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# Controlled Foreign Corporations: Exclusion of Subpart F Income by Receipt of Minimum Distributions-A Complexity of Rules and Regulations

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CONTROLLED FOREIGN CORPORATIONS:  
EXCLUSION OF SUBPART F INCOME  
BY  
RECEIPT OF MINIMUM DISTRIBUTIONS—  
A COMPLEXITY OF RULES AND REGULATIONS

I. Introduction

Subpart F of Part III, Subchapter N of Chapter 1 of the Internal Revenue Code of 1954, as amended,<sup>1</sup> has been considered "one of the most lengthy and complicated"<sup>2</sup> sections of the Code. One particular section, section 963 (minimum distributions), has been termed "one of the most complex schemes ever to be devised in the history of tax legislation,"<sup>3</sup> representing "the most complex and ingenuous concepts in the history of tax legislation,"<sup>4</sup> and "a completely new set of tax concepts."<sup>5</sup> Along with the ingenuous and extremely complex code sections go an "inordinate complexity of rules"<sup>6</sup> and "massive and enormously complex Regulations."<sup>7</sup>

This note is intended to set forth in general terms an explanation of the complex rules that are involved in minimum distributions.<sup>8</sup> There are many specific problems, that will not be considered. Litigation has just begun involving other sections of Subpart F and most certainly will soon arise involving section 963.

II. Background

Under former law a United States shareholder of a foreign corporation not engaged in a trade or business within the United States was not taxed on any portion of the foreign corporation's profits until they were distributed as a dividend or in liquidation.<sup>9</sup> This had the effect of allowing a United States citizen to legally defer taxes by conducting foreign operations through a corporation organized under the laws of a low tax country and accumulating the profits taxed at a nominal rate (well below United States tax rates). These accumulated profits would be used for reinvestment in foreign countries (thus having the effect of actually deferring United States taxes indefinitely) or would be distributed to the United States shareholder at some later time (thus deferring United States taxes until distribution).

1 INT. REV. CODE OF 1954, §§ 951-64.

2 Cherryman, *The New "Subpart F" Foreign Income Provisions of the Internal Revenue Code*, 4 WM. & MARY L. REV. 172 (1963).

3 *Id.* at 202.

4 Comment, *Minimum Distributions of Controlled Foreign Corporations under Section 963 of the Internal Revenue Code*, 26 OHIO STATE L.J. 460, 494 (1965).

5 Phelps, *How Minimum Distributions Can Reduce Tax On Subpart F Income*, 17 J. TAX. 356 (1962).

6 Friedman, *Minimum Distributions Under Section 963 - What Is Left of Subpart F?*, N.Y.U. 23RD INST. ON FED. TAX 955, 971 (1965).

7 *Id.* at 957.

8 For a good detailed analysis of minimum distributions, see Gifford, 105-2d T.M. (1970), *Controlled Foreign Corporations — Section 963*.

9 INT. REV. CODE OF 1954, §§ 881-82.

To end tax deferral on "tax haven" operations by United States persons who control such foreign corporations, subpart F was added to the Internal Revenue Code in 1962.<sup>10</sup> Its effect is to tax every person<sup>11</sup> who owns 10 percent or more of the total combined voting power of any foreign corporation (of which more than 50 percent of the voting power is owned by United States shareholders)<sup>12</sup> on his pro rata share<sup>13</sup> of undistributed earnings and profits derived from the insurance of United States risks<sup>14</sup> and from specific kinds of income from the sale of goods between related persons,<sup>15</sup> from the performance of services for related persons,<sup>16</sup> and from passive investment.<sup>17</sup> Additionally, previously excluded "subpart F income" withdrawn from investment in less developed countries<sup>18</sup> and earnings invested in United States property<sup>19</sup> are taxed under this section.

There are several instances in which subpart F income otherwise taxable to a United States shareholder is sheltered from the operation of this scheme. If the foreign base company income is less than 30 percent of the total gross income of the controlled foreign corporation, none of the corporation's income is taxable under subpart F.<sup>20</sup> If it is established to the satisfaction of the Commissioner that neither the creation, organization, or acquisition of the controlled foreign corporation nor the effecting of the transaction giving rise to the income has as one of its significant purposes a substantial reduction of taxes, then none of the resulting income is taxable under subpart F.<sup>21</sup> Also, certain dividends, interest, and gains from qualified investments in less developed countries are excluded from subpart F income to the extent they do not exceed any increase in the investment for the taxable year.<sup>22</sup> The most widely utilized "escape hatch," however, is the minimum distribution provision.<sup>23</sup>

### III. Purpose and Effect of Section 963

The function of section 963 (minimum distributions) is to eliminate the taxation of subpart F income of a controlled foreign corporation, or corporations, to the United States corporate shareholder under subpart F, provided the United States corporate shareholder receives the distributions required from the con-

10 Section 12 of the Revenue Act of 1962 (Pub. L. No. 87-834) added Subparts F & G (§§ 951-72) to the Internal Revenue Code.

