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NOTE

MCA, Inc. v. United States: Judicial Recognition of the Separate Interests Theory

I. INTRODUCTION

For United States federal tax purposes, the classification of an entity as a partnership or a corporation has significant ramifications, particularly with respect to entities in foreign countries.¹ Classification is especially important to the owners—whether shareholders or partners—of the entity because the question of whether they are taxed on their share of the profits or only upon repatriation will often depend on how the entity, set up under foreign law, is recognized by the Internal Revenue Service (Service). While entity classification in the domestic area has always been vulnerable to challenge, foreign entities face an additional problem in view of the Service's application of a rather complicated "separate interests" test.² While in theory the classification of a foreign entity embodies the same tests as the classification of a domestic entity,³ recent cases and revenue rulings have created uncertainty and confusion for United States taxpayers wishing to conduct some portion of their operations abroad. In *MCA, Inc. v. United States*,⁴ the United States Court of Appeals for the Ninth Circuit ex-

¹ Entity classification is important for foreign entities when dealing with transfers of property under I.R.C. §§ 367 and 1491, the timing and recognition of income and losses, the foreign tax credit, the source and interest of profit distributions, the allocation of income and expenses, and the calculation of earnings and profits. See New York State Bar Ass'n, Tax Section, *Report on Foreign Entity Characterization for Federal Income Tax Purposes*, 35 TAX L. REV. 167, 169-87 (1980) [hereinafter cited as *Tax Report*].

² See *infra* notes 51-92 and accompanying text.

³ Rev. Rul. 73-254, 1973-1 C.B. 613.

⁴ 685 F.2d 1099 (9th Cir. 1982), *rev'g* *MCA, Inc. v. United States*, 502 F. Supp. 838 (C.D. Cal. 1980).

amined this problem of classifying foreign entities for federal tax purposes. In this case of first impression, the court held that United States film distribution outlets in various foreign countries, which were organized as partnerships⁵ by a controlled foreign corporation (CFC)⁶ and by its employee trust, were partnerships for federal tax purposes. In so holding, the court refused to find that the CFC and its trust represented a "single economic interest,"⁷ although as a practical matter they were likely to act in concert in the management of the distributorships.⁸ In addition, the court held that provisions in the organizational documents of the distributorships that restricted the transferability of interests and limited the continuity of life should be given legal effect.⁹ The court rejected the unsupported assumption that the trustees of the employee trust would always act in concert with the corporations, even in derogation of their fiduciary duties. Nevertheless, while overruling the district court opinion on the facts, the court recognized the existence of the separate interests theory,¹⁰ the first and only time the theory has received any judicial support.

This Note will examine both the district court's and the court of appeals' application of the separate interests theory to the fact situation presented by the taxpayers in this case. It will also question the validity of the theory, and whether it can ever be consistently applied. Finally, it will explore whether the use of this stricter standard exclusively with respect to foreign entities is justified and what taxpayers who wish to use the partnership vehicle in conducting operations abroad will have to do in the future to minimize the risk of reclassification.

II. *MCA, INC. V. UNITED STATES*

A. Facts of the Case

As part of a joint venture agreement with Paramount Pictures Corporation, plaintiffs, MCA and its wholly owned subsidiary Universal Studios, formed a Dutch corporation, Cinema International Corpora-

⁵ In setting up these entities, the local attorneys in each country were advised to form the distribution entities so as to make them independent taxable entities and simultaneously avoid at least two of the four corporate characteristics (continuity of life, centralization of management, limited liability, and free transferability of interests) provided for in Treas. Reg. § 301.7701-2, T.D. 7889, 1983-21 I.R.B. 16, and Treas. Reg. § 301.7701-3 (1960).

⁶ For a definition of "controlled foreign corporation" see *infra* note 18.

⁷ See *infra* notes 50-78 and accompanying text.

⁸ 685 F.2d at 1104.

⁹ *Id.*

¹⁰ See *infra* notes 50-91 and accompanying text.

tion (CIC) to handle the distribution of their films abroad.¹¹ MCA and Paramount each received forty-nine percent of the corporation's stock.¹² "Stichting," an employee trust set up by MCA and Paramount for the benefit of CIC's board of directors owned the remaining two percent.¹³ Stichting operated under a three-member board of trustees, with two trustees appointed by the CIC board of directors, who in turn appointed the third.¹⁴

Shortly after Stichting was created, CIC and Stichting, through Stichting's wholly owned subsidiary Proteus, jointly established local distributorship outlets to distribute films in their respective geographic territories.¹⁵ In order to obtain favorable tax treatment under the Subpart F provisions of the Internal Revenue Code (Code),¹⁶ the organizational documents of each distributorship were designed so as to avoid inclusion of the corporate characteristics of continuity of life and free transferability of interests, thereby meeting the partnership requirements of Treasury Regulation 301.7701-2.¹⁷

Because it was undisputed that CIC was a "controlled foreign corporation" within the meaning of section 957(a) of the Code,¹⁸ all Sub-

¹¹ 685 F.2d at 1100.

¹² *Id.*

¹³ For the years in question, 1972 and 1973, the Board of Directors of CIC consisted of the chief executive officer of MCA and the chief executive officer of Paramount, both being granted the authority to choose three additional directors. *Id.*

¹⁴ For the years 1972 and 1973 the CIC Board of Directors appointed to the Board of Trustees the two chief executive officers of MCA and Paramount, who in turn appointed a Dutch attorney to act as the third trustee. *Id.* at 1101.

¹⁵ The 5 percent ownership interest in each local distributorship was owned by the employee trust through Proteus, B.V., a Netherlands corporation wholly owned by the employee trust, rather than directly, since in many foreign countries, the concept of a trust as a foreign owner is unknown, whereas a Netherlands B.V. is a generally recognized form of business organization which is commonly accepted as a foreign owner.

Brief for Appellants at 4, *MCA, Inc. v. United States*, 685 F.2d 1099 (9th Cir. 1982) [hereinafter cited as *MCA Brief*].

"Operation through CIC branch offices. . . was not a feasible alternative because of the commercial need to establish a permanent and separate presence in each country," 502 F. Supp. at 840, and because of local foreign law in many of the countries which prevented *foreign* corporations from engaging in film distribution. *Id.* Local distribution outlets were established in Argentina, Australia, Austria, Belgium, Brazil, Columbia, France, Germany, Guatemala, Hong Kong, Israel, Italy, Lebanon, Mexico, New Zealand, Panama, Peru, South Africa, Trinidad, United Kingdom and Venezuela. *Id.* at 842-43.

¹⁶ I.R.C. §§ 951-72 (1976).

¹⁷ The government conceded that each of the distributorships was organized for substantial business reasons unrelated to U.S. taxes. MCA chose to organize the distributorships as partnerships (rather than corporations) under the tests of the Income Tax Regulations so as to defer recognition of income and thereby minimize its tax liability. MCA clearly had a legal right to do this. See *MCA Brief*, *supra* note 15, at 11 (citing *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935)).

¹⁸ I.R.C. § 957(a) (1976) provides:

part F income¹⁹ earned by CIC was to be included in the taxable income of CIC's United States shareholders, MCA and Paramount, in the year the income was earned.²⁰ Among the items included in Subpart F income is "foreign base company income,"²¹ which includes all rents and royalties received from "related persons."²² An entity is a related person with respect to a CFC "if. . .(B) such person is a *corporation* which. . .is controlled by. . .the controlled foreign corporation; or (C). . .is a corporation which is controlled by the same person or persons which control the controlled foreign corporation."²³ Because the statute excludes "controlled partnerships" from its definition of related persons, partnership classification of the film distributorship outlets was critical. In this regard, the parties agreed that if the distributorships were indeed partnerships, MCA would prevail in the case because as a shareholder of CIC, MCA is subject to tax on its share of non-Subpart F income only when it actually receives it in the form of dividends.²⁴

B. The District Court's Opinion

In determining whether the entities were partnerships or corporations, the district court applied the test set out in *Larson v. Commissioner*.²⁵ Referred to as the "preponderance test," this objective test provides that a business organization that has associates,²⁶ and an objective to carry on a business and divide the gains therefrom, is to be treated as a "corporation" for United States income tax purposes if the organization has at least three of the four characteristics of "corporate-

For purposes of this subpart, the term 'controlled foreign corporation' means 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 (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

¹⁹ For a definition of what constitutes Subpart F income see *infra* notes 110, 114-16 and accompanying text.

