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# Tax Symposium: Subpart F, 1986 and Beyond

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## SUBPART F, 1986 AND BEYOND

Walter D. Schwidetzky†

### I. INTRODUCTION

Few areas of the tax code are as complex as the foreign tax provisions. To a large extent this complexity is unavoidable. The reach of the U.S. Treasury is not infinite. As in all areas of taxation, lines have to be drawn, and once they are drawn, methods have to be devised to prevent taxpayers from pretending to be on the far side of the line when they are actually on the near side. Developing those methods in the foreign tax area is exceptionally difficult. In part this is because the benefits to be obtained by taxpayers who properly place themselves outside of the reach of the U.S. Government are great, namely the avoidance of U.S. taxation altogether. When the benefits are great, so are the efforts of the taxpayers to achieve them. An often involved set of rules is needed to deal with taxpayers' increased level of creativity.

Adequate safeguards are also difficult to develop because adding foreign transactions to the tax mix increases exponentially the approaches taxpayers can take. For example, in the domestic corporate context there are U.S. corporations and U.S. shareholders. In an international corporate setting there might be domestic corporations with foreign shareholders, foreign corporations with domestic shareholders, foreign or domestic corporations with foreign and domestic shareholders and either foreign control or domestic control, foreign corporations formed in tax haven jurisdictions, foreign corporations formed in non-tax havens, and foreign corporations formed in countries with which the United States has, or has not, made income tax treaties.

The approach Congress has often taken is to provide an alternative response to each situation. As a consequence, U.S. taxation of foreign transactions, in addition to being highly involved, has also been highly fluid. Substantial revisions (such as those of the Tax Reform Act of 1986) are frequently made as Congress learns more about the foreign and domestic transactions and the varying and often impressively imaginative approaches of taxpayers.

This article will review and analyze one part of the picture, subpart F,<sup>1</sup> in light of modifications enacted by the Tax Reform Act of 1986.<sup>2</sup> The article will also discuss whether subpart F represents the best

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1. I.R.C. §§ 951-964 (1982 & West Supp. 1988) (subpart F is contained in part III of subchapter N).  
2. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

method of dealing with its subject, or whether this is one area where a simpler, more pervasive approach, would ultimately better serve not only the revenue and policy goals of Congress, but also the needs of taxpayers for reliable guidance and comprehensible tax provisions.

## II. AN OVERVIEW

### A. Relevant Foreign Tax Provisions

A domestic corporation, one incorporated in the United States, is taxable on its worldwide income.<sup>3</sup> Conversely, a foreign corporation, one formed under the laws of a foreign country, generally is only subject to domestic taxation on investment income payable by sources within the United States or by U.S. citizens, resident aliens and domestic corporations,<sup>4</sup> and on "income effectively connected with the conduct of a trade or business within the United States."<sup>5</sup> To qualify under the effectively connected test, the income generally must arise out of a U.S. trade or business.<sup>6</sup> Certain foreign source income and loss, however, can be deemed to be effectively connected with a U.S. trade or business.<sup>7</sup>

Subject to treaty limitations, foreign corporation's income that is taxable by the United States will be subject to a 30% withholding tax on gross income,<sup>8</sup> unless the income is effectively connected with a domestic trade or business, in which case it will be subject to the normal graduated corporate tax on its taxable income.<sup>9</sup> Taxpayers often prefer that their income fall within the effectively connected test, since this permits them to deduct their related expenses in computing taxable income, and the maximum rate on taxable income generally is 28%, less than the 30% withholding tax on gross income.<sup>10</sup> Certain U.S. source income is not taxed to foreign corporations<sup>11</sup> (perhaps most importantly portfolio

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3. Treas. Reg. § 1.11-1(a) (1979).

4. I.R.C. §§ 861, 862, 863, 881 (1982 & West Supp. 1988).

5. *Id.* § 882 (1982 & West Supp. 1988).

6. *Id.*

7. Income, gain, or loss from foreign sources will be treated as effectively connected with a U.S. trade or business if the foreign taxpayer has an office or other fixed place of business in the United States to which the income, gain or loss is attributable, provided the income, gain or loss consists of (1) rents or royalties derived in the active conduct of the trade or business from the use of, or gains and losses derived in the active conduct of a trade or business from the disposition of intangible property or (2) dividends, interest, or gains and losses from the sale of stock and securities or notes, bonds or other evidences of indebtedness (a) derived in the ordinary course of a banking, financing or similar business conducted within the United States or (b) received by a corporation, the principal business of which is trading stock or securities for its own account. I.R.C. § 864(c)(4) (West Supp. 1988); Treas. Reg. § 1.864-4, -5(a), (b) (1983). See I.R.C. § 865 (West Supp. 1988) (for sourcing personal property sales). See *POSTELWAITE* *infra* note 15, § 2.27.

8. I.R.C. § 881(a) (1982 & West Supp. 1988); Treas. Reg. § 1.881-2(a)(2), (3) (1973). See *Postelwaite* *infra* note 15, § 401-4.17.

9. I.R.C. § 882(a) (1982 & West Supp. 1988).

10. *Id.* § 882(c).

11. *Id.* § 881(c), (d) (West Supp. 1988).

interest<sup>12</sup>).

Because most foreign income earned by a foreign corporation lacks the required U.S. nexus to permit U.S. taxation under the rules discussed above, U.S. persons engaged in foreign business and investment prior to 1962 had an incentive to create foreign corporations in low tax foreign jurisdictions to conduct their activities. In many foreign jurisdictions the income of the foreign corporation was subject to a lower corporate level tax than if the corporation had been incorporated in the United States. Domestic shareholders owed no U.S. tax until funds were distributed from the foreign corporation.<sup>13</sup> The foreign corporation could reinvest the resulting tax savings, generating additional earnings. A number of countries enacted favorable tax legislation designed to encourage incorporation within their jurisdiction.<sup>14</sup> Their gain through fees and similar types of receipts was the U.S. government's tax revenue loss.

Congress, unwilling to cede tax revenues, investment funds, or business opportunities to foreign countries, and unsatisfied with the often uncertain application of traditional tools, such as section 482 and the step transaction and the assignment of income doctrines,<sup>15</sup> reacted in a number of ways. One response has been the Foreign Personal Holding Company (FPHC) provisions, which impute income to domestic shareholders who incorporate their foreign portfolio investments.<sup>16</sup> These rules principally apply to passive income earned by foreign corporations which are closely held by individuals, and are of limited application given this focus.<sup>17</sup> In 1962, Congress, desiring a more prophylactic approach, also enacted subpart F, which taxes U.S. shareholders currently on certain classes of (typically undistributed) income earned by foreign corporations which the U.S. shareholders control.<sup>18</sup> The subject income is

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12. *Id.* § 881(c) (West Supp. 1988). Portfolio interest generally consists of interest on nonregistered debt and does not include interest received by a 10% shareholder. *Id.* § 881(c)(3)(B) (West Supp. 1988).
  13. The law changed in 1962. See *infra* note 18 and accompanying text.
  14. See, e.g., 1 W. DIAMOND & D. DIAMOND, *TAX HAVENS OF THE WORLD* (1981).
  15. P. POSTELWAITE, *INTERNATIONAL CORPORATE TAXATION* § 12.03 (1980). See S. REP. NO. 1881, 87th Cong., 2d Sess. 78 (1962). The step transaction doctrine permits the government to collapse the taxpayer's sham like steps, and look at the substance of the transaction. See B. BITTKER, *FUNDAMENTALS OF FEDERAL INCOME TAXATION* § 1.5 (1983) [hereinafter BITTKER]. The assignment of income doctrine prevents one taxpayer from assigning income, and therefore the income tax liability, to another. BITTKER, *supra*, § 30.1-4. Under I.R.C. § 482 (West Supp. 1988) the Service may allocate income from one taxpayer (e.g. a foreign subsidiary) to another (e.g. the U.S. parent) to prevent the evasion of taxes or to clearly reflect income. See also I.R.C. § 269 (1982 & West Supp. 1988) (deductions disallowed for acquisitions made to evade or avoid income tax).
  16. I.R.C. §§ 551-558 (1982 & West Supp. 1988).
  17. The FPHC rules apply if, generally, 60% of the gross income is FPHC (essentially passive) income and more than 50% of the stock is held by not more than five individuals who are citizens or residents of the United States. I.R.C. § 552 (1982 & West Supp. 1988). See POSTELWAITE *supra* note 15, § 11.
  18. I.R.C. §§ 951-964 (1982 & West Supp. 1988). See generally, POSTELWAITE *supra* note 15, § 12; R. FEINSCHREIBER, *SUBPART F — FOREIGN SUBSIDIARIES AND*

entitled, unsurprisingly, "subpart F income."<sup>19</sup>

Congress felt that the reach of subpart F, as enacted prior to 1986, was inadequate and that U.S. taxpayers could continue inappropriately to defer U.S. taxation on income earned through U.S. controlled foreign corporations.<sup>20</sup> As part of the full court press that was the Tax Reform Act of 1986 (TRA '86), Congress broadened the application of subpart F in an attempt to eliminate any tax incentive U.S. taxpayers might have to conduct investment and business activities through foreign corporations or in foreign jurisdictions.<sup>21</sup> The TRA '86 generally narrows the exceptions to the application of subpart F and brings certain other types of income that are perceived to be particularly susceptible to manipulation within subpart F's coverage.<sup>22</sup> The numbing trade deficit did cause Congress to make an exception for certain export related transactions.<sup>23</sup>

### B. Subpart F, The Basics

An extended review of the operation of subpart F is beyond the scope of this article. In order to make this article's discussion of the 1986 amendments comprehensible to the uninitiated, however, a primer on the manner in which subpart F functions is appropriate.

Subpart F does not apply normally to investments in the stock of publicly held foreign corporations. Therefore, as is the case with publicly held domestic corporations, no portion of the corporate income of a publicly held foreign corporation is taxed to the investing shareholders.<sup>24</sup> The focus rather is on U.S. taxpayers who interpose a closely held foreign corporation between them and their foreign business or foreign invest-

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THEIR TAX CONSEQUENCES (1979); R. HOADES & M. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS (1984); S. VASEK, HOW A CFC'S INVESTMENT IN U.S. PROPERTY AFFECTS U.S. TAXES AND HOW TO COMPUTE A CFC'S INVESTMENT IN U.S. PROPERTY IN U.S. TAXATION OR INTERNATIONAL OPERATIONS, ¶ 7509-10 (1983); M. LAUGER, PRACTICAL INTERNATIONAL TAX PLANNING (1977); BICHEL & FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION, ch. 7 (1977); GIFFORD & STRENG, INTERNATIONAL TAX PLANNING, 377-449 (2d ed. 1979).

19. I.R.C. § 952 (1982 & West Supp. 1988). Tax Code drafters are not well known for their imagination.
20. See H.R. REP. NO. 79-277, 99th Cong., 1st Sess. 391-92 (1985).
21. See *infra* notes 79-277 and accompanying text.
22. *Id.*
23. I.R.C. § 954(c)(2)(B) (West Supp. 1988); see *infra* notes 152-58 and accompanying text.
24. Subpart F normally applies to CFC's in which U.S. shareholders own over 50% of the total outstanding voting stock or over 50% of the total outstanding stock by value. I.R.C. § 957(a) (West Supp. 1988). A U.S. shareholder is a U.S. citizen or resident who owns 10% or more of the foreign corporation's stock by vote or value. *Id.* §§ 951(b) (1982), 957(c) (West Supp. 1988). The ownership threshold for purposes of defining a CFC is reduced to a 25%-or-more test for captive insurance companies, *id.* § 953(c) (West Supp. 1988), and for insurance companies the subpart F insurance income of which exceeds 75% of the total gross insurance income. *Id.* § 957(b) (West Supp. 1988). It would be rare for any of these circumstances to exist in a publicly held corporation.

ments. While a tax avoidance motive is not a prerequisite to the application of subpart F, the provisions of subpart F are designed principally to apply to U.S. taxpayers with that tainted purpose. Subpart F generally applies to "controlled foreign corporations" (CFC's).<sup>25</sup> Corporations qualify as CFC's if on any day during the tax year more than 50% of the stock is owned by "United States shareholders."<sup>26</sup> "United States shareholders" are U.S. persons, (i.e. U.S. citizens, residents, partnerships, corporations, and certain estates and trusts<sup>27</sup>) who on the last day of the taxable year own at least 10% of the foreign corporation's stock.<sup>28</sup> The presumption is that only shareholders with significant holdings could be expected to have tainted motives.

### 1. Corporate Income Taxed To U.S. Shareholder

If the ownership requirements are met for an uninterrupted period of thirty days, income of the CFC within certain categories is taxed to the U.S. shareholders even though it is not distributed to them.<sup>29</sup> The income that is imputed is, principally, each U.S. shareholder's pro rata share of the subpart F income<sup>30</sup> and his pro rata share of the increase in corporate earnings invested in U.S. property.<sup>31</sup> A U.S. shareholder's pro rata share generally is equal to that shareholder's percentage ownership of the CFC's outstanding stock.<sup>32</sup> Subpart F income generally is reduced by expenses incurred to earn the income before being imputed to the U.S. shareholders.<sup>33</sup>

As will be seen in more detail shortly, subpart F income consists of

25. *Id.* §§ 951(a), (b) (1982), 957 (West Supp. 1988).

26. *Id.* § 957(a) (West Supp. 1988).

27. *Id.* §§ 957(c) (West Supp. 1988), 7701(a)(30) (1982).

