Tax Aspects of Doing Business Abroad - Subpart F Income

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TAX ASPECTS OF DOING BUSINESS ABROAD—
SUBPART F INCOME

In recent years, the “Song of the Lorelei” has again risen, but this time in
the modern version of trade expansion. United States corporations, the voya-
geurs of the ever expanding seas of commerce and trade, are being lured by
the siren songs of plentiful sources of labor, tax incentives, export and import
concessions, and bountiful returns, as sung by numerous foreign countries.
The danger lurking therein is not destruction from the foreign country, but
from the possible tax consequences in the United States which may be felt
by corporations as a result of heeding the songs of promise.

After deciding that it wishes to expand into a foreign market, a United
States corporation faces the task of how to go about it. For example, the cor-
poration may wish to proceed alone by bringing in its own capital and ma-
chinery to set up a plant in which it will have total control. The drawback
here is that often the large initial outlay of capital results in a tie-up of funds
in what hopefully will be a profitable venture, but which may not be so for
quite a while. Another way the corporation may approach this problem is
through manufacturing or licensing agreements with a foreign corporation.
While this may solve the outlay of capital problems, there is the greater
danger of the investor being left with nothing upon the termination of such
agreements. Finally, there is the possibility of a joint venture agreement
between the United States investor corporation and a foreign partner with
the end result being the formation of a new corporation (hereafter referred
to as an International). It is the International structure that seems the most
advantageous, for it contains the benefits of control if the contract is properly
prepared and the smallest capital outlay requirement. If the joint venture
is taken as the corporate structure which the United States corporation will
embark upon, what are the consequences which will be felt by this corpora-
tion as a shareholder in International?

This comment will consider two of the tax situations which may arise: the
tax consequences to the United States shareholder if the International quali-
fies as a “foreign personal holding company” (hereafter referred to as
FPHC); and the tax consequence felt if the International, failing to qualify
as a FPHC, qualifies as a “controlled foreign corporation” (hereafter referred
to as CFC) under Subpart F of the Internal Revenue Code of 1954. To fully
explain the tax provisions involved, the first parts of this comment will be
devoted to a study of the Code provisions relating to each of the two tax
consequence structures without specific reference to the particular corporate
problem. Only in the second sections of each discussion will the corporate
structure be delved into in order that the available specific consequences or
escapes may be seen.
The statutory sections relating to the FPHC tax are set out in the Internal Revenue Code of 1954 at sections 551-558. These provisions were enacted in 1937 to deal with what was then regarded as a prevalent abuse of using the foreign corporation to own portfolio investments, with the monetary effect being that such a corporation was but a "straw man." The tax provisions only affect the closely held corporation, those controlled by five or less individuals, and do not affect a widely held foreign corporation or a widely held United States parent corporation with foreign subsidiaries whose income is derived from investment sources. Generally, the provisions require that the "undistributed FPHC income" of a FPHC is to be included in the gross income of the citizens or residents of the United States who are "shareholders" in such a FPHC as set forth under the Code.1 The question thus arises: what do "shareholder," "FPHC," and "FPHC income" mean?

One of the shareholder requisites for a corporation being classified as a FPHC is that more than fifty percent in value of its outstanding stock must be owned at some time during the taxable year by or for not more than five individuals who are citizens or residents of the United States.2 This part of the shareholder requirement could, of course, be easily avoided if all that was taken into consideration was actual ownership. However, here as in other Revenue Code provisions, the rules of attribution take effect; therefore, indirect and constructive ownership must be considered. The constructive ownership tests to be applied are the same as those found within the domestic personal holding company provisions. Thus, stock directly or indirectly owned by or for a corporation, partnership, estate or trust is considered as being proportionately owned by its shareholders, partners, or beneficiaries; an individual is considered as owning the stock if it is directly or indirectly owned by or for his family or by or for his partner; and, any person having an option to acquire stock is considered as the owner of such stock.3 Therefore, the constructive ownership factor is not one to be lightly regarded; for, the Code looks beyond a corporation, directly to the shareholder.