²⁰ I.R.C. § 951(a)(1) (1976).

²¹ I.R.C. § 952(a)(2).

²² I.R.C. § 954(a)(1), (c)(3)(A).

²³ I.R.C. § 954(d)(3) (emphasis added). "Control" is defined as "the 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." *Id.*

²⁴ 685 F.2d at 1101.

²⁵ 66 T.C. 159 (1976), *acq.* 1979-1 C.B.I.

²⁶ "Associates" has generally been held to mean a number of persons uniting together for some special purpose or business. See *Morrissey v. Commissioner*, 296 U.S. 344, 356 (1935). Neither § 7701 nor its regulations define the term "associates," other than to say that having associates is an essential characteristic for an organization to be classified as an association. Treas. Reg. § 301.7701-2(a)(2).

ness": (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interests.²⁷

While the court conceded that if a literal interpretation of corporateness were used, none of the outlets would have the requisite three features of corporateness, it accepted the government's argument that these local distribution outlets were "in fact structured and operated in a manner which so closely parallels that of a corporation as to defeat their nominal characterization as 'partnerships.'" ²⁸ The government maintained that because MCA and its joint venturer, Paramount, were in actual control of both CIC, which had a ninety-five percent interest in each outlet, and the Stichting-CIC Employees Trust, which had a five percent interest in each outlet, CIC and the trust did not constitute separate and independent interests in the local distribution outlet.²⁹ The government pointed out that two of the people who controlled CIC, the chief executive officers of MCA and Paramount, were also two of the three trustees of Stichting. From this fact, it argued that "it would be difficult to foresee any circumstance in which [they, as trustees of Stichting] would find it necessary to act in derogation of the interest of CIC. . . with regard to the local outlets."³⁰ The government and the court discounted the strict fiduciary duties that both Netherlands and California law impose on the trustees, concluding that the enormous discretion accorded the trustees by the trust agreement empowered them to operate the trust in a manner consistent with the aims of CIC.³¹

The government's claim that the partnership interests were not separate, but identical, would under the separate interests theory cause the corporate characteristics of continuity of life and free transferability of interests to be present. This is so because if either partner, CIC or Stichting, had wished to sell its interest in a local outlet, the other would not have blocked the sale. Moreover, the characteristic of continuity of life will be found to exist if the separate interests theory is applied. This characteristic exists, of course, where "the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization."³² If there existed no separate interests which would demand termination upon the occurrence of one of these events, the government contended, a local outlet

²⁷ 66 T.C. at 172.

²⁸ 502 F. Supp. at 843.

²⁹ *Id.* at 844.

³⁰ *Id.*

³¹ *Id.* at 844-45.

³² Treas. Reg. § 301.7701-2(b)(1) (1960).

could survive such an occurrence just as a corporation would.³³

Because many of the outlets also possessed the corporate characteristic of limited liability, in addition to the two other characteristics provided by the separate interests theory, the court found the outlets to be associations taxable as corporations.³⁴ The income from these outlets constituted more than seventy percent of CIC's earnings. Consequently, under section 954(b)(3)(B), *all* of CIC's income was treated as foreign base company income.³⁵ In sum, CIC's entire income, including income received from those outlets that were not found to be taxable as corporations, was treated as Subpart F income and taxed as such to the CIC shareholders.

Commentators immediately condemned the district court opinion and its use of the separate interests test, primarily because the court failed to recognize that separate interests did indeed exist with respect to the distributorship outlets,³⁶ and because the court's application of Revenue Ruling 77-214 to the *MCA* facts was erroneous.³⁷ Moreover, some commentators expressed concern that the Service might try to apply the separate interests test to domestic entities³⁸ and that if the ruling in *MCA* was not modified or reversed, the only way to avoid future reclassification of entities as corporations would be to ensure that an unrelated party owned a significant percentage of the distribution entity.³⁹

C. The Court of Appeals' Opinion

Although the Court of Appeals for the Ninth Circuit ultimately

³³ 502 F. Supp. at 846.

³⁴ *Id.* at 847.

³⁵ Known as the "10-70" rule, I.R.C. § 954(b)(3) (1976) provides that if less than 10% of the CFC's gross income is Subpart F income, that amount will be treated as *de minimis* and will be totally disregarded. But if more than 70% of the CFC's gross income is Subpart F income, the *entire* gross income for that year will be treated as if it were Subpart F income.

³⁶ See Majers, *Entity Classification: The Separate Interests Test*, 8 INT'L TAX J. 263, 268-69 (1982). In addition to arguing that the fiduciary obligations of the trustees of the employee trust automatically gave rise to separate interests, the author criticizes the court for ignoring the presence of two additional, separate and distinct, 49% shareholders at the second level: *MCA* and *Paramount*. *Id.*

³⁷ *Id.* See *infra* notes 79-84 and accompanying text.

³⁸ See Majers, *supra* note 36, at 271. See also Hamilton, *MCA, Inc.—Classification Of Foreign Entities As Associations or Partnerships*, 59 TAXES 303, 306-07 (1981). As Hamilton points out, however, the Service decided not to apply the separate interests test to domestic entities in Rev. Rul. 79-106, 1979-1 C.B. 448. A similar attempt to incorporate it into proposed regulations on January 5, 1977, also failed. *Id.* at 306-07.

³⁹ Hamilton, *supra* note 38, at 307-08.

reversed and ruled in favor of the taxpayer,⁴⁰ it did so without overruling the separate interests test established by the Service in Revenue Ruling 77-214.⁴¹ In analyzing the facts of the *MCA* case, the court immediately distinguished them from the facts of Revenue Ruling 77-214⁴² by recognizing that CIC and Stichting, the two partners owning the distributorship entities, were beneficially owned by parties with separate and distinct economic interests—CIC principally by MCA and Paramount, and Stichting by the individual employees of CIC.⁴³ Thus, there existed a potential for legitimate conflict of interest between them in the management of the distributorships.⁴⁴

As to the government's theory that because CIC and Stichting were subject to the common control of MCA and Paramount, there was no potential for legitimate conflict of interest in the management of the distributorships, the court claimed that this argument disregarded the trustees' duty of loyalty to the Stichting beneficiaries.⁴⁵ While the trust instrument accorded the trustees broad discretion in the management of the trust, they had a duty under California law⁴⁶ to exercise their powers in good faith and without concern for their own personal interests or those of third parties. The court rejected the assumption implied in the government's theory that in the event of conflicting interests, the trustees would always choose the corporate interests of MCA and Paramount over the interests of the individual CIC employees who were the trust beneficiaries, thereby disregarding their fiduci-

⁴⁰ 685 F.2d at 1100.

⁴¹ 1977-1 C.B. 408. See *infra* notes 79-84 and accompanying text.

⁴² In that ruling, two domestic corporations had formed an unincorporated entity under German law and were each a wholly owned subsidiary of the same domestic parent. Rev. Rul. 77-214, 1977-1 C.B. 413.

⁴³ 685 F.2d at 1103.

⁴⁴ It is not material that conflict between the separate interests might occur only in occasional circumstances, because that is the typical situation between partners who have a basis for commitment to a joint business enterprise. It is only material that the *opportunity* for conflict exists. See *MCA Brief*, *supra* note 15, at 28.

⁴⁵ 685 F.2d at 1103.

⁴⁶ California law, rather than Netherlands law, was applied because the parties failed to give written notice of intent to raise an issue of foreign law as required by Rule 44.1 of the Federal Rules of Civil Procedure. In such a case, the court looks to the law of the forum state, here California, to determine the nature of the trustees' fiduciary duty. 685 F.2d at 1103. In any event, the trustees' duties and obligations under Netherlands law are similar. See *MCA Brief*, *supra* note 15, at 35-37 (opinion by Dutch counsel that in the event of a conflict between their duties as directors of CIC and their duties as trustees of the employee trust, the two chief executive officers would have had a duty under Netherlands law to take action to eliminate the conflict, or, if that were not possible, to resign as trustees in order to be replaced by others who had no such conflict of interest).

ary duty as trustees.⁴⁷ As the court pointed out, a similar theory had been rejected in the area of family partnerships.⁴⁸

Finally, the court rejected the government's argument that the regulations under section 7701 should be construed broadly to classify the distributorships as corporations and eliminate what the government argued was an abusive type of tax shelter. Because Congress wrote the statute unambiguously to apply to Subpart F income received from controlled corporations and not from controlled partnerships, the court refused to depart from the plain language of the statute. The court concluded that "[i]f the omission of income received from controlled partnerships has indeed created an unjustified loophole in the tax laws, the remedy lies in new legislation, not in judicial improvisation."⁴⁹ Having distinguished the facts of this case from those of Revenue Ruling 77-214, the Ninth Circuit thus left in doubt the validity of the separate interests test.

