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Liquidating the Foreign Personal Holding Company: Alternative Considerations

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Liquidating the Foreign Personal Holding Company: Alternative Considerations

Neil M. Goff, Esq.*

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I. INTRODUCTION

Prior to 1937, it was common for United States taxpayers to utilize offshore corporate entities, structured in the form of a foreign personal

holding company ("FPHC") to avoid United States taxation. As indicated by the House Committee Notes accompanying enactment of the Revenue Act of 1937, "[t]he evidence presented to the joint committee has shown that foreign personal holding companies have afforded one of the most flagrant loopholes for tax avoidance."¹ The primary problem faced by the lawmakers in 1937 was the fact that the United States was unable to acquire direct taxing jurisdiction over such companies due to the fact that such corporate entities were not located within the taxing jurisdiction of the United States.² As a result, Congress adopted an alternative approach which in the opinion of the lawmakers was justifiable on constitutional grounds;³ that is, to provide for a method of taxation that will reach the shareholders who own stock in such companies and over whom the United States has direct taxing authority.⁴ As a result, the FPHC provisions provided an alternative method of taxation which deemed the income of the FPHC to be distributed to the shareholders and required such shareholders to report as their income, the undistributed net income of such FPHC.⁵

Although there are certain similarities that exist between the FPHC provisions⁶ and the domestic PHC provisions,⁷ it is not the purpose of this work to address such differences. Rather, this Article will: (1) Discuss and analyze the operative provisions of the FPHC provisions;⁸ (2) Analyze the methods by which shareholders subject to the United States taxing jurisdiction may minimize the tax impact of liquidating a FPHC and repatriating its earnings to the United States taxing jurisdiction;⁹ and (3) Discuss miscellaneous considerations applicable in the context of such alternative liquidation techniques.¹⁰

However, before turning to an analysis of the available alternative liquidation techniques, it is first necessary to define the FPHC tax provisions which in and of themselves are replete with intricate rules and terms of art. Only after an understanding of the operative FPHC provi-

¹ H.R. REP. NO. 1546, 75th Cong., 1st Sess. (1938).

² *Id.*

³ See *Eder v. Comm'r*, 138 F.2d 27 (2d Cir. 1943) and *Rodney, Inc. v. Hoey*, 53 F. Supp. 604 (S.D.N.Y. 1944) (upholding the constitutionality of taxing United States shareholders on undistributed income).

⁴ See I.R.C. § 552 (1982) and Treas. Reg. § 1.551-2(d) (1958). All references to code sections are to the Internal Revenue Code of 1954, as amended, unless otherwise specified.

⁵ *Id.*

⁶ See I.R.C. §§ 551-58 (1982).

⁷ See I.R.C. §§ 541-47 (1982).

⁸ See *infra* text accompanying notes 11-142.

⁹ See *infra* text accompanying notes 143-218.

¹⁰ See *infra* text accompanying notes 219-304.

sions, is it possible to clearly analyze the available alternative liquidation techniques that may be utilized to repatriate foreign earnings to the United States.

II. IMPOSITION OF TAX AND DEFINITIONAL CONCEPTS

Section 551(a) of the Code provides that the undistributed foreign personal holding company income ("UFPHCI") of an FPHC should be included in the gross income of the citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts (other than estates or trusts the gross income of which includes only income from sources within the United States), who are shareholders in such FPHC (hereinafter called "United States Shareholders") in an amount and to the extent set forth in the Code.¹¹ It is important to note that the general rule of § 551(a) does not impose a tax on the FPHC itself.¹² Rather, the UFPHCI of such entity is deemed distributed to those shareholders over which the United States has taxing jurisdiction and included in such United States Shareholder's gross income whether or not distributed.¹³

Each United States Shareholder, who was a shareholder on the day in the taxable year of a FPHC which was the last day on which a United States group¹⁴ existed with respect to the FPHC, must include in his gross income,¹⁵ as a dividend, for the taxable year in which or with which the taxable year of the FPHC ends, the amount he would have received as a dividend¹⁶ if on such last day there had been distributed by the FPHC, and received by the shareholders, an amount which bears the same ratio to the UFPHCI of the FPHC for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.¹⁷

For example, if the last day in the taxable year on which the required United States group existed was also the end of the taxable year, the portion of the taxable year up to and including such last day would be equal to 100%. As a result, the United States Shareholders would be

¹¹ I.R.C. § 551(a) (1982); Treas. Reg. § 1.551-1 (1958).

¹² *Id.*

¹³ I.R.C. § 551(a)-(b) (1982). *See also* Treas. Reg. § 1.551-2 (1958).

¹⁴ I.R.C. § 552(a)(2) (1982) (defining United States Group).

¹⁵ I.R.C. § 61 (1982); Treas. Reg. § 1.542-2 (1958), T.D. 6795, 1965-1 C.B. 287, 288 (regarding domestic PHCs); Treas. Reg. § 1.555 (1958) (incorporating the domestic personal holding company rules for purposes of the FPHC calculations). *But see infra* notes 52 and 120.

¹⁶ Such a dividend is determined without regard to liquidating distributions. I.R.C. § 551(b) (1982).

¹⁷ *Id.*

required to report their distributive shares of UFPHCI. However, if the last day on which the required United States group existed was September 30, and the taxable year was a calendar year, the portion of the taxable year up to and including such last day would be equal to nine-twelfths ($\frac{9}{12}$ ths). Under this circumstance, the United States Shareholders would be required to report their distributive shares of only nine-twelfths ($\frac{9}{12}$ ths) of the UFPHCI.¹⁸

Furthermore, every United States Shareholder who is required to include in his gross income any amount with respect to the UFPHCI of a FPHC and who, on the last day on which a United States group existed with respect to the FPHC, owned 5% or more in value of the outstanding stock of such FPHC, is required to set forth in his return in complete detail the gross income, deductions and credits, taxable income, foreign personal holding company income ("FPHCI"), and UFPHCI of such FPHC.¹⁹

Section 551(d) of the Code provides that for purposes of determining the effect of distributions in subsequent taxable years, such amount of UPHCI, or a portion thereof, required to be included in gross income, directly or indirectly, as a dividend, shall be considered as paid in surplus or as a contribution to capital, and the accumulated earnings and profits as of the close of the taxable year shall be correspondingly reduced.²⁰ Furthermore, with respect to the basis of a United States Shareholder in his FPHC stock, the amount required to be included in gross income is treated as having been reinvested by the shareholder as a contribution to the capital of the corporation; but only to the extent that such amount was included in his gross income, increased or decreased by any adjustment of such amount in the last determination of the shareholder's tax liability made before the expiration of six (6) years after the date prescribed by law for filing the return.²¹

¹⁸ Treas. Reg. § 1.551-2(b) (1958).

¹⁹ I.R.C. §§ 551(c), 558 (1982); *see* I.R.C. § 6035 (1982) (requiring that Forms 957 and 958 be filed); *see also* I.R.C. §§ 6038, 6046 (1982) (requiring filing of Form 2952 for foreign corporation information and Form 959 for certain shareholders and directors of foreign corporations respectively); I.R.C. § 6046(c) (1982) (imposing certain attribution rules with respect to determining filing qualification); I.R.C. § 1494 (1982) (requiring that Form 926 be filed regarding imposition of an excise tax on the transfer of appreciated stock or securities to a foreign corporation). Failure to file the required information returns will subject the non-complying party to penalties imposed by I.R.C. §§ 6038(b), 7203, 7206-7207 (1982). Also, the failure to include UFPHCI in gross income will invoke an extended statute of limitations under I.R.C. § 6501(e)(1)(B) (1982). I.R.C. § 551(f)(2) (1982).

²⁰ I.R.C. § 551(d) (1982).

²¹ I.R.C. § 551(e) (1982). Also, this provision incorporates the extended statute of limitations under I.R.C. § 6501(e)(1)(B) (1982). *See* I.R.C. § 551(f)(2) (1982).

The above basis adjustment rules are designed to prevent double taxation with respect to UFPHCI. Such adjustments may be illustrated by the following examples.

Example 1: The M corporation is a FPHC. Seventy-Five Percent (75%) in value of its capital stock is owned by A, a citizen of the United States, and the remaining 25% is owned by B, a non-resident alien individual. For the calendar year 1981 M corporation has an UFPHCI of \$100,000. As a result, A is required to include \$75,000 of such income in gross income as a dividend in his individual tax return for the calendar year 1981. The \$100,000 is treated as paid in surplus or as a contribution to the capital of M corporation and its accumulated earnings and profits as of the close of the calendar year 1981 are correspondingly reduced. If after treating such \$100,000 as paid in surplus or as a contribution to capital, the M corporation has no accumulated earnings and profits at the close of 1981, and if for the calendar year 1982, the M corporation has no earnings and profits, but distributed \$40,000, the amount so distributed would be a non-taxable distribution and would not be included in the gross income of either A or B for the calendar year 1982. If, however, after treating the \$100,000 as paid in surplus or as a contribution to capital, the M corporation had accumulated earnings and profits of \$100,000 at the close of 1981, the facts otherwise being the same, the distribution in 1982 would be taxable to A as a dividend.²² The taxability of such distributions to B would depend upon the application of the tax sourcing rules relating to the treatment of dividends from a foreign corporation as income from sources within or without the United States.²³

Example 2: In Example 1, assume that the basis of A's stock was \$300,000. If A includes in gross income in his return for the calendar year 1981, \$75,000 as a dividend from M corporation (i.e., 75% of \$100,000), the basis of his stock would be \$375,000. After the non-taxable distribution of \$30,000 to A by the M corporation in 1982 (75% of the \$40,000 distribution) the basis of A's stock, assuming no other changes, would be \$345,000 (i.e., \$375,000—\$30,000). If A failed to include the \$75,000 as a dividend in gross income in his return for 1981 and his failure was not discovered until after the six-year period statute of limitations had expired, application of the basis adjustment rules would not increase the basis of A's stock. The subsequent non-taxable distribution of \$30,000 to A in 1982 would reduce his basis of \$300,000 (such basis having never been increased by the unreported \$75,000) to \$270,000 thus tending to compensate for his failure to include the earlier \$75,000 of UFPHCI as a dividend in his gross income for 1981. If the UFPHCI of the M corporation is readjusted within the applicable statute of limitations, thus increasing or decreasing the amount A would have had to include in his gross income, proper adjustment is also required to be made to the basis of A's stock on account of such readjustment.²⁴

²² Treas. Reg. § 1.551-5(b) (Ex.1) (1958).

²³ I.R.C. § 861(a)(2) (1982).

²⁴ Treas. Reg. § 1.551-5(b) (Ex. 2) (1958).

A. Definitional Concepts

Given the above-described mechanical approach of the statute, it is necessary to define just what is meant by a FPHC. Section 552(a) provides that for purposes of the Code, the phrase "FPHC" means any foreign corporation which meets the following two tests:²⁵ (1) gross income requirement, and (2) stock ownership requirement.

1. Gross Income Requirement

This test is met if at least 60% of the foreign corporation's gross income²⁶ for the taxable year is FPHCI,²⁷ but if the corporation is a FPHC with respect to any taxable year ending after August 26, 1937, then, for each subsequent taxable year, the minimum percentage will be 50 percent (in lieu of 60 percent), until a taxable year during the whole of which the stock ownership test (as discussed below) does not exist, or until the expiration of three (3) consecutive taxable years in each of which less than 50 percent of the gross income is FPHCI.²⁸ For purposes of the above test, the statute indicates that there shall be included in gross income the amount includable therein as a dividend by reason of the application of § 555(c)(2).²⁹

2. Stock Ownership Requirement

In addition to the above gross income test, section 552(a) also requires that at any time during the taxable year, more than 50 percent in value of such foreign corporation's outstanding stock must be owned, directly or indirectly, by or for not more than five (5) individuals who are citizens or residents of the United States, such shareholder being referred to as "United States Group."³⁰

However, the statute identifies certain entities that are not included within the scope of the FPHC provisions such as (i) a corporation exempt from tax under subchapter F, and (ii) a corporation organized and doing business under the banking and credit laws of a foreign country if it is established (annually, or at other periodic intervals) to the satisfaction of the Secretary that such corporation is not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed upon its shareholders. If the Secretary is

²⁵ I.R.C. § 7701(a)(3), (5) (1982).

²⁶ Gross income is defined in I.R.C. § 555(a) (1982).

²⁷ FPHCI is defined in I.R.C. § 553 (1982).

²⁸ I.R.C. § 552(a)(1) (1982).

²⁹ *Id.*

³⁰ I.R.C. § 552(a)(2) (1982). *See also* Treas. Reg. § 1.552-1(a) (1958) (last sentence).

satisfied that such corporation is not so formed or availed of, he shall issue to such corporation annually or at other periodic intervals a certification that the corporation is not a FPHC.³¹ Each United States Shareholder of a foreign corporation which would, except for the above exclusion, be a FPHC, is required to attach to and file with his income tax return for the taxable year a copy of the certification issued by the Secretary in this regard.³² Furthermore, a copy of such certification must be filed with the taxpayer's return for the taxable year if he has been a shareholder of such corporation for any part of such year.³³

Based upon the above statutory definition of a FPHC, three specific concepts must be addressed: (1) The requirement that a foreign personal holding company must be a foreign corporation; (2) The gross income requirement; and (3) The stock ownership requirement.

B. Foreign Corporation Requirement

The statute specifically requires that a FPHC must be a "foreign corporation."³⁴ The regulations indicate that a foreign corporation subject to classification as a FPHC is not subject to taxation under either § 531 or § 541.³⁵ However, the fact that a foreign corporation is a FPHC does not relieve the corporation from liability for taxes imposed generally upon foreign corporations,³⁶ since such taxes apply regardless of the classification of the foreign corporation as a FPHC.³⁷

As a general rule, foreign corporation status is determined by reference to the jurisdiction where such entity is formed.³⁸ For example, if a corporation is formed under the law of the United States or any State thereof, such entity cannot constitute a foreign corporation even if it derives all of its earnings from outside the United States.³⁹ Conversely, a corporate entity organized outside the United States will be characterized as a foreign corporation even though all of its income is earned from United States sources.⁴⁰ In determining corporation status, reference must be made to § 7701 of the Code which is the operative Code section for United States tax purposes regardless of the characterization of an

³¹ I.R.C. § 552(b)(2) (1982); Treas. Reg. §§ 1.552-4 to -5 (1958).

³² I.R.C. § 552(b)(2) (flush language); Treas. Reg. § 1.552-4(b) (1958).

³³ *Id.*

³⁴ I.R.C. §§ 552(a), 7701(a)(3), 7701(5) (1982).

³⁵ Treas. Reg. § 1.552-1(b) (1958).

³⁶ *Id.* See I.R.C. §§ 881-82, 897 (1982).

³⁷ *E.g.*, I.R.C. § 897(a)(1) (1982) (referring only to a "foreign corporation").

³⁸ I.R.C. § 7701(a)(3)-(5) (1982).

³⁹ I.R.C. § 7701(a)(3)-(4) (1982); See I.R.C. § 11(d) (1982).

⁴⁰ I.R.C. § 7701(a)(3), (5) (1982); See I.R.C. § 11(d) (1982) (indicating that foreign corporations are taxed under I.R.C. § 882) (1982).

entity outside the United States. For example, in Rev. Rul. 77-214,⁴¹ the Service examined a limited liability German corporation ("GmbH") in order to assess whether such entity possessed sufficient corporate attributes to justify characterization as an association taxable as a corporation.⁴² Furthermore, in Rev. Rul. 73-254,⁴³ the Service applied the rules of § 7701, and the regulations promulgated thereunder, in determining, for the United States tax purposes, the proper classification of an unincorporated foreign business organization to which a United States citizen had contributed various assets.