Another requirement imposed by the Code relates to the type of shareholder and his status in relation to the FPHC. Under the Revenue Code, a United States shareholder includes any of the following: citizen, domestic corporation, domestic partnership, and estate or trust (with the exception of the estate or trust whose only income is derived from sources within the United States).4 Further, the shareholder, to come within the purview of the Code

1 INT. REV. CODE of 1954, § 551(a).
2 INT. REV. CODE of 1954, § 552(a)(2).
3 INT. REV. CODE of 1954, § 554(a).
4 INT. REV. CODE of 1954, § 551(a).
need not be one of the shareholders whose existence created the FPHC status. Each shareholder, who was a shareholder on the last day in the taxable year of the corporation on which the "United States group" existed with respect to the company, must include in his gross income, as a dividend for the taxable year of the company, the amount he would have received as a dividend. Thus, if the shareholder is not needed to make the more than fifty percent requirement, and either sells or purchases stock during the year, he is still subject to the tax provisions.

"FPHC" is the second of the three inter-twined terms which must be understood. In order to qualify as a FPHC, a specified portion of the corporation's (International's) income must be foreign personal holding company income. This in effect means that at least sixty percent of the foreign corporation's gross income must be FPHC income for the taxable year. If, however, the corporation is a FPHC with respect to any taxable year ending after August 26, 1937, then for each subsequent year the minimum is only fifty percent until a taxable year in which, during the whole of the year, more than fifty percent United States stock ownership does not exist (and thus its qualification as a FPHC ceases); or until the expiration of three consecutive years in each of which less than fifty percent of the gross income is FPHC income.

Within the statutory framework of the Internal Revenue Code, it is provided that certain types of corporations will not be considered FPHCs, no matter what the composition of their gross income is. However, the notation of this fact loses its effectiveness as a tax planning guide when it is realized that no benefit would be gained by a manufacturing corporation seeking to fit within the exempt provisions. This is because either the corporate purpose would be destroyed or the company would find that it had unwillingly fallen within Subpart F income. Under the exempting provisions, a FPHC does not include: a corporation exempt from income taxation; a corporation organized under the banking laws of a foreign country if the Secretary or his delegate finds that it was not organized or availed of for the avoidance of a tax which otherwise would be imposed upon its shareholders; or a corporation exempt from tax under Subpart F of the Code.

The third term to be explained is "FPHC income," which includes all interest, royalties and rents, unless it is fifty percent or more of the gross income. Thus, the income composition is passive rather than active income, such as would arise from the manufacturing and sale of goods. Also included

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5 Treas. Reg. § 1.551-2(a).
7 The various effects of Subpart F income will be discussed in the second part of this comment.
are net gains on stock or securities transactions, except if the corporation is a regular dealer in such, and dividends, annuities, rent from stockholders, personal service income, and trust income. It might be noted in relation to personal service and rent income, that performance by a shareholder is limited. The amounts received by the corporation are to be included if at some time during the taxable year twenty-five percent or more in value of the outstanding stock of the corporation is directly or indirectly owned by or for the individual who has performed the services or used the property. Thus, the effect is the discouragement of a "front operation" and a resulting dividing of the entities.\(^9\)

Another important element of FPHC income is the inclusion of constructive dividends taxable to one FPHC by reason of its ownership of stock in another FPHC.\(^{10}\) Thus, if the foreign personal holding company is a shareholder in another FPHC, it must include as a dividend, as of the last day of the second company's taxable year, its distributive share of the second FPHC's undistributed FPHC income. If the United States group has ceased to exist on any day within the second company's taxable year, the dividend is reportable as of that day, but only in proportion which the part of the second company's taxable year bears to its entire taxable year.\(^{11}\) Dividends actually paid by the corporation qualify as a deduction, but such deduction is limited to the dividends actually paid during the taxable year. It is seen then, that the deduction does not include the following (which are allowed in the case of a domestic personal holding company): dividends paid in the following year under an accrual,\(^{12}\) dividend carryover,\(^{13}\) and deficiency dividends.\(^{14}\)

Once the requirements as set out in the Code and their effect on the United States shareholder have been stipulated, an opportunity presents itself to pause and reflect upon possible escapes and the consequences of such action. It may be observed that since the enactment of the FPHC provisions, foreign corporations (Internationals) have only infrequently been classified as FPHCs and the classification, if it occurs, is often due to inadvertence. The reason for this is twofold: the legislation has stringent impact since the shareholder of the foreign corporation may well be taxed on the undistributed income, never realizing the fruits of the income because of monetary restrictions placed on the foreign corporation by the foreign government; and secondly, the provisions are relatively easy to circumvent because of the narrow ownership provision definition.