28. *Id.* § 951(a)(1), (b) (1982); Treas. Reg. § 1.951-1(g) (as amended in 1983). The 10% threshold does not apply to certain "captive insurance" companies. I.R.C. § 953(c)(1)(A) (West Supp. 1988). See *infra* note 193 and accompanying text. There are also exemptions for certain shareholders of certain corporations organized under the laws of Puerto Rico, the Virgin Islands, and specified U.S. possessions. I.R.C. § 957(c)(1), (2) (West Supp. 1988); Treas. Reg. § 1.957-4(a)(2), (b), (c) (1964); Rev. Rul. 74-375, 1974-2 C.B. 215 (Puerto Rican resident shareholder of German corporation who acquired U.S. citizenship through the Immigration and Nationality Act, 8 U.S.C. § 1402 (1970), is a U.S. person for purposes of current I.R.C. § 957(c)). Certain related party shareholdings are aggregated for purposes of the 10% test. I.R.C. § 958 (1982).

29. I.R.C. § 951(a)(1) (1982).

30. *Id.* § 951(a)(1)(A) (1982). The pro rata share consists of the amount of subpart F income which would have been distributed to the shareholder if the corporation had actually distributed the subpart F income. Typically, the pro rata share will equal the percentage stockholding. See *id.* § 951(a)(2) (1982).

31. *Id.* § 951(a)(1)(B) (1982). Also imputed are: (1) shareholder's pro rata share of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries under I.R.C. § 954(b)(1) (1970) (repealed 1975), and (2) pro rata share of the corporation's previously excluded subpart F income withdrawn from foreign based company shipping operations under I.R.C. § 955(b) (1982). See *infra* notes 56-59, 211-16 and accompanying text.

32. I.R.C. § 951(a)(2) (1982).

33. *Id.* §§ 953(a)(2), 954(b)(5) (1982 & West Supp. 1988), 801(b) (West Supp. 1988).

readily movable passive and business income. These types of income are the kind taxpayers would be most likely to have an incentive to earn through a foreign corporation located in a tax haven jurisdiction. Non-subpart F income of a CFC generally is not subject to U.S. taxation until it is distributed to domestic shareholders. An incentive exists to have the CFC invest the income in U.S. assets directly, rather than to distribute the funds to the domestic shareholders and have them make the investment, because the former approach avoids taxation on the distribution. The policy reason for also imputing the increase in earnings invested in U.S. property is to prevent that type of tax avoidance. The United States also has a conflicting policy of encouraging domestic investment. Consequently, as will be discussed in more detail below, investment in a number of domestic assets will not trigger subpart F treatment.<sup>34</sup>

The amount of income that can be imputed to the U.S. shareholders under subpart F is limited to the CFC's "earnings and profits."<sup>35</sup> The computation of earnings and profits can be quite complex, but in a rough sense consists of the corporation's net economic profits.<sup>36</sup> There are significant differences between the computation of earnings and profits and the computation of taxable income, because the latter does not focus exclusively on economic income.<sup>37</sup> The calculation of earnings and profits does not generally involve the biases favoring and/or disfavoring conduct that are contained in the Code.<sup>38</sup>

The concept of earnings and profits plays a crucial role in the corporate taxation field. For example, distributions by a corporation are ordinary income dividends only to the extent of the corporation's earnings and profits.<sup>39</sup> The underlying principle is that it is appropriate for a shareholder to receive ordinary income taxation on corporate distributions if those distributions are made out of corporate earnings. Similarly, imputing income to shareholders under subpart F is defensible only to the extent of the CFC's earnings.

Subpart F income is broken down into five categories: insurance income, foreign base company income, boycott income, the sum of illegal bribes, kickbacks and similar unlawful payments (even though they constitute expenditures and not income), and income derived from foreign countries to which section 901(j) applies.<sup>40</sup> The provision for insurance income<sup>41</sup> arose because of congressional concern over the practice of

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34. POSTELWAITE, *supra* note 15, §§ 12.15, 12.33.

35. I.R.C. § 952(c) (West Supp. 1988).

36. *See id.* § 312 (1982 & West Supp. 1988). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.03 (5th ed. 1987) [hereinafter BITTKER & EUSTICE].

37. BITTKER & EUSTICE, *supra* note 36, ¶ 7.03.

38. *Id.*

39. I.R.C. §§ 301(c)(1), 316(a) (1982).

40. *See id.* § 952(a) (1982 & West Supp. 1988); *see infra* note 67 and accompanying text.

41. I.R.C. § 952(a)(1) (West Supp. 1988) (insurance income is defined under § 953).

forming foreign subsidiaries to insure U.S. risks.<sup>42</sup> This category was expanded by the TRA '86 to include insurance for non-U.S. risks, and will be discussed in more detail below. Foreign base company (FBC) income, in turn also is broken down into five categories, to wit foreign personal holding company (FPHC) income, FBC sales income, FBC services income, FBC shipping income and FBC oil related income.<sup>43</sup>

After TRA '86, FPHC income is specially defined in subpart F<sup>44</sup> and is no longer defined by reference to the foreign personal holding company code provisions, as was previously the case.<sup>45</sup> FPHC income consists principally of passive income. Included are income from dividends, interest (excluding certain export interest), royalties and rents (unless derived in the active conduct of a trade or business and received from an unrelated person), annuities and gains over losses from the disposition of certain categories of property.<sup>46</sup> As will be discussed in greater detail below, this area was significantly modified by the TRA '86. FPHC income is thus involved in two different sets of Code provisions, subpart F and, as noted above, the Foreign Personal Holding Company rules.<sup>47</sup> In the event both sets of provisions apply, subpart F controls.<sup>48</sup>

FBC sales income consists of income derived from the sales of personal property.<sup>49</sup> This provision was motivated by the common practice of U.S. corporations of selling their goods to foreign subsidiaries in "base countries" which had low tax rates.<sup>50</sup> The goods would then be sold to third party purchasers, lodging the business profits in the low tax jurisdiction.<sup>51</sup> The application of section 482 (which might allocate income back to the domestic parent) could be stymied by the use of an arm's length sales price on the sale to the base company, and the transaction between the foreign subsidiary and the foreign third party purchaser, with appropriate middleman markups, could be wholly outside the grip of the Treasury Department.<sup>52</sup>

FBC sales income rules apply if the following requirements are met:

- the purchase or sale is of personal property to, from, or on behalf of a party related to the CFC;
- the personal property is not manufactured or produced in the country in which the CFC is incorporated; and
- the property is sold for use outside the country in which the CFC is incorporated. (The reason for the same country exclusion, com-

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42. POSTELWAITE, *supra* note 15, § 12.17.

43. I.R.C. § 954(a) (1982 & West Supp. 1988).

44. *Id.* § 954(c) (West Supp. 1988).

45. *Id.* § 954(c) (1982) (repealed 1986).

46. *Id.* § 954(c) (West Supp. 1988).

47. *Id.* §§ 551-557 (1982 & West Supp. 1988).

48. *Id.* § 552(b)(1) (1982).

49. *Id.* § 954(d) (1982 & West Supp. 1988).

50. POSTELWAITE, *supra* note 15, § 12.20.

51. *Id.*

52. I.R.C. § 482 (1978 & West Supp. 1988); POSTELWAITE, *supra* note 15, § 12.20.



mon throughout subpart F, is that if the CFC is doing business in the country in which it incorporated, it is unlikely to have a tax avoidance motive for incorporation there.)<sup>53</sup>

FBC services income is income derived from the performance of technical, managerial or other skilled services for a related party, provided the services are rendered outside the country in which the CFC is incorporated.<sup>54</sup> Thus, for example, a domestic corporation may not avoid current income by having its foreign subsidiary give technical advice regarding property the parent manufactures. An exception is provided for FBC services income related to the sale of property manufactured by the CFC if the services are performed prior to the sale or are specifically related to the sale.<sup>55</sup> Services related to goods manufactured by the CFC are less likely to be tainted with a tax avoidance purpose.

FBC shipping income is income from the use, hire, lease, or disposition of aircraft or ships in foreign commerce.<sup>56</sup> Excluded, however, is income from shipping operations conducted within the country in which the CFC is incorporated and in which the aircraft or vessel is registered.<sup>57</sup> If income will qualify under the FBC shipping income provisions and other FBC income provisions, the former prevails.<sup>58</sup> To encourage this industry, an exclusion previously was provided also for FBC shipping income which was reinvested in FBC shipping operations.<sup>59</sup> As will be discussed in greater detail below, this exclusion was repealed by the TRA '86.

FBC oil related income was a latecomer (1982), and was added due to the readiness with which oil related income could be earned through tax haven countries.<sup>60</sup> FBC oil related income consists of foreign nonextraction income (i.e. income earned from the processing, transportation, distribution of oil and gas and the primary products into which they are processed and certain other similar income).<sup>61</sup> There is an exception for

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53. I.R.C. § 954(d)(1) (1982); Treas. Reg. § 1.954-3 (1983). See Pouell & Chopin, *Operating a Buy-Sell Controlled Foreign Corporation With A Fixed Place of Business In The United States*, 1 VA. TAX REV. 215 (1981).

54. I.R.C. § 954(e) (West Supp. 1988). Toan, *Foreign Base Company Services Income*, 3 INT'L. TAX J. 229 (1977).

55. I.R.C. § 954(e)(2) (West Supp. 1988). Needless to say, in Priv. Ltr. Rul. 85-36-007 (May 31, 1985), the Service took the position that when income was partly FBC sales income and partly non-FBC services income, it must be characterized under the predominant classification which under the facts was FBC sales income.

56. I.R.C. § 954(f) (1982 & West Supp. 1988). See also POSTELWAITE, *supra* note 15, § 12.24.

57. I.R.C. § 954(b)(7) (1982).

58. *Id.* § 954(b)(6) (1982).

59. I.R.C. § 954(b)(2) (1982) (repealed 1986); *id.* § 955 (1982 & West Supp. 1988). See POSTELWAITE, *supra* note 15, § 12.24.

60. I.R.C. § 954(g) (West Supp. 1988); 1 S. REP. NO. 494, 97th Cong., 2d Sess. (1982) (enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982).

61. I.R.C. §§ 954(g)(1) (West Supp. 1988), 907(c)(2), (3) (1982 & West Supp. 1988). Other income which qualifies as FBC oil related income is income from the disposi-

taxpayers producing under one thousand barrels of oil per day.<sup>62</sup> Additionally, FBC oil related income does not include nonextraction income from sources within the same foreign country in which the relevant oil and gas wells are located. This exclusion is due again to the presumed lack of a tax avoidance motive for intra-country activities.<sup>63</sup> Income qualifying both as FBC oil related income and another type of FBC income is treated exclusively as FBC oil related income.<sup>64</sup>

The final three categories of FBC income are boycott income, illegal bribe, and kickback income<sup>65</sup> (which are self explanatory) and, a TRA '86 addition, income from foreign countries covered by section 901(j).<sup>66</sup> Section 901(j) countries are, generally, countries with which the United States has inimical relations.<sup>67</sup> Unlike the other subpart F components discussed above, the focus of these three categories is on proscribing certain conduct (other than tax avoidance) of which Congress disapproves. Subpart F income generally is reduced by expenses incurred to earn income before being imputed to the U.S. shareholders.<sup>68</sup>

As discussed above, while the increase in earnings invested in U.S. property generally is imputed to U.S. shareholders, conflicting policies are involved. While using a CFC to make U.S. investments may have a tax avoidance motive, domestic investment is to be fostered.<sup>69</sup> This conflict was resolved with a rule addressing the former concern and exceptions addressing the latter. The imputed income is the excess of the amount invested in U.S. property at the close of the current year over the amount so invested at the close of the previous year.<sup>70</sup> The general definition of U.S. property is almost as broad as the term itself. It includes tangible property located in the United States, stock of a domestic corporation, an obligation of a U.S. person or any right to the use in the United States of a patent, copyright, invention, secret formula, or similar property.<sup>71</sup> However, the exceptions then proceed to subsume a healthy portion of the rule. The principal exceptions are obligations of the

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tion of assets used in the taxpayer's foreign trade or business of processing, and transporting or distributing oil and gas, as well as "the performance of any other related service," and related dividends and interest and recaptured losses. I.R.C. § 907(c)(2), (3), (4) (1982 & West Supp. 1988). Section 907(c)(2) (1982 & West Supp. 1988) refers to *taxable* income from oil and gas, so related expenses would be deductible.

62. I.R.C. § 954(g)(2) (West Supp. 1988).

63. *Id.* § 954(g)(1) (West Supp. 1988).

64. *Id.* § 954(b)(8) (West Supp. 1988).

65. *Id.* § 952(a)(3), (4) (1982 & West Supp. 1988).

66. *Id.* § 952(a)(5) (West Supp. 1988).

67. *Id.* § 901(j) (West Supp. 1988). An example would be countries with which the United States has severed diplomatic relations. *Id.* § 901(j)(2)(A)(ii) (West Supp. 1988).

68. *Id.* §§ 954(b)(5), 953(a)(2), 801(b) (West Supp. 1988).

69. POSTELWAITE, *supra* note 15, § 12.33.

70. I.R.C. § 956(a)(2) (1982). The amount invested at the close of the preceding year is reduced by amounts distributed during the preceding year. *Id.*

71. *Id.* § 956(b)(1) (1982).