Furthermore, in the FPHC context, tax purposes are even more crucial where tiered entity relationships exist. For example, if one corporation (the first-tier entity) is deemed to own all of the stock of another corporation (the second-tier entity), the characterization of the second-tier entity may be crucial to determining the FPHC status of the first-tier entity. If, for instance, the second-tier entity distributes funds to the first-tier entity, and such second-tier entity is classified as a corporation, the distribution back to the first-tier entity could be characterized as a dividend thereby generating FPHCI at the first-tier entity level.⁴⁴ If the first-tier entity is also a corporation subject to the FPHC provisions, the tax consequences to a United States citizen or resident may be increased significantly by virtue of the second-tier entity's income distributed (or deemed distributed) to the first-tier entity. However, if the second-tier entity is not a foreign corporation, any actual distribution to the first-tier entity will not be classified as a dividend and therefore may not generate FPHC income at the first-tier entity level. In addition, the second-tier entity cannot be classified as a FPHC.

In any event, it is imperative that the entity involved be a foreign corporation within the meaning of § 7701 (and the regulations promulgated thereunder) before the FPHC provisions apply.

C. Gross Income Requirement

Assuming a foreign corporate entity is involved, the statute requires

⁴¹ 1971-1 C.B. 408.

⁴² See Treas. Reg. § 301.7701-2, T.D. 6797, 1965-1 C.B. 553, 554; T.D. 7515, 1977-2 C.B., T.D. 7889, 1983-1 C.B. 362, 364, which sets forth four attributes of corporate or association status: (1) limited liability; (2) continuity of life; (3) centralization of management; and (4) free transferability of interests. Possession of more than two of such four attributes justifies characterization as an association taxable as a corporation. *Id.*

⁴³ 1973-1 C.B. 613.

⁴⁴ Furthermore, if the second-tier entity is also classified as a FPHC such entity will be deemed to have distributed its UFPHCI to the first-tier entity which must also run the gamut of the FPHC provisions.

that such foreign entity meet two tests.⁴⁵ The first test is the gross income requirement which is applied at the corporate level.⁴⁶ The second test is the stock ownership requirement which is applied at the shareholder level.⁴⁷

Section 552(a)(1) provides that if at least 60% of such foreign corporation's gross income for the taxable year is FPHCI (subject to a 10% reduction in the 60% requirement for each subsequent taxable year until a taxable year during the whole of which the stock ownership requirement does not exist, or until the expiration of three consecutive taxable years in each of which less than 50% of the gross income is FPHCI), the gross income requirement would be met.⁴⁸ The regulations make it clear, that in determining whether FPHCI is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts.⁴⁹ For a meaning of gross income in this context,⁵⁰ the regulations cross-reference the reader to § 555 and the regulations promulgated thereunder.

As indicated by the statute, the gross income requirement is a mechanical test designed to identify a FPHC by reference to various categories of passive income.⁵¹ In order to determine whether a particular foreign corporate entity falls within the purview of the gross income requirement, § 553 provides extensive definitions with respect to items that constitute FPHCI.⁵²

*1. Dividends, Interest, Royalties and Annuities, such as: Dividends,
Interest Royalties, Annuities, Stock and Security
Transactions, Commodity Transactions, Estates and
Trusts, Personal Service Contracts, Use
of Corporate Property by Shareholder and Rents.*

Section 553(a) provides that the phrase "FPHCI" means that por-

⁴⁵ I.R.C. § 552 (1982).

⁴⁶ I.R.C. § 552(a)(1) (1982).

⁴⁷ I.R.C. § 552(a)(2) (1982).

⁴⁸ See *supra* note 40.

⁴⁹ Treas. Reg. § 1.552-2(b) (1958).

⁵⁰ *Id.* Gross income is to be calculated as if the foreign corporation were a domestic corporation which is a personal holding company. I.R.C. § 555(a) (1982).

⁵¹ I.R.C. § 553 (1982).

⁵² The present regulations define FPHCI by reference to the domestic personal holding company regulations under Treas. Reg. § 1.543 (1958), T.D. 6739, 1964-2 C.B. 156, 156, T.D. 7261, 1973-1 C.B. 309, 316. The Revenue Act of 1964, Pub. L. No. 88-272, 79 Stat. 19 (1964) amended I.R.C. § 553 (1982) to be independent of § 543 and proposed regulations under I.R.C. § 553 (1982) have been issued.

tion of the gross income, determined for purposes of § 552 (regarding the definition of a FPHC), which consists of dividends, interest, royalties and annuities.⁵³ The regulations under § 553 are outdated and indicate that FPHCI shall consist of designated items as defined under § 543 and the regulations promulgated thereunder relating to personal holding company income of a domestic corporation subject to certain exceptions specifically set forth in the regulations under § 553.⁵⁴ However, the Service has issued proposed regulations under Section 553 which are designed to eliminate the necessity to refer to the domestic personal holding company provisions.⁵⁵ The proposed regulations under § 553 indicate that the term "dividends" include dividends as defined in § 316 and amounts required to be included in gross income under § 551 and the regulations promulgated thereunder (relating to FPHCI taxed to United States Shareholders).⁵⁶ Based on the above definition, a distribution will not constitute a dividend, unless it is a distribution out of earnings and profits.⁵⁷ Furthermore, certain additions to gross income under § 555(b) are also included in the term dividend.⁵⁸

The proposed regulations under § 553 indicate that the term "interest" means any amount includible in gross income, received for the use of money loaned and shall include imputed interest imposed by § 483 and any annual periodic rental payment under a redeemable ground rent (excluding amounts in redemption thereof) that is treated as interest.⁵⁹

The term "royalties" includes all amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises and other like property.⁶⁰ Royalties also include production payments and overriding royalties received from any interest in mineral, oil or gas properties.⁶¹ Furthermore, certain special rules apply to overriding royalties received from a sublessee by an

⁵³ I.R.C. § 553(a)(1) (1982).

⁵⁴ Treas. Reg. § 1.553-1, T.D.-6739, 1964-2 C.B. 156, 161; *See supra* note 52.

⁵⁵ Such proposed regulations were published in 33:9 Fed. Reg. 12,569 (1968).

⁵⁶ Treas. Reg. § 1.553-1(b)(1) (proposed Sept. 5, 1968).

⁵⁷ I.R.C. § 316(a)(1)-(2) (1982).

⁵⁸ I.R.C. § 555(b) (1982). However, the proposed regulations do not specifically address this issue.

⁵⁹ Treas. Reg. § 1.553-1(b)(2) (proposed Sept. 5, 1968). *See also* I.R.C. § 163(c) (1982) and Treas. Reg. § 1.163-1 (1957), T.D. 6593, 1962-1 C.B. 22, T.D. 6821, 1965-1 C.B. 360, 361, T.D. 6873, 1966-1 C.B. 101, 102, T.D. 7408, 1976-1 C.B. 48. In Rev. Rul. 72-527, 1972-2 C.B. 456, the Service held that tax exempt interest is not FPHCI. Furthermore, interest received by a party acting as a conduit for repayment in a properly structured transaction evidencing such characterization will not generate FPHCI. *See United States v. Ross*, 251 F. Supp. 175 (S.D.N.Y. 1966), *aff'd*, 368 F.2d 455 (2d Cir. 1966).

⁶⁰ Treas. Reg. § 1.553-1(b)(3)(i) (proposed Sept. 5, 1968).

⁶¹ Treas. Reg. § 1.553-1(b)(3)(ii) (proposed Sept. 5, 1968).

operating company which originally leased and developed natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.⁶²

In addition, significant problems are presented in determining whether a payment constitutes a rent or a royalty.⁶³ For example, in Rev. Rul. 54-284,⁶⁴ the Service was faced with characterizing payments received for certain films. The taxpayer licensed certain films for distribution and exhibition and received a percentage of the gross receipts. On these facts, the Service held that the amounts constituted rents for purposes of the FPHC provisions. However, amounts received for the sale of copyrights and other rights are not royalties.⁶⁵ In addition, a final determination as to whether a transfer of intangible property constitutes a sale or a license, turns upon whether the exclusive rights to exploit the property throughout its life have been transferred.⁶⁶ In Rev. Rul. 60-226,⁶⁷ the Service held that if exclusive rights have been transferred, payments received do not constitute FPHCI even if the consideration is measured by reference to receipts from the sale, performance, exhibition, or publication of a copyrighted work. Finally, in Rev. Rul. 75-202,⁶⁸ an author transferred a copyright to a personal holding company and simultaneously entered into therewith a 15-year employment contract to write, edit and compile future works. Subsequently, the corporation sold all of its rights to an unrelated third party for the entire copyright term. However, such rights would revert to the corporation in the event that they were not profitably exploited. On these facts, the Service held that the amounts received were for the sale of copyrights and did not constitute royalties under the FPHC provisions.

The proposed FPHC regulations define the term "annuities" to include annuities only to the extent includable in the computation of gross income under § 72 of the Code.⁶⁹

2. *Stock and Security Transactions*

The statute specifically provides that except in the case of regular dealers in stock and securities, gains from the sale or exchange of stock

⁶² *Id.* The term mineral is defined under the I.R.C. § 611 (1982) regulations. *Id.*

⁶³ The proposed regulations specifically state that royalties do not include rents. *Id.*

⁶⁴ 1954-2 C.B. 275.

⁶⁵ See *Dairy Queen of Oklahoma, Inc. v. Comm'r*, 250 F.2d 503 (10th Cir. 1957).

⁶⁶ See Rev. Rul. 60-226, 1960-1 C.B. 26.

⁶⁷ *Id.*

⁶⁸ 1975-1 C.B. 170.

⁶⁹ I.R.C. § 553(a)(2) (1982); Treas. Reg. § 1.553-1(b)(4) (proposed Sept. 5, 1968).

or securities constitute FPHCI.⁷⁰ The proposed regulations further clarify the above rule by indicating that the gain subject to inclusion in FPHCI shall be net gains from sale or exchange of stock or securities.⁷¹ For purposes of the FPHC provisions, the proposed regulations contain an extensive definition of the phrase "stock or securities."⁷² If there is an excess of losses over gains from such transactions, such excess (or net loss) shall not be used to reduce gross income or FPHCI for purposes of determining whether the corporation is a FPHC.⁷³ In addition, the capital loss carry-over provided under § 1212 shall not be taken into account.⁷⁴ Special rules apply for dealers in stocks or securities.⁷⁵

3. *Commodity Transactions*

The statute specifically provides that gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange constitute FPHCI.⁷⁶ This rule, however, shall not apply to gains or losses by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.⁷⁷ Furthermore, the regulations under § 553 indicate that in computing gross income and FPHCI, net gains from commodity transactions shall be utilized for this purpose.⁷⁸ Any excess of losses over gains from such transactions shall not be used to reduce gross income or FPHCI.⁷⁹ Furthermore, the capital loss carry-over under § 1212 is not taken into account.⁸⁰

⁷⁰ I.R.C. § 553(a)(2) (1982).

⁷¹ Treas. Reg. § 1.553-1(b)(5)(i) (proposed Sept. 5, 1968). See *Gray v. Comm'r*, 561 F.2d 753 (9th Cir. 1977) (holding redemption proceeds constitute FPHCI) and Rev. Rul. 73-277, 1973-1 C.B. 296 (where the Service held that gain realized by a first-tier Controlled Foreign Corporation on the sale of stock in a second-tier entity pursuant to a § 337 liquidation is not FPHCI).

⁷² *Id.*

⁷³ Treas. Reg. § 1.553-2(a) (proposed Sept. 5, 1968).

⁷⁴ *Id.*

⁷⁵ See I.R.C. § 553(a)(2) (1982); Treas. Reg. § 1.553-1(b)(5)(ii) (proposed Sept. 5, 1968). See I.R.C. § 1236 (1982). In Rev. Rul. 64-157 1964-1 C.B. 139 the Service defined a dealer in stock or securities. See also *United States v. Ross*, 251 F. Supp. 175 (S.D.N.Y. 1966), *aff'd*, 368 F.2d 455 (2d Cir. 1966) (investor rather than dealer status found).

⁷⁶ I.R.C. § 553(a)(3) (1982). However, only net gains are included for this purpose. See Treas. Reg. § 1.553-1(b)(6),-2(a) (proposed Sept. 5, 1968).

⁷⁷ I.R.C. § 553(a)(3) (1982); Treas. Reg. § 1.553-1(b)(6) (proposed Sept. 5, 1968). With this exception, however, all other speculative gains and losses on futures contracts are included. *Id.*

⁷⁸ See I.R.C. § 553(a)(3) (1982); See also *supra* note 76.

⁷⁹ Treas. Reg. § 1.553-2(a) (proposed Sept. 5, 1968).

⁸⁰ *Id.*

4. *Estates and Trusts*

The statute indicates that amounts includable in computing the taxable income of a corporation under part I of subchapter J,⁸¹ and gains from the sale or other disposition of any interest in an estate or trust shall also be included in FPHCI.⁸² Furthermore, this rule requires that the income includable in the corporation's income as received from a foreign or domestic trust, constitutes FPHCI regardless of the character of such income at the trust level. This rule therefore prevents a corporation from avoiding the FPHC provisions by merely being a beneficiary of a trust.

5. *Personal Service Contracts*

FPHCI also includes amounts received pursuant to a contract under which the corporation is to furnish personal services; if some person, other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or the individual who is to perform is designated (by name or by description), in the contract,⁸³ and amounts received from the sale or other disposition of such a contract.⁸⁴ This rule applies with respect to amounts received for services under a particular contract only if at some time during the taxable year 25% or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform such services.⁸⁵ Attribution rules apply in determining stock ownership for this purpose.⁸⁶ If the contract, in addition to requiring the performance of services by a 25% or more stockholder who is designated or would be designated, requires the performance of services by other persons which are important and essential, then only that portion of the amount received under such contract which is attributable to the personal services of the 25% or more stockholder will constitute FPHCI.⁸⁷ Incidental personal services of other persons employed by the corporation to facilitate the performance of the services by the 25% or more stockholder, however, shall not constitute

⁸¹ See I.R.C. § 641 (1982) and following, regarding the taxability of estates, trusts, and beneficiaries.

⁸² I.R.C. § 553(a)(4) (1982). See Treas. Reg. 1.553-1(b)(7) (proposed Sept. 5, 1968). It is not clear how a loss would be treated since it is not mentioned in the statute or regulations.

⁸³ I.R.C. § 553(a)(5)(A) (1982).

⁸⁴ I.R.C. § 553(a)(5)(B) (1982).

⁸⁵ *Id.* (flush language).

⁸⁶ Treas. Reg. § 1.553-1(b)(8)(ii) (proposed Sept. 5, 1968).

⁸⁷ *Id.*

important or essential services.⁸⁸ The proposed regulations also indicate that under § 482, gross income, deductions, credits or allowances between or among organizations, trades or businesses may be allocated if it is determined that allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such corporations, trades or businesses.⁸⁹

For taxable years beginning after December 31, 1967, the portion of the amount received under a contract which is attributable to the personal services of the 25% or more stockholder is to be determined under the proposed domestic personal holding company regulations.⁹⁰ These proposed regulations indicate that the amount includible in income is the amount received multiplied by a fraction the numerator of which is the sum of the amounts inuring for such taxable year to the benefit of such stockholder, and the denominator of which is the sum of the amounts inuring for such taxable year to the benefit of such stockholder and all persons who are required to perform important and essential services under such contract.⁹¹ For purposes of this rule, the amounts inuring to the benefit of a person for a taxable year shall be equal to the sum of: (i) amounts paid or credited in any medium during such year, directly or indirectly, to such person by the corporation as compensation, rent, interest, royalties and dividends (as defined in § 316(a)); and (ii) in the case of a person who is a stockholder, his proportionate share of the taxable income of the corporation for such year less (i) that amount by which the tax imposed by § 11 on such income exceeds the credits allowable under part IV, subchapter A, Chapter 1 of the Code, and (ii) the dividends (described in § 316(a)) paid during the taxable year.⁹²

If by applying the rules provided in § 544, a person would be considered to own any stock which is owned (directly or indirectly) by any other person, then amounts inuring to the benefit of such other person shall be considered to be inuring to the benefit of such person.⁹³ In any case, where the corporation has gross income from more than one contract for the taxable year, the above computations must be made with respect to each contract separately.⁹⁴ For purposes of said separate computations, the amount considered as inuring to the benefit of a person

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ Treas. Reg. § 1.553-1(b)(8)(iii) (proposed Sept. 5, 1968). This regulation refers the reader to Treas. Reg. § 1.543-10(c) (proposed Sept. 5, 1968).

⁹¹ Treas. Reg. § 1.543-10(c)(1) (proposed Sept. 5, 1968).