\(^9\) INT. REV. CODE of 1954, § 553(a)(6).
\(^{10}\) INT. REV. CODE of 1954, § 555(b), for illustration see Treas. Reg. § 1.555-2(b).
\(^{11}\) INT. REV. CODE of 1954, § 555(c)(1).
\(^{12}\) INT. REV. CODE of 1954, § 563(a).
\(^{13}\) INT. REV. CODE of 1954, § 564.
\(^{14}\) INT. REV. CODE of 1954, § 547.
Turning to the assumed corporate structure, it may be seen that the foreign personal holding company provisions are quite easily side-stepped. This occurs due to two main requirements of the Code. That is, the set percentage of FPHC income, and the number and percent holdings of the United States partner in the joint venture are not "either—or" provisions, but instead are mutual and must be met in order to come within the meaning of the statute.15 Thus, if one looks not to the United States corporation but to the individual shareholders to determine the number requirement, then, if the corporation is widely held, the United States corporation is not taxed under the Code provisions relating to FPHCs. The reverse is also true. If the income of the foreign corporation does not meet the structure and percentage requirements of the Code, the FPHC provisions will not apply, regardless of how few shareholders there are in the United States corporation.

A word of caution must be added. If the United States corporation seeks to avoid the tax consequences of the statute via manipulation of the ownership requirements, it may find itself in a trap. A foreign corporation failing to qualify as a FPHC by reason of a majority of the stock being owned by nonresident aliens, may well be taxed as a domestic personal holding company and be subject to the tax penalty that is imposed upon the corporation by reason of accumulating its income. Another consequence of failing to qualify as a FPHC is the realization that the corporation may qualify as being subject to the Internal Revenue Code provisions relating to Subpart F income. This consequence arises when the foreign corporation qualifies as a controlled foreign corporation.

TAX EFFECT OF INTERNATIONAL BEING TAXED AS A CONTROLLED FOREIGN CORPORATION

To bring the tax consequences of a controlled foreign corporation (CFC) into focus, the following example illustrates what had been occurring before 1962 when the corporation did not qualify as a FPHC. An American corporation that was engaged in the purchase and sale of goods would organize a foreign corporation in a "tax haven" country (a country with low tax rates). The foreign corporation would then buy goods from outside the country of its incorporation and would resell the goods to its parent United States company at a substantial profit. The price might even be more than the going sale price of such merchandise on the open market. In this way a large profit, perhaps even an unrealistic profit, would be siphoned into the foreign corporation without any United States tax cost, for the money the United States company paid its subsidiary would be taxed via the foreign country's rates.

Thus, under the pre-1962 provisions, a foreign corporation, even though it was American controlled, but not controlled within the provisions relating to FPHC, was not subject to United States tax laws relating to foreign source income. As a result, no United States tax was imposed with respect to the foreign source earnings of these corporations where they were in part controlled by their American parent company until a dividend was paid by the foreign corporation and was received by the United States stockholder. The tax was imposed at that time on the United States stockholder with respect to dividend income received, and if the shareholder was a corporation it was eligible for a foreign tax credit with respect to the taxes paid by the foreign subsidiary. Therefore, in the case of the foreign subsidiary, foreign income taxes were paid currently to the extent of the applicable foreign income tax, and not until distributions were made was an additional tax imposed, and then only to the extent that the United States rate was above the applicable foreign country tax rate. This latter tax effect was referred to as a tax deferral.16

President Kennedy, in his 1962 tax message, referred to removing tax deferral in the case of "tax havens" and stated that:

The undesirability of continued deferral is underscored where the deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures, aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent and licensing rights, the shifting of management fees and similar practices which maximize on the accumulation of profits in the tax havens, so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liability both at home and abroad.17

As a result of the above message the 89th Congress passed a revenue act which is commonly referred to as "Subpart F" of the Internal Revenue Code (set out in sections 950-972 of the Code) and which substantially provides for what President Kennedy requested.