11 INT. REV. CODE OF 1954, § 957(d) defines "United States Person."

12 *Id.* § 951(4)(b) defines "United States Shareholder." *Id.* § 957(a) defines "Controlled Foreign Corporation."

13 *Id.* § 951.

14 *Id.* §§ 952(a)(1), 953.

15 *Id.* §§ 952(a)(2), 954(a)(2), 954(d).

16 *Id.* §§ 952(a)(2), 954(a)(3), 954(e).

17 *Id.* §§ 952(a)(2), 954(a)(1), 954(c).

18 *Id.* §§ 951(a)(1)(A)(ii), 955. § 955(c) defines "less developed country corporations."

19 *Id.* §§ 951(a)(1)(B), 956.

20 *Id.* § 954(b)(3)(A). (Foreign base company income is defined in *Id.* § 954(a), see notes 15, 16 and 17, *supra*.) Conversely, if more than 70 percent of the gross income is of the subpart F type, all of the corporation's income is treated as subpart F income. *Id.* § 954(b)(3)(B).

21 *Id.* § 954(b)(4), as amended by § 909(a), Tax Reform Act of 1969, Pub. L. No. 91-172.

22 *Id.* § 954(b)(1); Treas. Reg. § 1.954-5 (1964).

23 Tillinghast, *United States Income Taxation of Foreign Source Income: A Survey of the Provisions and Problems*, N.Y.U. 29TH INST. ON FED. TAX. 1, 30 (1971).

trolled foreign corporation.<sup>24</sup> The purpose of the provision is to forego any tax on the United States corporate shareholder with respect to undistributed income of controlled foreign corporations in those cases where the combined foreign tax and United States tax (to the extent the latter is paid on the distributed income of the foreign corporation or paid by the foreign corporation on its earnings and profits) is not substantially below the United States corporate tax rate.<sup>25</sup> The fundamental scheme of the section is to require distributions from the controlled foreign corporation in such amounts as are necessary to bring the combined foreign and United States tax rate on the pre-tax and pre-distribution income of the controlled foreign corporation to approximately 90 percent of the United States corporate tax rate.<sup>26</sup> The required minimum distribution thus varies inversely with the effective foreign tax rate of the controlled foreign corporation. As the effective foreign tax rate increases, the required minimum distribution decreases.<sup>27</sup>

Literally, section 963 permits a United States corporate shareholder to elect to receive a minimum distribution regardless of whether the foreign corporation has subpart F income.<sup>28</sup> An election to receive a minimum distribution may enable the United States shareholder relief from the accounting, legal, and other administrative complexities of the balance of subpart F.<sup>29</sup> A United States shareholder who is not certain of the amount of its subsidiary's subpart F income should be permitted to make a section 963 election on the ground of administrative convenience.<sup>30</sup> Therefore, any otherwise eligible United States shareholder could make a section 963 election without regard to whether any of the subject foreign corporations have subpart F income for the year.<sup>31</sup> Thus, an election under section 963 can be merely precautionary.

The section does not protect the United States corporate shareholder from taxation of previously excluded subpart F income withdrawn from investments in less developed countries or earnings invested in United States property.<sup>32</sup> A minimum distribution election operates only to exclude taxation of undistributed income from the insurance of United States risks<sup>33</sup> and foreign base company income<sup>34</sup> of the controlled foreign corporation included in the election.

24 Creed & Miles, *Foreign Tax Credits of Domestic Corporations: Sections 902, 960, and 963*, N.Y.U. 24TH INST. ON FED. TAX. 1353, 1379, 1380 (1966).

25 S. REP. No. 1881, 87th Cong., 2d Sess. 88 (1962).

26 Creed & Miles, *supra* note 24, at 1380.

27 S. REP. No. 1881, 87th Cong., 2d Sess. 265 (1962); H. REP. No. 2508, 87th Cong., 2d Sess. 34 (1962).

28 GIFFORD, *supra* note 8, at A-6.

29 Some would regard section 963 as an added layer of complexity requiring additional accounting, legal and administrative work. See *Id.* at A-30.

30 *Id.* at A-7.

31 *Id.* The Internal Revenue Service does not necessarily agree with this, since treating distributions as minimum distributions enables the taxpayer to use the special rules for determining earnings and profits and foreign tax credits, usually to the taxpayer's advantage. Treas. Reg. § 1.963-4(c), T.D. 6767, 1964-2 CUM. BULL. 258-59.

