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## THE NEW "SUBPART F" FOREIGN INCOME PROVISIONS OF THE INTERNAL REVENUE CODE

REXFORD R. CHERRYMAN\*

### *Introduction*

The phrase "Subpart F" income was introduced into the vocabulary of the tax practitioner by the Revenue Act of 1962.<sup>1</sup> One of the most lengthy and complicated sections of that Act, although certainly not the most far-reaching nor well-known, is Section 12, which deals with Controlled Foreign Corporations and the new tax burdens placed upon certain U. S. persons, both individual and corporate, who hold shares of stock in them. The label "Subpart F" came into being as a result of the placement of these new provisions within the structure of the Code. To be precise, Subpart F fits in as follows:

Subtitle A: Income Taxes

Chapter 1: Normal and Surtaxes

Subchapter N: Tax based on Income from Sources  
Within or Without the United  
States

Part III: Income from Sources Without the  
United States

And finally: Subpart F: Controlled Foreign Corporations

This organizational view of Subpart F places it in the perspective in which it should belong, for in relation to the entire Code, Subpart F is a relatively obscure and highly technical part of the vastly complicated mechanism which attempts to impose an equitable tax on U. S. persons. It touches only a few taxpayers who happen to be engaged in certain bizarre financial maneuverings abroad.

That the frequency of these practices was rapidly gaining momentum is borne out by what Commissioner Caplin had

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<sup>1</sup> P.L. 87-834; 76 Stat. 999, approved October 16, 1962.

to say in his 1962 Annual Report on the general topic of U. S. investments abroad:

Research and analysis of data on problems created by the rapid growth of foreign investment by U. S. taxpayers are identifying more specifically the legislative and operative actions needed to encourage voluntary compliance in the foreign area. Analysis of data indicates that the 1,000 taxpayers examined had approximately 6,000 controlled foreign affiliates and subsidiaries. The program disclosed the extent to which "tax haven" countries are used to deposit and shift profits from the United States to countries in which there are few, if any, income taxes.<sup>2</sup>

The provisions of Subpart F were included in the Revenue Act of 1962 to cure what was generally conceded to be an inequity in the federal income tax system, namely, foreign "tax havens". The "tax haven" situation resulted from a tax deferral privilege to U. S. shareholders who controlled certain foreign corporations. The deferral was accomplished simply by not distributing earnings of the foreign corporations, which thereby caused them to escape current U. S. income tax under pre-Subpart F law. The foreign tax havens, notably Switzerland, were further exploited through devices such as intercompany pricing arrangements, the transfer of patent licensing rights, and the shifting of management fees and other corporate expenses in order to minimize and in some instances eliminate completely not only United States income taxes, but foreign taxes as well. Naturally such manipulation of foreign corporate financing by U. S. persons has created economic and political consequences which, in flagrant instances at least, have had a deleterious effect on the United States position as a leading power in the free world.

In contemplating legislation to remedy these conditions, the President and the Congress were also acutely aware of the fact that what they were about to tamper with was a delicate economic *status quo*, which, if unduly disrupted, would have a serious upsetting effect on the competitive position of U. S. controlled foreign corporations (CFC's) with respect to for-

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<sup>2</sup> 100th Annual Report of the Commissioner of Internal Revenue for the Fiscal Year ended June 30, 1962 (Sept. 20, 1962) at p. 54.

eign corporations not so controlled. Moreover, the economic growth of underdeveloped countries of the world where U. S. interests were substantial could seriously be hampered. There was also in existence long established yet delicate foreign tax credit machinery, which, if disturbed, could have far-reaching international political implications, particularly with respect to those countries where tax treaties with the United States were in effect. It was apparent at the outset that careful consideration had to be given to relief provisions in the proposed Subpart F which, while plugging the "tax haven" loophole, would still take into account these special circumstances.

American businessmen who had interests in controlled foreign corporations also recognized the necessity for extensive relief provisions, and they saw that Congress was faced with a serious and complicated legislative problem. The businessmen were articulate in pointing up the political and economic importance of relief measures, and they were supported in their contentions by some of the foremost tax scholars, attorneys, and accountants in the country, who were effective and eloquent in pleading their cases before congressional committee hearings. Much of the relief asked for was granted, and as a consequence, Subpart F in its final form is much like what has become of the Internal Revenue Code itself in the last nine years: a relatively simple imposition of a tax followed by intricate technical relief provisions, theoretically designed to make the tax imposed equitable for all persons, foreign as well as domestic.

The problem faced by Congress in 1962 can be more fully appreciated by reviewing the legislative history which led to final enactment of Section 12 of the Revenue Act of 1962. On April 20, 1961, President Kennedy, in his Message on Taxation to the Congress proposed legislation which would change the tax treatment of foreign income. On May 3, 1961, the President's message was amplified by Secretary Dillon in Hearings before the House Ways and Means Committee. No drafts of legislative proposals were offered by the Secretary in these hearings, however, until July 28, at which time the Treasury made public a draft bill on "tax haven" legislation, a draft, incidentally, which did not conform in all respects

to the President's message. On January 31, 1962, a second draft was issued by the Treasury which was immediately rejected by the Ways and Means Committee, which in turn offered its own draft for consideration by the Treasury. While the Treasury was engaged in an analysis of this draft, the House Committee scrapped it in favor of a new draft on February 27. The House Committee continued to make changes until March 12, at which time the bill was reported to the House, which passed it on March 29. Notwithstanding this hurdle having been cleared, Secretary Dillon, on May 10, offered additional amendments to the foreign provisions of the bill.

The bill was reported out of the Senate Finance Committee on August 16. After some amendments by the Senate, the most notable of which was the Kerr Amendment providing for minimum distribution relief provisions in the taxability of undistributed Controlled Foreign Corporation income.<sup>3</sup> It was passed by that body on September 6. The Conference Committee settled the differences between the versions of the two Houses and reported the bill out on October 1, and on October 2, both Houses agreed on that version. Throughout this extensive legislative process which the bill underwent, Subpart F bore much of the brunt of the controversy, and was the subject of many heated discussions, both official and otherwise. Finally, on October 16, 1962, eighteen months after his proposal was sent to Congress and after some nine thousand pages of public hearings had been recorded, the President signed a considerably modified and embellished Tax Bill into law.

### *Scope*

In outlining the scope and objectives of this study, it would be well to state at the outset that a general explanation of all the provisions of Subpart F is not within its purview. Numerous explanations of Subpart F have been published to date, some brief, designed for the non-technician, and some lengthy and including extensive commentary. Almost without exception these explanations are excellent. To add yet another "general explanation" to what is already a considerable array

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<sup>3</sup> Int. Rev. Code of 1954, sect. 963.

of such treatments of Subpart F would be of no real value. It seems more appropriate instead to offer a survey of significant explanatory materials which are currently available to the reader at this early stage in the development of Subpart F, with comments on what approaches have been taken, the extent to which the topic is treated, what aspects are emphasized, a word or two as to length and readability, and in general an appraisal of each contribution. Such a survey will comprise Part I of this study.

Part II will deal with official material, chiefly proposed Treasury Regulations on Subpart F, which are to furnish the flesh and muscle for the Subpart F statutory skeleton. The Regulations, by amplifying the Code, naturally serve to explain it, and on first thought it might seem helpful to include a discussion of them in the explanatory bibliographical material of Part I. The Regulations, however, are official pronouncements of the Treasury Department and hence carry a responsibility which privately authored explanations need not be burdened with. Absolute precision and accuracy remain indispensable to the Regulations. They must attempt to embrace all foreseeable facets involved in the promulgation of the Internal Revenue Code section they are intended to cover. Unofficial treatments, on the other hand, can sweep aside much bulky detailed matter in order to bring the essential provisions quickly into clear focus. The reader, therefore, would be well advised to acquire a general background and perspective of Subpart F by consulting some of the materials suggested in Part I before embarking on a serious study of the proposed Regulations outlined in Part II.

In addition to the proposed Regulations, there have been other official Announcements, Rulings, Orders, and the like, implementing Subpart F. These also are cited and discussed in Part II.