III. ENTITY CLASSIFICATION AND THE SEPARATE INTERESTS TEST

A. Definition of a Corporation for Tax Purposes

Despite its rather extensive regulations in other areas, Subpart F does not provide its own definition of a corporation. Therefore, the court in *MCA* referred to the tests prescribed by Treasury Regulation 301.7701-2. These tests grew out of the landmark decision in *Morrissey v. Commissioner*,⁵⁰ where the United States Supreme Court held that whether an unincorporated organization was to be taxed as a corporation would depend on the presence of six principal characteristics: (1) associates, (2) an objective to carry on a business and divide the gains therefrom, (3) centralization of management, (4) limited liability, (5) continuity of life, and (6) free transferability of interests.⁵¹ In 1960, the Service incorporated these characteristics into its regulations dealing with the classification of entities, intending at that time to make it difficult to be classified as a corporation for tax purposes.⁵² The Service

⁴⁷ 685 F.2d at 1104.

⁴⁸ *Id.* See *Bateman v. United States*, 490 F.2d 549 (9th Cir. 1973) (ruling that where the trustees were obligated to exercise their broad powers in accordance with fiduciary principles, absent evidence that the trustees had abused their fiduciary duties, the trusts must receive tax recognition).

⁴⁹ 685 F.2d at 1105.

⁵⁰ 296 U.S. 344 (1935).

⁵¹ *Id.* at 359.

⁵² The regulations were issued in response to *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), where the court, relying on *Morrissey*, found an unincorporated association of Montana doctors to be taxable as a corporation. See *Tax Report, supra* note 1, at 189. These regulations

required that "an unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics."⁵³

Because two of the characteristics—the presence of associates and the objective to carry on a business and divide the gains therefrom—are common to both corporations and partnerships, the regulations provide that they are to be disregarded and that an organization must possess three out of the four remaining corporate characteristics to be considered a corporation.⁵⁴ While the Code provides the standards, however, local law is applied to determine whether the legal relationships that have been established in the formation of the organization are such that the definitional standards have been met.⁵⁵

An organization has centralized management if any person, or any group of persons not including all the members, has continuing exclusive authority to make independent business decisions on behalf of the organization.⁵⁶ Centralized management does not exist if all members have the power to bind the entity, even though they have agreed contractually not to exercise that power, such as in a partnership with a management committee. In *MCA*, the parties stipulated that centralized management did not exist.⁵⁷ The government, however, claimed that *MCA*'s failure to argue the absence of this characteristic in its brief confirmed the presence of both free transferability and continuity of life.⁵⁸

have been accused of being pro-partnership. See, e.g., Fisher, *Classification Under Section 7701—The Past, Present, and Prospects For the Future*, 30 TAX LAW. 627, 630 (1977) (concluding that each of the corporate characteristics was drafted in such a fashion that more likely than not the corporate characteristic will be found not to exist).

⁵³ Treas. Reg. § 301.7701-2(a)(3) (1960). The Code defines a partnership as follows: "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation. . . ." I.R.C. § 7701(a)(2) (1976).

⁵⁴ Treas. Reg. § 301.7701-2(a)(3). While the regulations also make reference to "other factors" that may be significant in classifying an enterprise, *id.* § 301.7701-2(a)(1), the Service has made it clear that these factors will not be considered independent of their bearing on the major corporate characteristics. Rev. Rul. 79-106, 1979-1 C.B. 448. Thus, "it would appear that the test is certain and mechanical, focusing on the four major traits in the partnership context." P. POSTLEWAITE & M. COLLINS, *INTERNATIONAL INDIVIDUAL TAXATION* § 10.02 n.5 (1982).

⁵⁵ Treas. Reg. § 301.7701-1(c) (1960).

⁵⁶ Treas. Reg. § 301.7701-2(c)(1) (1960).

⁵⁷ 685 F.2d at 1102.

⁵⁸ Brief for Appellee at 23, *MCA, Inc. v. United States*, 685 F.2d 1099 (9th Cir. 1982) [hereinafter cited as Government Brief]:

Here, CIC has 95% control of the outlets, and *MCA* and *Paramount*, via control of *CIC*, *Stichting*, and *Proteus*, have total *de facto* control of the outlets. This very concentration of power acts to thwart a finding of (representative) centralized management, because *CIC* and

The characteristic of limited liability is present if, under local law, there is no member who is personally liable for the debts of, or the claims against, the organization.⁵⁹ Personal liability results when a creditor may obtain personal satisfaction from a member of the organization to the extent that the assets of the organization are insufficient to satisfy the creditor's claim.⁶⁰ The parties in *MCA* stipulated that under local law and under the organizational documents of most of the distributorships limited liability did exist.⁶¹

The regulations provide that continuity of life exists if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization.⁶² An agreement providing that upon the death or withdrawal of any member, the business will be continued by the remaining members, will *not* establish continuity of life if under local law the death or withdrawal causes a dissolution of the organization.⁶³ The parties in *MCA* agreed that

Proteus are synonymous. *MCA* has obviously opted not to advance its most convincing argument on the absence of this characteristic [under the rationale of *Zuckman v. United States*], because to do so would call attention to the real character of *CIC* and *Proteus*.

Id. at 24.

In its reply, *MCA* concurred with the government's reading of *Zuckman* that when there are few partners with substantial control, representative or centralized management is effectively ruled out, but maintained that *MCA* did not have de facto control but merely a 95% interest. Reply Brief for Appellant at 9, *MCA, Inc. v. United States*, 685 F.2d 1099 (9th Cir. 1982).

⁵⁹ Treas. Reg. § 301.7701-2(d)(1) (1960). While some argue that limited liability should preclude partnership status, the Service has ruled that an enterprise possessing this trait may be a partnership. See Priv. Ltr. Rul. 7737049 (June 17, 1977); see also *infra* note 60.

⁶⁰ Treas. Reg. § 301.7701-2(d)(1) (1960). See Prop. Reg. § 301.7701-2(a)(2), 45 Fed. Reg. 75,709-10 (1980), providing that if all members of an entity had limited liability under local law, the entity could not be classified as a partnership. Had this regulation been approved, it would have made the existence of the single corporate characteristic of limited liability dispositive of whether a domestic or a foreign organization is classified as a corporation for U.S. tax purposes. In *MCA*, this regulation would have given the government the result it wanted, as limited liability was the one corporate characteristic *MCA* conceded with respect to each of the distributorships.

The notice of proposed rulemaking accompanying this proposal was careful to point out, however, that the regulation was not intended to affect the application of the classification rules to any entities other than those that enjoy complete limited liability under the applicable local law. The regulation also would provide that entities organized under statutes corresponding to the Uniform Partnership or the Uniform Limited Partnership acts would continue to be classified under the existing rules because those statutes make general partners personally liable for partnership debts. Therefore, it would appear that except for equipment-leasing trusts and the few other types of entities that enjoy both limited liability and partnership tax status, without being subject to the UPA or the ULPA, the proposed regulation was aimed at the classification of foreign entities. In any case, the proposal was withdrawn on December 16, 1982. The Service said that "[i]n response to public commentary on the proposal, the IRS will reevaluate its means of classification." [1982] 10 STAND. FED. TAX REP. (CCH) ¶ 6288.

⁶¹ 685 F.2d at 1102.

⁶² Treas. Reg. § 301.7701-2(b)(1) (1960).