⁹² Treas. Reg. §§ 1.543-10(c)(2)(i), 10(c)(2)(ii)(a)-(b) (proposed Sept. 5, 1968).

⁹³ *Id.* (flush language).

⁹⁴ Treas. Reg. § 1.543-10(c)(3) (proposed Sept. 5, 1968).

with respect to a particular contract shall be an amount equal to the total amount inuring to the benefit of such person for the year multiplied by a fraction the numerator of which is the gross income of the corporation from such contract, and the denominator of which is the total gross income from all contracts which require the important and essential services of such person.⁹⁵

Recently, the Service has ruled that controlled corporations are not in receipt of PHCI where the services rendered by the corporation are performed by sole shareholder employees, so long as the clients of the corporation do not have the contractual right to the specific personal services of the shareholder employee and the services are not so unique as to prevent substitution. In 1975, the Service issued three rulings in this area dealing with a sole physician employee,⁹⁶ a sole songwriter employee,⁹⁷ and a sole accountant employee.⁹⁸ In each case the Service ruled that the income in question did not constitute PHCI. The same theory should apply equally in the context of FPHCI and employees conducting significant services outside of the United States.

6. Use of Corporate Property by Shareholder

FPHCI also includes amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25% or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property. This right could be obtained directly from the corporation or by means of a sublease or other arrangement.⁹⁹ However, this rule applies only to a corporation which has FPHCI for the taxable year computed without regard to Section 553(a)(6) and Section 553(a)(7), in excess of 10% of its gross income.¹⁰⁰ It is important to note, however, that such rule applies only if an individual shareholder rents property from the corporation. FPHCI is not generated if such property is leased from the corporation by a corporate shareholder or if the corporation leases property from a shareholder.¹⁰¹ In addition, as long as an individual does not own 25% of the stock, this rule has no

⁹⁵ *Id.* See the examples set forth at Treas. Reg. § 1.543-10(d) (proposed Sept. 5, 1968).

⁹⁶ Rev. Rul. 75-67, 1975-1 C.B. 169.

⁹⁷ Rev. Rul. 75-249, 1975-1 C.B. 171.

⁹⁸ Rev. Rul. 75-250, 1975-1 C.B. 172.

⁹⁹ I.R.C. § 553(a)(6) (1982). See Treas. Reg. § 1.553-1(b)(9) (proposed Sept. 5, 1968). The proposed regulations indicate the substance of the transaction that will govern.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

application.¹⁰²

7. Rents

Finally, FPHCI includes rents unless such rents constitute 50% or more of the gross income.¹⁰³ For purposes of this paragraph the term "rent" means compensation, however designated, for the use of, or right to use, property; but does not include amounts constituting FPHCI under § 553(a)(6) dealing with the use of corporation property by a 25% or more shareholder.¹⁰⁴ As noted previously in the discussion of royalties, it is not often clear whether a payment constitutes a rental payment or a payment for royalties.¹⁰⁵

It is important to note that as long as rental income constitutes 50% or more of the corporation's gross income, FPHCI is not created.¹⁰⁶ This rule applies in order to avoid imposition of the FPHC provisions on a foreign corporation actively engaged on a large scale in the rental of property.¹⁰⁷ However, if rents amount to less than 50% of gross income, all such amounts constitute FPHCI.¹⁰⁸

D. Stock Ownership Requirement

Section 552 indicates that in addition to the foreign corporation and gross income requirements, the United States citizens or resident shareholders of the foreign entity must be subject to the stock ownership requirement before the FPHC provisions apply.¹⁰⁹ The statute provides that the stock ownership requirement will be met if at any time during the taxable year more than 50% in value of such entity's outstanding stock is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, such shareholders referred to as the United States Group.¹¹⁰

¹⁰² *Id.* Treas. Reg. § 1.553-1(b)(9)(iii) (proposed Sept. 5, 1968) indicates that the attribution rules of I.R.C. § 544 (1982) will apply in this regard.

¹⁰³ I.R.C. § 553(a)(7) (1982). Treas. Reg. § 1.553-1(b)(10) (proposed Sept. 5, 1968).

¹⁰⁴ *Id.*

¹⁰⁵ *See supra* notes 63-68 and accompanying text.

¹⁰⁶ *See supra* note 103.

¹⁰⁷ Also, the proposed regulations indicate that FPHCI status will be avoided if significant services are rendered in conjunction with rental activity, such as hotels and motels. *See* Treas. Reg. § 1.553-1(b)(10)(ii) (proposed Sept. 5, 1968).

¹⁰⁸ However, the special rule discussed *supra* note 107 may avoid the creation of FPHCI where significant services are rendered.

¹⁰⁹ I.R.C. § 552(a)(2) (1982).

¹¹⁰ *Id.* *See* Treas. Reg. § 1.553-3 (proposed Sept. 5, 1968). Although focusing on individuals, the court in *Rodney, Inc. v. Hoey*, 53 F. Supp. 604 (S.D.N.Y. 1944) took a broader approach.

1. United States Group Control

It is important to note from the outset that the 50% test applies to the value of the outstanding stock and not necessarily strict ownership percentages.¹¹¹ Such 50% in value may be determined directly or indirectly by reference to extensive attribution rules contained § 554 of the Code.¹¹² Furthermore, it is necessary to consider any change in the stock outstanding during the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof, since the corporation comes within the classification if the statutory condition with respect to stock ownership are present at any time during the taxable year.¹¹³ In determining whether the statutory conditions with respect to stock ownership are present at any time during the taxable year, the phrase "in value" shall, in the light of all circumstances, be deemed the value of the corporate stock outstanding at such time without regard to treasury stock.¹¹⁴ Such value may be determined upon the basis of the corporation's net worth, earnings and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock.¹¹⁵ If the value of the stock which is used is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return.¹¹⁶ In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class.¹¹⁷

2. Directly or Indirectly

As indicated previously, the ownership requirement will be met if at any time during the taxable year more than 50% in value of the outstanding stock is owned "directly or indirectly" by or for not more than five individuals who are citizens or residents of the United States.¹¹⁸ No particular problem is presented in the context of direct ownership since it is generally easy to identify the shareholders who actually own an equity interest in the corporation. However, the statute specifically authorizes

¹¹¹ *Id.*

¹¹² Treas. Reg. § 1.552-3(a) (proposed Sept. 5, 1968) refers the reader to I.R.C. § 554 (1982) and the regulations promulgated thereunder.

¹¹³ Treas. Reg. § 1.552-3(b) (1958).

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.* See Rev. Rul. 59-60, 1959-1 C.B. 237 as amplified by Rev. Rul. 77-287, 1977-2 C.B. 319.

¹¹⁸ I.R.C. § 552(a)(2) (1982). The fact that stock may be owned "for" a person invokes a look-through approach in the FPHC area.

indirect ownership as also qualifying for the tainted stock ownership requirement.¹¹⁹ As a result of the indirect ownership language contained in the Code, it is possible to attribute FPHC status to a foreign entity by virtue of ownership in a domestic entity as well as by virtue of ownership in a foreign corporation.

For example, if a domestic corporation, partnership, estate or trust were to own stock in a foreign corporation, the language of the statute supports an analysis of FPHC status with respect to the foreign corporation by virtue of the stock ownership of the domestic corporation, partnership, estate or trust. Assume that all the stock of a foreign corporation X is owned by a United States corporation Z, corporation Z is in turn owned equally by two United States citizens, A and B, and a domestic partnership (i.e., one-third each) in which C and D are United States partner citizens. The ownership test is based upon the individuals involved as well as the individual partners of the domestic partnership and not the corporate entity Z. Since indirectly, 100% of the stock of the foreign entity (X) is owned by United States individuals who are citizens or residents, such foreign entity (X) constitutes a FPHC.

The same indirect principle applied to domestic entities also applies with respect to foreign entities. For example, assume that a foreign corporation (X) owns 80% of the stock of another foreign corporation (X-1) and the remaining 20% is owned by other non-United States interests. A determination of whether foreign corporation X is a FPHC is determined by a reference to those United States citizens or residents which own stock in the foreign corporation. Furthermore, it is possible that the second-tier foreign subsidiary (X-1) would also be considered a FPHC in this scenario, because X-1 stock owned by X can be deemed indirectly owned by the shareholder of X for purposes of the FPHC provisions.

3. *Attribution Rules*

The statute sets forth extensive constructive ownership rules in determining the ownership of stock in a FPHC.¹²⁰ Stock owned, directly or indirectly, by or for a corporation, partnership, estate or trust is considered as being owned proportionately by its shareholders, partners or

¹¹⁹ Indirect ownership should be contrasted with constructive ownership. See Treas. Reg. § 1.554-6(a) (proposed Sept. 5, 1968).

¹²⁰ I.R.C. § 554 (1982). Also, these constructive ownership rules apply in determining FPHCI: (1) under § 553(a)(5) (1982) regarding personal service contracts of 25% or more shareholder and (2) use of corporate property under I.R.C. § 553(a)(6) (1982). I.R.C. § 554(a) (1982). The existing § 554 regulations cross-reference the reader to the attribution regulations issued under I.R.C. § 544 (1982). However, proposed regulations were issued in 1968 under I.R.C. § 554 (1982) which supersede this cross-reference to the domestic PHC provisions.

beneficiaries.¹²¹ In addition, an individual is considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner.¹²² For purposes of this rule the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors and lineal descendants.¹²³

If any person owns an option to acquire stock, such stock is considered as owned by the person holding the option.¹²⁴ In addition, an option to acquire an option and each of a series of such options is also considered as an option to acquire such stock.¹²⁵ Furthermore, outstanding securities convertible into stock (whether or not convertible during the taxable year) considered as outstanding stock for purposes of the stock ownership requirements provided in § 552(a)(2), but only if the effect of the inclusion of such securities is to make the corporation a FPHC.¹²⁶ Special rules regarding convertible securities apply with respect to personal service contracts¹²⁷ and the use of property by corporate shareholders.¹²⁸ The general rule regarding convertible securities is subject to an exception which provides that where some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be included although the others are not included, but no convertible security shall be included unless all outstanding securities having a prior conversion date are also included.¹²⁹

In certain circumstances, the statute provides that reattribution is permissible in determining FPHC status.¹³⁰ As a result, stock considered as owned by an individual by reason of his being a beneficiary of a trust may be reattributed to a spouse by reason of the family attribution rules.¹³¹ In addition, stock owned by a parent corporation by reason of its ownership of all the stock in the subsidiary may be reattributed to the individual shareholders of the parent or to a partnership which is a

¹²¹ I.R.C. § 554(a)(1) (1982). As a result, a corporation, trust, estate, or partnership cannot be included in the United States Group under I.R.C. § 552(a)(2) (1982). *But see supra* note 110.

¹²² I.R.C. § 554(a)(2) (1982).

¹²³ *Id.* See Rev. Rul. 59-43, 1959-1 C.B. 146; Treas. Reg. § 1.554-3(a) (proposed Sept. 5, 1968). However, consideration must also be given to Estate of N.S. Miller, 43 T.C. 760 (1965) discussed, *infra* text accompanying notes 141-42.

¹²⁴ I.R.C. § 554(a)(3) (1982).

¹²⁵ *Id.* Treas. Reg. § 1.554-4 (proposed Sept. 5, 1968).

¹²⁶ I.R.C. § 554(b)(1) (1982).

¹²⁷ I.R.C. § 554(b)(2) (1982).

¹²⁸ I.R.C. § 554(b)(3) (1982).

¹²⁹ I.R.C. § 554(b)(3) (1982) (flush paragraph); Treas. Reg. § 1.554-5 (proposed Sept. 5, 1968).

¹³⁰ I.R.C. § 554(a)(5) (1982). The theory operating in I.R.C. § 554 is the maximization of stock ownership in order to establish FPHC status.

¹³¹ *Id.*

shareholder in the parent and then reattributed once again to the individual partners of the partnership.¹³² However, reattribution is permitted only if:

1. Stock constructively owned by reason of § 554(a)(1)¹³³ may be reattributed for the purpose of again applying such rule or for the purpose of applying the family and partnership rule set forth in § 554(a)(2) in order to make another person a constructive owner of such stock;¹³⁴ or

2. Stock constructively owned by reason of § 554(a)(3)¹³⁵ may be reattributed for the purpose of applying the entity attribution rules¹³⁶ or the family and partnership rules.¹³⁷

The statute strictly prohibits the attribution of stock under the family rules and partnership rules for purposes of utilizing such rule to establish that another individual is a constructive owner of stock.¹³⁸ As a result, stock may not be attributed from a husband to a spouse and reattributed from the spouse to her brother.

Finally, if stock may be considered owned by an individual by virtue of the family and partnership attribution rules or by virtue of the option attribution rules, the statute and proposed regulations indicate that such ownership will be deemed subject to the option rule.¹³⁹ This restriction is set forth in the statute in order to avoid reattribution of stock by virtue of the family and partner rules.¹⁴⁰

4. *Estate of N.S. Miller v. Commissioner*—Non-Resident Alien Attribution

In *Estate of N.S. Miller v. Commissioner*,¹⁴¹ the Tax Court was asked to clarify the constructive ownership rules imposed by § 554. In *Estate of N.S. Miller, Ava and Florence*, two non-United States sisters living in Canada owned common stock warrants in Investors Trust, Ltd., a Canadian corporation. Ava and Florence also had an American brother named Cyrus who did not own any shares or warrants in the Canadian corporation. Furthermore, Nettie and Elsie, two United citi-

¹³² Treas. Reg. § 1.551-2(a) (1958). See also *O'Falk's Department Store, Inc.*, 20 T.C. 56 (1953) (dealing with the predecessor section to I.R.C. § 544 — § 503(a)(1) of the 1939 Code).

¹³³ This section deals with stock owned through a partnership, corporation, estate, or trust.

¹³⁴ Treas. Reg. § 1.554-6(a)(1) (proposed Sept. 5, 1968).

¹³⁵ This section deals with option ownership.

¹³⁶ I.R.C. § 554(a)(1) (1982).

¹³⁷ I.R.C. § 554(a)(2) (1982). See Treas. Reg. § 1.554-6(a)(2) (proposed Sept. 5, 1968).

¹³⁸ I.R.C. § 554(a)(5) (1982); Treas. Reg. § 1.554-6(a)(3) (proposed Sept. 5, 1968); *Butler v. Paterson*, 148 F. Supp. 197 (N.D. Ala. 1957).

¹³⁹ I.R.C. § 544(a)(6) (1982) and Treas. Reg. § 1.554-7(a) (proposed Sept. 5, 1968).

¹⁴⁰ See *supra* note 138.

¹⁴¹ See *supra* note 123, *non-acq.*, 1966-1 C.B. 4.

zens who were sisters but were unrelated to Ava, Florence and Cyrus, also owned stock in the Canadian corporation. Based on these facts, Nettie and Elsie did not treat the corporation as a FPHC because as a United States Group, they owned only 22% of the stock in the Canadian corporation.

On these facts, the Service asserted that the warrants owned by Ava and Florence had to be counted in applying the ownership test and that even though Ava and Florence were not part of the United States Group, Cyrus was a United States citizen and by virtue of § 554 was deemed to own the warrants. Under this scenario, even though Cyrus owned no stock in the Canadian corporation, more than 50% ownership by five or fewer United States shareholders was present if Cyrus, Nettie and Elsie constituted a United States Group by virtue of § 554. On the facts, even though Cyrus did not own any stock in the Canadian entity, and Ava and Florence were not United States citizens or residents (and therefore not subject to United States tax) the attribution of ownership rules required that Nettie and Elsie report an allocable share of UFPHCI. The taxpayers, however, argued that they should not be taxed simply because two Canadian sisters who owned warrants in the Canadian corporation happened to fortuitously have a brother living in the United States who did not own any shares or warrants. Furthermore, the taxpayers contended that the attribution result advocated by the Service under § 554 was unwarranted.