In general, the act provided that certain types of income of the controlled foreign corporation, even though undistributed, were to be includible in the income of the United States shareholder in the year the income was earned by the foreign corporation. In these cases, the United States shareholder was permitted to take foreign tax credits to the same extent as if actual distributions had been made. Under the act only United States shareholders who held ten percent of the voting stock of the CFC were subject to tax on the

It was held that a foreign corporation was a CFC for the purpose of the provisions only if more than fifty percent of the combined voting power of all classes of stock was owned directly or indirectly by those shareholders having a ten percent or greater interest. The amount of Subpart F income which may be taxed in any year is limited to the earnings and profits of the CFC for the taxable year, less deficits not otherwise offset since 1959.19

In addition to certain types of undistributed earnings being treated as if they were distributed and taxed to the United States shareholder of the CFC, the act also provided that the earnings invested in United States property (with certain exceptions) were to be taxed to the United States shareholder.20 In general terms, United States property is property located in the United States or having its situs in the United States, unless used in foreign trade or business. Earnings invested in the United States property are treated first as arising out of Subpart F income, which means that to the extent that income is taxed to the United States shareholder, the income of the corporation will not again be taxed to the shareholder because of investments in United States property.21 Similarly, actual dividend distributions are treated first as being paid out of earnings invested in United States property, then out of Subpart F income and only finally, if any balance remains, out of accumulated earnings and profits of the corporation which have not already been taxed to the shareholder. Only when actual dividends are treated as paid out of the latter category do they represent taxable dividends to the shareholder.22

Thus, the Revenue Act of 1962 introduced several major changes in the taxation of foreign corporations; and one of the most important concepts was its effect on closing the tax loopholes of the foreign "tax havens." The device is essentially an extension of the FPHC tax, whereby the United States shareholder is still taxed currently upon earnings of the foreign corporation, whether or not they receive an actual distribution of the earnings. For this purpose, the shareholder requirements outlined in the area of FPHC are broadened beyond the five-person control group. Moreover, the classes of taxable income are greatly extended, and the shareholders are generally taxable upon such income without any minimum percentage requirements. The most important extension, as already mentioned, is to tax income arising from sales and service subsidiaries which are incorporated in low tax foreign countries and whose location serves no business purpose.

18 INT. REV. CODE of 1954, § 951(a)(1).
19 INT. REV. CODE of 1954, § 952(c).
22 INT. REV. CODE of 1954, § 951(a)(2).
If the corporate income is taxable to a shareholder under the traditional foreign personal holding company rules, he is not subject to this tax consequence. However, if the foreign corporation does qualify as a controlled foreign corporation, the amount of the tax imposed depends on the very complex formulas imposed in Subpart F. In order to help attain the proper perspective of these formulas, the following outline is provided to give the reader an insight into the complexities involved. Gross income of the United States shareholder includes the pro rata share of the foreign base company income, which includes:

1. Subpart F Income
   A. Includes:
      (1) FPHC income
      (2) Foreign base company sales income
      (3) Foreign base company service income
      (4) All other income when foreign base company income is more than seventy percent of gross income
   B. Excludes:
      (1) Foreign base company income which is less than thirty percent of gross income
      (2) Income as to which a minimum distribution has been made
      (3) Export trade income of an export trade association invested in export trade assets
      (4) Dividends, interests and gains from and reinvested in a less developed country
      (5) United States source income of a foreign corporation which has a United States trade or business
      (6) Blocked foreign income
      (7) Income as to which the IRS is satisfied resulted from a corporation not organized to reduce taxes

2. Previously excluded Subpart F income withdrawn from investment in less developed countries

3. Previously excluded Subpart F income of an export trade association, to the extent of decrease in export trade assets

4. Corporation's increase in earnings invested in United States property

SHAREHOLDER REQUIREMENTS

As in the FPHC there are certain holdings and income requirements which must be fulfilled in order to bring the International corporation within the Code provisions as a CFC. First, for the foreign corporation's income to be taxable to its United States shareholder, the corporation must qualify as a CFC for an uninterrupted period of thirty days or more during the tax year.\textsuperscript{23} This requires that more than fifty percent of the voting power be actually or constructively owned by United States shareholders, each of whom actually