⁶³ Treas. Reg. § 301.7701-2(b)(2) (1960).

under both the organizational documents and the applicable local laws, continuity of life did not exist with respect to the distributorships.⁶⁴ Relying on Revenue Ruling 77-214,⁶⁵ however, the government argued that the partners who controlled the outlets—CIC and Stichting—were not competing owners with separate interests, but were different components of a single interest represented by the MCA/Paramount joint venture.⁶⁶ This lack of a separate interest, it was claimed, gave rise to the presence of continuity of life on the theory that upon the happening of one of the specified events, there would be no separate interest to compel dissolution of the partnerships. What the government and the district court seemingly ignored was that the distributorships would be dissolved under local law upon the happening of any of the specified events, including the bankruptcy of either of its owners. Thus, the bankruptcy of either Stichting or CIC would *automatically* cause the dissolution of the distributorships whether or not the owners represented separate interests and despite their best efforts to continue them. Furthermore, the regulations specifically point out that while an agreement by which an organization is established may provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, such agreement does not establish continuity of life if, under local law, such an event would otherwise cause a dissolution of the organization.⁶⁷

Free transferability of interests exists if each member of the organization, or those members owning substantially all of the interests, may transfer their interests in the organization without the consent of the other members.⁶⁸ With respect to the distributorships in *MCA*, free transferability apparently did not exist because of applicable local law and because of the provision in the organizational documents provid-

⁶⁴ 685 F.2d at 1102.

⁶⁵ See *infra* notes 79-84 and accompanying text.

⁶⁶ Government Brief, *supra* note 58, at 26.

⁶⁷ See *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975). In *Zuckman*, the Court of Claims rejected the government's argument that one individual's control, both direct and indirect, of more than a 98% interest in the partnership gave it continuity of life, reasoning that the corporate general partner could still become bankrupt and, in such event, the partnership would *automatically* dissolve.

⁶⁸ Treas. Reg. § 301.7701-2(e)(1) (1960). If under local law, a transfer of the member's interests would result in the dissolution of the old organization and the formation of a new one, free transferability of interests does not exist. *Id.* If each member may transfer his or her interest to another only after offering it to the other members at fair market value, a modified form of free transferability exists. See Treas. Reg. § 301.7701-2(e)(2) (1960). Although the regulations provide that this modified form will be accorded less significance in characterizing an entity as a corporation, "there appears to be no practical difference. . . and either full free transferability or modified free transferability will count as a corporate characteristic." *Tax Report, supra* note 1, at 191.

ing that no member may transfer, pledge or in any way burden its interest in the outlet without the approval of the other member.⁶⁹ Here again the government argued that because there were no separate interests, the requirement that consent be obtained was an empty formality and, in reality, free transferability was present.⁷⁰

From the time of their promulgation,⁷¹ the section 7701 regulations have been severely criticized on the grounds that they are inconsistent with the Supreme Court's holding in *Morrissey*,⁷² and that their incorporation of a "preponderance test"⁷³ paved the way for "tax shelters" to obtain the coveted partnership status needed to make them so attractive to high-bracket investors. The Service recognized the latter effect, particularly with respect to limited partnerships, and on January 5, 1977, issued proposed regulations⁷⁴ that implicitly rejected the preponderance test. The Service stated that "[b]ecause the overall resemblance of an organization to a corporation is determinative for purposes of classification, an organization may be classified as an association when it resembles a corporation with respect to *two* or more of the four characteristics. . . ."⁷⁵ Furthermore, the regulations redefined the characteristics and provided that where only two of the characteristics were met, each of the characteristics would be reexamined to evaluate its relative importance to the determination of the organization's overall resemblance to a corporation.⁷⁶ Mysteriously, these proposed regulations were withdrawn the same day they were issued. Whether this was in response to pressure from other branches of government⁷⁷

⁶⁹ 685 F.2d at 1102.

⁷⁰ Government Brief, *supra* note 58, at 24. As MCA points out in its brief, however, even if CIC and the employee trust were not separate interests, neither one could vest a transferee with free transferability of interests, which the government claimed was one attribute of CIC's and the employee trust's interests in the distributorships, because the restriction in the organizational documents against the transfer of an interest by one owner of a distributorship without the consent of the other owner would clearly be enforceable by or against any transferee. Thus, the right to transfer an interest would at most apply to the *initial* transfer by either owner, and the power to transfer would be *incomplete* since the transferee could not be vested with the right to freely transfer his interests. See MCA Brief, *supra* note 15, at 17. Treas. Reg. § 301.7701-2(e)(1) (1960) provides: "In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization."

⁷¹ See *supra* note 52 and accompanying text.

⁷² 296 U.S. 344 (1935). See *Larson v. Commissioner*, 66 T.C. 159, 191 (1976) (Raum, J., dissenting); *Fisher*, *supra* note 52, at 660.

⁷³ Treas. Reg. § 301.7701-2(a)(3).

⁷⁴ See Prop. Reg. § 301.7701-1 to -3, 42 Fed. Reg. 1038-44 (1977).

⁷⁵ 42 Fed. Reg. at 1040 (emphasis added).

⁷⁶ Prop. Reg. § 301.7701-2(h) (example 4), 42 Fed. Reg. at 1042.

⁷⁷ See A. WILLIS, J. PENNELL, & P. POSTLEWAITE, *PARTNERSHIP TAXATION* § 184.03 (1981)

or represented the Service's tacit approval of the mechanical classification provided by the existing regulations is debatable. The Treasury Department has not yet made a public announcement about when, if ever, it intends to re-issue the proposed regulations.⁷⁸ In any event, until the issuance of Revenue Ruling 77-214, most observers assumed that only the criteria set forth in the section 7701 regulations would be used in classifying foreign entities for United States tax purposes.

B. Revenue Ruling 77-214

Revenue Ruling 77-214 was unique not only because the Service premised its holding on a test found neither in the Code nor in the regulations, but more fundamentally because it was the first time the legal ownership of an entity, rather than simply its legal structure, was examined in determining classification for tax purposes. The situation involved a German GmbH⁷⁹ formed by two wholly owned domestic subsidiaries of a United States corporation. The company was set up to provide marketing and support services for the parent company's operations in foreign countries. Given the great number of optional provisions that can be used to modify the character of a GmbH so that it can assume the characteristics of a partnership or a corporation, the Service looked to German law to determine the legal relationships of the parties involved. Although the German organization's memorandum of association provided that it would be dissolved by the death, insanity or bankruptcy of a shareholder and that the shares were not freely transferable, the Service declared it an association taxable as a corporation.⁸⁰

The Service found that under German law a GmbH possesses associates and an objective to divide profits, characteristics common to both corporations and partnerships, along with the corporate characteristics of limited liability and centralization of management.⁸¹ Thus, classification as a corporation would depend on finding either of the two remaining corporate characteristics, continuity of life and free

(the authors claim that the principal objection to the regulations was that they would severely limit the formation of tax shelters and thus inhibit the nation's economic recovery).

⁷⁸ *Id.* at § 184.10.

⁷⁹ *Gesellschaft mit beschränkter Haftung* (GmbH) literally means an association with limited liability. Formed pursuant to a memorandum of association, it is a juridical person under German law that has the corporate characteristics of limited liability and centralization of management. See Rev. Rul. 77-214, 1977-1 C.B. 408.

⁸⁰ *Id.*

⁸¹ *Id.*

transferability of interests.⁸² The Service ruled that because the parent corporation could control its domestic subsidiaries, which owned 100% of the GmbH, there were no separate interests to compel dissolution of the organization or to ensure that the interests were not freely transferable. Therefore, both of these characteristics were present and the GmbH was taxable as a corporation.⁸³ The district court in *MCA* adopted the identical rationale in finding the film distributorships to be taxable as corporations.⁸⁴

C. Reaction to the Ruling

Commentators immediately criticized Revenue Ruling 77-214. Opponents claimed that if two wholly owned subsidiaries of a United States parent constitute a single economic interest for the purpose of determining the presence or absence of the four characteristics that distinguish a partnership from a corporation, then this test also would have to be applied to the characteristics common to both partnerships and corporations: associates and a joint profit motive.⁸⁵ If this were the case, then under the regulations, the *MCA* distributorships would be neither partnerships nor corporations for tax purposes,⁸⁶ but rather branches of CIC, which of course would be treated quite differently.⁸⁷ Indeed, branches rather than separate entities would be found in every case where the test is applied.⁸⁸ While the Service has not yet gone this

⁸² *Id.*

⁸³ *Id.*

⁸⁴ See *supra* notes 25 to 39 and accompanying text.

⁸⁵ *Tax Report, supra* note 1, at 201.

⁸⁶ Treas. Reg. § 301.7701-2(a)(2) (1960) states:

Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit. . . , the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association.

