must use the same taxable year and the same determination date to calculate the year-end level of qualified ETA.¹⁹²

1. *Limited Purpose Consolidation*

The broad language of section 972¹⁹³ suggests that the United States shareholders are electing, for purposes of sub-

income treatment for the earnings and profits accumulated during the period in which such qualification occurred (see section 1248(d)(3)). This exception to the dividend treatment applies only if the shareholders have owned the stock for at least 10 years. Therefore, shareholders of an ETC which also qualifies as an LDC corporation can combine the current ETI and LDC investment income deferral privilege with the 10-year holding period requirement and remove this subpart F income from United States ordinary income tax treatment.

191. To compute the United States shareholder's ownership in the top-tier ETC, the direct and constructive ownership rules of sections 958(a) and 958(b) are available. See Treas. Reg. § 1.972-1(a)(1) (1964).

192. Treas. Reg. § 1.972-1(a)(4) (1964).

193. For purposes of this subpart and subpart F of this part, a United States shareholder of a controlled foreign corporation which is an export trade corporation may, under regulations prescribed by the Secretary or his delegate, treat as a single controlled foreign corporation—

(1) such controlled foreign corporation,

(2) all controlled foreign corporations which are export trade corporations and 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned by such controlled foreign corporation; and

(3) all controlled foreign corporations which are export trade corporations and 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned by controlled foreign corporations described in paragraph (2).

parts F and G, a comprehensive consolidation of foreign operations. Relying on the Congressional mandate to issue section 972 regulations, however, the Treasury Department has severely restricted the application and function of the consolidation election. Electing United States shareholders may defer the same portion of the consolidated export trade income which would have been deferrable if the export activity were conducted through one rather than a "chain" of export trade corporations. These shareholders recompute, on a consolidated basis, the section 970(a) limitations¹⁹⁴ to the ETI deferral privilege. For the sole purpose of recomputing these limitations, the United States shareholders consolidate the following five items of each ETC in the qualifying "chain":

1. total ETI,¹⁹⁵
2. total ETI which constitutes foreign base company income,¹⁹⁶
3. total export promotion expenses,¹⁹⁷
4. total qualifying gross receipts,¹⁹⁸ and
5. the annual change in the level of qualified export trade assets.¹⁹⁹

194. See text accompanying notes 102-13 *supra*.

195. The section 970(a)(2) overall limitation to the ETI deferral privilege is based on "the same ratio to the increase in the investments in export trade assets . . . as the export trade income which constitutes foreign base company income . . . bears to the entire export trade income of such corporation for such year." The total ETI of each ETC therefore directly affects this deferral privilege.

196. The amount of ETI which constitutes FBCI derived by each ETC affects all three limitations to the ETI deferral privilege. The section 970(a)(1)(A) export promotion expense limitation is based on "1½ times so much of the export promotion expenses . . . as is properly allocable to the export trade income which constitutes foreign base company income" The section 970(a)(1)(B) gross receipts limitation is based on the gross receipts giving rise to ETI which constitutes foreign base company income.

197. The section 970(a)(1)(A) limitation is based on 1½ times the export promotion expenses. Section 971(d) defines export promotion expenses as including wages, rental payments, depreciation and "other ordinary and necessary expenses of the corporation to the extent reasonably allocable to the receipt or production of export trade income."

198. The section 970(a)(1)(B) gross receipts limitation is an amount equal to 10 percent of so much of the gross receipts . . . accruing to such export trade corporation from the sale, installation, operation, maintenance or use of property in respect of which such corporation derives export trade income as is properly allocable to the export trade income which constitutes foreign base company income

199. The overall limitation to the ETI deferral privilege may "not exceed an amount which bears the same ratio to the increase in the

2. The "Chain" Concept

United States shareholders of a "chain" of effectively controlled ETC's may compute deferrable ETI based on either the section 970(a) per-ETC limitations or the consolidated limitations.²⁰⁰ Each member of the consolidation "chain" must qualify both as a controlled foreign corporation and an export trade corporation. In contrast to the minimum distribution chain concept, where part or all of the qualifying foreign corporations may be included in the elective scheme,²⁰¹ all members of the three-tier chain²⁰² must be included in a consolidation election.