\textsuperscript{23}\textsc{int. rev. code of 1954, § 951(a)(1)}. 
or constructively owns stock with at least ten percent of the voting power.\textsuperscript{24} The United States shareholders, as in the FPHC situation, may be citizens or residents of the United States, domestic partnerships, corporations, estates or trusts.\textsuperscript{25} It is to be noted that a shareholder is not taxed at all under Subpart F if he owns less than ten percent of the voting power; for, the Code provides that only those shareholders owning ten percent or more will be considered in arriving at the “more than 50 percent of the voting power” requirement.

For percentage holding purposes, all the voting control and constructive ownership tests and rules which apply in classifying the corporation as a CFC are applicable. The general rules for constructive ownership, as are found under section 318(a) of the Code, apply for the purpose of the fifty and ten percent tests whenever their effect is to create a controlled foreign company. These rules provide generally that the attribution rules of ownership through members of the family, partnership, estate or trust apply also. However, the statutes construing Subpart F prescribe several specific exceptions to these general rules. The family attribution rules do not apply to stock actually owned by a nonresident alien.\textsuperscript{26} Also, a stockholder is considered to own his proportionate share in stock owned by a corporation if he owns at least ten percent of the stock of that corporation.\textsuperscript{27}

As to voting power, the regulations contain a broad characterization of this power which may be sufficient for taxation. The United States shareholders have the requisite control if they have the power to elect, appoint, or replace a majority of that body of persons exercising the powers ordinarily exercised by the board of directors of a domestic corporation. Similarly, there is voting control if they can elect fifty percent of the board or can designate a person to cast the deciding vote in the event of a tie. Thus, normal ownership of voting stock will be disregarded if there is an express or implied agreement that the stock will not be voted or that it will be voted in a specific way, \textit{i.e.}, an agreement to shift the formal voting power away from the United States shareholder.\textsuperscript{28} The owner of a fifty-one percent interest in an association is considered to have the requisite voting control even though management powers are to be exercised by a single individual who must be elected unanimously by all the shareholders.\textsuperscript{29}

\textsuperscript{24} \textsc{Int. Rev. Code} of 1954, \S\ 951(b), 957(a).
\textsuperscript{25} \textsc{Int. Rev. Code} of 1954, \S\ 958.
\textsuperscript{26} \textsc{Int. Rev. Code} of 1954, \S\ 958(b)(1).
\textsuperscript{27} \textsc{Int. Rev. Code} of 1954, \S\ 958(b)(3).
\textsuperscript{28} \textsc{Int. Rev. Code} of 1954, \S\ 957.
\textsuperscript{29} \textsc{Treas. Reg.} \S\ 1.957-1(c).
COMPONENTS OF SUBPART F INCOME

Whereas, the examination of the shareholder requirements stands out for its brevity, the next requirement, Subpart F income, stands out for its complexity. The statutory description of the income taxable to the shareholder is intricate. The key ingredient is the CFC's Subpart F income, which consists of its foreign base income plus income derived from insurance of United States risks. Generally speaking, foreign base company income (hereafter referred to as FBCI) consists of FPHC income plus foreign base company sales income (hereafter referred to as FBCSI) and foreign base company service income (hereafter referred to as FBCRI). But, in addition to this, the shareholder may be taxed upon two types of previously excluded Subpart F income which has been withdrawn from investment, and upon any earnings invested in United States property.30

Treasury regulations attempt to prevent a reshuffling of income by the taxpayer among the three main components of FBCI so as to take advantage of the different rules and formulas for income from those three sources: investments, sales, and services. Thus, the income is classified in accordance with the substance of the transaction. Neither the designation applied by the parties nor by local law is controlling. What is actually rent, therefore, may not be considered as interest.31