United States, deposits with a U.S. financial institution, U.S. property held for export, and obligations of a U.S. person incurred for purposes of selling or processing property, such as a letter of credit.<sup>72</sup> These exceptions are necessary to encourage the purchase of U.S. financial instruments and to foster international business.<sup>73</sup>

## 2. Distributions

Since subpart F requires U.S. shareholders to include in their income earnings that are not actually received, a mechanism was needed to avoid a second incidence of income when the CFC actually makes a distribution to its shareholders of amounts they previously included in income.<sup>74</sup> The Code's solution is also found in the partnership and S corporation areas.<sup>75</sup> The shareholders' bases in the CFC stock is increased by the amount of income that is imputed.<sup>76</sup> Distributions by CFC's are excluded from the recipient shareholders' income to the extent of the earnings previously imputed to the shareholders (with a concomitant reduction in the stock basis).<sup>77</sup> The distribution rules raise questions of priority. When does a particular distribution consist of previously taxed subpart F items, and when does it consist of other items which have not yet been includable by the shareholders (because, for example, they were not subject to subpart F)? The Code takes a merciful approach and treats distributions as initially coming from previously taxed income (first from the increase in earnings invested in U.S. property, then from subpart F income) and only lastly from other earnings and profits.<sup>78</sup>

## III. CHANGES MADE BY TRA '86

### A. Control Requirement<sup>79</sup>

In order for U.S. shareholders to be able to achieve their tax objectives through the use of foreign corporations, they typically will need to control such corporations. Under prior law, therefore, subpart F normally only applied, and a foreign corporation generally only qualified as a CFC, if more than 50% of the voting power of the corporation was held by U.S. shareholders.<sup>80</sup>

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72. *Id.* § 956(b)(2)(A)-(C) (1982).

73. See S. REP. NO. 1881, 87th Cong., 2d Sess. 12 (1962).

74. Distributions will decrease a CFC's earnings and profits. See BITTKER & EUSTICE, *supra* note 36, ¶ 7.03.

75. I.R.C. §§ 705 (1982 & West Supp. 1988), 1367 (West Supp. 1988) (referring to partnerships and S corporations, respectively).

76. *Id.* § 961(a) (1982).

77. *Id.* §§ 959(a), 961(b) (1982).

78. *Id.* § 959(c) (1982).

79. The headings used in the discussion of the TRA '86 changes generally follow the format of STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (Comm. Print 1987) [hereinafter GENERAL EXPLANATION].

80. I.R.C. § 957(a) (1982) (amended 1986).

Congress felt that these control requirements were too manipulable.<sup>81</sup> Domestic shareholders could have practical control over foreign corporations and therefore fall within the intended ambit of the statute without meeting the definition of control.<sup>82</sup> For example, by issuing both nonvoting and voting classes of stock, domestic shareholders could hold a majority of the stock by value and thus obtain a majority of the tax benefits associated with the foreign corporation, while owning 50% or less of the voting stock and thus avoid subpart F. The domestic shareholders nonetheless could have the effective control needed to operate the foreign corporation if the balance of the outstanding voting stock was adequately dispersed.

As it has in other areas, Congress opted for a voting-or-value standard to redress this problem. A corporation will qualify as a CFC if stock representing more than 50% of either the voting power or the value of the corporation is owned by U.S. shareholders.<sup>83</sup>

### *B. Control and Related Parties*

Whether FBC income will be imputed to U.S. shareholders of a CFC under subpart F may depend on whether the relevant income arose in a transaction with a related party. For example, a CFC may have FBC sales income if it sells personal property purchased from its U.S. parent.<sup>84</sup> Prior to the TRA '86, a related person was defined under subpart F as (1) an individual, partnership, trust, or estate which controlled the foreign corporation, (2) a corporation which controlled or was controlled by the foreign corporation, or (3) a corporation which was controlled by the same person or persons that controlled the foreign corporation.<sup>85</sup> Control for these purposes was defined as direct or indirect ownership of stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote.<sup>86</sup> However, where the beneficial interests of a partnership, trust or estate were controlled by the persons controlling the CFC, but the CFC held no interest in the partnership, trust or estate, that entity was not related to the CFC. Congress, with some justification, felt that there was no rational basis for this exclusion.<sup>87</sup> Income of a CFC that would be treated as subpart F income

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81. S. REP. NO. 313, 99th Cong., 2d Sess. 371 (1986).

82. *Id.*

83. I.R.C. § 957(a) (1982 & West Supp. 1988). The House of Representatives proposed that the "more than 50%" test be lowered to a "50% or more" test. H.R. REP. NO. 426, 99th Cong., 1st Sess. 402-03 (1985). Congress rejected this approach on the understanding that under existing regulations the IRS could, in appropriate circumstances, deem the more than 50% test to be met even if technically that requirement was not met. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-626 to -27 (1986); Treas. Reg. § 1.957-1(b) (1963).

84. I.R.C. § 954(d)(1), (3) (1982 & West Supp. 1988).

85. I.R.C. § 954(d)(3) (1982) (repealed 1986).

86. *Id.* (flush language).

87. H.R. REP. NO. 426, 99th Cong., 1st Sess. 403 (1985); S. REP. NO. 313, 99th Cong., 2d Sess. 372 (1986).

if received from a subsidiary of the CFC would not be treated as subpart F income if it was routed through a controlled partnership.<sup>88</sup> This approach was used by certain companies in the Far East.<sup>89</sup> To resolve this imperfection, the definition of control was expanded to include a partnership, trust, or estate which controls or is controlled by a CFC as well as a partnership, trust, or estate which is controlled by the same persons that control the CFC.<sup>90</sup>

The definition of control for related party purposes was also liberalized by the TRA '86. As noted above, control under the general test was defined as direct or indirect ownership of stock possessing *more than 50%* of the total combined voting power of all classes of stock entitled to vote.<sup>91</sup> However, in defining a related party, a "50% or more test" was substituted for the "more than 50% test."<sup>92</sup> Congress again concluded that control should not be defined strictly in terms of voting power. The definition of control was expanded to include not only 50% or more of the total voting power of all classes of stock entitled to vote, but also 50% or more of the total value of the stock of a corporation or total value of the beneficial interests in a partnership, trust, or estate.<sup>93</sup> Why control is defined one way for purposes of defining a CFC (a "more-than-50%" test), and another way for purposes of defining a related party (a "50%-or-more" test) is unclear. While probably of little practical effect, since many CFC's and related parties would meet a 100% control test, the discrepancy does demonstrate rather arbitrary drafting on the part of Congress.

### C. *De Minimis and Full Inclusion Rules of Subpart C*

Previously, a *de minimis* rule provided that if less than 10% of a foreign corporation's gross income was FBC income, none of the income was treated as FBC income.<sup>94</sup> Conversely, if over 70% of the foreign corporation's gross income was FBC income, all of it was, and still is, treated as FBC income.<sup>95</sup> The *de minimis* rule was an important exception to subpart F because it permitted CFC's to reinvest their profits in portfolio items without current taxation.<sup>96</sup>

*De minimis* rules primarily exist to lessen the tax and administrative burdens when a taxpayer's participation in the proscribed activity is minimal. Congress felt that it was inappropriate to absolve supposedly minor infractions on the basis of a small percentage when a large amount of

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88. H.R. REP. NO. 426, 99th Cong., 1st Sess. 403 (1985).

89. Ball, Carter & Wright, *How U.S. Shareholders of A C.F.C. Are Treated After TRA '86*, 66 J. TAX 354, (1987) [hereinafter Ball].

90. I.R.C. § 954(d)(3) (West Supp. 1988).

91. *Id.* § 957(a) (1982) (repealed 1986); see *supra* note 80 and accompanying text.

92. *Id.* 954(d)(3) (West Supp. 1988) (flush language).

93. *Id.*

94. I.R.C. § 954(b)(3)(A) (1982) (repealed 1986).

95. *Id.* § 954(b)(3)(B) (West Supp. 1988).

96. Ball, *supra* note 89, at 356.

income, in absolute terms, could be involved.<sup>97</sup> In a move that was probably motivated more by revenue needs than by any identifiable tax policy concerns, Congress also concluded that the 10% threshold should be reduced.<sup>98</sup>

Under the TRA '86 *de minimis* rule, a foreign corporation will now only be deemed to have no FBC income if its actual FBC income and gross tax haven insurance income for the taxable year is less than the lesser of 5% of its gross income or one million dollars.<sup>99</sup> This *de minimis* rule, unlike its predecessor,<sup>100</sup> includes tax haven insurance income in the wake of the repeal of the separate *de minimis* rule for insurance income.

Insurance income was not previously counted toward the full inclusion rule's 70% test. The TRA '86 amended the full inclusion rule to include insurance income within its coverage on the reasonable grounds that there was no sound policy reason to distinguish it from FBC income or to have different standards for the *de minimis* and full inclusion rules.<sup>101</sup>

The General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation ("General Explanation") states that the 70% full inclusion rule does not apply to a company that is a CFC only for purposes of the captive insurance company provision.<sup>102</sup> Foreign corporations qualify as CFC's for purposes of imputing captive insurance tax haven income if U.S. shareholders own stock meeting a 25% (instead of the usual 50%) threshold.<sup>103</sup> The Joint Committee Staff apparently determined that it was inappropriate to apply the full inclusion rule to CFC's whose U.S. shareholders fall between the 25% and 50% thresholds. This position is supported by the Code which provides that the reduced ownership threshold applies "[f]or purposes only of taking into account" captive insurance income<sup>104</sup> and thus, by inference, excludes other purposes such as the application of the full inclusion rule. From a policy perspective this approach is difficult to justify. The full inclusion rule exists for administrative convenience and to discourage taxpayers from using foreign corporations for tax avoidance purposes. Those policy principles would apply with equal force to U.S. shareholders of CFC's with large relative amounts of captive insurance income,

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97. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-627 (1986).

98. *Id.* The legislative history does not give a reason for reducing the percentage threshold.

99. I.R.C. § 954(b)(3)(A) (West Supp. 1988). The Tax Reform Act of 1984 generally subjects related party factoring income and similar income to taxation under subpart F without regard to the general *de minimis* rule. TRA '86 does not alter the law in this regard. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-628 (1986).

100. I.R.C. § 953(a) (1982) (repealed 1986) (flush language applying 5% threshold).

101. *Id.* § 954(b)(3) (West Supp. 1988); H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-627 to -28.

102. GENERAL EXPLANATION, *supra* note 79, at 991.

103. I.R.C. § 953(c)(1)(B) (West Supp. 1988); *see infra* notes 174-210 and accompanying text.

104. I.R.C. § 953(c)(1) (West Supp. 1988).

regardless of the ownership threshold used for defining CFC status. If Congress felt that a 25% threshold justified the application of the captive insurance company provisions, that threshold should be sufficient to justify the application of the full inclusion rule to CFC's which are captive insurers.

#### D. Foreign Personal Holding Company Income

##### 1. Sales of Nonbusiness Property

Under prior law, gains from the disposition of investment property constituted FPHC income only to the extent of the excess of gains over losses from the sale or exchange of stock or securities by nondealers.<sup>105</sup> Gains from the disposition of other investment property were not covered.<sup>106</sup> Congress considered this exclusion to be inconsistent<sup>107</sup> and expanded the definition of FPHC to include gains from the disposition of most types of investment property.<sup>108</sup>

FPHC income now includes the excess gains over losses from the sales or exchanges of non-income producing property and property which gives rise to the FPHC income.<sup>109</sup> For example, income from the sale of diamonds held for investment would be included (since they generate no income until disposition) as would gain from the sale of a patent licensed by the seller to a related party, since the licensing income would be FPHC income.<sup>110</sup> Gains from the disposition of inventory and dealer property continue to be excluded.<sup>111</sup> The legislative history provides that gains from dispositions of art work by an art dealer would not be FPHC income.<sup>112</sup> However, a CFC is not considered a dealer simply by exhibiting or temporarily leasing art work held in storage or displayed in the corporate offices; the gains on the art work realized by such a CFC are subpart F income since the art work would not generate income.<sup>113</sup> Ultimately, this example does little to improve the understanding of the area. Dealer status has always been determined by a facts and circumstances test, an important component of which has always been the taxpayer's historical use of the subject property.<sup>114</sup> As will be discussed in greater detail below, income from commodity and currency transactions which

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105. *Id.* § 954(c)(1) (1982) (repealed 1986); *id.* § 553(a)(2) (1982).

106. *Id.*

107. S. REP. NO. 313, 99th Cong., 2d Sess. 363-64 (1986).

108. See I.R.C. § 954(c)(1)(B)-(D), (2) (West Supp. 1988).

109. *Id.* § 954(c)(1)(B) (West Supp. 1988).

110. GENERAL EXPLANATION, *supra* note 79, at 974.

111. I.R.C. § 954(c)(1) (West Supp. 1988) (flush language); see also *id.* § 1221(1) (1982).

112. S. REP. NO. 313, 99th Cong., 2d Sess. 367 (1986).

113. *Id.*

114. *Biedenharn Realty Co. v. United States*, 526 F.2d 409 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); *Wineberg v. Comm'r*, 326 F.2d 157 (9th Cir. 1963); *Welch v. Comm'r*, 19 B.T.A. 394 (1930), *aff'd in part, rev'd in part*, 59 F.2d 1085 (6th Cir. 1932) (*per curiam*).

arise as part of the taxpayer's business are also not FPHC income.<sup>115</sup>

If the Code is read literally, gain on the sale of land, buildings, or equipment used by the seller in an active trade or business could be FPHC income, since such properties usually do not directly generate income. That result would be inconsistent with the policy goals underlying subpart F, which focus on passive investments and certain types of readily movable business income.<sup>116</sup> Income from the disposition of assets used in an active business is outside these policy objectives. Accordingly, the House of Representatives Conference Committee Report (Conference Report) provides that gains from the sale of trade or business property is not within the confines of subpart F.<sup>117</sup>

## 2. Leasing Income and Interest

The TRA '86 retained the exclusion from FPHC income of rents and royalties received in the active conduct of a trade or business.<sup>118</sup> The legislative history provides that passive leasing income, always a sticking point when defining trade or business income, is not within the exclusion and therefore constitutes FPHC income.<sup>119</sup>

Congress was concerned that many taxpayers were attempting to avoid subpart F by restructuring their foreign investments so that instead of interest, the income generated would be fees, commissions, and similar items. The legislative history to the TRA '86 makes clear that income that is equivalent to interest will be treated as FPHC income.<sup>120</sup>

## 3. Commodities Transactions

The excess of gains over losses from futures transactions in any commodity, excluding certain business hedging transactions, is FPHC income subject to current U.S. taxation when earned by a CFC.<sup>121</sup> Subpart F income previously did not include income realized by passive investors from the disposition of commodity contracts other than futures contracts. In order to reach all passive commodity related income,<sup>122</sup> Congress expanded the definition of FPHC to encompass the excess of gains over losses from transactions in any commodities including, in addition to futures, forwards and similar transactions.<sup>123</sup>

The TRA '86 retains the exception for gains of a producer, processor, merchant, or handler of a commodity which arise from bona fide hedging transactions reasonably necessary to the customary conduct of

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115. See *infra* notes 121-44 and accompanying text.