The three-tier consolidation chain is composed of one top-tier CFC, second-tier CFC's which are controlled by the top-tier CFC, and third-tier CFC's which are controlled by the second-tier CFC's. A CFC qualifies as a top-tier CFC only if United States shareholders own more than 50 percent of the voting power of its voting stock. In the absence of the consolidation provision, these foreign corporations would still qualify as CFC's.²⁰³

While the constructive ownership rules determine whether a corporation qualifies as a CFC, they do not determine whether a CFC qualifies as a second- or third-tier member of a consolidat-

investments in export trade assets . . ." as the ETI which constitutes FBCI bears to the total ETI for the year. Section 970(c)(2) defines the increase in the investments in ETA as the amount by which the level of qualified ETA at the close of the tax year exceeds the level of such qualified ETA at the close of the preceding tax year.

200. In the absence of the section 972 election, section 970(a) imposes limitations to the ETI deferral privilege on each ETC. The statute provides that the subpart F income of *such* CFC shall be reduced, subject to limitations, by the qualifying ETI which constitutes FBCI.

201. Treas. Reg. § 1.963-1(e) (1964).

202. Treas. Reg. § 1.972-1(a)(3) (1964).

203. Section 957(a) defines a controlled foreign corporation as "any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned . . . or is considered as owned . . . by United States shareholders on any day during the taxable year of such foreign corporation." In computing this 50 percent ownership requirement, section 958 constructive ownership rules apply. The second-tier CFC must be directly owned (80 percent control) by the top-tier CFC. The ownership rules of section 958(b) would attribute this 80 percent ownership to the United States shareholders. If the top-tier CFC owns more than 50 percent of the second-tier CFC, section 958(b)(2) treats the top-tier as owning 100 percent of such stock even if the United States shareholders own only 51 percent of the voting stock of the top-tier CFC. They are presumed to also own 51 percent of the voting stock of the second-tier CFC. The same rationale applies to the ownership in the third-tier CFC. Section 951(a)(1)(A) requires the United States shareholders to include in gross income the subpart F income of such foreign corporations.

ing "chain." If a top-tier CFC *directly* owns at least 80 percent of the voting power of all classes of stock of another foreign corporation, the Regulations classify such other corporation as a second-tier CFC. If qualifying second-tier CFC's individually or together *directly* own at least 80 percent of the voting stock of another foreign corporation, such corporation qualifies as a third-tier CFC.²⁰⁴ If these CFC's qualify as ETC's, they become part of the consolidating "chain." The Regulations do not define "direct" ownership for purposes of determining "chain" status. They presumably refer to direct ownership under section 958(a) (1) (A) and not to stock owned through foreign entities.²⁰⁵

Electing United States shareholders compute the section 970 (a) limitations to the ETI deferral privilege

on a consolidated basis with respect to the entire interest which the electing United States shareholder owns in each of the export trade corporations in the chain, including any minority interest owned directly or indirectly by such shareholder in second-tier and third-tier corporations in the chain.²⁰⁶

While the qualification of foreign corporations as second- and third-tier CFC's is based solely on direct ownership, the United States shareholders' interest in the "chain" of CFC's is based on direct, indirect and constructive ownership rules. It is, therefore, essential to relate the subpart F constructive ownership rules to the consolidation election.

3. *Application of the Subpart F Ownership Rules to the Consolidation Election*

Section 958 (b) of subpart F provides a modified version of the corporate stock ownership rules.²⁰⁷ The constructive ownership rules prevent attempts by creative counsel to avoid the impact of subpart F by creating multiple foreign corporations. The rules determine (1) which foreign corporations qualify as CFC's, (2) which United States persons qualify as United States shareholders and (3) which foreign corporations are "related" for the purpose of characterizing foreign source sales income as subpart F foreign base company sales in-

204. Treas. Reg. § 1.972-1(a) (2) (1964).

205. See Treas. Reg. § 1.972-1(a) (8) (1964).

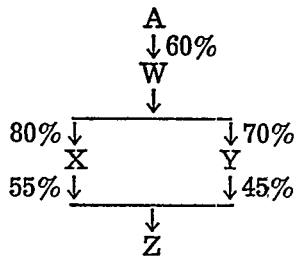
206. Treas. Reg. § 1.972-1(a) (3) (1964).