⁸⁷ Had the Service adopted this posture, see *infra* note 108, *MCA* would still have been entitled to judgment. This is because if the film distributorships were neither corporations nor partnerships, but were instead branches of CIC, there would still have been no Subpart F income and no current U.S. tax liability. *MCA* Brief, *supra* note 15, at 6. Because the distributorships would not be separate entities apart from CIC for U.S. tax purposes, CIC's income would be deemed to derive directly from the rental of films to unrelated parties and thus would not be Subpart F income. *Id.* at 6 n.9. See I.R.C. § 954(c)(3)(A) (1976) (foreign personal holding company income does not include rents and royalties derived in the active conduct of a trade or business and that are received from other than a related person).

Moreover, as explained earlier, the reasons why *MCA* set up separate entities in the first place were essentially non-tax related. See *supra* note 15 and accompanying text.. Thus, the abuses meant to be forestalled by the Subpart F provisions did not exist here.

⁸⁸ Shortly before Revenue Ruling 77-214 was issued, the Service issued five private letter rulings to taxpayers in which it held essentially that where all the interests of a foreign commercial

far, its application of the single economic interest test to some, but not all, of the characteristics is clearly inconsistent. Recently issued rulings demonstrate that the Service itself is unsure about the correct application of the test.⁸⁹

Furthermore, as pointed out by one commentator,⁹⁰ it would be possible to apply the single economic interest theory when determining whether centralization of management exists, employing the argument that where a single economic interest holds all the ownership and control, there is only one management voice. The finding of centralization of management, in addition to a finding of continuity of life and free transferability of interests, would result in the consistent classification of foreign entities owned by a single economic interest as corporations under the tests prescribed by section 301.7701 of the regulations. Thus, it would be impossible for a corporate group to operate a foreign partnership so long as its full ownership is held, directly or indirectly by a single corporate parent at any point in its structure. While the separate interests test has been extended this far only once,⁹¹ the uncertainty surrounding its application has caused taxpayers examining the tax ramifications of a particular foreign form of organization to fear that carefully structured business plans may be frustrated and the tax results reversed by new interpretations of the law.

venture are held by a single beneficial interest, the venture is to be characterized as a branch for U.S. tax purposes. See Priv. Ltr. Ruls. 7743060 (July 28, 1977), 7743077 (July 29, 1977), 7747083 (Aug. 26, 1977), 7748038 (Aug. 31, 1977), and 7802012 (Oct. 11, 1977). These rulings were immediately withdrawn prospectively by five subsequent private rulings. See Priv. Ltr. Ruls. 7806062, 7806056, 7806055, 7806057, and 7806058 (all Nov. 11, 1977). The Service offered no explanation other than the vague statement that the withdrawn rulings were "not in accord with views of the Service concerning the proper tax classification of foreign organizations that have only one beneficial owner." Priv. Ltr. Rul. 7806058 (Nov. 11, 1977).

⁸⁹ Compare Priv. Ltr. Rul. 7934096 (May 24, 1979) (French *société en nom collectif* (SNC), owned entirely by first and second tier wholly-owned subsidiaries of a U.S. corporation, found to be a partnership for tax purposes, ignoring the lack of separate interests) with Priv. Ltr. Rul. 7936050 (June 8, 1979) (Chilean *sociedad anónima*, owned by a U.S. corporation and its domestic subsidiary found to be a corporation for tax purposes, where Service claimed that because the U.S. parent "could be expected to exercise great influence" over the subsidiary holding the rest of the equity in the *limitada*, under the authority of Revenue Ruling 77-214, the corporate characteristic of free transferability was present).

⁹⁰ *Tax Report*, *supra* note 1, at 206.

⁹¹ See Priv. Ltr. Rul. 8034094 (May 29, 1980) (Service applied the single economic interest theory to the corporate characteristic of centralized management, reasoning that where a GmbH was owned entirely by a first and second tier subsidiary of a U.S. parent, the parent, which in effect owned all the interests in the GmbH, had the continuing authority to make the business decisions for it).

IV. NECESSITY OF DIFFERENT CLASSIFICATION STANDARDS

What is perhaps even more disturbing to planners than the application of the test itself is the fact that it is used exclusively with respect to foreign entities. The classification problem in *MCA* arose in the context of the Subpart F provisions, Code sections 951 through 972, and thus an understanding of these provisions and of the importance of entity classification is necessary to determine whether a different, stricter set of standards should be implemented to prevent abuse.

A. The Purpose Behind Subpart F

A foreign corporation, even one controlled by American shareholders, was not subject to United States tax on its foreign source income until 1962. Consequently, no United States tax was imposed at all until the income was repatriated by the foreign corporation to its United States shareholders⁹² in the form of dividends.⁹³ This system reflected the nation's policy of promoting the free flow of capital and goods in international commerce, and encouraging United States investment abroad.⁹⁴ It was felt that to tax earnings of foreign subsidiaries would place the United States firm in a disadvantageous position in comparison with foreign-owned competitors, especially those operating out of other industrialized nations which did not impose a similar burden on their citizens.⁹⁵

This policy of allowing a deferral of United States tax on the foreign earnings of a United States CFC until the earnings were distributed to the United States shareholders was seriously challenged in 1962, when the suggestion was made that the United States tax laws should be neutral in their application to domestic and foreign invest-

⁹² Even then it was the shareholder and not the corporation who was taxed, as the United States has the power to tax U.S. persons on all income, regardless of source. This reflected the United States' global, as opposed to the territorial, approach to taxation, under which the worldwide income of a U.S. person is fully subject to U.S. tax, unless a specific statutory exemption applies. See Hammer, *Tax Considerations of the International Business Venture*, 6 N.C. J. INT'L L. & COM. REG. 259 (1981).

⁹³ This phenomenon of tax deferral occurred only if the foreign subsidiary did not pay out its earnings to its U.S. shareholders as dividend distributions. Thus, it was not unheard of for a foreign subsidiary to lend money to its U.S. parent corporation; the incidence of a loan did not subject such monies to U.S. taxation. Consequently, the parent corporation had the tax-free use of the income of the foreign subsidiary.

G. RANZAL, *TAX DEFERRAL FOR FOREIGN CORPORATIONS: MINIMIZING SUBPART F. INCOME 4* (1973).

⁹⁴ Jenks, *Taxation of Foreign Income*, 42 GEO. WASH. L. REV. 537 (1974).

⁹⁵ See *id.* at 542. See also P. MCDANIEL & H. AULT, *INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION* 128 (1981); O'CONNOR, *United States Taxation of Earnings of American-Controlled Foreign Corporations*, 42 TAXES 588, 603 (1964).

ment.⁹⁶ In a message to Congress in 1961, President John F. Kennedy indicated the undesirability of continuing this tax deferral, proposing its elimination entirely.⁹⁷ His greatest indictment, however, was against the use of the tax deferral in tax haven countries, where an attempt was made to sharply reduce or eliminate tax liabilities both at home and abroad through the employment of artificial arrangements.⁹⁸

Congress did not eliminate tax deferral on foreign earnings entirely.⁹⁹ Rather, it enacted legislation to deal with the taxation of certain types of income earned by foreign corporations owned by United States controlling interests. In creating Subpart F, Congress' aim was to eliminate deferral of United States tax where the company is a non-operating foreign subsidiary, which passively receives investment income, set up in a country that imposes little or no tax.¹⁰⁰ Because the United States had no jurisdiction to tax such foreign corporations directly,¹⁰¹ Subpart F was directed at the United States shareholders of

⁹⁶ See Jenks, *supra* note 94, at 537; O'Connor, *supra* note 95, at 602-03. Treasury Secretary Dillon, in a statement before the House Ways and Means Committee, argued that such a deferral permitted an advantage for a U.S. firm operating abroad as compared with one operating within the U.S., and that if tax neutrality was to exist, it should be through the elimination of the tax factor in the U.S. investor's choice between domestic and foreign investment. HOUSE COMMITTEE ON WAYS AND MEANS, H.R. DOC. NO. 140, 87th Cong., 1st Sess. 23 (1961) (statement by Douglas Dillon, Secretary of the Treasury).

⁹⁷ President Kennedy felt that rather than fostering competition, the deferral privilege actually discriminated against investment within the U.S. and intensified internal unemployment, balance of trade, and balance of payment problems. See Comment, *Foreign Personal Holding Company Income of Controlled Foreign Corporations*, 31 U. FLA. L. REV. 155, 158 n.13 (1979).