Part III undertakes to cope with a few of the problems which the new Subpart F presents. Some problems are patent from a mere reading of the statute itself, while some, not quite so obvious, may arise later in the form of stumbling blocks to taxpayers who attempt to comply with the statute, and to the Treasury Department, too, when it attempts to

implement Subpart F and apply its provisions to specific fact situations. Once again, the Subpart F neophyte is urged to familiarize himself with some of the materials suggested in Part I before going into Part III.

# I.

## *A Bibliographical Survey of Explanatory Materials*

*Federal Taxes Report Bulletin 40 (October 5, 1962), Prentice-Hall, Inc., Englewood Cliffs, N. J. Concise Explanation of the New 1962 Tax Law.*

This 303 page booklet is made up of three major parts. The first sixty-three pages comprise the first major part and consist of an explanation of the Act. The next 114 pages are taken up by a reprint of the sections of the 1954 Code which were amended or added by the Act, with the newly enacted material distinguished through the use of italics, an extremely valuable feature. The last 116 pages are the Congressional committee reports explaining the enacted law, a masterpiece of editing, containing pertinent excerpts from the House Ways and Means Committee Report No. 1447, the Senate Finance Committee Report No. 1881, the Conference Committee Report, H. Rept. No. 2508, plus materials from the Congressional Record dated August 30 to September 5, 1962, when the Bill was introduced and debated on the floor. The General Explanation of the sections of the Act to be found in the Committee reports have been considerably abridged in this Prentice-Hall booklet in favor of a virtually unabridged reprint of the Technical Explanation of the parts of the Bill which were finally enacted.<sup>4</sup>

In the "concise explanation" comprising the first part, there is no editorial comment; only an objective and simplified explanation of the technical provisions of the Act is given. The carefully selected examples are less complicated than

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<sup>4</sup> For the complete reprint of the General Explanation and its value to the uninitiated inquirer into the provisions of the Act, see below, Report on the Committee on Finance, U. S. Senate, to accompany H.R. 10650 (Sen. Rept. No. 1881, 87th Cong. 2d Sess., Aug. 16, 1962).

those found in the Committee Reports, no attempt being made in this brief explanation to deal with the many ramifications of the Code sections.

The part containing the Technical Explanations of the Congressional committees is of particular value because of their official status insofar as they reflect Congressional intent behind the enactment of this legislation. Future recourse to these Technical Explanations is likely to be frequent in the Subpart F area where, because of the vast complexity of the problem, a complete and all-inclusive translation of precise congressional intent into rigid statutory language was found to be impossible.

*Research Institute of America, Inc., 489 Fifth Avenue, New York, 17, N. Y. What the '62 Tax Law Means to Business (October 5, 1962)*

This is a comprehensive and carefully compiled explanation of the entire Revenue Act of 1962, with the Foreign Income provisions of the Act beginning at p. 49. The material is organized and patterned in a manner similar to the RIA Tax Coordinator (a multi-volume looseleaf federal tax service), much of the material being identical to that found in the Coordinator, although not in the same order nor in one location. Observations and examples are abundant. Particularly helpful are the paragraph captions, as well as captions at the top of each page. The tone of this eighty-nine page booklet (thirty pages of which are devoted to the Foreign Income provisions of the Act) is gauged to attract readership among businessmen (as the title suggests) as well as tax specialists. Avoidance techniques are given some attention in this publication, but some of them unfortunately are no longer available to the tax planner because the limited time the taxpayer had to invoke them has elapsed.<sup>5</sup> These features in no way detract from the value of this publication both to businessmen and to tax attorneys.

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<sup>5</sup> For a discussion of some of these avoidance procedures now no longer available to the taxpayer, see Parts II and III of this study.



*Internal Revenue Service—Digest of Public Laws Enacted During the Second Session of the 87th Congress Which Pertain to Internal Revenue Matters*<sup>6</sup>

This is an official Internal Revenue Service Explanation of all 1962 tax legislation, including the Revenue Act of 1962 (beginning at p. 18). Subpart F takes up five pages of the Digest (beginning at p. 29). The material is organized by Code section.<sup>7</sup>

*Commerce Clearing House, Chicago 46, Ill. Explanation of the '62 Revenue Act (\$1.00)*

This 48 page booklet presents a summary in four sections: Business Credits, Income, and Deductions; Tax Treatment of Special Organizations; Taxation of Foreign Income and Investment—Information Returns; and the provisions for Specialized Taxpayers. Each paragraph of this explanation contains cross referencing between the section of the Act and IRC sections affected. The explanation of Subpart F takes up four pages, beginning at page 26. It is valuable to the reader who seeks a quick over-all view of Subpart F before pursuing its technical ramifications. A topical index is included in the pamphlet.

*Report on the Committee on Finance, U. S. Senate to accompany H. R. 10650 (Sen. Rep't No. 1881, 87th Cong. 2d Sess., August 16, 1962. U. S. Govt. Printing Ofc.)*

An excellent way to acquire an understanding of the technical provisions of Subpart F is to study the circumstances which gave rise to the enactment of the legislation. This

<sup>6</sup> Int. Rev. Bull. 62-50, 6.

<sup>7</sup> See also summary presented by Mr. Samuel R. McClurd, Director, Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, at the Tidewater Tax Conference held in Williamsburg, Virginia, on December 9, 1962. (4 Wm. and Mary L.R. 54 (1963)). If it is possible to describe comprehensively the foreign provisions of the Revenue Act of 1962 in one sentence, it was done by Mr. McClurd at this Conference: "... [T]he effect of the provisions can be summed up by saying that they all attempt to put an end to flagrant abuse situations that had arisen when the rate structures and jurisdictional concepts of foreign countries for taxing income did not meet, or overlapped the rate structures and jurisdictional concepts of the United States for taxing income."

report accomplishes this task, and is done in the light of the Bill in its August 15th form, which was substantially what was finally enacted into law on October 16th.

Each section of the Bill is taken and treated separately. Reasons for the provision and a General Explanation<sup>8</sup> of the provisions are given, and where the Senate Finance Committee amended the House provisions, an explanation is given which compares the two versions and gives reasons for the proposed Senate change.<sup>9</sup> Subpart F material takes up thirteen pages. Selected illustrative material is included. The report is a conceptual treatment of the Act and is recommended as initial reading for the student embarking on the perilous journey toward an understanding of the theory of the statutory provisions.<sup>10</sup>

*Robert W. Wales—Tax Policy in relation to Foreign Business Income*  
40 *Taxes* 961 (December, 1962).

After some very interesting and informative background concerning foreign business development leading to the President's proposal for remedial legislation in April of 1961, Mr. Wales continues his thirteen page article by outlining the general provisions of foreign income sections of the Act and interspersing some well-considered commentary on what effects those sections will have on U. S. business abroad. A good portion of his article is devoted to a synopsis of Subpart F, followed by a carefully reasoned appraisal of the results, which clearly reveals, along with the rest of his article, that Mr. Wales is an expert in his field. More on Mr. Wales' commentary is contained in part III of this study.

*Gordon Nicholson and Richard Hoefs—Foreign Aspects of Taxation*  
—1962 Act: Radical Changes Require Immediate Re-examination of Foreign Activities. 17 *J. Taxation* 348 (9 Dec. '62)

This lengthy title belies the real value of an article by two Chicago accountants who have taken the Foreign income

<sup>8</sup> The Report does not contain a Technical Explanation of H.R. 10650.

<sup>9</sup> A reprint of this Report was published on August 21st (C.C.H. Special 10, Srd. Fed. Tax Reports No. 37, August 21, 1962).

<sup>10</sup> This General Explanation is considerably abridged in the Prentice-Hall Report Bulletin 10 of October 5, 1962, described *supra*.

provisions of the 1962 Act (Sections 5, 7, 9-12, 14, 16, 18, 20 and 31) in numerical order. Section 12 occupies about one half of the entire seven page article in the *Journal of Taxation*. After a brief resume of the historical background behind the enactment of Section 12 the article goes on in captioned paragraphs to describe Subpart F income, certain branch income, Investments in U. S. property, operating losses, U. S. possessions, subsequent dividends, stock ownership rules, foreign tax credit, the individual's option to be taxed as a corporation, relief through minimum distribution and finally a description of Subpart G (Export Trade Corporations), which is also included in Section 12 of the Act. The article is solely descriptive; no attempt is made on the part of the authors to suggest tax planning alternatives in the light of the new tax concepts introduced by the 1962 Act.