The Tax Court agreed with the taxpayers and held that while the warrants should otherwise be counted as Canadian corporation stock, there should be no family attribution from Ava and Florence to Cyrus who was not even a shareholder and the warrants need not be included in the United States Group. It is unclear, however, whether the case stands for the proposition that stock owned by a non-resident alien cannot be attributed to a United States citizen or resident or rather such case is limited to its unique factual circumstances.¹⁴²

III. TAX CONSEQUENCES OF FOREIGN PERSONAL HOLDING COMPANY STATUS

Once it has been determined that a FPHC exists under the statute, it is necessary to determine the tax consequences to the United States Shareholders. Basically, the determination of such tax consequences

¹⁴² See Note, *Constructive Ownership of Stock Held By Nonresident Aliens In Foreign Personal Holding Companies*, 57 VA. L. REV. 657 (1971) and Sitrick, *Tax Court Reads New Exception into Stock Attribution Rules for Foreign PHCs*, 22 J. TAX'N 301 (1965).

turns upon a rather intricate calculation of what constitutes UFPHCI.¹⁴³ Before turning to an analysis of the calculation required to determine UFPHCI, it is helpful to first explore generally how such shareholders are taxed, the amount of income required for inclusion, and the timing considerations associated with income recognition.

A. Taxing the Shareholder

Despite the intricate machinations imposed by § 554 and the constructive ownership rules contained therein, once FPFC status has been established, it is clear that only actual shareholders must include a ratable share of UFPHCI in income.¹⁴⁴ In determining the amount of UFPHCI includable in income, stock owned indirectly or constructively is disregarded.¹⁴⁵ Furthermore, merely because a United States citizen or resident was not included within the United States Group¹⁴⁶ for purposes of testing stock ownership in a FPFC, all shareholders having actual share ownership in the FPFC, must include a ratable share of UFPHCI in gross income based upon actual stock ownership.¹⁴⁷ However, only shareholders who actually own stock on the last day of the year during which a United States Group exists are required to include a share of UFPHCI in their gross income.¹⁴⁸ If the United States Group exists on the last day of the year of such FPFC, each United States owner on that day reports his ratable share of UFPHCI. It may be possible to escape FPFC tax if a shareholder disposes of his shares during the year and the United States Group continues in existence subsequent to such sale.¹⁴⁹ However, if a shareholder disposes of his stock during the year, and the United States Group ceases to exist immediately thereafter, only the United States owners who owned stock on the day of disposition include in their gross income, the UFPHCI.¹⁵⁰

1. Amount Taxed

Section 551(a) of the Code sets forth the general rule that UFPHCI is includible in the gross income of a United States Shareholder.¹⁵¹ By

¹⁴³ I.R.C. § 556 (1982).

¹⁴⁴ I.R.C. § 551(a) (1982).

¹⁴⁵ *Id.*

¹⁴⁶ I.R.C. § 552(a)(2) (1982).

¹⁴⁷ *See* I.R.C. § 551(a) (1982).

¹⁴⁸ I.R.C. § 551(b) (1976).

¹⁴⁹ Under such a scenario, the United States Group is defined by reference to the last day of the year on which it exists. Treas. Reg. § 1.551-2(a) (1958).

¹⁵⁰ *Id.* *See* I.R.C. § 551(b).

¹⁵¹ I.R.C. § 551(a) (1982).

virtue of the fact that such income is undistributed, it is proper to classify such income inclusion as a constructive dividend.¹⁵² Section 551(b) provides that each United States shareholder, who was a shareholder on the day in the taxable year of the company which was the last day on which the United States Group existed with respect to such company, shall include in his gross income, as a dividend, the amount he would have received as a dividend¹⁵³ (determined as if any distribution in liquidation actually made in such taxable year had not been made)¹⁵⁴ if on such last day there had been distributed by the company and received by the shareholders an amount which bears the same ratio to the UFPHCI of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.¹⁵⁵

Based upon this rule, if a FPHC ceases to have a United States Group during the taxable year in question, each United States owner on the last day that such United States Group existed is taxed on his distributive share of the corporation's entire UFPHCI for the year. For example, if the United States Group of a calendar year FPHC ceases to exist on June 30, 1982, the UFPHCI of the corporation for the entire year of 1982 is calculated and each member of the United States Group would include one-half of his distributive share of such income.¹⁵⁶ However, a similar limitation does not apply if the United States Group begins during the year and continues throughout the year. For example, if the United States Group were to begin or come into existence on December 1, 1982, the above limitation does not apply. The United States stockholders on December 31, 1982 would include 100% of the UFPHCI attributable to their shares for the entire year. As a result, acquisition of stock in a foreign corporation during the year could result in purchasing additional UFPHCI and a related tax liability.¹⁵⁷

Finally, a shareholder's distributive share of UFPHCI is defined in terms of a dividend¹⁵⁸ while the 50% stock ownership test is based upon

¹⁵² I.R.C. § 551(b) (1982) characterization as a constructive dividend, however, does not change the shareholder's tax consequences.

¹⁵³ Although such portion of UFPHCI is a dividend, the I.R.C. §§ 116, 243 (1982) exclusions and deductions are not available. See M. MOORE & R. BOGLEY, UNITED STATES TAX ASPECTS OF DOING BUSINESS ABROAD 206 (1978). Also, the foreign tax credit is not available in the context of a constructive distribution. See Rev. Rul. 74-59, 1974-1 C.B. 183.

¹⁵⁴ As a result, UFPHCI cannot be reduced by virtue of a liquidating distribution.

¹⁵⁵ I.R.C. § 551(b) (1982).

¹⁵⁶ See *supra* note 18.

¹⁵⁷ In such a situation, an adjustment should be made to the purchase price of the stock to reflect the additional tax.

¹⁵⁸ I.R.C. § 551(b) (1982).

value.¹⁵⁹ As a result, the distributive share of UFPHCI of a United States Shareholder could differ from an amount based solely on the percentage of actual stock ownership. Consequently, it could be possible that the value of a United States Shareholder's stock interest may exceed say 25%, but less than 25% of UFPHCI is deemed distributed to the United States Shareholder.

2. *Timing Considerations*

The regulations provide that income is included in a shareholder's income for the year in which or with which the FPHC's taxable year ends.¹⁶⁰ As a result, a staggered corporate taxable year end may have the effect of deferring inclusion of UFPHCI in the taxable year of a shareholder.¹⁶¹ In addition, as noted previously, the date on which a United States Group terminates may also affect the amount of taxable income included.¹⁶² However, a determination of the United States Group's existence does not affect the year in which the income is included in the gross income of the United States Shareholders.¹⁶³

Furthermore, substantial confusion exists between the regulations and the courts regarding how much UFPHCI is taxable to a shareholder who is a non-resident alien individual in a foreign corporation and subsequently moves to the United States during the corporation's taxable year thereby subjecting such corporation and its shareholders to the FPHC provisions. The regulations take the position that all of the corporation's UFPHCI for the entire year is includable in gross income.¹⁶⁴ However, in *Marsman v. Commissioner*,¹⁶⁵ the Fourth Circuit Court of Appeals, in addressing the issue under the predecessor to § 551(b), reversed the Tax Court and held that a Philippine citizen that became a United States resident during 1940, need only include the income earned by her wholly owned FPHC during the last 101 days in her gross income as UFPHCI for 1940. Although the Service argued that the regulations require total inclusion of UFPHCI, the court refused to follow the Service's interpretation. The court held that Congress did not intend to tax income that was not subject to the United States taxing jurisdiction prior to the tax-

¹⁵⁹ I.R.C. § 552(a)(2) (1982).

¹⁶⁰ Treas. Reg. § 1.551-2(d) (1958).

¹⁶¹ For example, if a FPHC has a March 31, 1981 year end and the shareholder is on a calendar year, the FPHC's UFPHCI for the year April 1, 1980 to March 31, 1981 will not be taxed to the shareholder until 1981.

¹⁶² See *supra* notes 18, 157 and accompanying text.

¹⁶³ See *supra* note 160.

¹⁶⁴ See *supra* note 18.

¹⁶⁵ *Marsman*, 18 T.C. 1 (1952), *rev'd*, 205 F.2d 335 (4th Cir. 1953).

payer's move to the United States. If the income had been received directly by the taxpayer and not her holding company, it would not have been subject to United States tax.¹⁶⁶

In *Gutierrez v. Commissioner*,¹⁶⁷ the Tax Court refused to follow the *Marsman* decision even though it had previously adopted the Service's position prior to reversal by the Fourth Circuit. Rather, the Tax Court decided to follow the Fourth Circuit's decision and include only a portion of the UFPHCI. However, the Tax Court utilized a different analysis to arrive at the includible amount. The Tax Court held that the percentage should be applied to taxable income based upon a ratio the numerator of which is the number of days such entity qualified as a FPHC, and the denominator of which was 365 days. The *Marsman* court, however, had decided that the proper method was to specifically identify the income earned during the period that the corporation was a FPHC. The *Marsman* rationale was based upon the theory that if the shareholder had earned the income directly instead of through a foreign corporation the income earned up until taking up residency in the United States would not have been subject to United States tax.¹⁶⁸

Although the above decisions do not comport with the regulations, they appear to stand for the proposition that a non-resident who owns a foreign corporation and moves to the United States during the year need not include all of the foreign corporation's UFPHCI in the year residency is established in the United States.

B. Calculating Undistributed Foreign Personal Holding Company Income (UFPHCI)

The statute provides that the phrase UFPHCI means the taxable income of the FPHC adjusted in a manner provided in the statute minus the dividends pay deduction.¹⁶⁹ Furthermore, once UFPHCI has been calculated, such income must be characterized, and consideration must be given to the effect of tiered corporate relationships.

1. Taxable Income

As noted previously, the statute indicates that the starting point for calculation of UFPHCI is the taxable income of the FPHC.¹⁷⁰ For this

¹⁶⁶ *Marsman v. Comm'r*, 205 F.2d 335, 340-41 (19—).

¹⁶⁷ *Gutierrez*, 53 T.C. 394 (1969), *aff'd*, per curiam, 72-1 USTC § 9121 (D.C. Cir. 1971).

¹⁶⁸ See *supra* note 166 and accompanying text.

¹⁶⁹ I.R.C. § 556(a) (1982); I.R.C. § 557 (1982) states that UFPHCI is not subject to annualization under I.R.C. § 443(b) (1982).

¹⁷⁰ *Id.*

purpose, taxable income of the FPHCI is defined in § 63(a) of the Code computed without regard to subchapter N, Chapter 1 of the Code.¹⁷¹

2. Statutory Adjustments

Section 556(b) indicates that taxable income, is required to be adjusted in accordance with the various provisions set forth therein.¹⁷² In calculating UFPHCI there is allowed as a deduction Federal income and excess profits taxes and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under § 275(a)(4)), accrued during the taxable year.¹⁷³ However, no deduction is permitted for the accumulated earnings tax,¹⁷⁴ the personal holding company tax,¹⁷⁵ or the taxes imposed by corresponding sections of prior income tax law. Taxable income is reduced by such taxes based upon the accrual method of accounting regardless of whether the corporation is actually on the cash basis or the accrual basis of accounting for tax purposes.¹⁷⁶ However, a FPHC is not entitled to utilize the foreign tax credit¹⁷⁷ if a deduction for foreign taxes is claimed under § 164.¹⁷⁸

Furthermore, a deduction for charitable contributions provided under § 170 is allowed subject to certain limitations.¹⁷⁹ In addition, the term "contribution base" as utilized in § 170 is redefined and adjusted for purposes of the foreign personal holding company provisions.¹⁸⁰

¹⁷¹ Treas. Reg. § 1.556-1 (1958). A reference must also be made to the calculation of gross income under I.R.C. § 555 (1982).

¹⁷² I.R.C. § 556(b) (1982); Treas. Reg. § 1.556-2 (1958), T.D. 6376, 1959-1 C.B. 147, 149, T.D. 6900, 1966-2 C.B. 72, 97, T.D. 7207, 1972-2 C.B. 106, 160.

¹⁷³ I.R.C. § 556(b)(1) (1982); Treas. Reg. § 1.556-2(a)(1)(i) (1958), T.D. 6376, 1959-1 C.B. 147, 149, T.D. 6900, 1966-2 C.B. 72, 97.

¹⁷⁴ I.R.C. § 531 (1982).

¹⁷⁵ I.R.C. § 541 (1982).

¹⁷⁶ See Treas. Reg. § 1.556-2(a)(1)(i) (1958). However, a contested tax is not considered accrued until the contest is resolved. *Id.*

¹⁷⁷ I.R.C. § 901 (1982).

¹⁷⁸ See I.R.C. § 275(a)(4), 960(b)(3) (1982); Treas. Reg. § 1.960-5 (1971), T.D. 7649, 1979-2 C.B. 274, 279.

¹⁷⁹ I.R.C. § 556(b)(2) (1982).

¹⁸⁰ The contribution base as adjusted for the FPHC provisions is equal to the sum of: (1) the FPHC's taxable income less any net operating loss carry back (without regard to the 5% limitation of I.R.C. § 170(b)(2)); (2) any capital loss carry back under § 170(b)(2)(D) and § 1212(a)(1); (3) property expenses and depreciation (and presumably cost recovery) under § 556(b)(2)(5); (4) taxes paid for shareholders under § 556(2)(6); (5) contributions to pension trusts under § 556(b)(2), (6); and (6) any amounts added to gross income as a deemed distribution from another FPHC under § 556(b)(2) and § 555(b). Charitable deductions are limited to 50% of the contribution base for charitable organization listed in § 170(b)(1)(A) and a significantly lesser percentage for gifts to entities described in § 170(b)(1)(B). However, no carryovers are permitted. Treas. Reg. § 1.556-2(b)(ii) (1958).

Various special deductions permitted corporations provided in part VIII (except § 248) of subchapter B (§ 241 and following, relating to the deduction for dividends received by corporations, etc.) are also not allowed in calculating UFPHCI.¹⁸¹

Although the net operating loss deduction provided in § 172 is not permitted, there is allowed as a deduction the amount of the net operating loss for the preceding taxable year computed without deductions provided in part VIII (except § 248) of subchapter B.¹⁸²

The aggregate of deductions allowed under § 162¹⁸³ and § 167¹⁸⁴ and presumably § 168¹⁸⁵ which are allocable to the operation and maintenance of property owned or operated by the company, are allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Secretary)¹⁸⁶ to the satisfaction of the Secretary: (i) that the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;¹⁸⁷ (ii) that the property was held in the course of a business carried on bona fide for profits;¹⁸⁸ and (iii) either that there was a reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.¹⁸⁹

Finally, deductions provided in § 164(e)¹⁹⁰ and in § 404¹⁹¹ are not allowed in computing UFPHCI.¹⁹²

3. *Distribution Adjustments*

Section 556(a) provides that UFPHCI means the taxable income of a FPHC as adjusted above,¹⁹³ and furthermore, as reduced by the dividends paid deduction as permitted by § 561 of the Code.¹⁹⁴ Section 561 permits a deduction for dividends actually paid during the taxable

¹⁸¹ I.R.C. § 556(b)(3) (1982); Treas. Reg. § 1.556-2(c) (1958).

¹⁸² I.R.C. § 556(b)(4) (1982); Treas. Reg. § 1.556-2(d) (1958).

¹⁸³ I.R.C. § 162 (1982) concerns deductions relating to trade or business expenses.

¹⁸⁴ I.R.C. § 167 (1982) concerns deductions relating to depreciation deductions.

¹⁸⁵ I.R.C. § 168 (1982) concerns deductions relating to cost recovery deductions.

¹⁸⁶ Treas. Reg. § 1.556-2(e) (1958).

¹⁸⁷ I.R.C. § 556(b)(5)(A) (1982).

¹⁸⁸ I.R.C. § 556(b)(5)(B) (1982).

¹⁸⁹ I.R.C. § 556(b)(5)(C) (1982).

¹⁹⁰ I.R.C. § 164(c) (1982) concerns deductions relating to taxes of a shareholder paid by a corporation.

¹⁹¹ I.R.C. § 404 (1982) concerns deductions relating to pensions and trusts, etc.

¹⁹² I.R.C. § 556(b)(6) (1982).

¹⁹³ I.R.C. § 556(b) (1982).