32 INT. REV. CODE OF 1954, § 951(a)(1)(A).

33 As defined by *Id.* § 953(a).

34 As defined by *Id.* § 954.

## IV. Election

An election to receive minimum distribution in lieu of paying tax on the undistributed earnings of a controlled foreign corporation is only available to a United States shareholder which is a domestic corporation<sup>35</sup> and which consents to all the regulations prescribed by the Secretary or his delegate.<sup>36</sup> It is not available to individuals, partnerships, estates, or trusts.<sup>37</sup> However, an affiliated group of corporations which files a consolidated return for United States tax purposes, may, if it so elects, be treated as a single United States shareholder for purposes of making a minimum distribution election.<sup>38</sup>

The election is made by the United States corporate shareholder on a year-by-year basis, and the form of the election may change each year.<sup>39</sup> The election may be made with respect to one or more first-tier controlled foreign corporations;<sup>40</sup> it may be made with respect to foreign corporations connected in a chain of stock ownership;<sup>41</sup> or it may be made with respect to a group of controlled foreign corporations.<sup>42</sup> The election covers the earnings and profits of the controlled foreign corporation for taxable years ending within the taxable year of the United States shareholder.<sup>43</sup> If a controlled foreign corporation has two taxable years ending within the taxable year of the United States shareholder (*i.e.*, short tax year from a change in accounting period) a minimum distribution must be received with respect to each of the two taxable years.<sup>44</sup>

No special return or information return is required for a United States shareholder to elect to exclude subpart F income under section 963.<sup>45</sup> The regulations simply require that the United States shareholder file with its return for the taxable year a written statement that an election under section 963 is made for the taxable year, the names of the foreign corporations to which the election applies, and the necessary data to compute the minimum distribution.<sup>46</sup> The election applies only to the taxable year of the United States shareholder for which the election is made.<sup>47</sup> Once the period for making an election has expired, a section 963 election is irrevocable unless the United States shareholder can establish to the satisfaction of the Commissioner that reasonable cause exists

35 A domestic corporation includes corporations, associations, joint-stock companies, and insurance companies created or organized under the law of the United States or any State or Territory. *Id.* § 7701(a)(3), (4).

36 *Id.* § 963(a).

37 Section 962 provides for an individual to be "taxed" as if a corporation for purposes of subpart F. However, even if an individual makes an election under section 962, he does not qualify to make an election under section 963.

38 INT. REV. CODE OF 1954, § 963(e)(3).

39 *Id.* § 963(a).

40 *Id.* § 963(a)(1). A first-tier controlled foreign corporation is a foreign corporation whose stock is owned directly by the United States Shareholder. Treas. Reg. § 1.963-1(b)(2) (1964).

41 *Id.* § 963(a)(2).

42 *Id.* § 963(a)(3).

43 *Id.* § 951(a)(1)(A)(i).

44 Rev. Rul. 68-477, 1968-2 CUM. BULL. 317; further amplified by Rev. Rul. 71-453, 1971-2 CUM. BULL. 292.

45 Treas. Reg. § 1.963-1(c)(2)(iv) (1964).

46 *Id.* § 1.963-1(c)(2).

47 *Id.* § 1.963-1(a)(1).

for revocation or modification.<sup>48</sup> A United States corporate shareholder must make its election on or before the last day prescribed by law for filing its income tax return for the taxable year.<sup>49</sup>

### V. Distributions

A distribution is a payment in some form (not necessarily an actual cash transfer) to a shareholder of a corporation. It may be taxable to the shareholder as an ordinary dividend;<sup>50</sup> it may be taxed at a special rate;<sup>51</sup> or it may not be taxed at all.<sup>52</sup> Section 963 refers to a "minimum distribution." Not all distributions count toward a minimum distribution. A distribution to a United States shareholder counts toward a minimum distribution only to the extent that:

- (1) It is received by the United States shareholder within its taxable year to which the election relates, or within 180 days thereafter.
- (2) The United States shareholder chooses to include the distribution in gross income for the taxable year to which the election relates, even though the distribution is received after the end of the year.
- (3) The distribution is actual, rather than constructive, and taxable as an ordinary dividend. . . .
- (4) The distribution is deemed to be [from] the earnings and profits of the foreign corporation for [the] taxable year to which the election relates.<sup>53</sup>

Distributions are deemed to come first out of current earnings and profits and then out of the most recent accumulated earnings and profits of prior years.<sup>54</sup> A distribution is deemed to be out of earnings and profits of the taxable year to which the section 963 election relates only if it is made during the distribution period of the foreign corporation.<sup>55</sup> Normally the distribution period begins on the 61st day of the taxable year and ends on the 60th day of the next taxable year.<sup>56</sup> The United States shareholder, however, may elect a distribution period ending on any day between the last day of the foreign corporation's taxable year and 180 days thereafter.<sup>57</sup> Thus, the distribution period of any foreign corporation may be chosen on a year-by-year basis, within the limits of the zero to 180 day period. The United States shareholder's choice for one year does not

48 *Id.* § 1.963-1(c)(3)(ii)(a). Reasonable cause can exist only if, after the initial election, a material and substantial change in circumstances affecting the election occurs which reasonably could not have been anticipated when the election was made, and which, to a significant degree, was beyond the control of the electing United States shareholder. *Id.* § 1.963-1(c)(3)(ii)(b).