*Richard C. Munsche—Relief Provisions in Section 12 of the Revenue Act of 1962, 41 Taxes 53 (Jan. '63).*

The title of this six-page article accurately indicates the scope of another contribution to the literature written to date on Subpart F. An effective introduction is first presented in the form of an explanation of the economic circumstances surrounding the advent of the legislation. This is followed by a criticism, shared by many writers on this topic, of the taxation of undistributed income, which, in the opinion of the author and other critics, has the effect of ignoring the concept of what should be an inviolate corporate entity. Mr. Munsche then considers the general relief provision of Section 954(b)(4), which gives the Commissioner the discretion to afford complete relief where he feels that the creation of a controlled foreign corporation does not have the effect of a substantial reduction of income or excess profits taxes. Following this is a discussion and observation on the election provision afforded individuals<sup>11</sup> (which in effect puts a high bracket U. S. citizen in no worse position than if he were a corporate U. S. shareholder); the Export Trade Corporation relief measures (newly added by the Act);<sup>12</sup> and the Minimum Distribution relief proposed by Senator Kerr.<sup>13</sup> Although Mr.

<sup>11</sup> Int. Rev. Code of 1954, sect. 962.

<sup>12</sup> Subpart G (Int. Rev. Code of 1954, sects. 971 and 972).

<sup>13</sup> Int. Rev. Code of 1954, sect. 963.

Munsche's article is limited to these aspects of Subparts F and G, his deft treatment coupled with his penetrating remarks concerning them and their probable effect make his article an indispensable addition to the reading list of anyone interested in the technical provisions of Subpart F.

*Sidney R. Pine—How Export Trade Corporations Can Obtain U. S. Tax Deferral. 17 J. Taxation 358 (December, 1962).*

Although Subpart G, which is the principal subject matter of this article by a New York attorney, is not strictly within the scope of the study of Subpart F being made here, it is impossible to divorce the two, for in Subpart G there is afforded one of the major relief provisions enacted by Congress for U. S. taxpayers who would otherwise be subject to a tax on undistributed controlled foreign corporation earnings and profits where export trade corporations are involved. Mr. Pine's article is oriented to the tax planning aspects inherent in Subpart G, but in the process of pointing out how tax deferral can be achieved through financial readjustments (principally by shifting income from controlled foreign corporations to non-controlled corporations coupled with rearrangement of corporate structures) he has accomplished in a short space a worthwhile secondary objective of presenting the theory and structural makeup of Subpart G.

## II.

### *Proposed Treasury Regulations and Other Official Directives*

To date no Treasury Regulations for Subpart F have been published in final form. However, proposed regulations have been drawn up for the following Internal Revenue Code sections: Section 954 (Foreign Base Company Income); 955 (Withdrawal of Previously Excluded Subpart F Income from Qualified Investment); 956 (Investment of Earnings in U. S. Property); 957(a) (The Concept of Controlled Foreign Corporations); 957(c) (dealing with the exclusion from the category of CFC's of corporations organized in U. S. possessions); and finally 964(c) (which authorizes the Secretary of the Treasury to prescribe regulations governing accounting and record keeping requirements of U. S. shareholders of CFC's).

What follows in Part II is an outline of these proposed regulations as well as other official directives concerning Subpart F which are actually in force. They are taken up in Internal Revenue Code section order. A small organization chart for each set of proposed regulations is presented at the beginning of each Code section discussed to enable the reader to determine at a glance exactly what the regulations purport to cover and how they have been organized to perform their task. The organization of the final regulations should not deviate too sharply from what has been proposed. Following each organization chart are comments concerning some of the salient features of the proposed regulations.

### *Section 954<sup>14</sup>*

#### Proposed Regulations

##### 1.954-1 Foreign Base Company Income

- (a) In general
- (b) Exclusions
  - (1) Dividends, interest, and gains from qualified investments in less developed countries
  - (2) Income derived from aircraft and ships
  - (3) CFC corporations which do not have the effect of substantial reduction of income or similar taxes
- (c) Deductions to be taken into account
- (d) Special rules where foreign base company income is less than 30 percent or more than 70 percent of gross income
- (e) Definition of a related person

##### 1.954-2 Foreign personal holding company income

- (a) In general
- (b) Rents
- (c) Exclusions
  - (1) Dividends
  - (2) Interest
  - (3) Rents
  - (4) Royalties
  - (5) Gains from the sale or exchange of stock or securities

<sup>14</sup> Proposed Treas. Regs. 1.954-1 to 1.954-5, 27 Fed. Reg. 12759 (Dec. 27, 1962); Int. Rev. Bull. 63-1, 23 (Jan. 7, 1963). Hearings on these proposed regulations were held on March 12, 1963.

- (d) Classification of an item of income in accordance with the substance of a transaction
- 1.954-3 Foreign base company sales income
- (a) Income included
    - (1) In general
    - (2) Property manufactured, etc. within the country in which the CFC is created or organized
    - (3) Property sold for use, consumption, or disposition within the country in which the CFC is created or organized
    - (4) Property manufactured or produced by the CFC
  - (b) Foreign branches of controlled foreign corporations treated as separate corporations
- 1.954-4 Foreign base company services income
- (a) Items included
  - (b) Special rules
- 1.954-5 Increase in qualified investments in less developed countries
- (a) Determination of investment at close of current taxable year
  - (b) Election to determine investment at close of following taxable year
  - (c) Initial designation of a country as being an economically less developed country
  - (d) Illustrations

Proposed Regulations 1.954-1(b)(3) take up the discretionary clause of Section 954(b)(4) of the Code, where the Secretary or his delegate can grant an exception where he is satisfied that a foreign corporation is not availed of to reduce taxes. The proposed regulations, after a general statement to the effect that the circumstances of each case will have a bearing on whether or not there has been a substantial reduction of income tax, continue with the following general rule:

As a general rule, however, creation or organization of a controlled foreign corporation will be considered *not* to have the effect of substantially reducing income or similar

taxes if the foreign income, war profits, excess profits, or similar taxes paid in respect to an item of income described in section 954(d) or (e) by the controlled foreign corporation equal or exceed 90 percent of the foreign income, war profits, excess profits, or similar taxes that would have been paid in respect to the item of income to the foreign country which, within the meaning of paragraph (a)(3) of section 1.954-3, is the country of use, consumption, or disposition of the property which is sold, or which, within the meaning of paragraph (b)(2) of section 1.954-4, is the country where the services are performed, if the income had been derived from sources within such country and the controlled foreign corporation had been created or organized under the laws of, and managed and controlled in, such country.

Two examples are given in the proposed regulations. The first sets forth a situation where the effective tax rate is the same in both countries, thereby presenting a clear case where tax avoidance is not possible. The second example covers a situation where the tax rates of the country of incorporation and the outside country of use are 15% and 25% respectively, thereby creating an equally obvious instance of tax avoidance.

An interesting feature of the proposed regulations is that they allow the taxpayer to invoke Section 954(b)(4) without prior approval of the Internal Revenue Service. He does so merely by excluding any item of undistributed CFC foreign base company income from his return which he considers as falling under the provision, and attaching a detailed statement of justification for so doing.

Regulations 1.954-1 (d)(4) provide detailed rules for the treatment of foreign branches of CFC's as separate foreign entities for purposes of ascertaining foreign base company sales income. Section 954 of the Code is not specific on this point, and until the regulations are final, there is a possible loophole. The example in the proposed regulations presents a situation where the CFC foreign base company income before deductions is less than thirty percent of gross income, so that, taken alone, no amount would be included in Subpart F income. The branch, however, has more than seventy percent

FBCI, which, if the branch were a separate entity, would mean that the entire amount would be includable. According to the proposed regulations, the parent CFC would not be allowed to consolidate these two, but would be required to treat parent and branch as separate entities, and the full amount of the branch income would be designated as Subpart F income.

There is an exception to this requirement of treating a branch as a separate entity, however. Separate treatment is not required where branch income is taxed at less than five percentage points less than if it were in the same country as its home CFC, or where the CFC tax rate is not more than five percentage points above what it would be if the CFC were in the same country as the branch.