207. See INT. REV. CODE § 318 for the constructive ownership rules applicable to the ownership of domestic entities.

come. In addition, these rules determine CFC status for the purpose of the consolidation election.

If a foreign corporation owns more than 50 percent of another foreign corporation's voting stock, then under the constructive ownership rules, it is deemed to own 100 percent of the stock.²⁰⁸ Assume that domestic Corporation A owns 60 percent of the voting stock of foreign Corporation W, which in turn owns 80 percent of the voting stock of foreign Corporation X and 70 percent of the voting stock of foreign Corporation Y. Assume further that Corporation X owns 55 percent and Corporation Y owns 45 percent of the voting stock of foreign Corporation Z.

This case is illustrated as follows:



Using the constructive ownership rule of section 958(b) (2), Corporation X is deemed to own 100 percent of the voting stock of Corporation Z. Corporation W is also deemed to own 100 percent of Corporation Z's voting stock. Corporation A is deemed to own 60 percent of 100 percent, or 60 percent, of the voting stock of Corporation Z. Corporation Z, therefore, is a CFC within section 957. Corporations W, X and Y would likewise qualify as CFC's. Assuming these CFC's also qualify as ETC's, they may be consolidated under section 972 only if such CFC's also qualify as members of a section 972 "chain." Corporation W qualifies as a top-tier corporation since United States Corporation A owns more than 50 percent of its voting stock. Corporation X qualifies as a second-tier corporation, since the top-tier CFC directly owns at least 80 percent of its voting stock. Corporation Y does not qualify as a second-tier CFC, since Corporation W directly owns only 70 percent of its voting stock. Corporation Z does not qualify as a third-tier CFC, since the second-tier CFC, Corporation X, does not directly own 80 percent of Corporation Z's voting stock. The qualifying "chain" includes only Corporations W and X.

208. INT. REV. CODE § 958(b) (2).

While the section 958(b) constructive ownership rules determine the status of foreign corporations as CFC's, the section 958(a) direct and indirect ownership rules determine the percent of stock ownership for purposes of the gross income inclusions under section 951. Once the members of a "chain" are identified by the use of the section 972 direct ownership rules,²⁰⁹ the section 958(a) direct and indirect ownership rules determine the amount of subpart F income, including export trade income, taxable to the United States shareholders.

4. *Mechanics of the Consolidation Election*

The limited function consolidation election increases deferrable export trade income in situations where, if the activities of all the ETC's within a "chain" were conducted through a single ETC, the United States shareholders would obtain a larger section 970(a) deferral privilege. Tax benefits inure if deferrable ETI of one or more ETC's in a chain exceeds the section 970(a) deferral limitations,²¹⁰ and deferrable ETI of other members of the same "chain" is below these limitations. The consolidation averages the factors which affect the deferral limitations. Assume domestic Corporation A owns 100 percent of the voting stock of foreign Corporation X. Corporation X owns 100 percent of the voting stock of foreign Corporation Y. Corporation X sells slow turnover, high profit margin products in Western Europe. It is expanding its new export operations by reinvesting profits in qualified ETA's. The goods sold by Corporation X are well-known, and its advertising expenses are small. Corporation Y, on the other hand, sells high turnover, small profit margin products. Corporation Y incurs substantial advertising expenses. Corporation Y operates in an unstable, less developed country and repatriates most of its profits. Corporations X and Y use the same tax year and make the same section 970(c)(4) determination date election. For 1968, the relevant data for Corporations X and Y is as follows:

209. See Treas. Reg. § 1.972-1(a)(2) (1964).

210. This occurs if the export promotion expense limitation, the gross receipts limitation or the overall limitation of section 970(a) reduces the ETI deferral for ETI which constitutes foreign base company income.