⁹⁸ These arrangements took many forms, but the shelter Subpart F was designed to deal with most directly was the sale of goods manufactured in the U.S. to a subsidiary incorporated in one foreign country, the "base country", with the subsidiary in turn selling the goods to an affiliated corporation, the sub-subsidiary, organized in the country where the goods were to be resold to the ultimate consumer or to unrelated wholesalers. By fixing the prices so that the spread was largest between the cost of goods sold and the price paid by the unrelated buyers, this profit could be segregated in the "base company". If the base company was organized in a country that imposed no income tax or treated the base company's profit as exempt foreign-source income, the taxes paid by the parent to the U.S. and by the sub-subsidiary to the country of destination would be minimized. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 17.32 (4th ed. 1979). For an excellent example of the type of tax haven at which Subpart F was aimed, see R. RHOADES & M. LANGER, *INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS* § 3.01(2) (1982).

⁹⁹ Note that Subpart F did not eliminate deferral in all situations where a foreign corporation is owned by American interests, and was not intended to include income of CFC's generated in the country in which the corporation is located. P. MCDANIEL & H. AULT, *supra* note 95, at 128. In 1978, the Carter Administration proposed amending the tax law "to provide current taxation of all income earned by CFCs, not just the specified tax haven income, but that proposal was never approved by Congress." Hammer, *supra* note 92, at 260 n.3.

¹⁰⁰ H.R. REP. NO. 1447, 87th Cong., 2d Sess. 58 (1962), *reprinted in* 1962-3 C.B. 405, 462

¹⁰¹ See I.R.C. §§ 881, 882 (1976). A foreign corporation is subject to federal income tax on only two categories of gross income: (i) gross income that is derived from sources within the U.S.

such corporations¹⁰² and provided that such income was to be taxable to the shareholders in the year the income was earned by the foreign corporation, whether or not those earnings were actually distributed.

An understanding of the rules under Subpart F requires answering three basic questions: (a) What type of United States shareholder is subject to taxation under Subpart F? (b) What constitutes a controlled foreign corporation? and (c) What categories of the foreign corporation's income are subject to tax even though not distributed to the shareholders?¹⁰³

For the purposes of Subpart F, a United States shareholder is any United States person who owns or is considered as owning, under the attribution rules of section 958, ten percent or more of the total combined voting stock of such foreign corporation.¹⁰⁴ The shareholder must own the stock on the last day of the taxable year in which the corporation is a CFC.¹⁰⁵ Thus, if there are eleven unrelated United States shareholders, each owning 9 $\frac{1}{11}$ %, but together owning 100% of the voting stock of a foreign corporation, CFC status may be avoided.¹⁰⁶ In *MCA*, the stockholders of CIC were MCA (forty-nine percent), Paramount (forty-nine percent) and Stichting (two percent). So under section 951, MCA and Paramount were United States shareholders subject to tax on their share of CIC's Subpart F income in the year in which it was earned.

A controlled foreign corporation is one in which United States shareholders own, directly or indirectly, more than fifty percent of the voting stock on any day of the taxable year.¹⁰⁷ The legislative focus here is on closely-held corporations controlled by a small group of United States taxpayers, located in a foreign jurisdiction offering complete exemption from tax, lower corporate tax rates, or other favorable

but is not effectively connected with the conduct of a trade or business within the U.S. and (ii) gross income that is effectively connected with the conduct of a trade or business within the U.S.

¹⁰² See I.R.C. § 951(a) (1976). The Subpart F provisions were held constitutional in *Whitlock v. Commissioner*, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (1974), *mandamus granted*, 547 F.2d 506 (10th Cir. 1976), *cert. denied*, 430 U.S. 916 (1977); *Garlock, Inc. v. Commissioner*, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974); *Dougherty v. Commissioner*, 60 T.C. 917 (1973).

¹⁰³ Tillinghast, *United States Income Taxation of Foreign Source Income: A Survey of the Provisions and Problems*, 29 INST. ON FED. TAX'N 1, 24 (1971).

¹⁰⁴ I.R.C. § 951(b) (1976).

¹⁰⁵ I.R.C. § 951(a)(1).

¹⁰⁶ See P. MCDANIEL & H. AULT, *supra* note 95, at 120.

¹⁰⁷ I.R.C. § 957(a) (1976). Income will not be includible in the gross income of the U.S. shareholder, however, unless the corporation constitutes a CFC for an uninterrupted period of thirty days or more during the taxable year. I.R.C. § 951(a)(1).

tax status.¹⁰⁸ Here again, because MCA and Paramount are both United States shareholders and together own ninety-eight percent of the voting stock of CIC, it qualifies as a controlled foreign corporation.¹⁰⁹

There are four categories of undistributed income taxed to United States shareholders of controlled foreign corporations: (1) Subpart F income,¹¹⁰ (2) previously excluded Subpart F income withdrawn from investment in less developed countries,¹¹¹ (3) previously excluded Subpart F income withdrawn from foreign base shipping operations,¹¹² and (4) increases in earnings invested in United States property.¹¹³ Subpart F income includes income derived from the insurance of United States risks, foreign base company income, income attributable to international boycotts, and amounts attributable to illegal bribes and kickbacks.¹¹⁴ Foreign base company¹¹⁵ income, the type with which the court in *MCA* was concerned, is covered by section 954 and consists of foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.¹¹⁶

According to one commentator, the decision by Congress to tax the earnings of foreign personal holding companies arises from the various forms of abuse that operation as a corporation offers wealthy taxpayers.¹¹⁷ The tax benefits accorded the corporate entity are given on the fundamental assumption that corporations are to be the means of

¹⁰⁸ Note, *Comparative Analysis of Systems of Domestic Taxation of Controlled Foreign Corporations*, 14 VAND. J. TRANSNAT'L L. 99, 100 n.2 (1981); see P. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION § 12.05 (1980).

¹⁰⁹ Note that the regulations provide that "[a]ny arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained." Treas. Reg. § 1.957-1(b)(2) (1963). Thus, in determining whether a foreign corporation is a CFC, the facts and circumstances surrounding the use of such voting power may be as applicable as the legal ownership. Artificial arrangements have been found where the principal purpose was to shift sufficiently legal ownership to avoid controlled foreign corporation status. G. RANZAL, *supra* note 93, at 33.

¹¹⁰ I.R.C. § 951(a)(1)(A)(i) (1976).

¹¹¹ I.R.C. § 951(a)(1)(A)(ii).

¹¹² I.R.C. § 951(a)(1)(A)(iii).

¹¹³ I.R.C. § 951(a)(1)(B).

¹¹⁴ I.R.C. § 952(a) (West Supp. 1983).

¹¹⁵ A base company is a corporation or other limited liability company organized in a country that imposes little or no tax on domestic corporation income derived from sources outside the country. Usually involving the purchase and resale of personal property or the rendition of significant services, these corporations are set up solely for the purpose of conducting third-country operations. R. RHOADES & M. LANGER, *supra* note 98, at § 3.03(3)(b)(i).

¹¹⁶ I.R.C. § 954 (West Supp. 1983).

¹¹⁷ See Comment, *supra* note 97, at 156 n.6.

conducting an *active* enterprise.¹¹⁸ When use of the corporate entity serves no legitimate business purpose and only provides taxpayers with a means for sheltering income, the justification for these benefits is lost.¹¹⁹

The income earned by the MCA distributorships constituted foreign personal holding company income (FPHCI) under section 954(c)(1), which includes rents and royalties received from related persons.¹²⁰ The Code provides that if the rents or royalties are derived in the active conduct of a trade or business, they do not constitute FPHCI.¹²¹ This provision, however, does not apply if the income is received from a "related person."¹²² The Code also provides that FPHCI does not include some rents or royalties received from related persons, but only if the amounts received are for the privilege of using the property within the country in which the CFC is incorporated.¹²³

Because the MCA distributorships' income was earned outside the Netherlands, the country in which CIC was incorporated, whether the income constitutes FPHCI depends on whether the distributorships were related persons with respect to CIC. The applicable Code provision, section 954(d)(3), defines a related person as (1) an individual, partnership, trust or estate which controls the CFC; (2) a corporation which controls, or is controlled by, the CFC; or (3) a corporation which

¹¹⁸ The definition of 'foreign base company income' in Subpart F does not include income derived from the manufacture, production, or sale of property in the foreign corporation's country of incorporation. The rationale . . . was that these were legitimate business operations conducted in or from a foreign location. Subpart F was designed to reach only those cases where the international tax system was abused by flowing income into low tax jurisdictions which have no real connection with the business activity generating the income.