In no case, according to the proposed regulations, will branch income fall into the Subpart F category unless it could be so classified in circumstances where the branch was a separate CFC. If the proposed regulations on this point become final, there need be no fear, then, that branch income could ever receive less favorable treatment under Subpart F than corporate subsidiary income.

Proposed Regulations 1.954-2 deal with foreign personal holding income includability under Subpart F. Rents, for purposes of Subpart F, depart from the usual personal holding company exemption where fifty percent or more of gross income is rental income. The regulations, at 1.954-2 (b), are brief and do not expand on the statute. Paragraph (c) of 1.954-2 of the proposed regulations is an extensive treatment of exclusions to be taken into account with respect to dividends, interest, rents, royalties, and gains from sales of stock or securities. A banking institution becomes exempt with respect to its dividend income "if a substantial part of its business consists of receiving deposits of money or the making of loans." A similar dividend income exemption in the case of insurance companies applies. The test proposed by the regulations goes directly to the character of the business done, regardless of the name, charter powers, or the laws of foreign countries:



Although the name, charter powers, and subjection to the insurance laws of a foreign country are significant in determining the business which a controlled foreign corporation is authorized and intends to carry on, the character of the business actually done in the taxable year shall determine whether it is an insurance company for purposes of section 954 (c)(3)(B).

Royalties would qualify as nontaxable if the underlying invention, book, etc. was substantially developed by the CFC. Performance of marketing functions by the CFC will not of itself make the royalties nontaxable. Interest and dividends from related foreign corporations will not be taxed directly to U. S. shareholders if the related corporation is located and has substantially all its assets in the same foreign country as the CFC. Eighty percent book value of assets is the mark set by the proposed regulations to meet the test of "substantial assets," and is applied when actual payment of interest or dividends is made.

Proposed regulations section 1.954-3 gives examples of what "substantial transformation of property before sale" must be in order to take the sale of the property out of the FBCI category. Transforming wood pulp to paper, or steel rods to screws meet the test in the examples given at section 1.954-3(c)(4)(ii).

As yet, guidelines and formulas have not been proposed for allocating income based in intercompany pricing. Such devices are used to shift income between U. S. and foreign corporations, and the Treasury Department is currently studying the problem of exactly how Subpart F taxes should be imposed in these situations.

According to proposed regulations section 1.954-3(a)(3) there is a presumption that income from property sold to related persons outside the country is within Subpart F as foreign base company sales income, and that presumption must be rebutted by the taxpayer. Property sold to unrelated persons would be presumed to be disposed of if used in the country of destination for sale, and thus the income derived

therefrom would fall within Subpart F as foreign base company sales income. The regulations continue:

However, if at the time of a sale of property to a person other than a related person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the controlled foreign corporation must determine the country of ultimate use, consumption, or disposition of the property or the property will be presumed to have been used, consumed, or disposed of outside the country under the laws of which the controlled foreign corporation is created or organized.

Where manufacturing, assembly, or further construction is involved, proposed regulations section 1.954-3(a)(4)(iii) provide a test for determining whether such further processing is significant enough in degree so as to exclude the income from the sale of the product from foreign base company sales income. First, the operations conducted by the CFC must be "substantial." This is the general test. The proposed regulations then become more specific:

Without limiting this substantive test, which is dependent on the facts and circumstances of each case, such operations will be considered to satisfy the provisions of this subdivision if conversion costs (direct labor and factory burden) of the controlled foreign corporation account for 20 percent or more of total cost of goods sold. In no event, however, will packaging, repackaging, labeling, or minor assembly operations be treated as constituting the manufacture, production, or construction of property.

Proposed regulations section 1.954-4(b)(2), concerning foreign base company services income, require an allocation of the income from services performed both within and outside the CFC country. The value of the services performed by the employees would be the measure by which allocation would be made. A 20% to 80% range is established by the regulations, similar in concept to the 30% to 70% range for gross foreign base company income to be found in Code

Section 954(b)(3). Where services are less than 20%, no income need be included; where over 80%, all income is includable. Within the range an apportionment must be made.

Section 954(f) of the Code is considerably expanded upon in the proposed Regulations section 1.954-5. Increases in qualified investments in less developed countries provide yet another relief measure for those taxpayers subject to Subpart F income taxation. The regulations gave the taxpayer an election to determine investment increases at the close of a following taxable year; that is, the U. S. shareholder taxpayer is allowed to advance the determining dates, both opening and closing, by one year.<sup>15</sup>

*Section 955<sup>16</sup>*

*Withdrawal of previously excluded Subpart F income from qualified investment*

Proposed Regulations

- 1.955-1 Shareholder's pro rata share of amount of previously excluded Subpart F income withdrawn from investment in less developed countries
- (a) In general
  - (b) Amount withdrawn by CFC
  - (c) Decrease in qualified investments in less developed countries
  - (d) Shareholder's pro rata share of amount withdrawn by CFC
- 1.955-2 Amount of a CFC's qualified investments in less developed countries
- (a) Included property
  - (b) Special rules—excluded property
  - (c) Termination of designation as a less developed country
  - (d) Amount attributable to property

<sup>15</sup> Proposed Treas. Regs. 1.954-5(b).

<sup>16</sup> Proposed Treas. Regs. 1.955-1 to 1.955-6, 28 Fed. Reg. 3541 (Apr. 11, 1963). Deadline for submission of comments was May 27, 1963. No announcement of hearings has been made as this article goes to press.

- 1.955-3 Election as to date of determining qualified investments in less developed countries
  - (a) Nature of election
  - (b) Time and manner of making election, with and without consent
  - (c) Effect of election—general, returns, revocations, transfer of stock
  - (d) Illustration (four each)
- 1.955-4 Definition of less developed country
- 1.955-5 Definition of less developed country corporation
  - (a) General—treatment of receivables, location of other intangibles
  - (b) Shipping companies
  - (c) Determination of stock ownership
- 1.955-6 Gross income from sources within less developed countries
  - (a) General
  - (b) Interest
  - (c) Dividends
  - (d) Sale of tangible personal property
  - (e) Compensation from sale of tangible personal property

Proposed Regulations 1.955-5(a) provide the guidelines for determining the status of a less developed country corporation, a determination which the Code, at section 955(c)(1), leaves to the Secretary and the regulations. Where the eighty percent requirement of the statute has not been satisfied on each day of the tax year the district director, according to the proposed regulations, may accept evidence that such requirement has been satisfied on the last day of each month of the taxable year. Subparagraph (2) of proposed regulations 1.955-5(a) prescribes special rules concerning situs of intangibles. Receivables are to be considered to be located in the country of the residence of the debtor. The amounts must be ordinary and necessary for the debtor to carry out the contract, otherwise the transaction will not be treated as an arm's length bona fide debt. Other intangibles are to be considered to be located in proportion to the location of tangibles, using amounts located in less developed countries over total tangible

property as the ratio for apportionment. Until these regulations become final, however, a foreign corporation cannot know definitely whether it qualifies as a less developed country corporation as it is currently organized. Revenue Procedure 62<sup>17</sup> sets forth a transition rule for such corporations. They will be allowed less developed country corporation status for an entire tax year beginning after December 31, 1962, if they can meet the tests prescribed by the regulations within thirty days after the final regulations are published in the Federal Register.

On December 28, 1962, the President exercised the power given him in Section 955(b)(3) of the Code to designate less developed countries. In Executive Order 11071,<sup>18</sup> he designated *all* countries in the world, including territories, departments, provinces, and possessions, in existence on *or after* December 31, 1962, as less developed countries, with the only exceptions being (1) those countries (primarily in Western Europe) specifically listed in the statute as not eligible for designation, (2) countries within the Sino-Soviet Bloc (also statutorily prohibited), and (3) a notable single exception, Spain. The Order goes on to define foreign countries within the Sino-Soviet Bloc by listing them individually. The effective date of the Order is December 31, 1962. This sweeping directive of course has the effect of narrowing the application of Subpart F to CFC's in fifteen Western European countries plus Australia, Hong Kong, Japan, New Zealand, and the Union of South Africa.