49 INT. REV. CODE OF 1954, § 963(a). This includes any extensions of time for filing the return under section 6081.

50 *Id.* § 316.

51 *Id.* § 2501.

52 *Id.* § 332.

53 GIFFORD, *supra* note 8, at A-22, 23.

54 INT. REV. CODE OF 1954, § 316(a)(2).

55 Treas. Reg. § 1.963-3(c)(1) (1964).

56 *Id.* § 1.963-3(g)(1) (1964).

57 *Id.* § 1.963-3(g)(2) (1964).

bind it for any succeeding year.<sup>58</sup> In addition, the United States shareholder may elect different distribution periods for different foreign corporations subject to the same section 963 election.<sup>59</sup>

An exception of the rule requiring a distribution to be made during the distribution period before it may count toward a minimum distribution involves excess distributions; *i.e.*, amounts distributed in excess of the required minimum distribution. An amount received in excess of the amount required under section 963 does not qualify as a minimum distribution for that election year.<sup>60</sup> Therefore, the amount of the excess distribution cannot be included in gross income of the preceding year when received after the end of the taxable year even though received during the distribution period. The amount of the minimum distribution is included in gross income for the taxable year to which the election relates even though the distribution is received after the end of the year. The excess distribution is taken into account as a distribution in the taxable year of receipt.<sup>61</sup> Therefore, if the excess distribution is made in the tax year (other than during the special extended distribution period), no part of such excess may be treated as a minimum distribution in either the year of receipt<sup>62</sup> or the subsequent tax year.<sup>63</sup> If the excess distribution is made beyond the tax year but within the special extended distribution period, then the excess may be treated as a minimum distribution in the subsequent tax year if the United States shareholder so chooses.<sup>64</sup> This distribution is not made during the distribution period of the subsequent year to which it is being applied because the new distribution period does not begin until after the close of the preceding year's period,<sup>65</sup> which has not yet ended. In effect a legal fiction is created by considering the end of the distribution period to be the date that the excess amount is distributed. The excess amount is deemed distributed on the next day which is day one of the distribution period for the next tax year.<sup>66</sup>

Another exception to the distribution period rule involves deficiency distributions. If a United States shareholder elects to receive minimum distributions from one or more foreign corporations for a taxable year but fails to receive a sufficient distribution for the year, providing such failure is due to reasonable cause, a subsequent distribution to bring the minimum distribution to the required level may be made any time between the end of the foreign corporation's distribution period to which the attempted election relates and 90 days after deter-

58 However, Treas. Reg. § 1.963-3(g)(1) defines the distribution period as beginning immediately after the close of the preceding year's distribution period, or on the 61st day of the taxable year if no section 963 election applied to the preceding year.

59 GIFFORD, *supra* note 8, at A-26. "The flexibility provided may prove to be convenient where foreign corporations in a group or chain have different taxable years, as some confusion might be avoided by electing distribution periods which end on the same day." *Id.* at A-27.

60 Rev. Rul. 68-522, 1968-2 CUM. BULL. 320. However, there are no cases to date on this point. See note 122 *infra*.

61 Rev. Rul. 68-522, 1968-2 CUM. BULL. 320, *clarified and amplified* by Rev. Rul. 73-182, 1973 INT. REV. BULL. No. 16, at 21.

62 *Id.*

63 *Id.*

64 *Id.* "The choice to have the excess amount count toward the minimum distribution in the subsequent tax year does not constitute a modification or revocation of election. . . ." Rev. Rul. 73-182, 1973 INT. REV. BULL. No. 16, at 21.