116. See *supra* notes 18-19 and accompanying text.

117. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-614 to -15 (1986).

118. I.R.C. § 954(c)(2)(A) (West Supp. 1988).

119. H.R. REP. NO. 426, 99th Cong., 1st Sess. 393-94 (1985); H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-616 (1986).

120. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-615 (1986).

121. I.R.C. § 954(c)(1)(C) (West Supp. 1988).

122. S. REP. NO. 313, 99th Cong., 2d Sess. 364 (1986).

123. I.R.C. § 954(c)(1)(C) (West Supp. 1988).



business.<sup>124</sup>

An additional exception is provided for commodity transactions of a foreign corporation whose business is substantially that of an active producer, processor, merchant or handler of commodities.<sup>125</sup> This later exception, unlike the hedging exception, focuses on gains and losses of dealers in commodities. Given the expanded definition of covered commodities, this exception was necessary to avoid the inclusion of ordinary business transactions. Financial transactions having an investment rather than business orientation are not covered by this exception.<sup>126</sup> The necessary business nexus will generally be satisfied by regularly taking delivery of physical commodities,<sup>127</sup> or by engaging in substantial processing activities and incurring substantial expenses prior to the commodities sale, such as "concentrating, refining, mixing, crushing, aerating, and milling."<sup>128</sup> The fact that a company primarily trades in precious metals does not mean that it will qualify automatically under the business test. Traders in precious metals often principally have an investment focus. The Conference Report provides that taking delivery of precious metals through a financial institution such as a bank, indicates an investment motive.<sup>129</sup> The Conference Report overlooks the fact that a dealer could also be motivated to take delivery through a bank for reasons of safety, and regulations will be needed to ascertain when the dealer/investor line has been crossed.

Foreign currency transactions under I.R.C. section 988 also constitute FPHC income, but are addressed in a separate subparagraph of the Code.<sup>130</sup> Income from other foreign currency transactions may constitute FPHC income under the general commodity provisions.<sup>131</sup>

124. *Id.* § 954(c)(1)(C)(i) (West Supp. 1988).

125. *Id.* § 954(c)(1)(C)(ii) (West Supp. 1988).

126. S. REP. NO. 313, 99th Cong., 2d Sess. 367 (1986).

127. *Id.*

128. *Id.* at 368. It is also helpful if the taxpayer engages in the following:

[s]ignificant activities and incurring substantial expenses relating to the physical movement, handling, and storage of commodities, including (but not limited to) preparation of contracts and invoices, arrangement of freight, insurance, or credit, arrangement for receipt, transfer, or negotiation of shipping documents, arrangement of storage or warehousing, and dealing with quality claims; owning and operating physical facilities used in the activities just described; owning or chartering vessels or vehicles for the transportation of commodities, and producing the commodities sold.

*Id.* Active business gains and losses include those arising from financial transactions which constitute bona fide hedging transactions integrally related to a principal business of trading in physical commodities. GENERAL EXPLANATION, *supra* note 79, at 975.

129. S. REP. NO. 313, 99th Cong., 2d Sess. 367 (1986).

130. *See infra* notes 132-44 and accompanying text.

131. *See* H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-615 (1986). An example would be the "mark to market" under I.R.C. § 1256 (1982 & West Supp. 1988).

#### 4. Foreign Currency Gains

Subpart F was enacted in 1962 when currency exchange rates were fixed. The subsequent development of floating exchange rates permitted taxpayers to realize gains and losses on foreign currency transactions. Since these types of gains and losses can readily be routed through tax haven jurisdictions, Congress concluded that they should be subject to subpart F.<sup>132</sup> The TRA '86 expanded the definition of FPHC income to include certain foreign currency gains, specifically the excess of "section 988 gains" over "section 988 losses."<sup>133</sup> A detailed description of section 988 transactions is beyond the scope of this undertaking. Essentially a section 988 transaction is a foreign currency gain or loss arising from: (1) the acquisition of, or becoming an obligor under, a debt instrument<sup>134</sup> (for example, if a debt is denominated in German marks and the dollar falls after the money is borrowed, an American debtor will spend more dollars to repay the debt than were received when the funds were borrowed, causing a section 988 loss); (2) accruing or otherwise taking into account any item of expense or gross income or receipts which is to be paid or received after the date on which the item is accrued or taken into account;<sup>135</sup> (3) entering into or acquiring any forward contract, option, or similar financial instrument;<sup>136</sup> and (4) the disposition of a foreign currency.<sup>137</sup> Any such gain or loss will be characterized as ordinary income or loss.<sup>138</sup>

Income from foreign currency transactions does not receive subpart F treatment if the income arises from hedging and other transactions that are directly related to the business needs of the foreign corporation.<sup>139</sup> Thus, active foreign currency gains and losses arising from a CFC's business as an active foreign currency dealer are outside the confines of subpart F.<sup>140</sup> Foreign currency gains arising from hedging of inventory would generally also be exempted.<sup>141</sup> The General Explanation states that foreign currency gains would fall within subpart F if they stemmed from hedging a related person's inventory or other assets of a related person.<sup>142</sup> While there is little support in the statute or the legislative history for this exception to the exception, a technical amendment to limit the problem which the General Explanation addresses is justified.

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132. S. REP. NO. 313, 99th Cong., 2d Sess. 364 (1986).

133. I.R.C. § 954(c)(1)(D) (West Supp. 1988).

134. *Id.* § 988(c)(1)(B)(i) (West Supp. 1988).

135. *Id.* § 988(c)(1)(B)(ii) (West Supp. 1988).

136. *Id.* § 988(c)(1)(B)(iii) (West Supp. 1988), unless subject to the I.R.C. § 1256 (1982 & West Supp. 1988) "mark to market" rules.

137. *Id.* § 988(c)(1)(C) (West Supp. 1988). In the terminology of the statute the disposition would be of "nonfunctional currency." *Id.* § 988(c) (West Supp. 1988).

138. *Id.* § 988(a)(1)(A) (West Supp. 1988).

139. *Id.* § 954(c)(1)(D) (West Supp. 1988). GENERAL EXPLANATION, *supra* note 79, at 976.

140. GENERAL EXPLANATION, *supra* note 79, at 976.

141. *Id.*

142. *Id.*

The fact that the current statute only excepts a "transaction directly related to the business needs"<sup>143</sup> of the CFC could be interpreted to mean that the inventory or other assets have to be owned by the CFC if it is to have business needs requiring, for example, foreign currency hedging. It is also arguable, however, that the "business needs" of the CFC will be met if the CFC's business is hedging foreign currency for others. Under this latter interpretation a domestic corporation could form a CFC which would perform the hedging or comparable function, and any resulting foreign currency gains would not be subject to subpart F. A fair reading of the statute indicates that Congress wished to except foreign currency transactions which are made to assist *other* activities of the CFC, and not to except them when the hedging transactions constitute the business, as such, of the CFC (assuming the CFC was not a bonafide dealer). The latter interpretation would provide a tax incentive to conduct such activities through foreign corporations, an incentive Congress specifically did not want to offer.<sup>144</sup> An appropriate amendment would eliminate the ambiguity and potential for abuse.

#### 5. Dividends, Interest, and Securities Gains of Banking and Insurance Businesses

Dividends, interest, and gains from sales of stock and securities generally are treated as FPHC income subject to subpart F.<sup>145</sup> This rule did not apply under prior law if the income was: (1) received from unrelated persons through the conduct of a banking, financial or similar business;<sup>146</sup> (2) derived from an insurance company's investment with unrelated parties of unearned premiums, ordinary and necessary reserves, and certain other funds;<sup>147</sup> and (3) in the case of interest paid to the CFC by a related party and received in the conduct of a banking, financing or similar business, if both the payor and payee were engaged in that business, and if both predominantly were engaged in business with unrelated persons (a sort of backhanded *de minimis* exception).<sup>148</sup> These exceptions existed because the income would typically arise in a legitimate business context. The income nonetheless could be readily routed through foreign countries to minimize taxation. Lending can be done through any country, and indeed there has been a proliferation of controlled banking and insurance companies in various tax haven jurisdictions.<sup>149</sup> CFC's often claimed that their investment income was not subject to subpart F when that income arose from the conduct of a banking-related business.<sup>150</sup> The ability to manipulate readily where these types of income would

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143. I.R.C. § 954(c)(1)(D) (West Supp. 1988).

144. See *supra* notes 20-23 and accompanying text.

145. I.R.C. § 954(c) (West Supp. 1988).

146. *Id.* § 954(c)(3)(B) (1982) (repealed 1986).

147. *Id.*

148. *Id.* § 954(c)(4)(B) (1982) (repealed 1986).

149. H.R. REP. NO. 426, 99th Cong., 1st Sess. 393 (1985).

150. Ball, *supra* note 89, at 354.

arise and the resulting U.S. revenue losses caused Congress to conclude in the TRA '86 that the exceptions should be repealed.<sup>151</sup>

Congressional concern over the trade deficit resulted in a new exception for export financing interest.<sup>152</sup> Under this exception, interest derived in a banking business does not constitute FPFC income if it arises from financing the disposition for use or consumption outside the United States of property which is manufactured, produced, grown, or extracted in the United States by the interest recipient or a related party.<sup>153</sup> No more than 50% of the fair market value of the exported property can be attributable to products imported into the United States.<sup>154</sup>

The export exception does not liberalize previously existing subpart F rules, in particular the factoring rules that were enacted by the Tax Reform Act of 1984.<sup>155</sup> Under these rules, if a foreign corporation acquires a trade receivable from a related party (e.g., the U.S. parent), any income earned by the foreign corporation (typically a CFC) on the trade receivable will be treated as interest subject to subpart F, provided that the trade receivable arose from the disposition of inventory or stock in trade or from the performance of services by a related party.<sup>156</sup> More importantly, these rules also bring within the confines of subpart F the interest earned by a CFC from a loan made to a third party to finance the purchase of inventory or stock in trade of a party related to the CFC (often the U.S. parent).<sup>157</sup> The export financing exception thus applies principally to interest derived from financing the sale of noninventory property.

It is difficult to justify this limitation. The fact that inventory of a related party could be involved does not constitute adequate policy grounds for the exclusion, since the export financing interest exception is not offended by related parties. It specifically exempts interest received on the financing of the purchase of exported property which is manufactured by a party related to the taxpayer.<sup>158</sup> Encouraging exports is the order of the day. Inventory and stock-in-trade items are no less valuable exports than are other forms of export property. Quite to the contrary, exports typically consist of the taxpayer's stock-in-trade. The Code's po-

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151. H.R. REP. NO. 426, 99th Cong., 1st. Sess. 393 (1985).

152. I.R.C. §§ 904(d)(2)(G), 954(c)(2)(B) (West Supp. 1988).

153. *Id.* § 904(d)(2)(G) (West Supp. 1988). Generally § 954(d)(3)'s definition of a related person is used. *Id.* § 904(d)(2)(H) (West Supp. 1988); see *supra* notes 85-94 and accompanying text.

154. I.R.C. § 904(d)(2)(G)(ii) (West Supp. 1988).

155. I.R.C. § 864(d)(5)(A)(iii) (West Supp. 1988); GENERAL EXPLANATION, *supra* note 79, at 977.

156. I.R.C. § 864(d)(1), (2) (West Supp. 1988). Related person is defined to include any person who is related within the meaning of § 267(b), any U.S. shareholder as defined in § 951(b), and any person related to such U.S. shareholder within the meaning of § 267(b).

157. GENERAL EXPLANATION, *supra* note 79, at 977.

158. I.R.C. § 904(d)(2)(G)(i) (West Supp. 1988).

sition significantly undermines the export financing exception and should be repealed.

FPHC income does not include (1) dividends and interest received from a related person organized in the same foreign country as the recipient, provided that the related party had a substantial part of its assets used in its trade or business located in that country, or (2) rents and royalties received from a related person for the use of property within the country in which the recipient is created or organized.<sup>159</sup> While a CFC created for tax avoidance purposes would typically be incorporated in a tax haven jurisdiction and conduct business elsewhere, this structure does not prevent suspect tax avoidance.<sup>160</sup> Prior to the TRA '86, it was possible to structure intercompany transactions in a manner that would reduce the FPHC income of the group.<sup>161</sup> If one company in a group earned subpart F income, but paid interest to a related company in the same foreign country, the deduction of interest paid to the related company could reduce the first company's subpart F income.<sup>162</sup> The interest would not, however, have been subpart F income to the second company because of the same-country interest exception. The group's subpart F income would thus be lessened. Congress concluded that the exception should not apply under these circumstances.<sup>163</sup> Accordingly, under the TRA '86, interest, rent, and royalty payments do not qualify for the exclusion and will constitute subpart F income to the extent they reduce the corporate payor's subpart F income.<sup>164</sup>

## 6. Insurance Income in General

A CFC's insurance income previously was subject to subpart F only if it arose from the insurance of U.S. risks<sup>165</sup> or from the insurance of risks of *related* persons in *foreign* countries outside the insurer's country of incorporation.<sup>166</sup> Prior to the TRA '86, income from the insurance of

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159. *Id.* § 954(c)(3)(A) (West Supp. 1988).