Jenks, *supra* note 94, at 544.

¹¹⁹ Comment, *supra* note 97, at 156 n.6.

¹²⁰ I.R.C. § 954(c)(4)(C) (1976). Foreign personal holding company income, for the purposes of section 954, is patterned on the definition of foreign personal holding company income found in section 553, with certain modifications to broaden its scope. I.R.C. § 954(c)(1).

¹²¹ I.R.C. § 954(c)(3)(A). Note, however, that the regulations attempt to limit the use of this exemption by greatly restricting activities that constitute a trade or business. In the case of royalties, for example, the licensor must manufacture or produce the property or substantially add to its value prior to the leasing of such property. Treas. Reg. § 1.954-2(d)(1)(iii) (1964).

¹²² See *infra* notes 124-32 and accompanying text.

¹²³ I.R.C. § 954(c)(4)(C) (1976). If the property is used both within and without the country in which the CFC is incorporated, the portion of the income attributable to the use of the property outside the country of incorporation is foreign personal holding company income. Treas. Reg. § 1.954-2(c)(3) (1964). The policy underlying this exception is a Congressional determination that United States shareholders should not be penalized for conducting activities through a number of entities as opposed to only one. S. REP. NO. 1881, 87th Cong. 2d Sess. 1, 83 (1962), *reprinted in* 1962-3 C.B. 707, 789. Thus, the objective is to exclude such income from FPHCI where such amounts would reflect earnings of an active business if such activity had been conducted within the CFC's corporate shell.

is controlled by the same person or persons which control the CFC.¹²⁴

The government argued in *MCA* that this Code section should be interpreted broadly to eliminate what it termed "an abusive form of tax shelter."¹²⁵ It claimed that "Congress enacted Subpart F to eliminate the tax deferral advantage of doing business through [CFCs], by taxing currently to United States shareholders all income that is deemed earned by those shareholders," and that "Congress was more concerned with the nature of the income than the form of the entity generating the income."¹²⁶ The government further argued that the "use [in section 954(d)(3)] of the word 'corporation' in defining 'related person' was a matter of drafting convenience without particular significance,"¹²⁷ concluding that the abuse Congress sought to rectify occurs with other kinds of entities, including controlled partnerships.¹²⁸

Although there is no legislative history discussing Congress' definition of related persons under section 954(d)(3), one can scarcely conclude that the omission of the word "partnership" in subsection (B) was unintentional, because subsection (A) of the same section specifically includes a controlling partnership of a controlled foreign corporation in its definition of a related person.¹²⁹ Furthermore, given the fact that the Subpart F provisions were enacted in 1962, Congress' failure after twenty years to amend its provisions so as to include income earned by a controlled partnership certainly weakens the argument that its omission was the result of congressional oversight.

The purpose of the Subpart F provisions is to limit the deferral advantage only to those United States corporations that need the advantage in order to compete more effectively with businesses controlled by foreign interests which do not have to pay taxes on income earned by subsidiaries outside the foreign countries' boundaries.¹³⁰ The deferral advantage is not intended to include situations where no competitive purpose is to be achieved, such as where the CFC buys from its parent in one country and sells to a related corporation in another

¹²⁴ See I.R.C. § 954(d)(3) (Law. Co-op. Supp. 1983); Treas. Reg. § 1.954-1(c)(1) (1964). Control means direct or indirect ownership, applying the stock ownership attribution rules prescribed in section 958, of over 50% of the corporation's voting stock. See I.R.C. § 954(d)(3) (Law. Co-op. Supp. 1983).

¹²⁵ 685 F.2d at 1104.

¹²⁶ *Id.* at 1104-05.

¹²⁷ Government Brief, *supra* note 58, at 17.

¹²⁸ See *id.* While the government did not claim that the foreign film distribution arrangement was motivated wholly by tax-related considerations, it still characterized it as "exactly the kind of abusive shelter which the legislation was designed to foreclose." *Id.* at 9.

¹²⁹ I.R.C. § 954(d)(3)(A) (1976).

¹³⁰ P. McDANIEL & H. AULT, *supra* note 95, at 127-28.

country, or where the CFC is acting merely as a holding company.¹³¹ It is not altogether clear whether deferral should not be allowed in the situation where a controlled foreign corporation is dealing with a related *partnership*. The fundamental differences between operating as a corporation and operating as a partnership are significant enough that further congressional action is necessary before it can authoritatively be said that Subpart F was intended to tax such income. As the Ninth Circuit pointed out in *MCA*, if a loophole exists in the Subpart F provisions, a prospective change in the regulations under that section is preferable to a judicial distinction based on whether the entities involved are foreign or domestic.¹³²

B. Foreign Entity Classification

The government's main argument in *MCA* was that even if income was to be included as Subpart F income only if the distributorships were related corporations, the distributorships should be classified for tax purposes as corporations despite the fact they were organized as partnerships. For the purpose of United States taxation, the starting point for the classification of organizations is the standard prescribed by section 7701 of the Internal Revenue Code.¹³³ According to Revenue Ruling 73-254,¹³⁴ these tests and standards are to be used also in the classification of foreign organizations.¹³⁵ If the organization formed under foreign law is of the kind that can be classified for United States tax purposes either as a corporation or as a partnership,¹³⁶ classification will depend upon how the rights and obligations

¹³¹ *Id.* at 128.

¹³² 685 F.2d at 1105.

¹³³ See I.R.C. § 7701 (West Supp. 1983); Treas. Reg. § 301.7701-2, T.D. 6503, 1960-2 C.B. 409, T.D. 6797, 1965-1 C.B. 553, T.D. 7515, 1977-2 C.B. 482, T.D. 7889, 1983-22 I.R.B. 16; see also *supra* notes 50-70 and accompanying text.

¹³⁴ 1973-1 C.B. 613. This Revenue Ruling provided:

Held, the tests and standards which will be applied in classifying the unincorporated business organization as a partnership, as a trust, as an association taxable as a corporation, or as some other taxable entity will be determined under Section 7701 of the Code and the regulations thereunder. However, it is the local law of the foreign jurisdiction that must be applied in determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets.

¹³⁵ See, e.g., *Abbott Laboratories International Co. v. United States*, 160 F. Supp. 321, 325 (N.D. Ill. 1958), *aff'd per curiam*, 267 F.2d 940 (7th Cir. 1959).

¹³⁶ Examples of such organizations include a German GmbH (*Gesellschaft mit beschränkter Haftung*), a Columbian SRL (*sociedad de responsabilidad*), and a French SNC (*société en nom collectif*), where local law provides enough flexibility that classification for U.S. tax purposes will depend upon how the parties' rights and obligations are defined in the entity's governing documents.

of the parties are fixed in the organization's governing documents. There is no authority, however, flatly stating that an entity "incorporated" in a foreign jurisdiction will be treated as a corporation for United States tax purposes,¹³⁷ and recent private letter rulings issued by the Service seem to require careful structuring of the organizational forms of foreign entities if the risk of reclassification is to be minimized.¹³⁸

Certainly, classification of an entity under foreign law is not dispositive and is often irrelevant to the entity's status for United States tax purposes.¹³⁹ Moreover, the fact that the foreign jurisdiction's laws impose different tax treatment on the foreign organization than that imposed under United States tax laws should not affect the manner in which the tests under the regulations are applied.¹⁴⁰ The fact that the tax results in the foreign jurisdiction are different than in the United States is not a sufficient justification for subjecting foreign entities to a stricter standard.¹⁴¹

While the Ninth Circuit reversed the district court's decision in *MCA*, it still recognized that a separate interests test could be applied in determining the proper classification of a foreign entity for United States tax purposes. The Ninth Circuit seemed to ignore a prior ruling in which the Service refused to apply the separate interests test when classifying domestic entities. In that ruling,¹⁴² four domestic corpora-

¹³⁷ *Tax Report, supra* note 1, at 210.

¹³⁸ See *Tax Report, supra* note 1, at 222-38 (Appendix B). In response to the confusion and uncertainty, in 1976 the Service issued *Guidelines on Foreign Forms of Business Organizations* as part of its Internal Revenue Manual. The *Guidelines* listed nearly 200 forms of business organizations used in 45 countries, tentatively classifying them as corporations or partnerships. It was careful to point out, however, that the classifications were not to be "construed as the position of the Service" and that each case was subject to the factors outlined in the regulations. *Id.* at 196.