65 See note 58 *supra*.

66 Rev. Rul. 73-182, 1973 INT. REV. BULL. No. 16, at 21.

mination of inadequate distributions.<sup>67</sup> Even though the distribution is not made during the distribution period, it is treated as having been made for, and received in, the taxable year of the United States shareholder for which the election applies.<sup>68</sup>

## VI. Determining Minimum Distributions

The amount of the required minimum distribution under a section 963 election is determined by multiplying the United States shareholder's proportionate share of the earnings and profits<sup>69</sup> of the foreign corporations included in the election by the tabular percentage:<sup>70</sup>

$$\text{Min. Dist.} = \text{Prop. Share E \& P} \times \text{Tabular \%}$$

Earnings and profits are determined first without reduction for foreign income tax or distributions made by the foreign corporation.<sup>71</sup> Distributions received by the foreign corporation from other controlled foreign corporations included in the election<sup>72</sup> and foreign income taxes are then subtracted:<sup>73</sup>

$$\text{E \& P} = \text{Pre-tax \& Pre-dist. E \& P} - (\text{F.T.} + \text{Dist. Rec'd})$$

The United States shareholder's proportionate share of earnings and profits of the foreign corporation is determined by multiplying the earnings and profits as just determined by the percentage ownership:<sup>74</sup>

$$\text{Prop. Share E \& P} = \text{E \& P} \times \% \text{ Ownership}$$

The tabular percentage varies depending upon the effective foreign tax rate of the foreign corporation or corporations subject to the section 963 election. The effective foreign tax rate is determined by dividing the United States shareholder's proportionate share of the foreign income, war profits, or excess profit

67 INT. REV. CODE OF 1954, § 963(e)(2). Besides showing reasonable cause and timely receipt, the United States shareholder must also file a claim for treatment of the distribution as a deficiency distribution and pay any interest, additional tax, and penalties which apply. Treas. Reg. § 1.963-6(b) (1964).

68 Treas. Reg. § 1.963-3(d) (1964).

69 In a chain or group election, "consolidated" earnings and profits are used. Consolidated earnings and profits are the sum of the United States shareholder's proportionate shares of earnings and profits for all foreign corporations in the chain or group reduced by deficits in such earnings and profits. Treas. Reg. § 1.963-2(d)(3) (1964).

70 Tables are included in INT. REV. CODE OF 1954, § 963.

71 Earnings and profits are determined according to INT. REV. CODE OF 1954, § 964 and Treas. Reg. § 1.964-1 (1964), which in general provide that the determination shall be made according to rules substantially similar to those applicable to domestic corporations.

72 Foreign income tax on these distributions from other controlled foreign corporations included in the election are subtracted only if the United States shareholder chooses to take such tax into account in determining the effective foreign tax rate. Treas. Reg. § 1.963-4(b)(1) (1964).

73 Treas. Reg. § 1.963-2(d)(1) (1964).

74 The proportionate share is the amount which the United States shareholder would receive if the foreign corporation's entire earnings and profits for the year were distributed on the last day of its taxable year or the last day it was a controlled foreign corporation. Treas. Reg. § 1.963-2(d)(2) (1964).

75 Or taxes in lieu of income, war profit, or excess profit taxes. Treas. Reg. § 1.963-1(b)(7) (1964).



taxes<sup>75</sup> paid or accrued<sup>76</sup> to a foreign country or possession of the United States<sup>77</sup> for the taxable year on or with respect to<sup>78</sup> its earnings and profits before taxes, by the proportionate share of earnings and profits before taxes. The proportionate share of the foreign income, war profits, or excess profit taxes is determined in the same manner as the proportionate share of earnings and profits; that is, simply by multiplying the foreign taxes paid or accrued by the percentage ownership:

$$\text{Prop. Share F.T.} = \text{F.T.} \times \% \text{ Ownership}$$

Finally, the effective foreign tax rate, the variable needed to determine the tabular percentage, is determined as above mentioned:

$$\text{E.F.T.R.} = \frac{\text{Prop. Share F.T.}}{\text{Prop. Share E \& P} + \text{Prop. Share F.T.}}$$

## VII. Types of Elections

A United States corporate shareholder may make a first-tier election with respect to one or more first-tier controlled foreign corporations.<sup>79</sup> A first-tier election applies only with respect to stock directly owned.<sup>80</sup> Where the stock of the controlled foreign corporation is owned through a foreign trust, foreign estate, or foreign partnership, the United States shareholder may not subject the controlled foreign corporation to a first-tier election but must make a chain election.<sup>81</sup> The advantage of a first-tier election is its simplicity. The United States shareholder simply determines the controlled foreign corporation's effective tax rate, finds the statutory percentage from the appropriate table under section 963, and then multiplies its proportionate share of the controlled foreign corporation's earnings and profits for the year by the statutory percentage to arrive at the amount of the required distribution.<sup>82</sup> The distribution is treated the same as any other dividend from a foreign corporation for purposes of United States taxation.

A United States corporate shareholder may make a chain election, on a chain-by-chain basis, with respect to one or more chains of foreign corporations.<sup>83</sup> A chain consists of one first-tier foreign corporation (not necessarily a controlled foreign corporation) and one or more lower-tier foreign corporations connected

76 Foreign income taxes do not include any tax which is deemed paid by a foreign corporation under INT. REV. CODE OF 1954, § 902(b). *Id.*

77 If distributions from a foreign corporation which has paid United States income tax on United States income do not qualify for a section 245 dividend received deduction, the United States shareholder may treat the amount of the United States income tax as a foreign income tax. Treas. Reg. § 1.963-2(c)(3) (1964).