160. S. REP. NO. 313, 99th Cong., 2d Sess. 366 (1986).

161. *Id.*

162. *Id.* I.R.C. §§ 952(c), 954(b)(5) (1982) (amended 1986). Deductible interest can reduce earnings and profits. See BITTKER & EUSTICE, *supra* note 36, at ¶ 7.03.

163. S. REP. NO. 313, 99th Cong., 2d Sess. 366 (1986).

164. I.R.C. § 954(c)(3)(B) (West Supp. 1988). TRA '86 provides a limited five year exclusion from subpart F FPHC income for certain mining related income. GENERAL EXPLANATION, *supra* note 79, at 978.

165. I.R.C. §§ 952(a)(1) (1982) (repealed 1986), 953(a) (1982 & West Supp. 1988) (as amended 1986). Income from the insurance of U.S. risks included income from insurance and reinsurance and the issuance of annuity contracts on the lives of U.S. residents on property located in and activities taking place in the United States. *Id.* § 953(a) (1982) (repealed 1986).

166. Insurance income from insurance of risks of related persons in foreign countries outside the insurer's country constitutes FBC services income. Under § 137 of the Tax Reform Act of 1984 insurance services provided to a related party were considered to be performed where the risk was located. If the services were performed for a related party outside the insurer's country of incorporation the income would be FBC services income, since it did not fall within the intra-country exception to FBC

non-U.S. risks was generally outside the scope of subpart F. There was little point to this exclusion. Insurance income is easily movable to a tax haven jurisdiction and thus constitutes the type of income at which subpart F is directed.<sup>167</sup> All insurance income that can have a tax avoidance taint should therefore have been covered.

The TRA '86 remedied this problem by expanding the definition of tax haven insurance income to include any income attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks in a country other than the country of creation or organization, including transactions involving unrelated parties.<sup>168</sup> Both investment income as well as premium income of insurance companies is within the purview of this provision. To prevent any mutual back scratching arrangements, subpart F also applies to insurance income of risks located in the country of creation or organization which are earned as part of an arrangement under which another corporation receives a substantially equal amount of premiums for insurance of other country risks.<sup>169</sup> For example, a CFC might make an arrangement with a local insurance company in a tax haven jurisdiction by which the CFC would insure the local company's intra-country risks in exchange for the local company's insuring the CFC's risks outside the country. The substance of the transaction is that the CFC is insuring other country risks, and that is how the Code would now view the transaction.

Prior law did not treat a CFC's income from the insurance of U.S. risks as subpart F income if the CFC's insurance income accounted for under 5% of the foreign corporation's total insurance income.<sup>170</sup> This *de minimis* rule was repealed in 1986. As was discussed earlier, however, all tax haven insurance income is now subject to the general subpart F *de minimis* rule which exempts FBC income and insurance income from subpart F if in the aggregate they constitute less than the lesser of 5% of the CFC's gross income or \$1,000,000.<sup>171</sup> In turn, gross insurance income now falls within the 70% full inclusion rule, which treats all the CFC's income as subpart F income if over 70% of gross income consists of FBC and gross insurance income.<sup>172</sup> Previously, insurance income was not subject to a full inclusion rule. It should be noted, however, that the threshold for determining CFC status is reduced from a "more than

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services income of I.R.C. § 954(e)(1)(3) (West Supp. 1988). See *supra* notes 54-60 and accompanying text. See also *Subpart F — Operative Concepts and Rules* 433, Tax Mgmt. (BNA) (1983); GENERAL EXPLANATION, *supra* note 79, at 983.

167. H.R. REP. NO. 426, 99th Cong., 1st Sess. 395 (1985).

168. I.R.C. § 953(a)(1) (West Supp. 1988). The amount of income subject to tax under subpart F is the amount that would be taxed under subchapter L if it were a domestic insurance company subject to certain modifications. *Id.* § 953(a)(2) (West Supp. 1988).

169. *Id.* § 953(a)(1)(B) (West Supp. 1988).

170. I.R.C. § 953(a) (1982) (flush language) (repealed 1986).

171. I.R.C. § 954(b)(3)(A) (West Supp. 1988); see *supra* notes 94-105 and accompanying text.

172. I.R.C. § 954(b)(3)(B) (West Supp. 1988).

50%” shareholding under prior law to a “more than 25%” shareholding, provided that the insurance income subject to subpart F exceeds 75% of the total subpart F and nonsubpart F insurance income.<sup>173</sup> The reason for varying the threshold is not immediately apparent.

## 7. Captive Insurance Income

Captive insurance companies are one of the Code’s favorite targets. A captive insurance company is a company organized primarily to provide insurance protection to its owners or persons related to its owners.<sup>174</sup> Premiums paid to captive insurance companies are generally not deductible. The primary criterion upon which the courts focus in distinguishing captive insurance from bona fide third party insurance is the absence or existence of risk shifting to an unrelated party.<sup>175</sup>

It has been possible for offshore insurance companies which provide insurance for their domestic shareholders to avoid captive status. The Service has taken the position that a foreign insurance company which provided insurance only for its thirty-one shareholders was not a captive insurer.<sup>176</sup> The thirty-one shareholders were unrelated, no shareholder held a controlling interest, and no shareholder’s risk coverage exceeded 5% of the total risks insured.<sup>177</sup>

The diffusion of ownership which allowed foreign insurance companies to avoid captive status often also kept them outside subpart F, because none of the shareholders normally would own 10% of the stock. Only shareholders who owned 10% or more of the stock were counted

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173. *Id.* § 957(b) (West Supp. 1988).

174. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-617 (1986).

175. *Carnation Co. v. Comm’r*, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965 (1981) (taxpayer corporation’s agreement with insurance company did not constitute insurance to the extent of reinsurance by taxpayer’s wholly owned subsidiary); *Humana Inc. v. Comm’r*, 50 T.C.M. (CCH) 784 (1985); *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555, 56 AFTR 2d 85-5636 (1985); Rev. Rul. 77-316, 1977-2 C.B. 53. In *Mobil Oil*, the court held that amounts paid to a wholly owned captive insurance subsidiary of Mobil were not deductible since the risk of loss had not been shifted away from Mobil. Risk shifting was also emphasized by the Supreme Court in *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941) (“elements of risk-shifting and risk-distributing are essential to a life insurance contract”).

176. Rev. Rul. 78-338, 1978-2 C.B. 107-08. In *Crawford Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Ohio 1985), the court held that an insurance premium paid by the taxpayer to a captive insurance company was an ordinary and necessary business expense. The court based its holding upon the following: (1) the captive insurance company was not formed by the taxpayer for tax avoidance purposes; (2) the captive insurance company was a separate and independent corporate entity from the taxpayer; (3) the premiums charged were actuarially based and proportionate to the risks covered; (4) the taxpayer was neither a shareholder of the captive insurance company nor of any of the shareholders of the captive; (5) the partial ownership of the captive by four employees of the taxpayer did not constitute an “economic family”; and, (6) the insurance policy named various nonaffiliated persons or entities and insured them against risks similar to those insured against for the taxpayer permitting a distribution of the risk. *Crawford*, 606 F. Supp. at 147.

177. Rev. Rul. 78-338, 1978-2 C.B. 107.

for purposes of determining whether or not the corporation was controlled by U.S. shareholders.<sup>178</sup> Moreover, premiums received from U.S. persons by foreign captives were by treaty often exempt from excise tax.<sup>179</sup>

Given these factors, Congress was concerned that premium income could avoid tax anywhere in the world (an anathema to any government).<sup>180</sup> Barring an income tax treaty exempting the foreign recipient from U.S. tax, this typically could have been true only for the insurance of non-U.S. risks, since premium income (net of losses) from the insurance of U.S. risks is U.S. source income provided the insurer is engaged in a U.S. trade or business.<sup>181</sup> Consequently, premium income will be subject to a graduated tax on the resulting taxable income if it is effectively connected with a U.S. trade or business.<sup>182</sup> Even under these circumstances there could still have been an advantage to using a foreign corporate insurer if it was not a CFC, since income earned from the investment of the premiums abroad, normally would not have been subject to a U.S. tax.<sup>183</sup> The economic advantage of avoiding U.S. tax on this latter income would have worked to the benefit of insureds if they were shareholders.

Congress concluded that U.S. shareholders of these "disbursed ownership captives"<sup>184</sup> should not be able to avoid current U.S. tax on insurance income received by the captive insurance company from shareholders and other related parties.<sup>185</sup> In Congress's view, the insurance subsidiaries were not true third party insurers, but were formed exclusively to insure a relatively small number of predefined parties.<sup>186</sup> Additionally, to the extent prior law provided tax incentives to organize insurance companies in tax haven countries, amendments were necessary to implement the congressional objective of eliminating any tax motivation for incorporating overseas.<sup>187</sup>

Tax haven insurance income that is "related person insurance income" ("RPII") now is covered by subpart F.<sup>188</sup> A CFC is defined specially, and somewhat curiously, in this area. Instead of the "more than 50%" test generally applied to determine CFC status,<sup>189</sup> or the previ-

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178. See *supra* notes 25-28 and accompanying text.

179. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-617 (1986).

180. *Id.*

181. I.R.C. §§ 861(a)(7), 832(b)(3) (1982).

182. *Id.* § 882(a) (1982 & West Supp. 1988), Rev. Rul. 80-222, 1980-2 C.B. 211, (rules that premium income is not subject to a § 881(a) withholding tax).

183. See notes 7, 13, 14 and accompanying text. Generally, U.S. shareholders are only currently taxable on corporate income of a foreign corporation if that foreign corporation is a CFC. See *supra* notes 25-28, 79-83 and accompanying text.

184. See Ball, *supra* note 89, at 356.

185. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-618 (1986).

186. *Id.*

187. H.R. REP. NO. 426, 99th Cong., 1st Sess. 391 (1985).

188. I.R.C. § 953(c)(2) (West Supp. 1988).

189. *Id.* § 957(a) (West Supp. 1988).



ously discussed "more than 25%" test applicable to foreign corporations whose income consists principally of insurance income,<sup>190</sup> the Code adopts a "25% or more" test for purposes of imputing RPII.<sup>191</sup> Why the threshold must be exceeded for CFC's normally, but only equalled in the captive insurance company context is not immediately apparent. At a minimum it demonstrates a lack of appreciation for consistency in Code drafting. The 10% threshold is eliminated in the definition of a U.S. shareholder.<sup>192</sup> Any U.S. shareholder, regardless of the degree of ownership, is therefore counted for purposes of computing the 25% test and for purposes of the imputation of a proportionate share of the RPII to the shareholder.<sup>193</sup>

RPII is defined as any insurance income attributable to an insurance or reinsurance policy where the primary insured is either a U.S. shareholder (as specially defined above) of the foreign corporation or related to such a shareholder.<sup>194</sup> Investment income attributable to RPII is also subject to subpart F treatment.<sup>195</sup> RPII also includes income arising from officers' or directors' insurance where the insureds are officers or directors of the U.S. shareholders of the CFC (or related companies) and the U.S. shareholders (or related persons) directly or indirectly pay the premiums.<sup>196</sup>

Stock and mutual insurance companies are also subject to these new subpart F rules. The policy holders of mutual insurance companies are treated as the shareholders.<sup>197</sup>

There are three exceptions to the application of subpart F to captive insurers. Two of the exceptions provide *de minimis* rules. Subpart F will not apply if the CFC's RPII is less than 20% of its gross insurance income for the year.<sup>198</sup> Insurance income in this regard, is defined as it is for subpart F generally, except the exclusion of income for same country risks does not apply.<sup>199</sup> RPII also will not constitute subpart F income if less than 20% of the total combined voting power of all classes of voting stock and less than 20% of the total value of the corporation are owned by persons who are primary insureds under any policies of insurance or

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190. *Id.* § 957(b) (West Supp. 1988); see *supra* note 173 and accompanying text.

191. I.R.C. § 953(c)(1)(B) (West Supp. 1988).

192. *Id.* § 953(c)(1)(A) (West Supp. 1988).

193. *Id.* The Service is authorized to prescribe regulations to prevent the avoidance of subpart F through cross-insurance and comparable arrangements. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-620 to -21 (1986).

194. I.R.C. § 953(c)(2) (West Supp. 1988). For these purposes a related person is defined by reference to § 954(d)(3). See *supra* notes 84-93 and accompanying text.

195. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-618 (1986).

196. *Id.* The special rules for computing tax haven insurance income provided by § 953(b), which modify the application of subchapter L, apply in computing RPII. A technical correction may be needed to achieve this result. See GENERAL EXPLANATION, *supra* note 79, at 979.

197. I.R.C. § 953(c)(4) (West Supp. 1988).

198. *Id.* § 953(c)(3)(B) (West Supp. 1988).