¹⁹⁴ I.R.C. § 556(a) (1982).

year¹⁹⁵ and certain consent dividends for the taxable year.¹⁹⁶ The obvious practical difference between a consent dividend and an actual dividend distribution, is that the shareholder will be taxed on the actual dividend distribution rather than on UFPHCI of which such dividend would have been a part if not distributed. However, substantial tax difference may result by virtue of the fact that a shareholder receives an actual distribution (or consent distribution) rather than UFPHCI.¹⁹⁷

Actual dividend distributions are defined by reference to § 316 and include distributions of money or property out of accumulated or current earnings and profits of the corporate entity.¹⁹⁸ Furthermore, the amount of any distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference.¹⁹⁹ As a result, it is not possible to avoid UFPHCI by creating preferential distributions and retaining profits in the corporation. In addition, the statute specifically indicates that liquidating distributions do not qualify for the dividends paid deduction so to avoid the FPHC tax by eliminating such entity's UFPHCI in the last year.²⁰⁰

Actual dividend distributions received by a shareholder within the taxable year or on or before the 15th day of the third month after the foreign corporation's year end will serve to reduce undistributed foreign personal holding company income.²⁰¹ However, such distribution must be a bona fide distribution subject to withholding rather than a mere paper transaction.²⁰²

Furthermore, § 565 provides that a consent dividend or hypothetical distribution may qualify to reduce undistributed foreign personal

¹⁹⁵ I.R.C. § 561(a)(1) (1982). Rev. Rul. 68-127, 1968-1 C.B. 287 (dividend paid is not reduced proportionately by foreign source income).

¹⁹⁶ I.R.C. § 561(a)(2) (1982). See I.R.C. § 565 (1982). Also, I.R.C. § 561(a)(3) (1982) provides for a dividend carryover in the case of a personal holding company. Although this language applies to a domestic PHC, there is no prohibition against applying the same provision to a FPHC.

¹⁹⁷ For example, in Rev. Rul. 74-59, 1974-1 C.B. 183, the Service ruled in the context of the FPHC provisions that the foreign tax credit applies only to actual distributions.

¹⁹⁸ I.R.C. § 562(b) (1982).

¹⁹⁹ I.R.C. § 562(c) (1982).

²⁰⁰ I.R.C. § 562(b) (1982).

²⁰¹ I.R.C. § 563(c) (1982).

²⁰² The Service could rely on numerous judicial principles to characterize a formative distribution as a sham.

holding company income.²⁰³ A consent dividend is deemed a hypothetical distribution because although the shareholder is taxed on the distribution, such shareholder is deemed to have agreed to reinvest the funds in the corporation thereby receiving a corresponding increase in the basis of his stock.²⁰⁴ In addition, the corporation makes a corresponding decrease in its earnings and profits.²⁰⁵ A consent dividend is classified as a preferential distribution not eligible for the dividends pay deduction unless it is made pro rata or when taken together with actual distributions is a pro rata distribution with respect to all shareholders.²⁰⁶ Such a consent distribution is eligible for dividends pay deduction only to the extent the corporation has earnings and profits from which to distribute a dividend.²⁰⁷

4. Characterizing the Income

Section 551(a) provides that UFPHCI shall be includible in the income of the shareholder in the manner and to the extent set forth in this part.²⁰⁸ Section 551(b) provides that the amount includible in income is includible as a dividend.²⁰⁹ As explained previously, if such dividend distribution is not an actual distribution, it is deemed a constructive dividend distribution to the shareholder.²¹⁰ Under § 316, a distribution is a dividend only if it is made out of accumulated earnings and profits or out of earnings and profits for the current year.²¹¹ If earnings and profits are not present, or if present are insufficient to cover the entire deemed or actual distribution, dividend characterization is not appropriate.²¹² As a result, it is necessary to determine the earnings and profits of the FPHC. In *Untermeyer v. Commissioner*,²¹³ the Board of Tax Appeals held that for purposes of determining the taxability of a dividend from a foreign corporation, earnings and profits are to be determined under United States principles applicable to domestic corporations. As a result, a foreign personal holding company income must refer to § 312 of the Code in order to make such calculation.²¹⁴ In addition, if a dividend is to be

²⁰³ I.R.C. § 565(a) (1982).

²⁰⁴ I.R.C. § 565(c)(2) (1982).

²⁰⁵ Treas. Reg. § 1.565-3(a) (1958), T.D. 6777, 1965-1 C.B. 8, 12 (1964).

²⁰⁶ I.R.C. § 565(b) (1982); Treas. Reg. § 1.565-2(a)-(b) (1958).

²⁰⁷ I.R.C. § 565(b)(1) (1982); Treas. Reg. § 1.565-2(c)(1) (1958).

²⁰⁸ I.R.C. § 551(a) (1982).

²⁰⁹ I.R.C. § 551(b) (1982).

²¹⁰ *Id.*

²¹¹ I.R.C. § 316(a)(1)-(2) (1982).

²¹² See I.R.C. § 301(c)(1)(3) (1982).

²¹³ 24 B.T.A. 906 (1931), *aff'd*, 59 F.2d 1004 (2d Cir. 1932), *cert. denied*, 287 U.S. 647 (1932).

²¹⁴ I.R.C. § 312 (1982).

characterized by reference to a FPHC's earnings and profits, it is fair to conclude that the corporate level tax consequences to a FPHC will be identical to those of a domestic corporation.²¹⁵

5. *Tiered Relationships*

Consideration must also be given to tiered relationships if a FPHC in turn owns stock in another foreign corporation. Under the FPHC rules, the income of a second-tier foreign corporation is not deemed directly includable in the income of the United States Group.²¹⁶ Rather, the attribution rules are applied to determine whether such second-tier entity is a FPHC insofar as the stock ownership test and gross income test is concerned.²¹⁷ If, in fact, the second-tier entity is a FPHC, it is deemed to have distributed its income via a dividend to its corporate shareholder, the first-tier corporation.²¹⁸ If the first-tier corporation is then deemed to be a FPHC (after taking into account the presumptive dividend distribution from the second-tier foreign corporation) then the UFPHCI of the first-tier corporation also includes the UFPHCI of the second-tier which is in turn includible in the income of the United States Group. However, if the first-tier corporation is not a FPHC (after including the presumptive dividend distribution from the second-tier corporation) the income of the first-tier corporation does not include the second-tier corporation's income and such first-tier entity's income is not includible in the gross income of its shareholders unless actually distributed out of earnings and profits. The same principles are applied all the way down the line with respect to multi-tiered relationships.

IV. LIQUIDATION ALTERNATIVES

To this point, the discussion has centered upon the general operation of the FPHC tax provisions, and how such provisions directly affect the shareholders of a FPHC. However, of primary importance, in the FPHC context, is the available alternative methods that shareholders of such an entity may utilize to repatriate foreign earnings to the United States with a minimum of tax impact. Although the shareholders of a FPHC may attempt to minimize the tax impact of repatriating foreign earnings to the United States taxing jurisdiction, the Service normally takes a contrary position and seeks to tax such foreign earnings as ordinary income rather than as more favorably taxed long-term capital gain.

²¹⁵ I.R.C. § 312(a)(1) (1982).

²¹⁶ See *supra* note 18.

²¹⁷ Treas. Reg. § 1.551-2(a) (1958).

²¹⁸ See *supra* note 18.

Furthermore, an intricate statutory structure has been enacted by Congress to prevent, to the greatest extent possible, the conversion of ordinary income into capital gain. As a result, it is necessary to assess the available liquidation alternatives and determine which liquidation technique will minimize the overall tax impact to the shareholders and the FPHC upon repatriation of foreign earnings to the United States taxing jurisdiction.

Basically, the taxing statute provides six (6) alternative methods of liquidating a corporate entity and distributing the assets of such entity to its shareholders. The six (6) alternative liquidation techniques are: (1) A straight liquidation;²¹⁹ (2) A one-month liquidation;²²⁰ (3) A tax deferred subsidiary liquidation;²²¹ (4) A § 338 subsidiary liquidation;²²² (5) A 12-month liquidation;²²³ or (6) A partial liquidation.²²⁴ The following will explore the availability of each liquidation technique, and attempt to assess the circumstances under which each particular alternative may offer a beneficial or least restrictive method of repatriating foreign earnings to the United States taxing jurisdiction.

A. Straight Liquidation

In concept, a straight liquidation is simple and merely involves the distribution of corporate assets to shareholders in complete liquidation and cancellation of their shares of stock. However, ultimate assessment of the tax consequences of a straight liquidation requires an analysis of such tax consequences at both the corporate and shareholder levels.

1. Corporate Level Tax Consequences

In a straight liquidation, the income tax consequences, at the corporate level, for United States federal income tax purposes are governed by § 336 of the Code.²²⁵ As a general rule, since a foreign corporate entity is involved, and such foreign corporation is not normally subject to the

²¹⁹ I.R.C. §§ 336 (liquidating corporation), 331 (shareholder), and 334(a) (basis in assets distributed) (1982).

²²⁰ I.R.C. §§ 336 (liquidating corporation), 333 (shareholder), and 334(c) (basis in assets distributed) (1982).

²²¹ I.R.C. §§ 336 (liquidating corporation), 332 (corporate shareholder), and 334(b)(1) (basis in assets distributed) (1982).

²²² I.R.C. §§ 336 (liquidating corporation), 332 (corporate shareholder), and 338 (general tax consequences and basis in assets distributed) (1982).

²²³ I.R.C. §§ 336 (liquidating corporation), 337 (liquidating corporation), 331 (shareholder) and 334(a) (basis of assets distributed) (1982).

²²⁴ I.R.C. §§ 311 (liquidating corporation), 302 (shareholder) and 334(a) (basis of assets distributed) (1982).

²²⁵ I.R.C. § 336 (1982).

taxing jurisdiction of the United States,²²⁶ the federal tax consequences to such liquidating entity under § 336 are of little import insofar as United States corporate tax consequences are concerned. However, if a foreign corporate entity is subject to the United States taxing jurisdiction,²²⁷ such entity must look to § 336 in order to determine its tax consequences.²²⁸ Furthermore, if the corporate entity involved is not subject to the United States taxing jurisdiction, the corporate tax consequences may indirectly affect income recognition at the shareholder level.²²⁹

Section 336(a) of the Code sets forth the general rule that except as provided elsewhere in the statute²³⁰ and in § 453B,²³¹ no gain or loss will be recognized to a corporation on the distribution of property in complete liquidation.²³² The regulations promulgated under § 336 clarify the point even further by indicating that no gain or loss is recognized regardless of the fact that such property may have appreciated or depreciated in value since its acquisition by the corporation.²³³ The notion expressed in § 336, that a corporation does not recognize gain or loss when it distributes appreciated or depreciated property with respect to its stock, is commonly known as the General Utilities Doctrine named after the landmark Supreme Court case of *General Utilities and Operating Company v. Helvering*.²³⁴ However, this general doctrine has been substantially eroded by numerous statutory²³⁵ and judicial²³⁶ recapture doctrines designed to prevent realization by a corporation and its shareholders of a double tax benefit.

2. Shareholder Level Tax Consequences

In a straight liquidation, the tax consequences of the distributee shareholder are governed by § 331 of the Code.²³⁷ As a general rule,

²²⁶ I.R.C. § 11(d), 882 (1982).

²²⁷ I.R.C. § 882 (1982).

²²⁸ I.R.C. § 336 (1982).

²²⁹ I.R.C. §§ 1246-1248 (1982).

²³⁰ I.R.C. § 336(b) (1982).

²³¹ I.R.C. § 453B (1982) (regarding the disposition of installment obligations).

²³² I.R.C. § 336(a) (1982).

²³³ Treas. Reg. § 1.336-1 (1955).

²³⁴ *General Utils. & Operating Co. v. Comm'r*, 296 U.S. 200 (1935).

²³⁵ I.R.C. § 47 (investment tax credit), I.R.C. § 111 (tax benefit rule), § 1245 (depreciation on personal property), § 1250 (depreciation on real property), § 617(d) (mining exploration expenses) (1982). See also §§ 1252, 1253, 1254 and 1255 (1982).

²³⁶ For discussion of Assignment of Income Doctrine, see *J. Ungar, Inc. v. Comm'r*, 244 F.2d 90 (2d Cir. 1957). For discussion of Tax Benefit Rule, see *Hillsboro Nat'l Bank and Bliss Dairy, Inc.*, 83-1 U.S.T.C. ¶ 9229 (1983). For discussion of Court Holding doctrine, see *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950); *Comm'r v. Court Holding Co.*, 324 U.S. 331 (1945).

²³⁷ I.R.C. § 331 (1982).

§ 331 of the Code provides that the distributee shareholder will be required to recognize gain or loss determined by reference to the difference between the fair market value of assets distributed in the liquidation (net of corporate liabilities assumed)²³⁸ as compared to the basis of such shareholders in their respective stock interests.²³⁹ In the event a foreign entity owns substantially appreciated assets, § 331 requires that the shareholders recognize all inherent gain in the distributed corporate assets reduced only by such shareholder's adjusted basis in their stock and any debts or corporate obligations assumed by the shareholders in liquidation.²⁴⁰ As a result, a significant tax liability could result (even at capital gain rates) upon the distribution of substantially appreciated assets in a straight liquidation of a FPHC.

The primary consideration at the shareholder level in the context of a straight liquidation is the proper characterization of any gain resulting on the liquidation. Ideally, the distributee shareholders would like to characterize such gain as long-term capital gain which is taxed more favorably.²⁴¹ As a general rule, if the distributee shareholder has held his stock as a capital asset²⁴² in excess of one year,²⁴³ and the collapsible corporation provisions²⁴⁴ are not applicable, capital gain will result upon liquidation. However, in the context of a FPHC, gain characterization must also run the gauntlet of § 1248 of the Code in order to achieve capital gain characterization.²⁴⁵ If the FPHC may also be characterized as a foreign investment company, reference must also be made to § 1246 of the Code to determine the proper characterization of any gain recognized on liquidation.²⁴⁶ Potential recharacterization of gain at the shareholder level in the context of a straight liquidation (and other applicable liquidation alternatives) will be discussed in greater detail herein.

B. One-Month Liquidation

In a qualifying one-month liquidation, the shareholders of a qualified corporation may achieve substantial tax benefits by electing the provisions of § 333 of the Code, which governs the tax consequences to the

²³⁸ *Ford v. United States*, 311 F.2d 951 (Ct. Cl. 1963); Rev. Rul. 72-137, 1972-1 C.B. 101.

²³⁹ I.R.C. § 331(a) (1982); Treas. Reg. § 1.331-1(b) (1955), T.D. 6949, 1968-1 C.B. 107, 112.

²⁴⁰ See *supra* notes 237, 239.

²⁴¹ I.R.C. § 1202 (1982).

²⁴² I.R.C. § 1221 (1982).

²⁴³ I.R.C. §§ 1222(3), 1223 (1982).

²⁴⁴ I.R.C. § 341 (1982). See *infra* text accompanying notes 396-399.

²⁴⁵ I.R.C. § 1248 (1982). See *infra* text accompanying notes 313-370.

²⁴⁶ I.R.C. § 1246 (1982). See *infra* text accompanying notes 371-395.

distributee shareholders.²⁴⁷ Any tax consequences at the corporate level in a one-month liquidation are still governed by § 336.²⁴⁸ As a general rule, the shareholders of a qualifying corporation that elect a one-month liquidation will not be required to recognize gain upon the liquidation if such corporate entity does not have cash (or cash equivalents), post-1953 stock or securities, or current or accumulated earnings and profits.²⁴⁹

However, one of the primary requirements for a qualified one-month liquidation is that a "domestic"²⁵⁰ corporation be involved. As a result, since the FPHC provisions apply only to foreign corporate entities,²⁵¹ a FPHC will never constitute a qualified corporation within the meaning of § 333 of the Code, and therefore, the shareholders of a FPHC will not be entitled to elect the benefits otherwise available to shareholders of a qualified domestic corporation under § 333 of the Code.