78 A special timing rule provides that foreign income taxes paid or accrued on minimum distributions received during the distribution period shall be treated as paid or accrued for the taxable year to which the section 963 election relates. Treas. Reg. § 1.963-2(e)(3) (1964).

79 INT. REV. CODE OF 1954, §§ 963(a)(1), (c)(1). See note 40 *supra*.

80 Treas. Reg. § 1.963-1(d)(1) (1964). Directly owned is to be construed as within the meaning of § 958(a)(1)(A) of the INT. REV. CODE OF 1954.

81 GIFFORD, *supra* note 8, at A-8.

82 If elections are made for more than one first-tier controlled foreign corporation (first-tier elections are not interdependent), these same steps are applied to each corporation.

83 INT. REV. CODE OF 1954, §§ 963(a)(2), (c)(2).

in a series.<sup>84</sup> Only the stock owned directly by the United States shareholder in the first-tier corporation and the stock owned indirectly in the lower-tier corporations by reason of the direct ownership of the stock in the first-tier corporation may be included in the election.<sup>85</sup> The United States shareholder does not have to include every tier of every corporation connected in the series,<sup>86</sup> but must include the first-tier foreign corporation<sup>87</sup> and the lower end of the chain must end with a controlled foreign corporation.<sup>88</sup> The United States corporate shareholder must also include every corporation in the chain of ownership between the first-tier foreign corporation and the controlled foreign corporation at the end of the chain.<sup>89</sup> Thus lower-tiers, or part of a lower-tier, can be omitted from the chain election. The consolidated earnings and profits and foreign taxes of all the corporations included in the chain are used in computing the minimum distribution requirements. The advantage or disadvantage of omitting lower-tiers, or part of a lower-tier, depends primarily upon the effective foreign tax rates of these members of the chain and the presence of deficits in their earnings and profits.

A United States corporate shareholder may make a group election, applying to all controlled foreign corporations in which it directly or indirectly owns stock and all foreign corporations through which it owns stock in a controlled foreign corporation.<sup>90</sup> There are three possible modifications of the basic group. The United States corporate shareholder may elect to exclude all less developed country corporations;<sup>91</sup> it can elect to exclude all foreign corporations with blocked income;<sup>92</sup> and it can elect to include certain foreign branches as if they were wholly owned subsidiaries.<sup>93</sup> Exclusion of less developed country corporations can be beneficial if they have relatively low tax rates, as the exclusion might increase the over-all effective foreign tax rate and thus reduce the minimum distribution required for the group. This exclusion, however, will result in liability for tax on any undistributed subpart F income of the less developed country corporation<sup>94</sup> since a section 963 election entitles the United States corporate shareholder to exclude subpart F income only from the controlled foreign corporations subject to the election.<sup>95</sup> When a corporation with blocked income is excluded, the United States corporate shareholder must also exclude foreign corporations in which it indirectly owns stock by reason of its ownership

84 Treas. Reg. § 1.963-1(e)(1) (1964).

85 *Id.*

86 *Id.*

87 *Id.*

88 *Id.*

89 *Id.*

90 INT. REV. CODE OF 1954, §§ 963(a)(3), (c)(3).

91 *Id.* § 963(c)(4)(A).

92 *Id.* § 963(c)(4)(C).

A foreign corporation is deemed to have blocked income if it is established to the satisfaction of the Secretary or his delegate that the earnings and profits of a foreign corporation sufficient to constitute its share of a pro rata minimum distribution could not have been distributed to the United States shareholder because of currency or other restriction or limitations imposed under the laws of any foreign country. *Id.* Treas. Reg. § 1.963-1(f)(3) (1964).

93 *Id.* § 963(c)(4)(B). Treas. Reg. § 1.963-1(f)(4)(i) defines branches as permanent organizations maintained to engage in active conduct of a trade or business.

94 To be kept in mind, certain dividends, interest, and gain from qualified investments in less developed countries are excluded from subpart F income. *Id.* § 954(b)(1).