199. *Id.*

reinsurance issued by the corporation (or by persons related to such persons).<sup>200</sup>

Under a third exception, a corporation which is a CFC solely by virtue of the new rules, may elect to treat RPII as income effectively connected with the conduct of a U.S. trade or business.<sup>201</sup> Effectively connected income is excluded from subpart F.<sup>202</sup> The relevant insurance income thus will be subject to U.S. tax at the corporate level, eliminating the need to tax the shareholders.<sup>203</sup> Once the election is made, it is revocable only with the IRS's consent.<sup>204</sup> The foreign corporation must waive all treaty benefits, since they might reduce the U.S. tax.<sup>205</sup> The Service may impose additional requirements to insure that the tax is paid and, additionally, may collect the tax from the U.S. shareholders if the corporation itself does not pay.<sup>206</sup> While offshore captives are subject to U.S. taxation on their RPII if the election is made, they may also receive the same tax benefits as any other similarly situated U.S. insurer in this regard.<sup>207</sup> Thus, net operating losses from large claims may be carried back three years and forward fifteen years under I.R.C. section 172. This is of particular benefit to insurers of those risks for which the tax law does not permit deductions for reserves.<sup>208</sup>

Foreign mutual insurance companies will be viewed as incurring a large amount of RPII if they insure a significant number of U.S. persons because such companies are owned by their policy holders. However, in the typical case, the income also will be effectively connected with the conduct of a U.S. trade or business.<sup>209</sup> Since subpart F does not apply to effectively connected income, if it lacks treaty protection, applicable foreign mutual insurance companies should continue to be able to avoid subpart F, but not U.S. taxation.<sup>210</sup>

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200. *Id.* § 953(c)(3)(A) (West Supp. 1988). Related parties are again defined by reference to § 954(d)(3); *see supra* notes 84-93 and accompanying text.

201. I.R.C. §§ 953(c)(3)(C) (West Supp. 1988), 882 (1982 & West Supp. 1988). *See supra* notes 3-12 and accompanying text.

202. I.R.C. § 952(b) (West Supp. 1988). This assumes that the income is not exempt from taxation (or subject to a reduced rate of taxation) under a treaty.

203. *See supra* notes 3-12 and accompanying text.

204. I.R.C. § 953(c)(3)(D)(i) (West Supp. 1988).

205. *Id.* § 953(c)(3)(C)(i)(II) (West Supp. 1988).

206. *Id.* § 953(c)(3)(C)(ii) (West Supp. 1988); H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-619 (1986).

207. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-619 (1986).

208. *Id.* I.R.C. § 172 (1982 & West Supp. 1988). Congress adopted the election primarily with such foreign insurers in mind. Income treated as effectively connected under the election is considered effectively connected for purposes of the code provisions providing a deduction for certain dividends received by 10% U.S. owners of foreign corporations. I.R.C. § 245 (1982 & West Supp. 1988); H.R. CONF. REP. NO. 841, 2d Sess. II-620 (1986).

209. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-620 (1986).

210. *Id.*

## 8. Shipping Income

Under prior law, FBC shipping income was not subject to current taxation under subpart F to the extent it was reinvested in FBC shipping operations.<sup>211</sup> The income was taxed only when it was withdrawn from qualified shipping operations.<sup>212</sup> This exception, unique to FBC income, was enacted to encourage investment in shipping operations.<sup>213</sup> In 1986 Congress repealed the exception without any discussion of why it originally came into being. The repeal can be defended given Congress's desire to eliminate incentives for foreign investments. The effect of the original rule was to promote U.S. investment in foreign rather than domestic shipping operations, since as long as the funds were invested in that fashion a typically higher U.S. tax could be avoided.

Congress was also concerned that income derived from activities conducted in space, Antarctica, or on or under water not within the jurisdiction of any country, might escape taxation in any country.<sup>214</sup> Accordingly, Congress expanded the definition of FBC shipping income to include these items.<sup>215</sup> One suspects the additional revenues that will be generated will be limited.

A technical correction will be necessary to make clear that FBC shipping company provisions do not modify the prior rules which tax income withdrawn from qualified shipping reinvestments to the extent not previously taxed under subpart F.<sup>216</sup> Future years reinvested FBC shipping income which avoided U.S. taxation under the pre-1986 Code might be withdrawn from qualified shipping investments, thus making taxation appropriate.

## 9. Exception for Foreign Corporations Not Used To Reduce Taxes

Taxpayers previously subject to subpart F could avoid current taxation of FBC income, if they could establish that the tax savings was not a "significant purpose" in earning income through CFC's.<sup>217</sup> If there is no tax advantage to routing income through a foreign corporation, the concern over tax avoidance which gave rise to subpart F is allayed. This exception's underlying interpretive regulations provided an objective test, but a subjective analysis was also possible, since there can be various interpretations as to when a "significant purpose" exists. Congress believed that the subjective nature of the significant purpose test tended to

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211. I.R.C. § 954(a)(4), (b)(2), (f), (g) (1982) (repealed 1986). More specifically, FBC income did not include FBC shipping income to the extent that the amount of such income did not exceed the increase for the taxable year in qualified investments in FBC shipping operations. *Id.* § 954(b)(2) (1982).

212. *Id.* § 955 (1982 & West Supp. 1988).

213. POSTELWAITE, *supra* note 15, § 12.24.

214. H.R. REP. NO. 426, 99th Cong., 1st Sess. 395 (1985).

215. I.R.C. §§ 954(f) (flush language), 863(d)(2) (West Supp. 1988).

216. *Id.* § 955 (1982 & West Supp. 1988). See GENERAL EXPLANATION, *supra* note 79, 982 n.5.

217. I.R.C. § 954(b)(4) (1982) (repealed 1986).

involve taxpayers and the IRS in prolonged disputes and litigation.<sup>218</sup> Furthermore, the very fact that certain types of income were included within subpart F indicated that they were sufficiently prone to manipulation to raise the presumption of tax avoidance if that income was earned by a foreign corporation.<sup>219</sup>

The objective test contained in the regulations compared the tax rate paid in the CFC's country of incorporation with the lesser of what would have been either the U.S. tax or the tax of the country in which the FBC income was actually earned.<sup>220</sup> This latter tax, not always actually imposed, often required the computation of a hypothetical tax on hypothetical income with hypothetical deductions.<sup>221</sup> All of these items were potentially subject to dispute, and conflicted with Congress's desire for a simplified, reliable rule.<sup>222</sup>

Congress repealed the subjective test and adopted a modified version of the regulations' objective test.<sup>223</sup> Section 954(b)(4) now provides that upon election by the taxpayer, FBC income and insurance income do not include items of income received by a CFC which the taxpayer establishes, to the Service's satisfaction, are subject to an effective rate of foreign tax greater than 90% of the maximum U.S. corporate tax rate.<sup>224</sup> There no longer is an alternative comparison to the tax rate in the country in which the FBC income is earned. The General Explanation states that the computation of the foreign tax must be made applying U.S. tax rules.<sup>225</sup> No specific reference to this issue, however, is made in the legislative history. An alternative would be to apply earnings and profits con-

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218. H.R. REP. NO. 426, 99th Cong., 1st Sess. 396 (1985). Treas. Reg. § 1.954-1(b)(4)(ii). T.A.M. 86-43-004 (Nov. 3, 1986) involved such a dispute. There a CFC's business income did not constitute subpart F income, but the taxpayer's interest income, which from 1974 to 1979 represented 16% of its total income, was FPHC income. In 1980 and 1981, the years at issue, a business decline caused the percentage of the CFC's income that consisted of FPHC interest income to increase 59%. The CFC argued that the investment of its profits in interest bearing accounts was a business necessity and that circumstances beyond its control (i.e., the business downturn) caused the relative percentage of interest income to increase. The Service recognized that the business downturn was beyond the CFC's control, but maintained that it was predictable. The Service also argued a finding of a "tax reductive purpose" was not precluded by the fact that the CFC did not generate any FBC income from its trading activities. Further, one of the stated purposes for creating the CFC in the relevant foreign country was that no income or similar taxes were imposed by that jurisdiction. Consequently, the Service concluded that the significant purpose test was not met.

219. H.R. REP. NO. 426, 99th Cong., 1st Sess. 396 (1985).

220. Treas. Reg. § 1.954-1(b)(4)(ii), (iii) (1984).

221. H.R. REP. NO. 426, 99th Cong., 1st Sess. 396 (1985); Treas. Reg. § 1.954-1(b)(4)(iv) (1984).

222. H.R. REP. NO. 426, 99th Cong., 1st Sess. 396 (1985).

223. *Id.* at 400.

224. I.R.C. § 954(b)(4) (West Supp. 1988). The GENERAL EXPLANATION, *supra* note 79, at 983, provides that foreign tax for these purposes includes the deemed-paid foreign tax under §§ 902 and 960.

225. GENERAL EXPLANATION, *supra* note 79, at 982.

cepts.<sup>226</sup> Since the comparison is made to the U.S. tax rate on the relevant income, consistency and ease of application lends itself to the use of U.S. tax principles in the computation of the foreign tax as well.

While transactions without a tax avoidance motive may be swept in by this new test, Congress's perspective is reasonable. As the Code becomes increasingly complex, bright line tests provide taxpayers with valuable planning guidance. Further, Congress's premise that there is a tax avoidance motive if a low foreign tax jurisdiction is involved would, in the vast majority of cases, be correct.

The new objective test applies separately with respect to each "item of income" received by a CFC.<sup>227</sup> The legislative history indicates, however, that the Service should provide reasonable groupings of items that bear substantially equal effective rates of tax in a given country.<sup>228</sup>

Specifically excluded from the application of this exception, without explanation in the legislative history, is FBC oil related income.<sup>229</sup> This category of income is generally treated with suspicion by the Code.<sup>230</sup>

This discriminatory treatment for FBC oil related income is difficult to justify in this context. Admittedly, levies that are assessed by foreign countries on oil and gas income are not always true taxes. Often the assessments are royalty substitutes. The Code has responded to these problems. Section 901(f) denies foreign tax credits for foreign levies on income from oil and gas wells in which the taxpayer does not have an economic interest, if purchase or sale is at a price which is not based on fair market values.<sup>231</sup> Section 907(b) stipulates that no foreign tax credit is given for assessments on foreign oil related income which exceed the general rates of tax imposed by the relevant foreign country on non-oil and gas income.<sup>232</sup> A similar approach could be taken for purposes of section 954(b)(4). Once assurance is obtained that the taxes are bona fide, there is no policy justification for discriminating against oil and gas income. Simplification is not a defense, since sections 901(f) and 907 will normally require the taxpayers to make an investigation into the genuineness of the taxes on oil and gas income regardless. A viable alternative might be to repeal section 954(b)(4) and decline to provide an exception

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226. Ball, *supra* note 89, at 357.

227. I.R.C. § 954(b)(4) (West Supp. 1988).

228. H.R. REP. NO. 426, 99th Cong., 1st Sess. 400 (1985). By way of example, the House Report provides that all interest income earned by a CFC within its country of incorporation may be treated as a single item of income, if the interest is uniformly taxed. *Id.*

229. I.R.C. § 954(b)(4) (West Supp. 1988). See *supra* notes 60-64 and accompanying text.

230. See, e.g., I.R.C. §§ 901(a) (West Supp. 1988), 907 (1982 & West Supp. 1988), 954(a)(5) (West Supp. 1988); Landis, *The Impact of the Income Tax Laws on the Energy Crisis: Oil and Congress Don't Mix*, 64 CALIF. L. REV. 1040 (1976).

231. I.R.C. § 901(f) (1982); an economic interest is one that looks to production of oil and gas (e.g., rentals payable regardless of production) for its return. F. BURKE & R. BOWHAY, *INCOME TAXATION OF NATURAL RESOURCES* § 2.09 (1985).

232. I.R.C. § 907(b) (West Supp. 1988).

from subpart F income treatment for highly taxed foreign income at all. A repeal would reduce this area's complexity and would not necessarily be inequitable, as will be discussed in more detail in the proposal section of this article.

Since the scope of the transactions which are covered by subpart F was significantly expanded by the TRA '86, subpart F's provisions will apply more often.<sup>233</sup> Concomitantly, the exemption for foreign corporations not used to reduce taxes should also apply more frequently, and indeed Congress hoped that the flexibility provided by a readily applicable exception would become a more important part of subpart F.<sup>234</sup>

## 10. Deficits

Subpart F income cannot exceed a CFC's earnings and profits for the year.<sup>235</sup> Previously the current and prior years' earnings and profits deficits (i.e. losses) of a CFC in any income category, including income not within subpart F's purview, could reduce the CFC's other positive earnings and profits and thereby reduce subpart F income.<sup>236</sup> As a consequence, subject to certain limitations, U.S. tax on a CFC's subpart F income might be avoided by merging a corporation with earnings and profits deficits into it.

Under the prior law's "chain deficit" rule, if a CFC had a current deficit in earnings and profits, another CFC in the same chain of ownership could have its current earnings and profits surplus and thereby its subpart F income reduced by that related CFC's deficit.<sup>237</sup> The chain deficit rules, unlike the earnings and profits, generally, were calculated at the U.S. shareholder level.<sup>238</sup> CFC's were in the same chain of ownership if one CFC owned another or if a U.S. shareholder held interests in multiple CFC's.<sup>239</sup>

It is in this area that the previous foreign tax provisions had perhaps the greatest tendency to produce foreign investment. This area therefore was also where Congress found a great inducement for change.<sup>240</sup> Similar (partially remedied) problems existed in the foreign tax credit area.

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233. H.R. REP. NO. 426, 99th Cong., 1st Sess. 401 (1985).

234. *Id.*

235. I.R.C. § 952(c) (West Supp. 1988).

236. I.R.C. § 952(c) (1982) (repealed 1986).

237. I.R.C. § 952(d) (1982) (repealed 1986); Treas. Reg. § 1.952-1(d) (1983).

238. The chain deficit rules, unlike the earnings and profits rules generally, were calculated "with respect to" a U.S. shareholder. I.R.C. § 952(d) (1982) (repealed 1986) (flush language). Thus, in determining a U.S. shareholder's share of subpart F income, the earnings and profits surplus of one CFC would be reduced by a related CFC's deficit earnings and profits. Treas. Reg. § 1.952-1(d) (1983).