C. Tax Deferred Subsidiary Liquidation

Despite the significant changes made to the taxation of certain subsidiary liquidations by the Tax Equity and Fiscal Responsibility Act of 1982,²⁵² a tax deferred subsidiary liquidation remains intact.²⁵³ As a general rule, if a domestic corporation receives a distribution (with respect to stock) in complete liquidation from another domestic corporation in which it owns at least 80% of the stock thereof, no gain or loss is recognized at either the distributing corporation level or the distributee shareholder corporate level.²⁵⁴ Basically, § 332 (which sets forth the tax consequences to the distributee corporate shareholder) represents a congressional exception to the straight liquidation provision applicable to shareholders based on the theory that such liquidation really represents a mere change in the form of conducting business.²⁵⁵ Although § 336 still governs the tax consequences to the liquidating corporate subsidiary, no gain or loss will be recognized to the liquidating subsidiary in a qualified tax deferred subsidiary liquidation.²⁵⁶

Although the above theory and treatment operates unhampered in the domestic arena, the regulations promulgated under § 332 indicate

²⁴⁷ I.R.C. § 333 (1982).

²⁴⁸ I.R.C. § 336 (1982).

²⁴⁹ I.R.C. §§ 333(e)-(f) (1982).

²⁵⁰ I.R.C. § 333(a) (1982).

²⁵¹ I.R.C. § 552(a) (1982).

²⁵² I.R.C. §§ 332, 334(b)(2), 338 (1982).

²⁵³ I.R.C. §§ 332, 334(b)(1) (1982).

²⁵⁴ I.R.C. §§ 332 (shareholder), 336(b)(2) (1982).

²⁵⁵ Treas. Reg. § 1.332-1 (1955).

²⁵⁶ I.R.C. § 336(b)(2) (1982).

that § 367 places a limitation on the application of § 332 in the case of a foreign corporation.²⁵⁷ As a result, because a foreign corporation is not usually subject to the United States taxing jurisdiction with respect to earnings abroad, Congress has imposed a limitation that will not permit a foreign subsidiary to be liquidated at a gain without requiring some tax recognition. As a result, the temporary regulations promulgated under § 367 require that a U.S. parent corporation seeking to liquidate a foreign subsidiary under § 332 must include in its gross income the foreign subsidiary's accumulated earnings and profits attributable to the parent stock in such subsidiary.²⁵⁸

If the foreign subsidiary has been very profitable, the inbound toll charge equal to accumulated earnings and profits may constitute a significant tax burden on the domestic parent. As a result, the parent should consider whether it would be cost effective to elect not to pay the inbound toll charge and convert the liquidation to a straight liquidation governed by § 331.²⁵⁹ Under the straight liquidation alternative, gain, and potential dividend exposure is limited to the amount of gain realized on the liquidation.²⁶⁰

However, before determining whether a tax deferred subsidiary liquidation is possible, it is necessary to determine whether a foreign subsidiary, 80% or more of the stock of which is owned by a United States corporate shareholder, may in fact be characterized as a FPHC under § 552(a) of the Code.²⁶¹ As noted previously, in order to be characterized as a FPHC, both a gross income requirement and a stock ownership requirement must be met.²⁶² Although little problem is presented with respect to a foreign subsidiary meeting the gross income requirement, it does not appear that the stock ownership requirement can be met. Section 552(a)(2) provides that in addition to the gross income requirement more than 50% in the value of the FPHC's outstanding stock must be owned, directly or indirectly, by or for not more than five *individuals* who are citizens or residents of the United States.²⁶³ If 80% or more of the stock of a foreign corporation is owned by a United States corporate shareholder (in order to meet the primary stock ownership requirement

²⁵⁷ *Id. supra* note 255.

²⁵⁸ Treas. Reg. § 7.367(b)-2 (1977).

²⁵⁹ I.R.C. § 331 (1982).

²⁶⁰ Treas. Reg. § 1.331-1(b) (1955), T.D. 6949, 1968-1 C.B. 107, 112; I.R.C. §§ 1248, 1246 (1982).

²⁶¹ I.R.C. § 332 (1982).

²⁶² I.R.C. § 552(a)(1)-(2) (1982).

²⁶³ I.R.C. § 552(a)(2) (1982).

of a tax deferred subsidiary liquidation)²⁶⁴ it would seem virtually impossible to attribute more than 50% in the value of the outstanding stock to remaining individual shareholders who are citizens or residents of the United States when, in fact, they would only own, at the most, 20% of the foreign subsidiary stock.²⁶⁵ Therefore, it appears that FPHC status and parent subsidiary status for purposes of a tax deferred subsidiary liquidation, are mutually exclusive and in the context of a FPHC, it will not be possible to repatriate earnings to the United States taxing jurisdiction through utilization of a tax deferred subsidiary liquidation.

D. Section 338 Subsidiary Liquidation

Section 338 of the Code was enacted by the Tax Equity and Fiscal Responsibility Act of 1982 to replace subsidiary liquidations governed by old § 334(b)(2) of the Code.²⁶⁶ Section 338 was enacted to prevent certain perceived abuses utilized by taxpayers under old § 334(b)(2) and to clarify that the statutory provisions of § 338 are intended to govern a qualifying transaction defined only in § 338 thereby displacing the judicial Kimbell-Diamond Doctrine.²⁶⁷

As is the case with a tax deferred subsidiary liquidation, one of the primary requirements of a § 338 subsidiary liquidation is that the acquiring corporate entity "purchase"²⁶⁸ 80% or more of the stock target subsidiary.²⁶⁹ As a result, before a § 338 subsidiary liquidation may operate in the context of a FPHC, one of the shareholders must be a corporate entity which owns 80% or more of the stock in the FPHC. Based upon the stock ownership requirement imposed by § 552(a)(2), 50% in the value of the outstanding stock of the corporation must be owned directly or indirectly by or for not more than five *individuals* who are citizens or residents of the United States. As a result, a § 338 subsidiary liquidation and the FPHC provisions are mutually exclusive.²⁷⁰

E. Twelve-Month Liquidation

Oftentimes, one of the primary purposes for undertaking a liquidation is to acquire assets of the corporation and subsequently dispose of such assets. Prior to enactment of the twelve-month liquidation provi-

²⁶⁴ I.R.C. § 332(b)(1) (1982).

²⁶⁵ *Id.*

²⁶⁶ I.R.C. § 334(b)(2) (1954) and new I.R.C. § 338 (1982).

²⁶⁷ *Kimbell-Diamond Milling Co. v. Comm'r*, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951).

²⁶⁸ I.R.C. § 338(h)(3)(A) (1982).

²⁶⁹ I.R.C. § 338(d)(3), (h)(7) (1982).

²⁷⁰ I.R.C. § 552(a)(2) (1982).

sion under § 337 of the Code,²⁷¹ it was possible for the Service to attribute a sale by shareholders of assets received in a corporate liquidation, to the liquidating corporation.²⁷² The effect of such sale attribution was to subject the liquidating corporation to a tax on the gain resulting from the sale and furthermore impose a second tax on the shareholders when they receive a distribution of the remaining sale proceeds in liquidation.²⁷³ Such recharacterization often turned upon factual determinations regarding which party actually negotiated the sale of the asset.²⁷⁴

In order to alleviate this factual nightmare, § 337 of the Code was enacted to permit either the corporation or its corporate shareholders, or both, to negotiate the sale of corporate assets during a qualified twelve-month liquidation.²⁷⁵ Although § 337 insulates a shareholder from a double tax in this regard, liquidations occurring outside the context of § 337 still run the risk that a sale of the assets by the distributee shareholders shortly after the liquidation may, in fact, be attributed back to the corporation.²⁷⁶

Section 337(a) provides that if within the twelve-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation (less assets retained to meet claims) are distributed in complete liquidation, then no gain or loss will be recognized to such corporation from the sale or exchange by it of property within such twelve-month period.²⁷⁷ Therefore, § 337 may be characterized as a provision which governs the tax consequences of the liquidating corporation with respect to sales occurring between the liquidating corporation and third parties. However, the tax consequences to the liquidating corporations on the distribution of remaining assets and proceeds in liquidation (including proceeds of any sale generated under § 337) are governed by § 336 of the Code.²⁷⁸ In addition, the shareholders, in a twelve-month liquidation, must look to § 331 of the Code, the same provision that governs a shareholder's tax consequences in the context of a straight liquidation.²⁷⁹

Section 337 indicates that its provisions may apply to any corpora-

²⁷¹ I.R.C. § 337 (1982).

²⁷² *Cumberland Public Service Co.*, 338 U.S. 451 (1950); *Court Holding Co.*, 321 U.S. 331 (1945).

²⁷³ *Id.*

²⁷⁴ *Id.*

²⁷⁵ I.R.C. § 337 (1982).

²⁷⁶ I.R.C. § 331 (straight liquidation), 302(e) (partial liquidation) (1982). See B. BITTKER AND J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 11.63, 11-69 (3d Ed. 1971).

²⁷⁷ I.R.C. § 337(a) (1982).

²⁷⁸ I.R.C. § 336 (1982).

²⁷⁹ I.R.C. § 331 (1982).

tion.²⁸⁰ Therefore, since there is no restriction imposed on the word "corporation," it is reasonable to conclude that the benefits of § 337 are available to a domestic and foreign corporation alike unless some other Code provision limits its applicability.²⁸¹ For example, the twelve-month liquidation provisions of § 337 will not apply to a foreign corporation to the extent that such foreign corporation is subject to the collapsible corporation rules of § 341.²⁸² In addition, § 337 will not apply to the sale or exchange of a United States real property interest by a foreign corporation under § 897 of the Code.²⁸³

As mentioned previously, the tax consequences to a distributee shareholder in a twelve-month § 337 liquidation are governed by § 331 of the Code.²⁸⁴ In most instances, such shareholder will recognize capital gain unless such gain is recharacterized by virtue of the collapsible corporation provisions,²⁸⁵ § 1246 or § 1248 of the Code.²⁸⁶ In the event that § 1246 or § 1248 of the Code require a recharacterization of gain at the shareholder level, the impact of § 337 and the extent to which gain recognition is required at the corporate level may have a direct effect upon the character and extent of ordinary income at the shareholder level.²⁸⁷ However, in certain instances, the protection against gain recognition provided by § 337, will minimize the amount of corporate earnings and profits necessary to generate ordinary income under §§ 1246 and 1248.²⁸⁸ The impact of § 1246 and § 1248 on the characterization of a shareholder's gain are discussed in greater detail herein. In any event, the twelve-month liquidation provisions of § 337 present a potentially favorable method for a FPHC to liquidate and repatriate earnings to its U.S. shareholders.

F. Partial Liquidation

Prior to the Tax Equity and Fiscal Responsibility Act of 1982, a partial liquidation was defined under § 346 of the Code.²⁸⁹ However, the Tax Equity and Fiscal Responsibility Act of 1982 substantially revised

²⁸⁰ I.R.C. § 337(a) (1982).

²⁸¹ See I.R.C. § 897(d)(2) (1982).

²⁸² I.R.C. § 341 (1982). See also I.R.C. § 337(c)(1)(A) (1982). *Leisure Time Enterprises, Inc.*, 56 T.C. 1180 (1971).

²⁸³ See *supra* note 281.

²⁸⁴ I.R.C. § 331 (1982).

²⁸⁵ I.R.C. § 341 (1982).

²⁸⁶ I.R.C. §§ 1246, 1248 (1982).

²⁸⁷ I.R.C. § 1248(d)(2) (1982).

²⁸⁸ Treas. Reg. § 1.1248-2(d)(2)(ii) (1964), T.D. 7293, 1973-2 C.B. 228, 247; Treas. Reg. § 1.1248-3(b)(2)(ii) (1964), T.D. 7293, 1973-2, C.B. 228, 248 and T.D. 7545, 245, 248.

²⁸⁹ I.R.C. § 346 (1982).

the treatment accorded partial liquidations. Under old § 346, a partial liquidation was defined as a transaction falling into one of the following three categories: (1) A distribution which was one of a series of distributions leading to a complete liquidation of a corporation;²⁹⁰ (2) A distribution in redemption of part of the stock of the corporation where such distribution was not essentially equivalent to a dividend;²⁹¹ or (3) A distribution that terminated one of two or more active trades or businesses engaged in by the distributing corporation.²⁹² Prior to the Tax Equity and Fiscal Responsibility Act of 1982, § 346 was merely definitional and the operative Code sections were § 336 (with respect to the corporation)²⁹³ and § 331 (with respect to the shareholders).²⁹⁴

The Tax Equity and Fiscal Responsibility Act of 1982 substantially revised the treatment accorded partial liquidations. The definitional provisions normally set forth in old § 346 were moved to § 302(e); under the redemption provisions.²⁹⁵ A series of liquidating distributions, which qualified as a partial liquidation under old § 346, was redefined to constitute a complete liquidation of a corporation.²⁹⁶ The final major change to the partial liquidation provisions prohibited a corporate shareholder from benefiting from § 302 treatment due to abuses that occurred under prior law.²⁹⁷ Furthermore, since the partial liquidation provisions are now contained in § 302 of the Code, § 336 no longer protects gain recognition at the corporate level, and a corporation undertaking a partial liquidation must run the gauntlet of § 311 of the Code in order to determine if gain recognition will occur at the corporate level.²⁹⁸

As a result, in order for a shareholder to benefit from long-term capital gain, in the context of a partial liquidation, sale or exchange treatment must be supplied by § 302 of the Code.²⁹⁹ Furthermore, any capital gain resulting to a shareholder in a qualified partial liquidation, may be recharacterized by §§ 341,³⁰⁰ 1246³⁰¹ or 1248.³⁰² In the event of recharacterization under §§ 1246 and 1248, the impact that § 311 now

²⁹⁰ I.R.C. § 346(a) (1982).

²⁹¹ *Id.*

²⁹² *Id.*

²⁹³ I.R.C. § 336 (1982).

²⁹⁴ I.R.C. § 331(a)(2) (1954).

²⁹⁵ I.R.C. § 302(e) (1982).

²⁹⁶ I.R.C. § 346(a) (1982).

²⁹⁷ I.R.C. §§ 302(b)(4), 302(e)(5) (1982).

²⁹⁸ I.R.C. § 311 (1982).

²⁹⁹ I.R.C. § 302 (1982).

³⁰⁰ I.R.C. § 341 (1982).

³⁰¹ I.R.C. § 1246 (1982).

³⁰² I.R.C. § 1248. (1982).

has at the corporate level (i.e., potential gain recognition and an increase to earnings and profits) in the context of a qualified partial liquidation may ultimately determine the character and extent of gain recognition at the shareholder level.³⁰³ The particulars associated with §§ 341, 1246 and 1248 are discussed in greater detail herein. In any event, it is clear that the partial liquidation provisions of the Code apply to a foreign corporation as well as to domestic corporations, and therefore represent an alternative technique of repatriating earnings to the United States shareholders of a FPHC.³⁰⁴

V. SPECIAL CONSIDERATIONS

The previous analysis has set forth the general rules associated with alternative liquidation techniques involving FPHCs and the general requirements that must be met in order for them to apply. However, due to the fact that a foreign corporation may not necessarily be subject to United States taxation on its corporate earnings, Congress has enacted an intricate statutory scheme, independent of the liquidation rules, to assure that ordinary income, not previously subject to United States tax, may not be repatriated to the United States as capital gain when such earnings would have been taxed as ordinary income had they been earned by a domestic corporation. Therefore, ultimate selection of a liquidation technique will depend on the following statutory considerations that may affect the character and extent of gain recognition in a corporate liquidation: (1) The impact of a § 1248;³⁰⁵ (2) The impact of § 1246;³⁰⁶ (3) Application of the collapsible corporation provisions to foreign corporations;³⁰⁷ (4) Section 367 ruling considerations;³⁰⁸ (5) The dividends paid deduction;³⁰⁹ (6) Controlled foreign corporation overlap;³¹⁰ (7) Treaty considerations;³¹¹ and (8) The Foreign Investment in United States Real Property Act.³¹²

A. Section 1248 Considerations

Section 1248 of the Code was enacted to tax as ordinary income,

³⁰³ I.R.C. §§ 311(d), 1248 (1982).

³⁰⁴ I.R.C. §§ 302, 311 (1982) do not limit their application to domestic corporations.

³⁰⁵ I.R.C. § 1248 (1982).

³⁰⁶ I.R.C. § 1246-1247 (1982).

³⁰⁷ I.R.C. § 341 (1982).

³⁰⁸ I.R.C. § 367 (1982).

³⁰⁹ I.R.C. §§ 561, 562 (1982).