95 *Id.* § 963(a).

of the stock of the foreign corporation with a blocked income if an amount of earnings and profits sufficient to constitute its share of a pro rata minimum distribution cannot be distributed to the United States shareholder through the foreign corporation with the blocked income.<sup>96</sup> If the United States shareholder elects to include foreign branches located in foreign countries or possessions of the United States,<sup>97</sup> all foreign branches must be included.<sup>98</sup> The advantage of including foreign branches in a group election is that the branch is regarded as having distributed the entire amount of its earnings and profits for the year;<sup>99</sup> thus the entire earnings and profits may count toward the required minimum distribution for the year as a constructive dividend.<sup>100</sup>

### VIII. Special Problems

In a chain or group election, even though the United States shareholder has received distributions sufficient to constitute the minimum distribution required under the schedule, no exclusion under section 963 is allowed unless a minimum overall tax burden is met.<sup>101</sup> For purposes of determining the minimum overall tax burden, special rules relating to the determination of earnings and profits,<sup>102</sup> foreign taxes,<sup>103</sup> and the computation of the foreign tax credit<sup>104</sup> have been provided. The special rules provide for the non-averaging of taxes on successive distributions through the chain or group,<sup>105</sup> limitations on the exclusion of taxes on intercorporate distributions,<sup>106</sup> and allocation of deficits in the chain or group.<sup>107</sup>

Corporations subject to a chain or group election are permitted to make minimum distributions on a pro rata or non-pro rata basis.<sup>108</sup> A pro rata minimum distribution is the distribution from each foreign corporation subject to the section 963 election of an amount equal to the statutory percentage of the United States shareholder's proportionate share of earnings and profits of that corporation.<sup>109</sup> When the special rules are applied, unless a pro rata distribution is made, the "overall United States and foreign tax"<sup>110</sup> must equal or exceed the smaller of:

96 Treas. Reg. § 1.963-1(f)(3) (1964).

97 A branch located in Puerto Rico or a United States possession does not qualify to be treated as a separate foreign subsidiary unless the branch would be a controlled foreign corporation if incorporated under the laws of the possession and the United States shareholder's gross income for the taxable year includes the branch income derived from sources within the possession. INT. REV. CODE OF 1954, § 963(c)(4)(B).

98 Treas. Reg. § 1.963-1(f)(4) (1964).

99 INT. REV. CODE OF 1954, § 963(c)(4)(B).

100 However, it should be noted that the minimum overall tax burden must be met, which could limit the amount of constructive dividend. See note 101 *infra*.

101 Treas. Reg. § 1.963-4(a)(1) (1964).

102 *Id.* § 1.963-4(b) (1964).

103 *Id.*

104 *Id.* § 1.963-4(c) (1964).

105 *Id.* § 1.963-4(c)(2) (1964).

106 *Id.* § 1.963-4(b)(1) (1964).

107 *Id.* § 1.963-4(b)(2), (c)(2)(i)(c) (1964).

108 *Id.* § 1.963-4(a)(1) (1964).

109 *Id.* § 1.963-4(a)(2)(i) (1964).

110 Defined in *Id.* § 1.963-4(a)(2)(ii) (1964).

- (1) The overall United States and foreign tax which would be paid or accrued had a pro rata minimum distribution been made, or
- (2) The consolidated pre-tax and pre-distribution earnings and profits of the chain or group multiplied by 90 percent of the United States corporate tax rate (without regard to the surtax exemption).<sup>111</sup>

If a pro rata minimum distribution is made, the requirement is met.<sup>112</sup> Without applying the special rules, the minimum overall tax burden is the second part of the above: that is, the overall United States and foreign tax must equal or exceed the consolidated pre-tax and pre-distribution earnings and profits of the chain or group multiplied by 90 percent of the United States corporate tax rate (without regard to the surtax exemption).<sup>113</sup> Upon application of the special rules, the foreign tax credit is reduced and deferred, if necessary, to bring the overall United States and foreign tax up to the required minimum overall tax burden.<sup>114</sup> If the special rules are not used and the minimum overall tax burden is not met, there is no provision for the reduction of the foreign tax credit; rather, the exclusion under section 963 will not apply, and the United States shareholder remains taxable under subpart F.<sup>115</sup> To avoid this, the United States shareholder would be forced to apply the special rules unless the minimum overall tax burden was met in the first instance.

Under the regular foreign tax credit rules, deficits in one foreign corporation are not taken into account in determining the accumulated earnings and profits of any other related foreign corporation.<sup>116</sup> The effect of the inclusion of a deficit corporation in a group or chain election is the reduction of consolidated earnings and profits, thus increasing the overall effective foreign tax rate with a resultant reduction of the required minimum distribution. When the special rules are utilized regarding the required minimum distribution, there is an additional benefit to including a deficit corporation in a chain or group election: the United States shareholder's proportionate share of the deficit is applied to the proportionate share of earnings and profits of each foreign corporation in the chain or group that does not have a deficit.<sup>117</sup> This serves to reduce the United States shareholder's proportionate share of earnings and profits of each corporation for foreign tax credit purposes<sup>118</sup> thus having the effect of accelerating the receipt of the foreign tax credit for foreign taxes which it has paid.<sup>119</sup>

The foreign tax credit under the special rules for minimum distribution is

111 *Id.* § 1.963-4(a)(1)(ii)(b) (1964).