239. I.R.C. § 952(d) (1982) (repealed 1986). These rules could be applied if one CFC owned another CFC under the attribution rules of § 958(a)(2). Under the attribution rules, stock held by a CFC was attributed to its shareholders. *Id.* § 958(a)(2) (1982).

240. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-623 (1986).

Given the inter-relationship between subpart F and the foreign tax credit rules, a brief background discussion of the latter is appropriate.

The foreign tax credit rules permit U.S. taxpayers to reduce their U.S. taxes on a particular category of foreign income by the applicable foreign income tax.<sup>241</sup> If those foreign taxes exceed the U.S. taxes, the income normally is not subject to U.S. taxation. The excess of foreign taxes over U.S. taxes on foreign income may not offset U.S. taxes on U.S. income.<sup>242</sup> Subject to a number of limitations, it was possible, however, for the excess of foreign tax credits over U.S. taxes arising from a given type of foreign income to reduce the otherwise applicable U.S. tax on another type of *foreign* income.<sup>243</sup> This latter income would be subject to U.S. taxation if the applicable U.S. tax exceeded the foreign tax. Since foreign taxes cannot directly offset U.S. taxes on U.S. income, taxpayers with foreign income which generated excess credits had an incentive to earn other low foreign tax income overseas instead of earning that income in the United States.<sup>244</sup> The excess credits from the high foreign income could offset the U.S. taxes on the low tax foreign income. On a bottom line basis, the U.S. government was thus subsidizing the revenues of foreign governments in high tax countries by permitting a portion of the "extra" foreign taxes on their highly taxed foreign income to offset the U.S. tax on more modestly taxed foreign income.<sup>245</sup> Higher foreign taxes were made less painful by the fact that taxpayers could use any excess credits to reduce U.S. taxes on other foreign income. Existing limitations on this conduct, as well as additional changes to the foreign tax credit rules made by the TRA '86, however, now severely limit the excess foreign tax credits from one type of foreign income that may offset U.S. taxes on another type of foreign income. The result is a further reduction of the incentive to earn investment and other types of low tax income overseas rather than domestically.<sup>246</sup>

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241. I.R.C. §§ 901-908 (1982 & West Supp. 1988).

242. *Id.* § 904(a) (West Supp. 1988); *see also* H.R. REP. NO. 426, 99th Cong., 1st Sess. 329-30 (1985).

243. The credit was computed separately for passive interest income, dividends from a domestic international sales corporation (I.R.C. § 923(b) (West Supp. 1988)), foreign trade income, distributions from a foreign sales corporation (*id.* § 904(d)(1) (West Supp. 1988)) and oil and gas extraction income (*id.* § 907 (1982 & West Supp. 1988)). Other income was lumped together so that if foreign taxes on one type of this other income exceeded the allocable U.S. taxes, the excess would offset U.S. taxes on another type of this other income. *Id.* § 904(d)(1)(E) (West Supp. 1988).

244. H.R. REP. NO. 426, 99th Cong., 1st Sess. 333-34 (1985).

245. *Id.*

246. I.R.C. § 904(d) (1982) (repealed 1986); *see supra* note 241. Section 904(d) as amended by the TRA '86 increased the number of separate limitations, which now include passive income, high withholding tax interest, financial services income, shipping income, dividends from non-controlled § 902 corporations, dividends from DISC's and former DISC's, § 923(b) foreign trade income, distributions from a FSC, and income from other sources. *See* Ball, Carter & Wright, *New Tax Law Makes Major Changes to the Foreign Tax Credit Limitation*, 66 J. TAX'N 140(10) (1987).

If a CFC's loss (i.e. earnings and profits deficit) from one foreign income category offsets income (i.e. earnings and profits surplus) in another foreign income category, there is a comparable problem. Since a CFC's loss cannot be used to offset U.S. income of its U.S. shareholders,<sup>247</sup> CFC's that have or expect foreign losses have an incentive to earn other income abroad. The earnings and profits deficit from one foreign activity could offset the earnings and profits surplus from another and reduce the associated U.S. tax on income attributable to the latter.<sup>248</sup> Congress wanted to reduce the incentive to earn that other income (which would often be subpart F income) abroad instead of in the United States.<sup>249</sup>

Congress also wanted to simplify the operation of the "separate limitation look-through rules" made applicable to foreign tax credits by the TRA '86 so, to the extent feasible, they would conform to the subpart F rules.<sup>250</sup> Under the new foreign tax credit provisions, income is classified into an increasing number of categories or "separate limitations."<sup>251</sup> As was the case previously, foreign taxes on a particular category of income generally may offset U.S. taxes on the same type of income, but may not offset U.S. taxes on other categories of income.<sup>252</sup> Defining "separate limitation income" for foreign tax credit limitation purposes differently than for subpart F purposes would have substantially complicated the application and administration of the foreign tax credit "look-through" rules.<sup>253</sup> For example, separate limitation passive and shipping income are defined under the separate limitation rules with reference to their subpart F categories of FPHC income and FBC shipping income.<sup>254</sup> If passive and shipping income are computed differently under the foreign tax credit rules and subpart F, separate definitions for foreign tax credit purposes would have been required, further complicating matters and violating Congress's (mostly fanciful) goal of simplicity.<sup>255</sup>

Previously, deficits in earnings and profits incurred by foreign corporations before their acquisition by U.S. corporations could be used to shelter post-acquisition subpart F income, unless the Service could show that the acquisition was made to evade or avoid income tax.<sup>256</sup> Again, Congress felt this ability to acquire and use foreign losses gave taxpayers

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247. Foreign corporations may not file consolidated returns with their affiliated domestic parents. Only includible corporations may file consolidated returns, I.R.C. § 1504(a)(1)(A) (West Supp. 1988), and a foreign corporation does not qualify as an includible corporation. *Id.* § 1504(b)(3) (1982).

248. See *supra* note 245.

249. *Cf.* H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-623 (1986).

250. *Id.*

251. I.R.C. § 904(d)(1) (West Supp. 1988); see *supra* note 246.

252. I.R.C. § 904(d)(1) (West Supp. 1988).

253. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-623 (1986).

254. I.R.C. § 904(d)(1)(A), (D) (West Supp. 1988).

255. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-623 (1986).

256. *Id.* See also I.R.C. § 269 (1982 & West Supp. 1988).



an unnecessary incentive to earn income abroad.<sup>257</sup>

The deficit rules were also inconsistent with present and prior law requiring gain recognition upon the incorporation of a foreign branch.<sup>258</sup> Without this rule U.S. corporations could not only reduce their worldwide income and the associated U.S. tax by using losses incurred by a foreign branch to offset other income, they could also avoid U.S. tax on the subsequent profits of the foreign enterprises (often business income not subject to subpart F) by incorporating them tax-free (otherwise possible under section 351)<sup>259</sup> when they turned profitable.<sup>260</sup> However, a similar utilization of losses, followed by avoidance of tax on the income, could be achieved under prior law by using CFC's via the chain deficit rule.<sup>261</sup> Here the foreign operation would be incorporated immediately. The early year losses would be immediately used, however, by offsetting them against income earned elsewhere in the foreign chain.

The chain deficit rule also permitted some taxpayers to use the same deficits twice. The legislative history gives the following example:

Assume . . . that a U.S. corporation controls two foreign corporations. One of these foreign corporations owned the other. One of the foreign corporations (the "loss corporation") has a current deficit in earnings and profits of \$100. To fund the deficit, the U.S. corporation makes an additional \$100 contribution to the loss corporation's capital. That capital contribution increases by \$100 the U.S. corporation's basis in its stock in the loss corporation. Under the chain deficit rule, the \$100 deficit reduced the second [CFC's] currently taxable subpart F income in the year in which the deficit arose. In the following year, the U.S. corporation's stock in the loss corporation becomes worthless. Under the rules governing the deduction of losses for worthless securities, that stock is a capital asset and the U.S. corporation may therefore deduct in full its basis in the stock, including the \$100 of that basis corresponding to the prior year's additional capital contribution. The loss corporation's \$100 deficit in earnings and profits thus reduces the U.S. corporation's taxable income twice, once in the first year under the chain deficit rule, and then again in the following year under the rule allowing a loss deduction for worthless securities. A similar result may be achieved when debt was used to fund a [CFC's] loss and is later written off.<sup>262</sup>

Accordingly, the TRA '86 repealed the chain deficit rule.<sup>263</sup> The

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257. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-623 (1986).

258. *Id.* at II-624. See also I.R.C. § 367(a)(3)(C) (West Supp. 1988).

259. I.R.C. § 351 (1982 & West Supp. 1988). But see *id.* § 367 (1982 & West Supp. 1988).

260. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-624 (1986).

261. *Id.*

262. *Id.*

263. *Id.* at II-621; I.R.C. § 952(d) (1982) (repealed 1986).

extent to which accumulated earnings and profits deficits may reduce current positive earnings and profits was also reduced. Only accumulated deficits arising from FBC shipping income, FBC oil related income, subpart F insurance income, and FPHC income may, with restrictions, be used in this fashion.<sup>264</sup> A CFC's accumulated deficit in one of those categories will be able to offset only future income within that same category.<sup>265</sup> The accumulated deficit may not offset future income in one of the other categories.<sup>266</sup>

Pre-1987 deficits may not offset post-1986 subpart F income.<sup>267</sup> Congress gave no reason for this part of the rule, and there does not appear to be any immediately apparent policy justification, other than Congress's annoyance at its own prior generosity. If post-1986 deficits can offset future income, there is no reason why unused, and otherwise qualifying, pre-1987 deficits cannot do so also.

The blessed categories are subject to additional restrictions. To benefit from the new accumulated deficit rule, the foreign corporation must qualify as a CFC in both the deficit year and the subpart F income year.<sup>268</sup> Subpart F insurance income may be reduced under the new accumulated deficit rule only if the CFC was predominantly engaged in the active conduct of an insurance business in both the year in which the deficit was incurred and the year in which the income was earned.<sup>269</sup> FPHC income may be reduced only if the CFC is predominantly engaged in the active conduct of a banking, financing, or similar business in both the deficit and income years.<sup>270</sup>

The legislative history does not discuss why the blessed categories are blessed. Congress appears to have a preference for CFC income from bona fide businesses, over those which are strictly investment, or worse yet, tax avoidance vehicles. This perspective explains the exclusion of nonbanking FPHC income which would, typically, have an investment focus, and the exclusion of FBC services and sales income, which often are earned by CFC's which were formed for tax avoidance purposes by domestic corporations. Since bona fide businesses are less likely to have a tax avoidance objective as a seminal motivation for the involvement in foreign transactions, Congress's classifications can be defended, despite their addition to subpart F's complexity.

Accumulated deficits arising from activities which do not fall within the specified classifications are orphaned. In this regard Congress overreached its objectives. Limiting the deductibility of certain past losses to certain future income can be defended. Eliminating losses unused cur-

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264. I.R.C. § 952(c)(1)(B) (West Supp. 1988).

265. *Id.*

266. *Id.*

267. *Id.* § 952(c)(1)(B)(ii) (West Supp. 1988).

268. *Id.* § 952(c)(1)(A), (c)(1)(B)(ii) (West Supp. 1988); H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-621 to -22 (1986).

269. I.R.C. § 952(c)(1)(B)(iii)(III), (c)(1)(B)(v) (West Supp. 1988).

270. *Id.* § 952(c)(1)(B)(iii)(IV), (c)(1)(B)(vi) (West Supp. 1988).

rently from ever being deducted from future income is a far more difficult proposition to justify, and for corporations with unchanged shareholdings, unprecedented in the Code.<sup>271</sup> Traditionally, taxpayers which incur current business and investment losses that cannot be offset by current income are permitted to carry those losses forward and deduct them in future income years.<sup>272</sup> As a consequence, a taxpayer's taxable income in any year reflects that taxpayer's overall performance. The Code generally does not focus exclusively on current income but rather also considers expenses incurred in past loss years which might have allowed the taxpayer to earn the current income. There is no apparent reason why earnings and profits deficits in other categories, FBC sales income for example, should not be able to offset future earnings and profits surpluses in those same categories. Accordingly, the accumulated deficits rule should be amended to permit the deduction of unused earnings and profits deficits against corresponding future earnings and profits surpluses.

Accumulated deficits continue to be computed at the shareholder level. A U.S. shareholder reduces the subpart F inclusion within one of the relevant categories by that shareholder's pro rata share of the accumulated deficit for that category.<sup>273</sup> The pro rata share is based on the lesser of the shareholding in the deficit year or income year.<sup>274</sup> Consequently, pre-acquisition deficits cannot reduce post-acquisition subpart F income, since the pre-acquisition shareholding will be zero. A similar result would apply to merged corporations. Premerger losses of the merged corporation could only offset the surviving corporation's subpart F income if the merged corporation and the surviving corporation qualify as CFC's. Further, only shareholders of a merged corporation which continued as shareholders of the surviving corporation could benefit from the inherited deficit.

The TRA '86 retained the prior rule permitting a CFC's *current* deficits in any income category to reduce current subpart F income in any category.<sup>275</sup> At first glance Congress's policy concerns might seem better served by applying the equivalent of the accumulated deficit rule for current deficits and current income. Taxpayers incurring current losses in a CFC will have an incentive to find current, foreign income for the CFC to earn. The most readily available income typically will qual-

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271. *Id.* § 382 (West Supp. 1988) does place restrictions on loss carryovers where there has been an "owner shift" or "equity structure shift" to the value of the old loss corporation multiplied times the long-term tax exempt rate. *Id.* § 382(b)(1), (g) (West Supp. 1988).

272. *Id.* §§ 172 (1982 & West Supp. 1988) (net operating loss carryovers limited to 15 years), 1212 (1982 & West Supp. 1988) (capital loss carryovers generally unlimited).

273. *Id.* § 952(c)(1)(B)(i) (West Supp. 1988).