### *Section 956<sup>19</sup>*

#### Proposed Regulations

##### *Investment of earnings in U. S. property*

#### 1.956-1 Shareholder's pro rata share of a CFC's increase of earnings invested in U. S. property

##### (a) General

<sup>17</sup> TIR 431 (Dec. 21, 1962); Int. Rev. Bull. 62-51, 28.

<sup>18</sup> Int. Rev. Bull. 63-6, 9.

<sup>19</sup> Proposed Treas. Regs. 1.956-1 and 1.956-2, 28 Fed. Reg. 3547 (Apr. 11, 1963).

- (b) Amount of CFC's investment of earnings in U. S. property, and treatment  
Dividend limitation, treatment of earnings and profits, treatment of certain investments of earnings in U. S. property
- (c) Shareholder's pro rata share of increase
- (d) Date and basis of determinations
- (e) Amount attributable to property  
General rule, rule for pledges and guarantees, excluded charges, statement required

1.956-2 Definition of U. S. property

- (a) Included property
- (b) Exceptions—excluded property
- (c) Treatment of pledges and guarantees
- (d) Definitions—"acquired"

The first half of the proposed regulations for section 956 of the Code provide very complex rules for the determination of a U. S. shareholder's pro rata share of CFC increase in earnings invested in U. S. property. The example given in the proposed regulations at section 1.956(c)(2) is patterned closely after the one given in the Technical Explanation in the Committee Reports, except that the former expands on the latter and introduces additional facts, resulting in a more detailed analysis of the Code provision. As for the second section of these regulations, dealing with the definition of U. S. property, the illustrations are abundant. Special attention is devoted to plugging a possible loophole in the form of conduit financing arrangements,<sup>20</sup> e.g., a CFC pledge of stock of its subsidiary to secure a debt of a U. S. person.

The other half of the proposed regulations, dealing with Code section 956(b)(1), provides that U. S. property for purposes of investment of CFC earnings must be "acquired" after December 31, 1962. The proposed regulations 1.956-2(d) go into the exact meaning of the word *acquired*, and illustrate the term with six examples involving shares of stock in related corporations.

<sup>20</sup> Proposed Treas. Regs. 1.956-1(c)(2).

*Section 957*<sup>21</sup>

## Proposed Regulations

## 1.957-1 Definition of a foreign controlled corporation

- (a) General rule
- (b) Percentage of total combined voting power owned by U. S. shareholders
- (c) Illustrations (ten each)

In an attempt at avoidance, some U. S. shareholders owning amounts of foreign corporation stock substantial enough to bring that corporation within the CFC category, were transferring part of their holdings to non-U. S. shareholders. T.I.R. 433 of December 21, 1962,<sup>22</sup> has plugged this loophole where these arrangements are such as to keep effective voting control in the hands of U. S. shareholders. The Internal Revenue Service, according to T.I.R. 433, will look behind the mere ownership of the stock to find any agreement which abridges the non-U. S. shareholder's voting freedom in such a manner as to keep voting power in the hands of the original U. S. shareholder.

The provisions of T.I.R. 433 are contained in proposed regulations section 1.957-1(b)(2), which are illustrated by ten excellent examples, reflecting situations (apparently adapted from actual case studies) where two classes of stock are outstanding in the foreign corporation, the common stock normally being held by a non-U. S. shareholder while the preferred is held by a U. S. corporation with certain rights (e.g. redemption, dissolution) exercisable by the preferred shares, thereby creating a situation which renders the foreign corporation a CFC. In the proposed regulations heavy emphasis is placed upon voting control, actual or implied, direct or indirect. Where, for example, U. S. shareholders have the ultimate power to elect a majority of the board of directors or a similar governing body, to install the president or chief officer of the corporation, or to indicate the person who may break a tie vote in such elections, then the proposed regulations would have the U. S. shareholders holding the voting

<sup>21</sup> Proposed Treas. Regs. 1.957-1, 28 Fed. Reg. 828 (Jan. 29, 1963).

<sup>22</sup> Int. Rev. Bull. 63-6, 6.

power of *all* the stock entitled to vote, whether or not they own it outright.

*Section 957*<sup>23</sup>

Proposed Regulations

1.957-3 Corporations organized in U. S. possessions

- (a) General rule
- (b) Special provisions—United States defined, possession of the U. S. defined, determination of source of gross income, manufacture or processing

Proposed Regulations Section 1.957-3 amplify the corresponding Code provision<sup>24</sup> concerning corporations organized in U. S. possessions. After delineating possessions from the rest of the United States (defined as the States and the District of Columbia) the principal emphasis is on just what is included as manufacture or processing, citing many examples of what are evidently manufacturing activities currently existing to a substantial degree principally in Puerto Rico and other Caribbean possessions.<sup>25</sup>

Regulations 1.957-2 and 1.957-4 have not been proposed as yet. They will deal with the special rule for insurance<sup>26</sup> and with the concept of United States Persons as it relates to Subpart F.<sup>27</sup>

*Section 964*<sup>28</sup>

Proposed Regulations

1.964-3 Records of U. S. shareholders

- (a) Shareholder's records or responsibility
- (b) Records maintained by the CFC
- (c) Time for completion

<sup>23</sup> Proposed Treas. Regs. 1.957-3, 28 Fed. Reg. 3551 (Apr. 11, 1963).

<sup>24</sup> Int. Rev. Code of 1954, sect. 957(c).

<sup>25</sup> Proposed Treas. Regs. 1.957-3(b)(4).

<sup>26</sup> Int. Rev. Code of 1954, sect. 957(b).

<sup>27</sup> Int. Rev. Code of 1954, sect. 957(d).

<sup>28</sup> Proposed Treas. Regs. 1.964-3 and 1.964-4, 28 Fed. Reg. 2913 (Mar. 23, 1963).



- (d) Records by more than one person with respect to the same corporation; agreement to designate, requirement for transfer of responsibility, amended agreements
- (e) Additional records and statements on notice
- (f) Retention of records

1.964-4 Information requirements

- (a) Alternative rules
- (b) Investment of earnings in U. S. property; U. S. property, exceptions from U. S. property
- (c) Income—from insurance of U. S. risks, foreign personal holding income, foreign base company sales income, branch income, manufacturing income, foreign base company services income, income from qualified investments in less developed countries, export trade income, deductions of expenses, taxes, etc.
- (d) Minimum distributions—corporation by corporation election, chain-by-chain election, group election
- (e) Eighty percent of gross income not Subpart F income

Proposed regulations setting requirements for records and accounts to be maintained under section 964 (c) allow such records to be kept in the language and currency customarily used in the country of incorporation, provided translations are made available to the Internal Revenue Service when needed. The regulations further ameliorate the record-keeping burden by requiring only evidence in records sufficient to establish compliance with the minimum distribution requirements of Section 963, where that section is invoked by the taxpayer to obtain tax relief, or to establish that not more than twenty percent of gross income was not in the Subpart F category. A noteworthy disparity exists between this twenty percent requirement and the thirty percent maximum of gross foreign base company income beneath which no current tax is imposed on undistributed current earnings and profits.<sup>29</sup>

The proposed regulations allow U. S. shareholders of CFC's at their option to keep records at home or to insure

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<sup>29</sup> Proposed Treas. Regs. 1.964-4(e).

that the CFC's do so abroad, so long as English translations can be made available to the Internal Revenue Service within ninety days after demand.

Regulations 1.964-1 and 1.964-2 are to be proposed at a later date. They will deal with the definition of (1) earnings and profits and operating deficits and (2) the blocked foreign income exclusions, respectively.

### *Concluding Comment on Subpart F Regulations*

As of May 2, 1963, some seventy-four pages of proposed regulations had been published, covering less than one-third of Subpart F. At this rate Subpart F will require some two hundred twenty pages of Regulations, a conservative estimate when viewed in the face of what is to come, e.g., defining Subpart F income (IRC Section 952), special rules for foreign tax credit (960), basic provisions (961), the minimum distributions relief provisions (963), subjects which will require equally extensive treatment.