	<u>Corp. X</u>	<u>Corp. Y</u>	<u>Combined</u>
Total subpart F income	\$125	\$125	\$250
ETI which constitutes FBCI	100	100	200
Increase in ETA for 1968	200	50	250
Export promotion expense allocable to ETI which constitutes FBCI	80	100	180
Gross receipts allocable to ETI which constitutes FBCI	600	1500	2100

Absent the consolidation election, Corporation A would have a \$140 gross income inclusion under section 951(a)(1)(A), computed as follows:

Total subpart F income	\$250
Section 970(a) deferral privilege	
Corporation X	
ETI which constitutes FBCI	\$100
Subject to the gross receipts limitations (10% of \$600)	(60)
Corporation Y	
ETI which constitutes FBCI	\$100
Subject to the overall limitation (increase in ETA)	(50)
Net section 951(a)(1)(A) inclusion	<u>\$140</u>

Electing the section 972 consolidation, Corporation A can combine the corporations' export trade income, their ETA level, their export promotion expenses and their gross receipts allocable to ETI which constitutes foreign base company income. The 200 dollars of potentially deferrable ETI would then be limited by the lower of the following three limitations:²¹¹

- | | |
|---|-------|
| (1) Increase in the level of qualified ETA | \$250 |
| (2) 1½ times the qualified export promotion
expenses (1½ x \$180) | 270 |
| (3) 10 percent of the gross receipts which produced
ETI which constitutes FBCI (10% x \$2,100) | 210 |

Since the ETI which constitutes FBCI is less than each of the three limitations. Corporation A would defer the entire 200 dollars. Corporation A would include in gross income only the 50 dollars net subpart F income.

5. Termination of the Election to Consolidate

There are three situations in which the section 972 election terminates. (1) The election terminates if a top-tier ETC ceases to qualify as either a CFC or an ETC, or no longer meets the re-

211. See text accompanying notes 99-101 *supra*.

quirements as a top-tier member of a "chain."²¹² A CFC ceases to qualify as an ETC if, within the last three years, it derived less than 90 percent of its gross income from sources outside the United States and/or less than 75 percent of its gross income qualified as export trade income.²¹³ (2) The election also terminates when an ETC, which otherwise qualifies as a second- or third-tier ETC, does not use the same tax year or the same section 970(c) (4) determination date elected by the top-tier ETC. (3) The Commissioner may consent to a termination of the consolidation election, but once the election terminates, the Commissioner's consent must be obtained before the United States shareholder makes another election.²¹⁴

VI. PROPOSED EXPANSION OF THE EXPORT TRADE CORPORATION CONCEPT

The subpart G deferral privilege was a legislative attempt to divert the controlled foreign corporation's operations to the exportation of United States manufactured and produced goods and United States related services. The subpart G export trade corporation concept has been of limited success in improving the balance of payments position, however, because the subpart F and subpart G provisions are unusually complex, because there are a limited number of potential subpart G export trade corporations, and because there are numerous subpart G limitations to the deferral privilege. Two recent Congressional proposals illustrate the variety of methods by which the export trade corporation concept could be expanded.

A recent House bill²¹⁵ proposes income tax incentives for individuals and corporations that manufacture or produce export goods within the United States. Qualifying export income would be taxable at 70 percent of the ordinary income tax rate. A taxpayer electing this 30 percent tax reduction could not utilize the Western Hemisphere Trade Corporation deduction.²¹⁶ A 1968 Senate bill proposes tax incentives for domestic "small business export trade corporations" to encourage the expansion of export

212. Treas. Reg. § 1.972-1(a) (6) (1964).

213. INT. REV. CODE § 971(a) (1). The 75 percent ETI requirement is reduced to 50 percent if more than 50 percent of the CFC's gross income for the three-year period qualifies as ETI derived from the sale of agricultural products grown in the United States. See INT. REV. CODE § 971(a) (2).