274. *Id.* § 952(c)(1)(B)(iv) (West Supp. 1988).

275. *Id.* § 952(c)(1)(A) (West Supp. 1988). See BITTKER & EUSTICE, *supra* note 35, ¶ 7.03, for the general proposition that current deficits (i.e., losses) reduce a corporation's current earnings and profits. Aggregate foreign losses may reduce U.S. source income only to the extent they exceed aggregate foreign income. I.R.C. § 904(f)(5)(A) (West Supp. 1988).

ify as subpart F income. If taxpayers are not anticipating losses, it would be relatively rare for taxpayers to be able to react quickly enough to earn substantial current income in a CFC once they ascertain that the CFC will suffer offsetting current losses. However, if losses are expected, taxpayers will have an incentive to earn income, including subpart F income, overseas to offset current deficits created by the losses. However any other rule would completely disallow the taxpayers' losses, by not permitting the foreign current deficits to offset foreign current earnings and profits if the losses do not arise in one of the categories to which the remnants of the accumulated deficit rule still apply. This would only further increase the discussed inequity of the new accumulated deficit rule. Offsetting current earnings and profits with current deficits under the current rules is appropriate. If, however, the suggested modification to the accumulated deficit rule were adopted, this would not necessarily be the case. Indeed, there would then be no need to bifurcate current and accumulated deficit rules. One rule could be substituted under which earnings and profits deficits could only reduce earnings and profits surpluses arising in the same category.

Congress did provide a penalty for taxpayers who take undue advantage of the current deficit provisions. TRA '86 provides that if subpart F income is reduced under the current deficit rule, the excess of the CFC's earnings and profits over its subpart F income in any subsequent year is re-characterized as subpart F income to the extent of the prior year's reduction.<sup>276</sup> The born again subpart F income, like any other subpart F income, will be currently included in the income of the U.S. shareholders.<sup>277</sup> This further complicates the Code by creating the equivalent of a new category of subpart F income, a complexity that would be avoided if the suggested change is made.

#### IV. PROPOSAL

The principal purposes behind subpart F are twofold; to prevent taxpayers from avoiding U.S. tax through the use of foreign corporations and to eliminate any tax incentive taxpayers might have to conduct their affairs abroad. The difficulty with subpart F is that it is essentially reactive. For each move of the taxpayer, subpart F provides a countermove. The result is a highly complex, technical and administratively burdensome set of Code provisions. There are numerous income categories, inclusions, exclusions, limitations, modifications, exceptions, and exceptions to the exceptions. The modifications to subpart F by TRA '86 represent a current example of the complexities that arise as Congress endeavors to "fine tune" this part of the Code.

The heart of subpart F's dilemma is Congress's acceptance of the premise that foreign corporations, even when controlled by U.S. taxpay-

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276. I.R.C. § 952(c)(2) (West Supp. 1988).

277. See *supra* notes 29-32 and accompanying text.

ers, should be respected as foreign entities and therefore generally should be exempt from U.S. taxation. That premise is faulty. A foreign, non-subpart F business activity conducted by U.S. shareholders will be subject to U.S. taxation if it is conducted through a U.S. corporation, and will avoid U.S. taxation if a foreign corporation is utilized. There is no policy justification for treating transactions differently based solely on whether the U.S. taxpayer incorporates in Delaware or in the Belize. If U.S. taxation is appropriate, it should apply regardless of the business vehicle used. By the current Code's taxing scheme, Congress has expressed a general policy of taxing U.S. taxpayers on their worldwide income.<sup>278</sup> To achieve that objective, as well as the goal of simplification, Congress should replace subpart F with a rule which provides, generally, that all U.S. citizens and residents are taxable on their pro rata shares of all foreign income, irrespective of the structure through which it is earned.<sup>279</sup> Such an approach would be more equitable and reliable than the current one and be far less complex. Indeed, the various income classifications take up a good portion of subpart F (and of this article).<sup>280</sup>

One objection to ending all deferral of U.S. taxes for domestic shareholders of foreign corporations is that an increased level of domestic taxation on U.S. participants in foreign business transactions could adversely affect exports. This concern was a principal reason why Congress did not take a more pervasive approach to subpart F upon its original enactment.<sup>281</sup> Subpart F, however, provides an inartful means of encouraging exports. Many types of active business income that have nothing to do with exporting are excluded. Indeed, a U.S. corporation could own a foreign subsidiary which earns income from import transactions and avoid subpart F, though not U.S. source income.<sup>282</sup> More commonly, U.S. taxpayers can use foreign corporations to conduct many types of exclusively non-U.S. businesses and avoid U.S. taxation.<sup>283</sup> If Congress wishes to provide incentives for exporting, more precise tools should be used which encourage exports without permitting nonexport related income simultaneously to avoid tax. Examples that currently exist in this regard are the TRA '86's export financing interest, and foreign sales corporations.<sup>284</sup>

As in all areas of tax, exceptions to an approach of full inclusion

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278. POSTELWAITE, *supra* note 15, § 1.01.

279. Cf. Shepherdson, *The Simplification of subpart F*, 17 CASE W. RES. J. INT'L L. 459 (1985) (proposing several substantive modifications to subpart F and concluding that a unitary tax system developed through international agreements would be the best approach to accomplish a tax simplification objective. A proposal to bring all types of income within the confines of subpart F was also made.).

280. I.R.C. §§ 951(a)(2), (3), 952, 953, 954, 955 (1982 & West Supp. 1988).

281. H.R. REP. NO. 1447, 87th Cong., 2d Sess. 57 (1962).

282. See *supra* notes 40-73 and accompanying text.

283. A foreign manufacturing business, for example, is outside the scope of subpart F. The income would not fall within the subpart F classification. See *supra* notes 40-73 and accompanying text.

284. See I.R.C. §§ 921-927, 954(c)(2)(B) (West Supp. 1988).

would not be completely avoidable. It would not be fair to tax domestic shareholders currently on the income of publicly held foreign corporations. In this case the stock of the foreign corporation constitutes the investment and a tax avoidance motivation is typically lacking. In the normal subpart F circumstance that requires a statutory response, the foreign corporation is a tax avoidance *vehicle* to make investments or conduct business, and the corporate stock does not represent the investment. Further, investors in publicly held foreign corporations, owing to their generally small holdings, would have no practical way to force the foreign corporation to furnish them with information on their pro rata share of income or loss. Any new rule, therefore, should be limited to closely held foreign corporations.

While there is no iron clad definition of a closely held corporation, something analogous to the *Foreign Personal Holding Company* rules could be used. These provisions apply if five or fewer U.S. citizens or resident individual shareholders own over half the foreign corporation's stock.<sup>285</sup> That standard is probably too restrictive for the purposes of a rule designed to expand U.S. taxation. A more suitable standard would be to subject income to current taxation for corporations in which fifteen or fewer shareholders (individual or corporate) have control. The concerns which caused the TRA '86 to adopt vote or value standards in determining control are valid.<sup>286</sup> Shareholders can have effective control without owning a majority of the voting stock. The threshold test, therefore, would be met if fifteen or fewer shareholders hold over 50% of the foreign corporation's stock by value or vote. To avoid abuse, related parties would continue to be counted as one shareholder, and the current attribution rules would continue to apply.<sup>287</sup>

Some minimum threshold of U.S. ownership is also appropriate. Again, it might be difficult for U.S. shareholders, if they have very limited shareholdings, to obtain the information necessary to determine their share of the foreign corporate income or loss. Furthermore, the administrative burden could be great, providing a strong disincentive for participation in foreign business transactions. Code provisions which discourage foreign investment, in addition to violating the congressional policy, could invite reprisals. Thus, some minimum U.S. shareholding would appear appropriate.

On the other hand, U.S. control would not appear to be an absolute prerequisite. Substantial U.S. participation would insure sufficient influence in the affairs of the corporation for U.S. participants to be able to obtain the necessary tax information. A closely held foreign corporation normally constitutes an incorporated joint venture of a small number of parties. Giving the U.S. participants the relevant data normally should not pose a substantial burden. Further, the U.S. taxpayers generally

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285. *Id.* § 552(a)(2) (West Supp. 1988).

286. *See supra* notes 80-83 and accompanying text.

287. *See* I.R.C. § 958 (1982).

would be in a position to insist on receiving the relevant information as a precondition to their participation. The captive insurance rules provide a reasonable percentage.<sup>288</sup> Before foreign corporate income is imputed to domestic shareholders, the domestic shareholders must own 25% or more of the foreign corporation's stock, by vote or value.<sup>289</sup> Again, existing related party and attribution rules should continue to apply.<sup>290</sup>

Since this proposed revision of subpart F would only apply to foreign corporations which are closely held, it is highly unlikely that the U.S. stockholding would be widely diffused. It should not be difficult, therefore, to impute income to all U.S. participants. The 10% minimum threshold which typically applies currently before income is imputed<sup>291</sup> thus seems unnecessary, and could permit domestic shareholders who fall under that generous threshold to avoid, in absolute terms, U.S. tax on large amounts of foreign income. Reducing the threshold to 1% would eliminate tax windfalls while serving the needs of administrative convenience.

Since deferral of taxes occurs when the foreign corporation has profits, as under current law, income should only be imputed to the U.S. shareholders to the extent of income measured by earnings and profits. In the interest of simplicity, as under current law, losses should not flow through. If U.S. taxpayers want to use foreign losses to offset other income, they can conduct their foreign activities through a domestic branch (with the losses therefore incurred directly by the domestic corporation),<sup>292</sup> or through a domestic subsidiary (with the parent obtaining the benefit of the losses by filing a consolidated return).<sup>293</sup> If the participation of foreign nationals dictates the use of a foreign corporation, the U.S. taxpayers can obtain the benefit of the losses by having a branch or domestic subsidiary enter into a joint venture with the foreign corporation.<sup>294</sup>

If imputed income is limited to earnings and profits, and earnings and profits deficits can offset CFCs with earnings and profits, CFCs with deficits will have the same incentive to earn foreign income as they did prior to the TRA '86. Accordingly, a deficit rule continues to be required. The TRA '86's version was premised on the subpart F income categories.<sup>295</sup> With the expansion of the types of income that will be subject to subpart F, a new deficit rule must be developed. Congress's implicit focus in the TRA '86 on bona fide business activities seems sensi-

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288. See *supra* notes 174-93 and accompanying text.

289. I.R.C. § 953(c)(1)(B) (West Supp. 1988).

290. *Id.* § 958 (1982).

291. *Id.* § 951(b) (1982); see also *supra* notes 27-28 and accompanying text.

292. See POSTELWAITE, *supra* note 15, § 1.02.

293. I.R.C. § 1501 (1982). *But see* note 247 *supra* (U.S. and foreign corporations may not file consolidated returns).

294. Partnership tax rules would apply, and losses from the activity would flow through to the U.S. joint ventures. I.R.C. § 702 (1982 & West Supp. 1988).

295. See *supra* notes 263-74 and accompanying text.

ble. Business activities tend to have the nontax focus necessary to avoid extensive abuses. Further, if business activities were not exempted, a disincentive to engage in foreign business transactions could exist. This again violates principles of neutrality and could invite foreign reprisals. Therefore, a CFC's unused business earnings and profits deficits should only offset its future business earnings and profits surpluses. Orphaning nonbusiness earnings and profits, debatable under the current taxing scheme, is wholly indefensible when all income flows through to the U.S. shareholders. Accordingly nonbusiness earnings and profits deficits should offset future nonbusiness earnings and profits surpluses. Congressional concern regarding the chain deficit rule is valid; it provided excessive incentive for foreign investment and it should not be resurrected as part of any revision of subpart F.<sup>296</sup>

If the domestic shareholders are not achieving any tax deferral by using a foreign corporation, there is little need to impute income to them. Thus a rule similar to the current one could be adopted whereby no income would be imputed if the corporation pays an income tax equal to 90% of the equivalent U.S. tax.<sup>297</sup> However, this rule is more sensible under a subpart F which has only limited application. The more expansive approach taken by this proposal would be simplified by omitting the exception. U.S. taxpayers would not be adversely affected if the foreign taxes credit paid by the corporation could be credited against their U.S. taxes.<sup>298</sup>

This proposal could pose a disadvantage to U.S. controlled foreign corporations exclusively doing foreign business. Foreign corporations controlled by non-U.S. persons might not be subject to similar rules by their own home countries. The foreign rivals could incorporate in tax haven jurisdictions and thus be at a competitive advantage. This circumstance, however, does not represent an actual discrimination against foreign business, which is treated the same as U.S. business for U.S. tax purposes. Further, since these activities are exclusively foreign, there may be little or no U.S. benefit and therefore little or no need for U.S. incentives. If particular industries are suffering unduly, a specifically targeted relief provision could be added. It should be recalled, however, that yielding to special interests caused much of the Code's current and much criticized complexity.

A final issue concerns developing countries. They may find it more difficult to obtain U.S. business support if foreign corporate income will be imputed to U.S. shareholders. The solution, as in the export areas, if one is necessary at all, is to provide a tax vehicle specifically targeted at this situation rather than one that is broadly encompassing. Thus, cor-

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296. See *supra* notes 237-62 and accompanying text.

297. See *supra* notes 217-34 and accompanying text.

298. See generally I.R.C. §§ 901-908 (1982 & West Supp. 1988); see *supra* notes 241-47 and accompanying text.



porations doing business in developing countries might, for a time, be excepted from these rules.

The once ironclad principle that corporations are separate taxable entities apart from their shareholders is honored in the breach if these suggestions are followed. However, the veil has already been thoroughly pierced by subpart F in its current form, and if Congress's policy goals of eliminating tax avoidance and reducing tax incentives for investing overseas through foreign corporations are to be realized, the process should be expanded.