## III.

### *Some Problem Areas*

#### *The Constitutional Issue*

The constitutionality of Section 951 was discussed considerably in the hearings before the Senate Finance Committee and has, since the passage of the Act, been considered by several tax authorities.<sup>30</sup> In *Eisner v. Macomber*<sup>31</sup> there was a clear statement that corporate income could not be taxed to the shareholder without his actually realizing that income by receiving it. In arguing against the proposition set forth in *Eisner*, the Treasury Department relies heavily on *Helvering v. Horst*,<sup>32</sup> but in *Horst*, unlike *Eisner* and unlike the situation created by the enactment of Subpart F, the taxpayer exercised a dominion over income which was to be received in the future, namely, the transfer of bond coupons as a gift to a donee, which the court determined was sufficient economic

<sup>30</sup> 18 J. Taxation 127 (Feb., 1963). Hearings before Sen. Fin. Cmtee. on H.R. 10650, 87th Cong., 2nd Sess., 3039, 3043.

<sup>31</sup> 252 U.S. 189 (1920).

<sup>32</sup> 311 U.S. 112 (1940).

satisfaction to the donor to render it taxable to him. In Subpart F no such situation exists, and the Treasury's optimism in relying on *Horst* would not appear justified, particularly in the light of the fact that *Eisner* has never been overruled by the Supreme Court.

*Difficulties with the Subpart F income concept*

Subpart F income is divided into two basic categories in section 952, each of which can be treated separately. Income derived from the insurance of United States risks comprises the first category, and takes up relatively little room in the statutory material enacted,<sup>33</sup> and relatively little space is devoted to it in the Committee Reports. It is cross-referenced to Subchapter L of the Code in several respects, particularly in the area of deductions.<sup>34</sup>

It is the second category of Subpart F income namely, Foreign Base Company Income which commands the lion's share of space in the Code, in the explanatory material found in the Committee Reports and in materials published to date in periodicals. The Treasury Department, realizing the importance of this feature of the Revenue Act of 1962, published its proposed regulations in this area on December 27, 1962,<sup>35</sup> before any other regulations were promulgated in the area of foreign income under the new Act. (See Part II *supra*) Very briefly, foreign base company income includes (1) personal holding company income, i. e., dividends, interest, rents, royalties, capital gains from transactions in securities, and commodity profits; (2) sales income, including profits or commissions earned on the purchase or sales of goods when a "related person" is involved and where the goods were both purchased and sold in countries other than the country of incorporation ("outside" countries); and (3) services income, which includes technical and managerial services furnished a "related person" in an "outside" country.

The personal holding company type income generally includes the same type of income set forth in Section 553

<sup>33</sup> Int. Rev. Code of 1954, sect. 953.

<sup>34</sup> Int. Rev. Code of 1954, sects. 809, 817, and 832.

<sup>35</sup> 27 Fed. Reg. 12759 (Dec. 27, 1962); Int. Rev. Bull. 63-1, 23.

relating to foreign personal holding companies. There is an important modification in the rental category, however. The 50% of gross income test is not available to the taxpayer insofar as Subpart F is concerned. That is to say, all rents, even though more than 50% of gross income, are includable. There is relief for the taxpayer, however, where rents and royalties otherwise includable are derived from the active conduct of business received from third persons, for certain transactions of banking and financial institutions, and for dividends and interest received from a company incorporated in the same country, provided a substantial portion of its assets are located there also.

The principal difficulty in this area is a definitional one. What constitutes an "active conduct of a business" for purposes of excluding rental and royalties income from Subpart F income will, in some borderline cases, be difficult to determine without a meticulous analysis of many facts surrounding the business in question. The proposed regulations are principally concerned with the exclusions allowed where there is personal holding company income from dividends, interest, rents, royalties, and certain gains from sales of stock or securities. In each of these instances, the rules are extensive and complex. Where exclusions are claimed under these rules, the Internal Revenue Service audit burden will not be an easy one.

Sales and services income occupied a great deal of time in the hearings and discussions of the Bill, and the arguments often became heated. By way of background, there existed a situation in Europe where sales and services corporations were organized in low-tax countries outside the country of manufacture, whose taxes were significantly higher. American businessmen who controlled these foreign business activities found it worthwhile to avail themselves of lower income taxes in countries such as Switzerland, to set up its sales and services activities thereby removing a portion of the aggregate profits from the taxing jurisdiction of countries like France and Germany, whose rates are comparatively high. By bringing income derived in such a manner to Subpart F, Congress seeks to discourage such practices. Why these practices should be discriminated against through tax legislation was the main bone of contention on the part of American businessmen,

for they saw no valid reason for being denied opportunities to meet foreign competition by seeking tax avoidance through whatever tax havens might be available. In any case, Subpart F takes in certain foreign base company sales and services income. For instance, an American parent corporation controls a manufacturing subsidiary in France and it in turn has incorporated its sales activities separately in Switzerland. The Swiss activity buys the output of the French manufacturer and sells the merchandise throughout the world. Whatever is sold outside Switzerland comes within the purview of Subpart F, and income therefrom, though not distributed, will be taxable to American shareholders of the U. S. parent corporation. The same theory applies to services, principally technical and managerial, provided by a Swiss subsidiary. It is interesting to note that in both situations, "related persons" must be involved. For example, if a Swiss company is controlled by individual U. S. citizens, and it obtains its merchandise for resale from unrelated suppliers, no Subpart F income is involved.

With respect to services income, problems are bound to arise as to what exactly constitutes services performed on behalf of any related person, and further, just where services are performed. Although the proposed regulations are detailed and, on initial examination, apparently carefully drafted, difficulty will surely be encountered in defining these relationships. Minor assembling, packaging, or labeling of merchandise from another country, for example, will not according to the proposed regulations, remove sales and services income from the taint of Subpart F, although Subpart F can be avoided where there is manufacturing, construction, or assembly in the sales corporation. There is a line to be drawn, but no amount of carefully phrased regulatory guidance can draw such a line exactly so as to cover every conceivable situation. As each case arises under the new law, it must be tested in the light of its own facts. It would seem to be a task for the courts.

*Some accounting and audit stumbling blocks*

(a) The accounting and administrative burdens imposed by the 1962 foreign tax haven legislation will be of a magnitude that in most cases will be unwarranted by the goals the legis-

lation was intended to attain. All accounting transactions will require a specialized review to ascertain and segregate those items which are responsive to Section 12. The multifarious relief provisions and the involvement with foreign countries further complicate the accounting requirements. Not only will the taxpayer be saddled with these problems, but the Internal Revenue Service will have to cope with a preposterous audit burden which will require not only highly specialized training of agents in the International Operations Division, which will be expensive and lengthy, but probably will require personnel who are fluent in certain foreign languages as well.

To determine foreign base company income, for example, it will be necessary to establish additional accounting records to keep track of fluctuations in qualified investments in less developed countries and to segregate dividend income derived therefrom so as to be able to exclude it; to determine service income from related persons outside the country of incorporation; to determine sales income in a similar manner; and to ascertain what property has changed hands through sales with related persons outside the country.

(b) A *de minimis* rule suggested by the AICPA,<sup>36</sup> but not incorporated into the law, would in many cases have ameliorated much of the unwarranted accounting burden, discussed in (a) above. Where foreign base company income is potentially less than 20% of the taxpayer's gross income, or where a shareholder is required to report \$10,000 or less taxable income, the AICPA proposal would have allowed the taxpayer to disregard foreign base company income. Such a simple provision could easily have been added to the law, with a minimum of verbiage, and would have eliminated a reporting duty for many a middle-income taxpayer who happened to have foreign holdings in his modest investment portfolio.

(c) In legislation as complex as that found in Section 12 of the Revenue Act of 1962, there is a natural inclination on the part of Congress to leave many matters of detail to the

<sup>36</sup> Comments on Amendments to the Tax Bill (H.R. 10650) proposed by the Treasury Dept., submitted to the Senate Finance Committee June 26, 1962, by the AICPA Committee on Federal Taxation. 114 J. Accountancy 61 (Aug., 1962).

Secretary to administer through regulations, and to provide him with discretion. In section 954(b) (5) of the Code, the Secretary is given a rare discretionary power to determine, through regulations, what deductions for foreign base company income will be allowable. Standards are not to be found in the law, other than the very broad statement that the Secretary "take into account deductions (including taxes) properly allocable to such income." Such discretion allowed the Executive Branch is, in effect, the power to determine what is taxable income, and is virtually unprecedented in the history of federal income tax law.