214. Treas. Reg. § 1.972-1(a) (7) (1964).

215. H.R. 3320, 90th Cong., 1st Sess. (1967).

216. INT. REV. CODE § 922.

trade and contribute to a favorable balance of payments position.²¹⁷ The "small business corporation" would act as a foreign distributor for domestic companies which lack "facilities, experience or inducement to enter or remain in the foreign market field acting alone." The tax incentive is modeled after the 14 percent Western Hemisphere Trade Corporation deduction but establishes a ceiling on this deduction.²¹⁸

Any export incentives should be tied to the balance of payments problem more closely than is the indirect subpart G incentive. Both the small business export trade corporation proposal and the 30 percent tax reduction proposal are desirable because they would encourage the establishment of new export corporations as well as benefiting existing export corporations.²¹⁹ Both incentives should require the repatriation of sales proceeds, however, to realize the goal of an improved balance of payments position.²²⁰

In addition, any incentives must comply with this country's obligations under GATT. A GATT member nation may not, without resorting to the balance of payments exception,²²¹ directly subsidize exports. GATT member nations may, however, grant indirect export subsidies, such as export rebates of national sales taxes.²²² Since the United States has no national sales tax and economists claim they cannot realistically measure the portion of an income tax which is passed on to the consumer, the United States has not granted any tax rebate upon export. United States businessmen claim that the discrepancy between sales tax rebates by Western European countries and the lack of rebates by the United States has put American businesses at a

217. S. 3947, 90th Cong., 2d Sess. (1968).

218. In addition to the two proposals discussed in this section, some Congressmen favor the liberalization of the export incentives in order to grant benefits similar to the British Overseas Trade Corporation (OTC) provisions. The OTC legislation attempted to equate the tax consequences to resident corporations and foreign corporations operating wholly outside the United Kingdom. Tax preferences are granted to resident export and nonexport corporations. The British OTC legislation was enacted by the Finance Act of 1957 and repealed by the Finance Act of 1965. See generally W. BARNES, *WORLD TAX SERIES: TAXATION IN THE UNITED KINGDOM* 22 (Cum. Supp. 1959).

219. The LDC corporation tax incentives were designed to achieve this reallocation function, but they have been ineffective.

220. The sales proceeds should be measured by the net (after expenses) sales income.

221. General Agreement on Tariffs and Trade, Protocol of Provisional Application, Proclamation No. 2671A, 3 C.F.R. 139 (1943-48 Comp.), art. XII(1) exception to art. XI(1).

222. See generally GATT art. XVI.

competitive disadvantage. The proposed domestic ETC tax reduction would tend to equalize these competitive positions without violating GATT.²²³

VII. CONCLUSION

Subpart G of the Internal Revenue Code was designed to continue tax deferral for subpart F "controlled foreign corporations" which export goods and services from the United States. As an exception to subpart F which currently taxes certain income earned by CFC's, subpart G provides an indirect incentive to export trade. Several infirmities in the present export trade corporation concept have rendered it impotent in accomplishing its avowed objective of improving the balance of payments problem. The subpart G limitations to the export trade income deferral privilege, coupled with the foreign direct investor controls, have severely restricted the practical utility of the incentives. The export promotion expense and export receipt limitations assure that substantial overseas activity is being conducted but do not directly foster improvement in the United States balance of payments position. The deferral is also conditioned upon the reinvestment of export trade income in qualified export trade assets. This limitation encourages the expansion of export trade, but discourages repatriation of capital to the United States. Where a foreign export corporation incorporates and operates in the same country, subpart F does not apply and the corporation avoids United States income tax without complying with the subpart G conditions. The subpart G deferral applies to the "net" subpart F income remaining after reduction for the relevant subpart F exclusions and deferral privilege. Only in an exceptional situation would an export trade corporation make a qualified minimum distribution or have deferrable income from qualified less developed country investments. Subpart G thus grants tax benefits to United States shareholders of controlled foreign corporations that derive export trade income through the "tax haven" *modus operandi*. This subpart G dependence on the complex provisions of subpart F has rendered the administration of this tax incentive by the Government and its utilization by

223. The small business export trade corporation proposal probably does not violate GATT; in fact, the bill precludes the tax reduction on sales income derived from countries which are members of GATT. The less developed countries account for most of the nonmember countries. Since the United States does not have balance of payments problems with the LDC's, this proposal will encourage increased export trade without an appreciable effect on our balance of payments.

United States shareholders very difficult. United States shareholders of multiple export trade corporations may, however, free themselves of some of the strict limitations to the deferral privilege by consolidating various aspects of the foreign operations. Congress should therefore repeal this limited tax preference and enact legislation independent of the subpart F provisions which will encourage a reallocation of resources into export activities.