³¹⁰ I.R.C. §§ 951-964 (1982).

³¹¹ See *infra* text Section VG.

³¹² I.R.C. § 897 (1982).

earnings of a foreign corporation that previously escaped United States taxation. However, § 1248 operates on the United States shareholder owning stock in certain corporations by taxing as ordinary income (to the extent of the corporation's earnings and profits), gain recognized on disposition of stock or in other specified distribution transactions.³¹³

1. Parties Affected

The statute provides that a United States person may have dividend income on the sale or exchange of stock or in transactions governed by § 302 or § 331³¹⁴ of the Code with respect to a foreign corporation after December 31, 1962 if at any time during the five-year period ending on the date of the sale or exchange the following two events exist:

1. Such person owns within the meaning of § 958(a), or is considered as owning by applying the rules of ownership of § 958(b), 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the five-year period ending on the date of the sale or exchange;³¹⁵ and

2. The corporation was a controlled foreign corporation within the meaning of § 957 of the Code.³¹⁶

The above two requirements are phrased in the conjunctive and therefore must exist simultaneously. It does not matter which event occurs first. The term "person" is defined under § 7701(1) as including an individual, a trust, estate, partnership, association, company or corporation.³¹⁷

2. Transactions within the Scope of Section 1248

Section 1248(a)(1) identifies three basic transactions within the scope of § 1248: (1) A sale or exchange of stock in a foreign corporation;³¹⁸ (2) A distribution from a foreign corporation governed by § 302 of the Code;³¹⁹ or (3) A distribution from a foreign corporation governed by § 331 of the Code.³²⁰ It is also important to note that § 1248 does not create gain but merely recharacterizes it. Therefore, § 1248 specifically requires that gain recognized on a sale or exchange may be included in gross income as a dividend to the extent of the earnings and profits of the

³¹³ I.R.C. § 1248 (1982).

³¹⁴ I.R.C. § 1248(a)(1) (1982).

³¹⁵ I.R.C. § 1248(a)(2) (1982).

³¹⁶ *Id.*

³¹⁷ I.R.C. § 7701(1) (1982).

³¹⁸ I.R.C. § 1248(a)(1) (1982).

³¹⁹ *Id.*

³²⁰ *Id.*

foreign corporation.³²¹ As a result, the particular transaction involved must be taxable and generate gain recognition.³²² Therefore, if a § 367 ruling is obtained, and gain recognition is avoided, § 1248 would not apply to any gain realized on such a transaction.³²³ This same principle also applies to transactions governed by § 337 of the Code.³²⁴ Furthermore, § 1248 does not apply to: (1) A distribution and redemption of stock to pay death taxes under § 303 of the Code,³²⁵ and (2) The taxation of boot in a reorganization governed by § 356 of the Code.³²⁶

From a practical standpoint, it does not appear that § 1248 would apply to a transaction otherwise treated as a dividend³²⁷ under another section of the Code, as ordinary income³²⁸ or to a transaction involving the sale of an asset held for no more than one year.³²⁹ Based upon the above rule, it is clear that § 1248 could apply to recharacterize gain in a straight liquidation, a twelve-month liquidation under § 337 of the Code and a partial liquidation.

3. *Extent of Gain Recharacterization*

Under § 1248, a United States shareholder will be deemed to have recognized dividend income to the extent of such shareholder's pro rata share of the lesser of: (1) Gain recognized on the sale or exchange or deemed sale or exchange; or (2) Earnings and profits of the corporation accumulated in tax years after December 31, 1962 during the time that such United States person held stock while the foreign corporation involved was a controlled foreign corporation.³³⁰ Gain in excess of the lesser of the previous amounts would generally be treated as capital gain.³³¹ Furthermore, any gain attributable to pre-1963 years or to unrealized depreciation would be taxed as capital gain assuming such stock was held in excess of one year as a capital asset³³² and the collapsible corporation provisions do not apply.³³³

³²¹ I.R.C. § 1248 (1982) (flush language). However, only post December 31, 1962 earnings and profits are taken into account.

³²² *Id.*

³²³ I.R.C. § 367(a)(1) (1982).

³²⁴ I.R.C. § 1248(d)(2) (1982).

³²⁵ I.R.C. § 1248(g)(1) (1982).

³²⁶ I.R.C. § 1248(g)(2) (1982).

³²⁷ I.R.C. § 1248(g)(3)(A) (1982).

³²⁸ I.R.C. § 1248(g)(3)(B) (1982).

³²⁹ I.R.C. § 1248(g)(3)(C) (1982).

³³⁰ I.R.C. § 1248 (1982) (flush paragraph).

³³¹ I.R.C. § 1221 (1982); § I.R.C. § 341 (1982) (this section is probably not applicable).

³³² I.R.C. §§ 1221, 1222(3) (1982).

³³³ I.R.C. § 341 (1982).

As a result, the most important consideration under § 1248 is determining the earnings and profits of the foreign corporation since such earnings and profits will ultimately determine the extent of dividend income. The taxpayer, in this regard, has the burden of proving the correct amount of earnings and profits.³³⁴ A failure to demonstrate the correct earnings and profits will result in the entire gain being treated as a dividend.³³⁵ Although this determination may be somewhat relaxed with respect to corporate shareholders, in the context of a FPHC this will be of little help.³³⁶

4. *Determining Earnings and Profits*

The regulations promulgated under § 1248 provide two alternative methods of computing undistributed earnings and profits with respect to blocks of stock: (1) The simple case method;³³⁷ and (2) The complex case method.³³⁸ Under the simple case method, all computations are based on a single block of stock. For this purpose, the phrase "block of stock" means a group of shares sold or exchanged in one transaction, but only if: (i) the amount realized, basis and holding period are identical for each such share; and (ii) the excess of any § 951 amount included in gross income is identical for each share.³³⁹ One of the specific requirements that must be met for the simple case method to apply to such corporate entity is that on no such day may the corporation be characterized as a FPHC under § 552.³⁴⁰ As a result, if a FPHC is involved, the simple case method for calculating undistributed earnings and profits is not available. In such event, reference must be made to the complex method of computing undistributed earnings and profits.

Under the complex method a "block of stock" means a group of shares sold or exchanged in one transaction only if the amount realized, basis and holding period are identical for each share, and a certain adjustment would be identical for each share if computed separately.³⁴¹ Furthermore, the regulations under the complex method indicate that with respect to a share or block of stock in a foreign corporation, a person's tentative ratable share for the taxable year of the corporation must

³³⁴ I.R.C. § 1248(h) (1982).

³³⁵ *Id.*

³³⁶ Treas. Reg. § 1.1248-1(d) (1964) (regarding the deemed foreign tax credit for CFC foreign taxes).

³³⁷ Treas. Reg. § 1.1248-2 (1964), T.D. 7293, 1973-2 C.B. 228, 247.

³³⁸ Treas. Reg. § 1.1248-3 (1964), T.D. 7293, 1973-2 C.B. 228, 248 and T.D. 7545, 245, 248.

³³⁹ Treas. Reg. § 1.1248-2(b) (1964).

³⁴⁰ Treas. Reg. § 1.1248-2(c)(1)(ii) (1964).

³⁴¹ Treas. Reg. § 1.1248-3(a)(5) (1964).

be reduced by the amount included under § 551 in the gross income of such person during the period such share, or block, was considered to be held by such person by reason of § 1223.³⁴² As a result, double taxation is avoided under § 1248.

Regardless of the method utilized, earnings and profits must be computed in accordance with the regulations promulgated under § 964 of the Code.³⁴³ Although the Code indicates that such rules are substantially similar to those applicable to domestic corporations, the regulations are more complicated in nature and description.³⁴⁴

In order to avoid double taxation, the Code specifically provides that the following items shall be excluded from a determination of earnings and profits: (i) amounts included in gross income under § 951,³⁴⁵ (ii) gain realized from the sale or exchange of property pursuant to a plan of complete liquidation adopted under § 337 of the Code;³⁴⁶ (iii) earnings and profits of a foreign corporation which were accumulated during any taxable year beginning before January 1, 1976 while such corporation was a less developed country corporation under § 902(d) as in effect before enactment of the Tax Reduction Act of 1975;³⁴⁷ (iv) any item included in the gross income of the foreign corporation for any taxable year beginning before January 1, 1967 as income derived from sources within the United States of a foreign corporation engaged in a trade or business within the United States, or for any taxable year beginning after December 31, 1966 as income effectively connected with the conduct by such corporation of a trade or business within the United States as long as such item of income was not exempt from taxation under any treaty obligation of the United States;³⁴⁸ and (v) amounts included in gross income under § 1247 of the Code.³⁴⁹ In addition, the regulations indicate that any amount included in gross income under § 551 dealing with FPHCs, is also excluded from earnings and profits determination.³⁵⁰

Based upon the above rules, it is clear that a twelve-month liquidation under § 337 provides favorable tax benefits to the distributee shareholders and also does not increase earnings and profits under § 1248.

³⁴² Treas. Reg. § 1.1248-3(e)(3) (1964).

³⁴³ Treas. Reg. § 1.1248-2(d)(1) (1964).

³⁴⁴ I.R.C. § 1248(c)(1) (1982).

³⁴⁵ I.R.C. § 1248(d)(1) (1982).

³⁴⁶ I.R.C. § 1248(d)(2) (1982). Regarding inclusion of recapture in earnings and profits under I.R.C. § 1248 (1982), *See* *Brigham v. United States*, 539 F.2d 1312 (3rd Cir. 1976); *Pielmeier v. United States*, 543 F.2d 81 (9th Cir. 1976).

³⁴⁷ I.R.C. § 1248(d)(3) (1982).

³⁴⁸ I.R.C. § 1248(d)(4)(A)-(B) (1982).

³⁴⁹ I.R.C. § 1248(d)(5) (1982).

³⁵⁰ *See supra* note 340.

However, this benefit will only occur if the twelve-month liquidation plan would be available to the corporate entity had it been a domestic corporation.³⁵¹ As a result, if the gain realized were subject to the collapsible corporation provisions of § 341, § 337 would not apply and earnings and profits under § 1248 would be increased accordingly.³⁵²

5. *Limitation on Individual's Tax*

During hearings conducted by the House-Senate Conference Committee at the time of enactment of the Revenue Act of 1962, the lawmakers considered a situation where, due to progressive ordinary income rates, it was possible that an individual could pay more income tax than a domestic corporation.³⁵³ To alleviate this injustice, Congress placed a limitation on the tax applicable to individuals under § 1248.³⁵⁴ Due to the fact, however, that the Economic Recovery Tax Act of 1981 reduced the overall individual tax rate to 50%, the underlying premise of this limitation is now somewhat questionable.³⁵⁵ In any event, such limitation still exists under § 1248.

Basically the limitation provides that an individual's tax on the sale or exchange of stock in a controlled foreign corporation under § 1248 will be no greater than if the foreign corporation had been a domestic corporation, paid only the United States corporate taxes and subsequently made a liquidating distribution that was taxed at capital gains rates. This same limitation was extended to partners under § 1248 by the Revenue Act of 1978.³⁵⁶ In this situation a six-step approach may be utilized to compute the individual taxpayer's limitation. The six steps are as follows: (1) The foreign corporation involved must compute its applicable tax as if it were a domestic corporation;³⁵⁷ (2) The tax determined in Step 1 is reduced by any income tax paid by the foreign corporation;³⁵⁸ (3) The amount of dividend income includable in gross income under § 1248 is computed;³⁵⁹ (4) The difference between the amount of United States tax the foreign corporation would have paid over the United States taxes actually paid is then subtracted from the amount of

³⁵¹ I.R.C. § 1248(d)(2).

³⁵² See I.R.C. § 341 (1982); see also I.R.C. § 337(c)(1)(A) (1982); *Leisure Time Enterprises, Inc.* 56 T.C. 1180.

³⁵³ *Hoover v. United States*, 348 F. Supp. 502 (C.D. Cal. 1972).

³⁵⁴ I.R.C. § 1248(b) (1982).

³⁵⁵ I.R.C. § 1 (1982).

³⁵⁶ I.R.C. § 751(e) (1982).

³⁵⁷ I.R.C. § 1248(b)(1)(A) (1982). However, you must disregard Subchapters F, G, H, L, M, N, S, and T.

³⁵⁸ I.R.C. § 1248(b)(1)(B) (1982).

³⁵⁹ I.R.C. § 1248(b)(2) (1982); *Treas. Reg.* § 1.1248-4(b) (1964).

dividend income determined under Step 3;³⁶⁰ (5) The amount determined under Step 1 is taxed at long-term capital gains rates,³⁶¹ and (6) Steps 5 and 2 are added.³⁶² The overall effect is to avoid bunching of income and the potentially inequitable result occasioned by the progressive tax rates.

6. *Planning Considerations*

As mentioned previously, the provisions of § 1248 will apply only if the United States shareholder owns at least 10% of the total combined voting power of all voting stock and the corporation involved is a CFC within the meaning of § 957.³⁶³ Although it is possible to have a corporate entity meet the definition of a FPHC and the CFC at the same time, to the extent that a FPHC may avoid classification as a CFC, the provisions of § 1248 will not apply.³⁶⁴ Furthermore, to the extent that an FPHC is also a CFC, and the provisions of § 1248 will apply, beneficial tax results may occur by virtue of electing a twelve-month liquidation under § 337 of the Code.³⁶⁵ In computing earnings and profits of the corporation to determine dividend income at the shareholder level, amounts previously included in income under § 551 are excluded from the earnings and profits computation.³⁶⁶ In addition, any gain realized but unrecognized by virtue of § 337 will not increase corporate earnings and profits.³⁶⁷ Therefore, § 337 constitutes a statutorily permitted limitation on dividend income recognition at the shareholder level. Furthermore, if a § 337 twelve-month liquidation is elected, a subsequent sale of assets distributed in liquidation may not be attributed to the corporation.³⁶⁸ However, in the context of a straight liquidation or a partial liquidation, a subsequent disposition by the shareholders, of assets received in liquidation, may invoke application of the judicially formulated Court Holding Company doctrine which may attribute such sale back to the corporation thereby potentially increasing corporate earnings and profits and the amount of ordinary income recognition at the shareholder level.³⁶⁹ Furthermore, utilization of a partial liquidation will now invoke

³⁶⁰ Treas. Reg. § 1.1248-4(c)(1) (1964).

³⁶¹ I.R.C. § 1248(b)(2) (1982).

³⁶² I.R.C. § 1248(b) (1982).

³⁶³ I.R.C. § 1248(a)(2) (1982).

³⁶⁴ *Id.*

³⁶⁵ I.R.C. § 1248(d)(2) (1982).

³⁶⁶ See *supra* note 340.

³⁶⁷ I.R.C. § 1248(d)(2) (1982). However, consider the impact of recapture. See *Brigham*, 539 F.2d 1312; *Pielmeir*, 543 F.2d 81.

³⁶⁸ I.R.C. § 337 (1982). See *Cumberland Public Service Co.*, 338 U.S. 451 (1950); *Court Holding Co.*, 321 U.S. 331.

³⁶⁹ See *supra* note 276.

application of § 311 which may create gain at the corporate level, thereby increasing corporate earnings and profits and ordinary income gain recognition at the shareholder level.³⁷⁰

B. Section 1246 Considerations

Just as a FPHC may also qualify as a CFC and invoke application of § 1248, it is also possible that a FPHC may also be classified as a foreign investment company thereby invoking application of § 1246.³⁷¹ As a result, it is also necessary to determine the circumstances under which § 1246 may apply to recharacterize income recognized upon the liquidation of an FPHC.