(d) In complying with section 951, how is a shareholder, particularly a small shareholder, to know of the existence of a CFC? What of the small shareholder who needs information about the corporation and is unable to obtain it? Quite conceivably the corporation may refuse, on the ground that it would be too costly, for example, to furnish the information needed. There is nothing in the law which prohibits such a refusal, nor is there provision for allowing the shareholder to deduct his expense in obtaining needed information, should he be able to enter into such an agreement with the corporation. He will need time, in any event, to inaugurate additional accounting records required in order to comply with the law.

(e) Section 951(a) (2) (B) taxes shareholders on Subpart F income, with reductions allowed for actual dividends received and subject to tax as such. Can the shareholder include among such reductions gains recognized by him pursuant to a sale of stock under the conditions of Section 1248,<sup>37</sup> which requires dividend income treatment for such gains? The law is not clear. It would seem that he should.

(f) The Internal Revenue Service, in performing its audit function, will be faced with a problem similar to that presented in (e) above with respect to obtaining information. Commissioner Caplin, in his 1962 Annual Report, had this to say:

The difficulties of obtaining full information on foreign affiliates are much greater than on domestic entities. For-

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<sup>37</sup> Int. Rev. Act of 1962, sect. 16.

eign economic espionage laws have been invoked to delay, hinder, and sometimes entirely prevent the acquisition of data pertinent to examinations. Research continues on the most practical ways to require the production of information in regard to foreign subsidiary and affiliate transactions.<sup>38</sup>

This statement was made before enactment of Subpart F, which has made even more imperative the requirement for detailed information concerning foreign corporate activities.

### *Minimum distributions relief*

Section 963 sets forth one of the most complex schemes ever to be devised in the history of tax legislation to provide a measure of relief from taxation of Subpart F income where a CFC makes certain minimum distributions to its shareholders. The substantive part of this section begins at paragraph (b), which sets forth a table of minimum distributions as a percentage of current earnings and profits, juxtaposed against a series of effective foreign tax rate percentages. This rate depends on the earnings and profits for the current year and taxes accrued for the current year. The U. S. parent can apply the minimum distribution table in a number of ways where tiers of subsidiaries and/or branches are involved. Although income taxes resulting from increased investments in U. S. property are not affected, income from insurance of U. S. risks must be lumped in with Subpart F income in using the table. One of the biggest problems with respect to applying section 963 is that of computing the earnings and profits for foreign tax purposes. This task is complicated enough in domestic corporation situations. In CFC situations there must be superimposed many other factors, such as depreciation calculations on foreign assets (frequently of vague origin); the gyrating rates of foreign currency exchange; consolidated returns—not at all uncommon where foreign business is involved; the variegated types of foreign reserve accounts, some of them secret; the blocked foreign income exemption found in section 964(b); the possible election to take up sales income in installments; differing foreign accounting methods; and the foreign language

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<sup>38</sup> *Supra*, note 2, at 54.



from which all this must be translated. Code section 963(f) leaves to the Treasury Department the chore of weaving these threads into an intelligible pattern, including providing "regulations for the determination of the amount of foreign tax credit in the case of distributions with respect to the earnings and profits of two or more foreign corporations."

To date there have been no regulations proposed by the Treasury Department on any aspect of section 963. When they are proposed and the public has its requisite forty-five days to file comments, there will undoubtedly be a deluge of briefs filed, and a date for hearings will probably be set. This will all take time, before final regulations can be published. Then not only taxpayers but revenue agents will have to master their content, which will take more time. Until then, the minimum distribution relief will be available to U. S. taxpayers only in simplest of situations, where, for example, a Swiss sales subsidiary of a French parent corporation coming under the CFC category is paying a 12% income tax, and the CFC chooses to apply minimum distributions rules separately, as it can do to any or all first tier subsidiaries. In this simple situation, a quick reference to the table in section 963(b) reveals that a distribution of eighty-six per cent of current earnings and profits will avoid a current tax on the remaining 14% of foreign base company income retained by the CFC. But even here the relief is trivial, and hardly worth the high price exacted for it. The solutions to more sophisticated minimum distribution problems, which are bound to come, will have to await the final Treasury Regulations for Code section 963, a delay which may have a cramping effect on certain U. S. controlled business activities abroad.

#### *The CFC branch income taint*

Section 954(d) (2) states that certain branch income of CFC's shall be treated substantially as if the branch were a wholly owned corporate subsidiary generating "foreign base company sales income" for its parent. The section leaves to the Treasury the task of prescribing, through regulations, just what income attributable to the branch will be classified as foreign base company sales income. The word *substantially* found in the Code has been pinpointed in the proposed regu-

lations,<sup>39</sup> which state that separate corporate treatment of a branch of a CFC applies where (1) the branch income is taxed at an effective rate of at least five percentage points less than would apply if the branch income were taxed in the country where the CFC is incorporated or where (2) the income of the CFC, exclusive of the branch, is taxed at an effective rate of at least five percentage points below that which would apply if the entire income were taxed in the country where the branch is located. This means that where there is a tax rate disparity between the two foreign countries involved of five percentage points or more, (which country having the greater rate being irrelevant) the branch company income becomes tainted with the label "foreign base company sales income," provided the other tests are met (e.g.—30% or more gross income test, *inter alia*). The regulations as proposed reassure the taxpayer that branch income can acquire no worse status than it would have if the branch were in actuality a foreign subsidiary. The problem which these provisions give rise to is that the regulations are, as of this writing, still in the proposal stage, thus leaving tax planners unable at present to take decisive action in instances where it is possible, through slight manipulations of income and expense allocations, to obviate tax liabilities in this area. How soon the die will be cast in the form of final Treasury Regulations on this point is problematical. The area is a complicated one, and final Regulations do not appear imminent.

#### *Foreign tax credit*

Section 960 provides for a foreign tax credit in the case of corporate U. S. shareholders of CFC's.<sup>40</sup> Subpart F creates a new difficulty, however, and one which necessitates what is probably the most complicated provision of the Act. In a nutshell, the difficulty is created by the fact that the U. S. shareholder, under Subpart F, is to be taxed on income not actually received. Heretofore, foreign tax credit has been concerned with taxes actually paid. Now a hypothetical foreign tax that *would have been paid* had there been an actual distribution, is introduced.

<sup>39</sup> Proposed Treas. Regs., sect. 1.954-3(b).

<sup>40</sup> This credit is subject to the "grossing up" requirement of sect. 9 of the new Act, incorporated in Int. Rev. Code of 1954, sects. 78 and 962.

The nub of the problem with respect to the foreign tax credit arises when there is an actual distribution subsequent to the time the U. S. shareholder has paid a tax on attributed Subpart F income. Section 959 provides relief by exempting these subsequent distributions on the theory that the income should in no event be taxed twice to the shareholder. In this instance a tax would have been paid under section 951. Section 960 provides that in such cases where exempt actual distributions are made which bear an additional foreign tax, a foreign tax credit is allowed. Provision is also made for including gross income for purposes of allowing the credit, and for refunds where the credit doesn't save tax (as in the case of an operating loss in the CFC) in the year when the distribution of dividends is made. Furthermore, earnings and profits are utilized in an intricate system of priorities, taking into account first amounts attributable to increases in U. S. property investments, then Subpart F income amounts, and finally other earnings and profits. To date, no regulations have been proposed covering this aspect of the new law, but in the Committee Reports, four comprehensive examples are given to illustrate section 960, the first two covering application of the credit for foreign taxes "deemed to have been paid" when the taxpayer is obliged to take up income pursuant to section 951, and the last two covering the time that income is distributed in a subsequent tax year. Until the final regulations are published, these examples must serve as the computational guidelines for determining what amount of foreign taxes are deemed to have been paid by domestic corporations.<sup>41</sup>

*Less developed country designations*<sup>42</sup>

Code section 955(b) (3) requires the President, should he desire to terminate a designation of a less developed country, to notify both Houses of Congress of his intent to do so at least thirty days prior to the effective date of the termination. This clause would seem to prevent such a termination without at least a thirty day waiting period, despite the fact that in some cases both Congress and the President manifestly might

<sup>41</sup> These taxes would be required to be taken up as income under the "grossing up" provisions of Int. Rev. Code of 1954, sects. 78 and 962.