112 *Id.* § 1.963-4(a)(1)(ii)(a) (1964).

113 *Id.* § 1.963-4(a)(1)(i) (1964).

114 *Id.* §§ 1.963-4(a)(1)(ii)(b), 1.963-4(c)(3). Any credit so deferred becomes available only upon the subsequent distribution of the earnings and profits of the controlled foreign corporation to which the credit is allocated.

115 *See* Creed & Miles, *supra* note 24, at 1388.

116 Treas. Reg. §§ 1.902-1(a)(2) (1957), 1.902-3(c)(5) (1965).

117 *Id.* § 1.963-4(b)(2)(i) (1964).

118 *Id.* § 1.963-4(c)(2)(i)(c) (1964).

119 INT. REV. CODE OF 1954, § 78 gross-up formula is equal to:

$$\frac{\text{Dividend}}{\text{After tax E \& P}} \times \text{F.T.}$$

If earnings and profits are reduced, the amount of the foreign tax credit will be increased.

determined by multiplying the foreign tax by the product of the required minimum distribution over the consolidated earnings and profits after taxes and allocation of deficits:

$$\frac{\text{Required minimum distribution}}{\text{Adjusted consolidated E \& P}} \times \text{F.T.}^{120}$$

The required minimum distribution in the case of a non pro rata distribution is the amount necessary to produce an overall tax burden at least equal to the burden had a pro rata distribution been made.<sup>121</sup> The special rules are only applicable to the extent of the minimum distribution required.<sup>122</sup> The regular foreign tax credit rules must be used for excess distributions.<sup>123</sup> They are modified, however, to reflect the effect of the special rules on the required minimum distribution.<sup>124</sup> The formula for determining the foreign tax credit on the excess distribution is:

$$\frac{\text{Excess Distribution}}{\text{Remaining accumulated profits}} \times \text{Remaining F.T.}^{125}$$

## IX. Conclusion

The complexity of the rules involved in minimum distributions basically stems from the alternatives available under the scheme and the necessary computations involved in these alternatives. This complexity, however, is directly proportionate to the multiplicity of the United States shareholder's foreign operations. If the corporate shareholder simply has one foreign subsidiary corporation which it owns directly one hundred percent and the foreign subsidiary has no subsidiaries of its own, computation under section 963 is relatively simple. If, on the other hand, the United States corporate shareholder owns multiple subsidiary corporations which in turn own multiple subsidiaries, then computation under section 963 becomes extremely difficult because of the nature of the foreign operations itself, and the possible groupings with the inclusion or exclusion of less developed country corporations, deficit corporations, corporations with blocked income, and so on.

It appears that the Internal Revenue Service has decided that minimum

120 Rev. Rul. 73-182, 1973 INT. REV. BULL. No. 16 at 21.

121 *Id.*

122 Rev. Rul. 68-640, 1968-2 CUM. BULL. 321; Rev. Rul. 73-182, 1973 INT. REV. BULL. No. 16, at 21. Prior to the 1973 ruling, commentators agreed unanimously that the Internal Revenue Service position was erroneous. Gifford, "Excess" Distributions Under Section 963: *Computation of the Foreign Tax Credit*, 26 TAX L. REV. 317 (1971) explains why application of the special foreign tax credit rules to the entire amount distributed in the year of a minimum distribution appears to be correct. Also, Waris, *Current Foreign Income Problems Involving Subpart F and Related Statutes*, N.Y.U. 27TH INST. ON FED. TAX. 977 (1969) discusses the problem. However, the 1973 ruling restates the Internal Revenue Service's position, and by modifying the regular foreign tax credit rule for the excess distribution solves some of the problem. This issue has yet to be litigated.

123 Rev. Rul. 73-182, 1973 INT. REV. BULL. No. 16, at 21.

124 *Id.*

125 *Id.*

distributions under section 963 is to be an exact determination. While this seems reasonable, the original intention of section 963 was to avoid subpart F taxation for companies that were not withholding income in "tax haven" places but were making distributions of this income to their United States shareholders. The system of special rules and regulations applying only to that amount which is within the exact determination of the *required* minimum distribution and the "ordinary with adjustments treatment" applying to the difference between the actual distribution and the *required* minimum distribution seems to frustrate the original purpose of section 963. The result is special accounting and mathematical problems involved in what was intended to be an "escape valve" for those cases in which total taxes on a world wide operation were not substantially below the taxes that would have been paid had the entire operation been carried on in the United States. This result appears inconsistent with the original intention of the section, especially in regard to excess distributions and the determination of the foreign tax credit.

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