1. *General Rule*

Section 1246(a) provides that in the case of a sale, exchange or distribution governed by § 302 or § 331, occurring after December 31, 1962, of stock in a foreign corporation which was a foreign investment company at any time during the period during which the taxpayer held such stock, any gain shall be treated as ordinary income to the extent of the taxpayer's ratable share of earnings and profits of such corporation accumulated for taxable years beginning after December 31, 1962.³⁷² For purposes of determining earnings and profits, a taxpayer's ratable share thereof will be determined under regulations prescribed by the Secretary but shall only include his ratable share of accumulated earnings and profits of the corporation for the period during which the taxpayer held the stock.³⁷³ However, earnings and profits do not include any amount previously included in gross income of the taxpayer under § 951, but only to the extent an exclusion did not occur by virtue of § 959, or any taxable year during which such corporation was not a foreign investment company but only if: (i) the corporation was not a foreign investment company at any time before such taxable year; and (ii) such corporation was treated as a foreign investment company solely by reason of § 1246(b)(2).³⁷⁴ The burden is on the taxpayer to establish the correct amount of the accumulated earnings and profits of the foreign investment company and his ratable share thereof.³⁷⁵ If the taxpayer is unable to determine the correct amount of accumulated earnings and profits and

³⁷⁰ I.R.C. §§ 302, 311 (1982).

³⁷¹ I.R.C. § 1246 (1982).

³⁷² I.R.C. § 1246(a)(1) (1982).

³⁷³ I.R.C. § 1246(a)(2)(A) (1982).

³⁷⁴ I.R.C. § 1246(a)(2)(B) (1982).

³⁷⁵ I.R.C. § 1246(a)(3) (1982).

his ratable share thereof, all gain from the sale or exchange of the stock will be considered as ordinary income.³⁷⁶ Furthermore, the foreign investment company stock must meet certain holding requirements specified in the statute in order for § 1246 to apply.³⁷⁷

2. *Definition of Foreign Investment Company*

Section 1246(b) provides that the phrase "foreign investment company" means any foreign corporation which, for any taxable year beginning after December 31, 1962 is: (i) registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2) either as a management company or as a unit investment trust; or (ii) engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (within the meaning of § 3(a)(1) of such Act, as limited by paragraphs (2) through (10) (except paragraph (6)(C)) and paragraphs (12) through (15) of § 3(c) of such Act) at a time when more than 50% of the total combined voting power of all classes of stock entitled to vote, or of the total value of shares of all classes of stock, was held, directly or indirectly (within the meaning of § 958(a)), by United States persons (as defined in §§ 7701(a)(30)).³⁷⁸ The section further provides that a foreign investment company stock will continue to be classified as such if it is exchanged for stock the basis of which is determined by reference to the basis of stock in a foreign investment company.³⁷⁹ Furthermore, characterization as a foreign investment company cannot be avoided by transferring such stock to another entity in exchange for other stock.³⁸⁰ Special rules apply to stock acquired from a decedent.³⁸¹ Every United States person who on the last day of the taxable year of a foreign investment company, owns 5% or more in the value of the stock of such company is required to furnish an information report to the Secretary with respect to such company in accordance with the regulations.³⁸² Section 312(j) provides special earnings and profits rules with respect to foreign investment companies so defined under § 1246.³⁸³

³⁷⁶ *Id.*

³⁷⁷ I.R.C. § 1246(a)(4) (1982).

³⁷⁸ I.R.C. § 1246(b)(1)-(2) (1982).

³⁷⁹ I.R.C. § 1246(c) (1982).

³⁸⁰ I.R.C. § 1246(d)(1)-(2) (1982).

³⁸¹ I.R.C. § 1246(e) (1982).

³⁸² I.R.C. § 1246(f) (1982).

³⁸³ I.R.C. § 1246(g) (1982).

3. Election Under Section 1247

As indicated by the above rules, the thrust of § 1246 is to assure that accumulated earnings and profits, not subject to the United States taxing jurisdiction, will be taxed as ordinary income if an appropriate event described in § 1246 occurs. However, if the accumulated earnings and profits are otherwise subject to United States taxation § 1246 may be avoided. In this regard, § 1247 provides that if a foreign investment company subject to § 1246 distributes to its shareholders 90% or more of what its taxable income would be if it were a domestic corporation, § 1246 may be avoided.³⁸⁴ In order to make the election, a foreign investment company, within the meaning of the statute, must meet the following three requirements: (i) distribute to its shareholders 90% or more of what its taxable income would be if it were a domestic corporation;³⁸⁵ (ii) designate in a written notice mailed to its shareholders at any time before the expiration of 45 days after the close of its taxable year the pro rata amount of the amount (determined as if the corporation were a domestic corporation) of the net capital gain of the taxable year; and the portion thereof which is being distributed;³⁸⁶ and (iii) provide such information as the Secretary deems necessary to carry out the purpose of § 1246 as set forth in the regulations.³⁸⁷

For purposes of computing taxable income, the corporation will compute its taxable income the same as a domestic corporation without regard to: (1) corporate net capital gain;³⁸⁸ (2) the § 172 net operating loss reduction;³⁸⁹ and (3) any deduction provided by part VIII of subchapter B (other than the deduction provided by § 248, relating to organizational expenditures).³⁹⁰ For purposes of distributing 90% or more of the corporation's taxable income, a distribution made after the close of the taxable year and on or before the 15th day of the third month of the next taxable year is treated as a distribution during the taxable year to the extent elected by the company on or before the 15th day of the third month.³⁹¹ Furthermore, in computing net capital gain, the capital loss carry over permitted under § 1212 is not applied to losses incurred in or with respect to taxable years before the first taxable year to which the

³⁸⁴ I.R.C. § 1247(a)(1)(A) (1982).

³⁸⁵ *Id.*

³⁸⁶ I.R.C. § 1247(a)(1)(B) (1982).

³⁸⁷ I.R.C. § 1247(a)(1)(C) (1982).

³⁸⁸ I.R.C. § 1247(a)(2)(A)(i) (1982).

³⁸⁹ I.R.C. § 1247(a)(2)(A)(ii) (1982).

³⁹⁰ I.R.C. § 1247(a)(2)(A)(iii) (1982).

³⁹¹ I.R.C. § 1247(a)(2)(B) (1982).

election applies.³⁹²

Once the election is made, it continues until terminated by one of the following three events: (i) the company fails to comply with the provisions specified above unless it is shown that such failure is due to reasonable cause and not due to willful neglect;³⁹³ (ii) the company is a FPHC;³⁹⁴ or (iii) the company is not a foreign investment company which is described in § 1246(b)(1).³⁹⁵ Therefore, if the corporate entity involved is a FPHC, the election under § 1247 will not shield the shareholders of such corporation from the imposition of § 1246 recharacterization.

C. Applying the Collapsible Corporation Provisions

Section 341 of the Code refers to corporations generically and does not impose a restriction that such entity be domestic or foreign.³⁹⁶ As a result, it is clear that § 341 will apply to foreign corporations which are collapsible within the meaning of the statute. As a result, § 341 may apply as an independent statutory provision capable of recharacterizing gain to shareholders engaged in the liquidation of an FPHC. Section 341(a) recharacterizes long-term capital gain resulting from the sale or exchange of stock held as a capital asset into ordinary income.³⁹⁷ Therefore, if a FPHC falls within the definition of a collapsible corporation,³⁹⁸ a resulting liquidation may generate ordinary income to the shareholders. Although a detailed analysis of § 341 and its applicable provisions is beyond the scope of this article, it is accurate to state that any liquidation of a FPHC must take into account the provisions of § 341 and if, in fact, the FPHC is found to be a collapsible corporation, the shareholder should explore the various means of escaping application of § 341³⁹⁹ in order to preserve potential long-term capital gain that may result upon the liquidation.

D. Section 367 Ruling Considerations

After enactment of the Tax Reform Act of 1976, and the applicable changes made to § 367, the shareholder of a FPHC must be concerned with the following two basic categories of transactions within the scope

³⁹² I.R.C. § 1247(a)(2)(C) (1982).

³⁹³ I.R.C. § 1247(b)(1) (1982).

³⁹⁴ I.R.C. § 1247(b)(2) (1982).

³⁹⁵ I.R.C. § 1247(b)(3) (1982).

³⁹⁶ I.R.C. § 341 (1982).

³⁹⁷ I.R.C. § 341(a)(1)-(3) (1982).

³⁹⁸ I.R.C. § 341(b) (1982).

³⁹⁹ I.R.C. § 341(d)-(f) (1982).

of § 367: (i) outbound transactions;⁴⁰⁰ and (ii) inbound and foreign transactions.⁴⁰¹ An outbound transaction may be loosely defined as a transfer of property by a United States person to a foreign corporate entity. As a general rule, the transferor must first request a ruling from the Service that the transaction is not made in pursuance of a plan having as one of its principle purposes, the avoidance of United States income tax.⁴⁰² Such request must be filed within 183 days of the beginning of the transfer.⁴⁰³ In the event such request is not made or if the request is made but denied by the Service, the foreign corporation is denied status as a corporation for purposes of United States tax and gain is assessed appropriately.⁴⁰⁴

By contrast, an inbound transaction generally involves property moving into the United States, such as the liquidation into a United States parent of a foreign subsidiary.⁴⁰⁵ Furthermore, exclusively foreign transactions are also generally governed by the rules relating to inbound transactions.⁴⁰⁶ Under the inbound and exclusively foreign transaction rules, no ruling is necessary for an exchange beginning after December 31, 1977.⁴⁰⁷ The foreign corporation will be generally treated as a corporation except to the extent the regulations otherwise provide. However, § 367 provides that its scope is generally concerned with transactions described in §§ 332, 351, 354, 355, 356, or 361 of the Code.⁴⁰⁸ In the context of a FPHC liquidation, none of the above Code sections will operate and therefore § 367 would have no effect.⁴⁰⁹ Furthermore, taxpayers utilizing the § 367 provisions generally attempt to avoid recognition of income on the particular transaction involved. As a general rule, in the liquidation context, gain or loss will be recognized, and the taxpayer's foremost planning objective is generally directed at seeking capital gain characterization of such income rather than avoiding income recognition.

E. Dividends Paid Deduction

Section 556 of the Code provides that subsequent to the calculation

⁴⁰⁰ I.R.C. § 367(a)(1) (1982).

⁴⁰¹ I.R.C. § 367(b) (1982); Treas. Reg. § 7.367(b)-1 (1977).

⁴⁰² I.R.C. § 367(a)(1) (1982).

⁴⁰³ *Id.*

⁴⁰⁴ *Id.*

⁴⁰⁵ Treas. Reg. 7.367(b)-1(a) (1977).

⁴⁰⁶ Treas. Reg. 7.367(b)-5 (1977).

⁴⁰⁷ *Id.*

⁴⁰⁸ I.R.C. § 367(a)(1) (1982).

⁴⁰⁹ *See supra* text accompanying notes 252-265.

of UFPHCI, such amount must be reduced by the dividends paid deduction.⁴¹⁰ Section 561(a) provides that a deduction for dividends shall be equal to the sum of: (i) dividends paid during the taxable year;⁴¹¹ (ii) consent dividends for the taxable year as defined under § 565;⁴¹² and (iii) in the case of a personal holding company, any carry over dividend amounts.⁴¹³ In the context of liquidating a FPHC, the question arises whether utilization of the dividends paid deduction will reduce the overall amount of corporate earnings and profits thereby minimizing the tax impact upon a liquidation. However, § 562(b) provides that the dividends paid deduction will not apply in the case of a FPHC in the context of a liquidation. Therefore, liquidating distributions by a FPHC do not qualify for the dividends paid deduction.⁴¹⁴

F. Controlled Foreign Corporation Overlap

The statute specifically contemplates that a FPHC and a CFC may be characterized under the tax law that applies simultaneously to a single corporate entity.⁴¹⁵ However, the thrust of the FPHC provisions and the CFC provisions are to tax, as ordinary income, amounts that have previously escaped United States taxation. The purpose of these provisions is not to tax twice the same amounts of income. As a result, if both the FPHC provisions and the CFC provisions apply, the FPHC provisions have priority.⁴¹⁶ However, due to the broad scope of the CFC provisions, in the event a corporate entity avoids status as a FPHC, it is still possible that such entity may be characterized as a CFC. Furthermore, special rules apply in the context of the CFC provisions to FPHC income. As a result, in the context of assessing the tax impact of liquidating a FPHC, it will also be necessary to determine whether such FPHC may also be classified as a CFC in order to assure that any planning in this area does not become a trap for the unwary.

G. Treaty Considerations

Once the tax consequences under the Code have been determined, with respect to liquidation of a FPHC, it is also necessary to determine the impact of any treaty obligations that the United States might have with the country in which the foreign corporation is located. As is often

⁴¹⁰ I.R.C. § 556(a) (1982).

⁴¹¹ I.R.C. § 561(a)(1) (1982).

⁴¹² I.R.C. § 561(a)(2) (1982).

⁴¹³ I.R.C. § 561(a)(3) (1982).

⁴¹⁴ I.R.C. § 562(b)(1) (1982).

⁴¹⁵ I.R.C. § 951(d) (1982).

⁴¹⁶ *Id.*

the case, favorable tax benefits may be granted under the treaty provisions to capital gain and/or dividend income. Since both of these characterizations are possible in the context of liquidating a FPHC, it is imperative to assess the availability of potential tax benefits under applicable treaty obligations.

H. Foreign Investment in United States Real Property

Prior to enactment of the Foreign Investment in Real Property Act of 1980,⁴¹⁷ it was common practice for foreign corporations to dispose of United States real property interests and avoid taxation thereon. However, with enactment of § 897 of the Code, dispositions by foreign individuals and/or entities of investments in United States real property and/or a United States real property holding company are treated as though such gain were effectively connected with the conduct of a United States trade or business.⁴¹⁸ Therefore, such a foreign entity and/or individual will be taxed in much the same manner as a domestic corporation or individual with respect to United States real property interests. In certain limited circumstances, however, treaty provisions may supercede § 897 at least through December 31, 1984.⁴¹⁹

In addition, due to the broad impact of new § 897, if a FPHC invests in a United States real property interest and/or a United States real property holding corporation, such investments may have a significant impact on the method of liquidation ultimately selected by the FPHC. For example, § 897 provides that a § 337 twelve-month liquidation will not apply to any sale or exchange of any United States real property interests by a foreign corporation.⁴²⁰ Therefore, to the extent a FPHC may have relied upon § 337 to avoid the increase in earnings and profits granted by § 1248, untended tax benefits may result if it is determined that § 897 applies to the FPHC.⁴²¹

These are also special rules which apply to certain United States shareholders of liquidating foreign corporations. Under § 897(1) if a corporation adopts a plan of complete liquidation and if, solely by reason of § 897(d), § 337(a) does not apply to the sale or exchange, or § 336 does not apply to distributions, of United States real property interests by such corporation, then, in the case of any shareholder who is a United States citizen or resident and who has held stock in such corporation

⁴¹⁷ I.R.C. § 897 (1982).

⁴¹⁸ I.R.C. § 897(a) (1982).

⁴¹⁹ This special rule applies with respect to Canada and the United States.

⁴²⁰ I.R.C. § 897(d)(2) (1982).

⁴²¹ I.R.C. § 1248(d)(2) (1982).

continuously since June 18, 1980 for the first taxable year of such shareholder in which he receives a distribution in complete liquidation with respect to such stock: (i) the amount realized by such shareholder on the distribution shall be increased by his proportionate share of the amount by which the tax imposed of such corporation would have been reduced if § 897(d) had not been applicable; and (ii) such shareholder shall be deemed to have paid, on the last day prescribed by law for the payment of the tax imposed on such shareholder for such taxable year, an amount of tax equal to the amount of the increase described § 897(1).⁴²² In effect, § 897(1) grants certain United States shareholders tax treatment as if the corporate entity involved had been entitled to utilize the benefits of § 337. This rule is very similar to the one granted minority shareholders under § 337(d).⁴²³

Although a complete analysis of § 897 is beyond the scope of this article, it is imperative that a FPHC and its shareholders assess the impact of § 897 on any proposed liquidation involving United States real property interests.

VI. CONCLUSION

As indicated by the above analysis, the liquidation of a FPHC involves careful planning and an ability to weave one's way through an intricate maze of statutory rules. Furthermore, from a practical standpoint it is necessary to have access to all corporate records of a foreign entity in order to determine such corporate entity's earnings and profits from inception to the date of liquidation. Without a careful analysis of the history of the foreign corporation involved and the intricate statutory structure imposed by Congress to assure that earnings are taxed in accordance with their true character, the liquidation of a FPHC may generate unintended and unfavorable tax consequences.

⁴²² I.R.C. § 897(1) (1982).

⁴²³ I.R.C. § 337(d) (1982).