<sup>42</sup> See discussion of Executive Order 11071, *supra*. Part II, under Code sect. 955.

desire it immediately, as might happen, for example, should a country's political leanings suddenly shift to the Communist bloc. In the light of this possibility, this clause, as presently worded, might prove cumbersome and even embarrassing to the United States in diplomatic maneuverings which often require swiftly-timed action in order to be effective.

*Recent Swiss legislation affecting Subpart F*

The most prominent tax haven in Europe for the purpose of establishing base companies is Switzerland, as evidenced by the fact that as of March 1, 1961, there were more than five hundred U. S. owned corporations in that country, of which one hundred seventy had been organized in the immediately preceding twelve months.<sup>43</sup>

The Swiss government, however, in its growing apprehension over the possible displeasure of other countries concerning the possible abuse of tax conventions and treaties involving Switzerland, has taken measures<sup>44</sup> which, in effect, clamp down on those companies who do not make "appropriate" dividend distributions, by denying exemption from or reduction of withholding taxes levied by third countries pursuant to treaty arrangements. The effect of the Swiss Decree will be to encourage U. S. shareholders to avail themselves of the Kerr relief provision allowing an abatement of Subpart F income tax where distributions are made.<sup>45</sup>

*The "missing tier" enigma*

Internal Revenue Code, section 318(a) (2) (C) requires that constructive ownership be attributed to a person according to a percentage interest in *value* of the owned stock. Subpart F does not have this "value" rule, but has only a "voting control" rule. It is only where more than 50% of the voting stock is owned by U. S. persons that Subpart F can come into play. This distinction between the constructive ownership rules of Subpart F<sup>46</sup> and section 318 can produce some bizarre

<sup>43</sup> President's Tax Message, Exhibit II, Table 15 (Apr. 20, 1961).

<sup>44</sup> Decree of the Federal Council of December 14, 1962.

<sup>45</sup> Int. Rev. Code of 1954, sect. 963.

<sup>46</sup> *Id.*, sect. 958(b) (2).

results where a U. S. grandparent, foreign parent, and a foreign (grandson) subsidiary situation exists. For example, U. S. grandparent owns 40% of the common voting stock and 100% of the non-voting preferred stock of French parent. Common stock represents 20% equity in parent and preferred stock represents the other 80%. The remaining 60% of the common stock is owned by strangers each of whom owns less than 10%, and each of whom are strangers to one another. With only 40% voting control in grandparent, parent is clearly not a CFC, although grandparent, by *value*, owns 88% (20% of 40%) plus 80%) of French parent. Parent, however, owns 100% of all stock in a Swiss subsidiary. Under section 318 (a) (2) (C), 88% voting power in Swiss grandson is attributable to U. S. grandparent. Hence, the missing tier: grandson is a CFC while parent is not!

The proposed regulations for section 954 do not contemplate this possibility. The simplest and most realistic rule to apply to this type of "missing tier" situation would be to say that grandson is not a CFC, for voting control in the U. S. grandparent is missing. This interpretation would be in keeping with the intent behind section 951, which requires voting control to bring foreign corporations within Subpart F. Needless to say, this interpretation would be the most expedient solution to an apparent unintended effect of the application of the constructive ownership rules.

#### *Discretionary relief*

Tucked away in section 954(b) (4) is an escape valve clause which gives the Secretary broad discretionary powers in the area of Subpart F. He may grant complete relief from Subpart F taxability where it appears to him that tax avoidance is not being sought by the taxpayer. The section reads as follows:

(4) Exception for foreign corporations not availed of to reduce taxes.—For purposes of subsection (a), foreign base company income does not include any item of income received by a controlled foreign corporation if it is established to the satisfaction of the Secretary or his delegate with respect to such item that the creation or organization of the controlled foreign corporation receiving

such item under the laws of the foreign country in which it is incorporated does not have the effect of substantial reduction of income, war profits, or excess profits taxes or similar taxes.

It is axiomatic in the field of Administrative Law that where Congress delegates discretion in specific areas of legislation to the Executive Branch, standards for the administration of that area should be prescribed by Congress in the statute. Here, standards for qualification under the exception afforded by section 954(b) (4) are absent. For example, precisely what income must not be substantially reduced, that of the parent foreign corporation, the subsidiary, or the U. S. shareholder corporation? What is the standard against which the "substantial reduction" must be made? The words "creation or organization of a CFC" are also bothersome. Does this mean that a foreign corporation in existence before enactment can never avail itself of the exception? Surely, to be equitable it should be eligible, but the statute is not clear on the point, and many would argue that to leave such an issue to the Treasury is clearly an excessive delegation of legislative power.<sup>47</sup>

It is likely that this subparagraph in Subpart F will receive considerable attention by U. S. shareholders who feel that their operations abroad are not carried on for tax avoidance purposes, for if they can successfully convince the Treasury Department that they should be excepted under section 954(b) (4), it will not be necessary for them to bother with more specific—and complicated—relief provisions of Subpart G, minimum distributions, percentage of gross income test, CFC test, less developed country provisions, etc., to seek avoidance.

#### *CFC fiscal year delay*

Foreign corporations which for the first time under Subpart F are taxable on undistributed earnings and profits were given an opportunity, in a Technical Information Release,<sup>48</sup>

<sup>47</sup> The proposed regulations further delegate the discretion to the district director level, which tends further to aggravate the situation. Proposed Treas. Regs. 1.954-1(b) (3).

<sup>48</sup> TIR 451 (Feb. 1, 1963), Rev. Proc. 63-7, Int. Rev. Bull. 63-6, 21.

to establish their fiscal year for U. S. tax purposes by filing a statement with a district director to the effect that a new fiscal year had been adopted. This means that certain Foreign Corporations could avail themselves of a "stay of execution" under Subpart F by adopting a fiscal year beginning December 1, 1962, thereby not becoming taxable on Subpart F income until after December 1, 1963. This move, however, had to be made by February 15, 1963, at the latest, according to the Technical Information Release (namely the fifteenth day of the third month following the close of the tax year established). Those corporations who, within the half month period from the publication of the Release until the deadline date, employed this device to put off their effective beginning taxable years are doubly fortunate. First and most obvious is the fact that they have managed to defer Subpart F tax liability for a good part of a year. Secondly, the delay allows the foreign corporations to put their affairs in order and perhaps rearrange their financial operations so that they may never become subject to the tax imposed by Subpart F. What is more, this respite will provide them an opportunity to do some watchful waiting while the Treasury Department struggles with implementing Regulations, Rulings and other directives. By November, 1963, it is hoped at least that much of the air will be cleared with respect to many of the confused areas created by the foreign income provisions of the Revenue Act of 1962.

### *Conclusion*

The legislation was hastily drafted in the light of its incredibly complex provisions. In mid-1962, when hearings were in full swing and scores of taxpayers were voicing serious objections to policies reflected in the Bill, Senator Byrd announced that the Senate Finance Committee would hold "very limited" hearings on additional Treasury proposals. Witnesses were limited to ten minutes apiece before the Committee, and the rule was strictly enforced. During the summer, the consensus among those whose business it was to keep abreast of pending legislation was one of pessimism over the prospects of the Bill's enactment in the current session of Congress. It came as something of a surprise to some when suddenly, on October 16th, the Act was on the books, passed and approved. Many had thought that insofar as the proposed Subparts F

and G were concerned, the press of time in the session should have precluded decisive action until the January session of the next Congress.

Taxpayers are entitled to carefully considered legislative analysis of new Code provisions which will affect their businesses. Careful consideration was not possible here. There was no attempt to evolve a tightly drafted, polished imposition section of limited scope which would have obviated the requirement of the myriad relief provisions found to be necessary in the current Subpart F. The new Subpart F may be found to be costly to the United States. It will tend to have a negative effect on the respect U. S. taxpayers presently hold for our self-assessment taxing system, a respect which the Internal Revenue Service is presently bending intensive effort to build up.