¹³⁹ Majers, *supra* note 36, at 264; see *Arundel Corp. v. United States*, 102 F. Supp. 1019 (Ct. Cl. 1952) (Puerto Rico treated a joint venture formed by three U.S. corporations as a separate taxable entity while under the principles of U.S. tax law, it was held to be a partnership). But see *Raffety Farms, Inc. v. United States*, 511 F.2d 1234, 1239 (8th Cir. 1975), *cert. denied*, 423 U.S. 834 (1975), where the court recognized the potential for the abuse of the split tax personality of entities. Referring to the limitation on the owner's personal liability under Mexican law, the court stated that a "[t]axpayer may not escape liability in a foreign nation's courts under one theory and then seek an advantage in this nation's courts by contending its opposite."

¹⁴⁰ See *Tax Report, supra* note 1, at 211.

¹⁴¹ *Id.* at 212. The government argued in *MCA* that the use of the separate interests test goes to the substantive presence of the corporate characteristics, or in other words, that no additional factors are being engrafted on the regulations but rather the regulations are simply being read in a common-sense way that give effect to their substance. *Government Brief, supra* note 58, at 20-21. The government failed to explain, however, why this "common-sense" approach was not taken in its classification of a domestic entity in Revenue Ruling 75-19, see *infra* notes 142-45 and accompanying text.

¹⁴² Rev. Rul. 75-19, 1975-1 C.B. 382.

tions, all subsidiaries of the same domestic parent, entered into a partnership agreement for the purpose of purchasing a crude oil storage barge and chartering it to an unrelated corporation. The arrangement among the subsidiary corporations was formed under a statute corresponding to the Uniform Partnership Act (UPA).¹⁴³ It was stipulated that the subsidiary corporations each had business reasons for existence independent of the business to be performed under the partnership agreement, and that the agreement was not entered into for the purpose of avoiding or evading federal income tax. The Service held that because the arrangement was subject to a statute corresponding to the UPA, it automatically lacked the corporate characteristics of continuity of life, centralization of management, and limited liability. Therefore, the arrangement did not have more corporate than noncorporate characteristics and was classified as a partnership for federal tax purposes.¹⁴⁴ What is clear from this ruling is that a taxpayer may choose the form of *domestic* organization to fit both business needs and tax objectives as long as the taxpayer is willing to take on all the burdens as well as the benefits connected with the choice. Why the same free choice does not prevail for foreign entities is not exactly clear.¹⁴⁵

One commentator suggests that one possible ground for distinction with respect to foreign entities may be found in the regulations under section 7701.¹⁴⁶ There, constant reference is made to general partnerships that are subject to a statute corresponding to the UPA, and limited partnerships that are subject to a statute corresponding to the Uniform Limited Partnership Act (ULPA), as lacking certain corporate characteristics.¹⁴⁷ In a foreign jurisdiction, such statutes obviously do not exist, thereby affording a basis for distinction.¹⁴⁸ Because these for-

¹⁴³ *Id.* at 382-83.

¹⁴⁴ *Id.*

¹⁴⁵ See *Tax Report, supra* note 1, at 208-09, which states:

The Service has not yet articulated reasons why the tests for the classification of a foreign entity held by two or more commonly controlled owners should not be the same tests that appear in Revenue Ruling 75-19. Further, Revenue Ruling 73-254 endorses the use of the same standards for classifying both foreign and domestic entities.

If there are policy justifications for the use of a different standard, the policies should be stated and dealt with in a specific and limited fashion.

¹⁴⁶ See P. POSTLEWAITE & M. COLLINS, *supra* note 54, at § 10.03 n. 21.

¹⁴⁷ See Treas. Reg. § 301.7701-2(b)(3) (1960) (continuity of life); Treas. Reg. § 301.7701-2(c)(4), T.D. 6503, 1960-2 C.B. 409, 416, T.D. 7889, 1983-22 I.R.B. 16, 17 (centralization of management); Treas. Reg. § 301.7701-2(d)(1) (1960) (limited liability).

¹⁴⁸ See P. POSTLEWAITE & M. COLLINS, *supra* note 54, at § 10.03. *But see* *Zuckman v. United States*, 524 F.2d 729, 734-35 (Ct. Cl. 1975) (finding of no continuity of life did not depend solely upon the regulation's explicit reference to the ULPA, but also upon the regulation's general statement that continuity of life does not exist if the occurrence of any of certain events causes dissolution of the partnership under local law).

eign laws create entities that do not track our domestic forms, the argument is made that the entities fail to guarantee they are economically and practically functioning as labelled under foreign law.¹⁴⁹ This argument completely ignores, however, the rule that in applying the four characteristics classification test, relationships are examined as they exist under local law,¹⁵⁰ which may be foreign law. The references to the UPA and ULPA merely provide a guarantee that entities organized under those acts will meet certain requirements, regardless of state law on the subject.

Furthermore, as the New York State Bar Association Report points out,¹⁵¹ in other areas where there were specific potential abuses to be forestalled in the choice of the foreign entity to be used, Congress has legislated various Code sections to deal with them.¹⁵² In addition, other nonstatutory doctrines, such as the assignment of income doctrine, the step transaction, and the sham and corporation conduit approaches, exist to prevent income from being unjustifiably sheltered. As the New York Bar Association noted: "These reduce the possibility of taxpayer abuse in selecting an appropriate foreign entity to the point where there seems to be no further justification for frustrating the taxpayer's selection of the tax character of his foreign organization."¹⁵³

V. CONCLUSION

The Ninth Circuit's recognition of a different standard for classification of foreign entities, a standard found in neither the Code nor the regulations, is unreasonable given the Service's earlier ruling that the same tests are to be used for classifying both foreign and domestic entities. Furthermore, there is nothing in the Subpart F provisions to indicate that Congress was concerned about entities that technically meet

¹⁴⁹ Government Brief, *supra* note 58, at 28 n.13.

¹⁵⁰ *See, e.g.*, Treas. Reg. § 301.7701-2(b)(2) (1960) (continuity of life); Treas. Reg. § 301.7701-2(d)(1) (1960) (limited liability); Treas. Reg. § 301.7701-2(e)(1) (1960) (free transferability of interests).

¹⁵¹ *Tax Report, supra* note 1, at 209.

¹⁵² *See, e.g.*, I.R.C. § 269 (1976) (acquisitions made to evade or avoid income tax); I.R.C. § 367 (West Supp. 1983) (transfers to controlled foreign corporations), I.R.C. §§ 551-558 (1976 & West Supp. 1983) (foreign personal holding companies); I.R.C. § 679 (Supp. V 1981) (taxing grantors on income from certain foreign trusts); I.R.C. § 1248 (West Supp. 1983) (sale or exchange of stock in controlled foreign corporations).

¹⁵³ *Tax Report, supra* note 1, at 211. Ironically, the § 7701 regulations were supposedly drafted with the aim of making it difficult to qualify as a corporation in order to limit the availability of corporate fringe benefits not otherwise available to venturers doing business in the partnership form.

the partnership requirements but have, according to the government, all the attributes of a corporation.

Notwithstanding the inconsistencies in its application, and the Ninth Circuit's ruling that it was not applicable to the facts of the *MCA* case, the "separate interests test" appears to be here to stay. For planners, the most straightforward way to avoid the separate interests test is to have an unrelated third party own a small but significant percentage of the distribution entity.¹⁵⁴ This third-party ownership presumably would indicate that neither of the corporate characteristics of continuity of life or free transferability of interests would be present. In addition, express provisions that outline the effects of the various events and circumstances should be included in the organizational documents and should be designed so as to avoid the finding of corporate characteristics. Despite the fact that the courts and the Service have tended to ignore the entity's organizational documents, by explaining the impact and consequences of the operation of local law, provisions negating the presence of continuity of life or free transferability of interests may be given effect.

Solutions such as these are only temporary. The tax ramifications of choosing to operate as one type of entity over another are significant enough that taxpayers must be able to rely on something more predictable in planning their foreign business ventures. The criteria for an entity's tax classification should be the same for both foreign and domestic entities, and if there is a potential for abuse in a particular area, it can be handled better through the legislative or regulatory processes.

Daniel N. Zucker

¹⁵⁴ Hamilton, *supra* note 38, at 307-08.