All income from the performance of an integrated business transaction is to be classified in accordance with the predominant characteristic of the transaction unless the United States shareholder of such corporation establishes that a different method is proper, even though a part of such income could incidentally be imputed to another class of income. Thus, if a corporation rents property and also furnishes incidental maintenance services, all of the income is rent. On the other hand, where a controlled foreign company is engaged in performing separate transactions, even though pursuant to the same contract, the income from each such transaction is to be separately classified. For example, if the corporation rents construction equipment and also furnishes engineering services consisting of planning a construction site, the income is partly rent and partly services.32

FOREIGN PERSONAL HOLDING COMPANY INCOME

The first component of Subpart F income is the type of passive income which may qualify a corporation as a FPHC. Generally, to review, if the corporation's gross income consists of at least sixty percent of this type of income in a one year time span, and if it meets the five person, fifty percent

30 Int. Rev. Code of 1954, §§ 951(a), 952(a), 954(a), 970(b).
stock ownership test, then all of the corporation's undistributed income is taxable to the United States shareholder. But even if the corporation fails to qualify as a FPHC, this holding company income may be taxable under tests pertaining to CFC. The statutory provisions pertaining to CFC incorporate by reference the definition of FPHC income as found in section 553 of the Internal Revenue Code of 1954, and generally include rents, royalties, interests, dividends, annuities, personal service contracts, and gain on stocks and securities. However, there are several significant exceptions.

One of these exceptions is applicable to rent and royalties. All such income is included only if it constitutes less than fifty percent of the gross income of the corporation. Also, the CFC provisions provide that rents and royalties received from an unrelated person and derived from active conduct of a trade or business will not be considered as FPHC income. In relation to rent and royalty income arising from active conduct, the frequency with which the corporation enters into rent and royalty transactions will not of itself qualify as proof of the active conduct of a trade or business. Nevertheless, rents will be considered as being derived from the active conduct of a trade or business if, as part of the regular operations, the corporation makes the leased property or acquires it and then adds substantial value to it; or, if the corporation leases realty and performs active and substantial management and operational functions with respect to the leased property; or also, if the corporation leases personal property temporarily while it is idle and not in its ordinary use in the corporation's business. Royalties similarly qualify if the property was developed, created or produced by the corporation, or if it was acquired and the corporation added substantial value—all as part of the corporation's regular operation.

As another exception to incorporating CFC provisions, interests and gains from sale or exchange of stock or securities derived from the conduct of a banking, financing or similar business will not be considered FPHC income. Also, certain income received from related persons (fifty percent control) is also excluded, based upon the theory that a United States shareholder would not have been taxed on such income if he were the direct shareholder of the related person who here is a business entity. For this reason, dividends and interest received from the related corporation, which is organized under the laws of the same foreign country as the CFC and has a substantial part of its assets (eighty percent) used in a trade or business located in that foreign country, are not included in the FPHC income aspects of FBCI.

37 Treas. Reg. § 1.954-1(b)(1).
Although dividends, interest, and security gains are generally classified as FPHC income, and in turn foreign base company income, an exception is also provided whereby if the income is derived from qualified investment in a less developed country (hereafter referred to as LDC), such will not be included—maybe! The provisions relating to LDC will be discussed at greater length later. The last of the exceptions deals with dividends received by a CFC. At first blush almost all dividends received by a CFC are included in FPHC income and, thus, also included in FBCI. However, numerous exceptions are contained in several sections of Subpart F and must be considered in order to determine if a dividend received by the CFC becomes part of the computations in determining FBCI.88

FOREIGN BASE COMPANY SALES INCOME

The second of the general groupings of income under Subpart F is foreign base company sales income. FBCSI is income derived from the purchase and sale of personal property if the property is either purchased from or sold to a related person. The income may be in the form of profits, commissions, fees, or otherwise, provided that the property is manufactured, produced, grown, or extracted outside of the corporation’s country or incorporation, and that it is sold for use, consumption or disposition outside of that country.39 The provision also applies to the case where the CFC does not take title to the property but acts on a fee or commission basis. For example, if a Panamanian corporation buys a product manufactured in the United States by a related United States corporation and sells the product to an unrelated person for use in France, the Panamanian corporation’s profits become subject to the tax. The same result would apply if the Panamanian corporation bought a product manufactured in Canada for use in France from a United Kingdom subsidiary of the related United States corporation. In other words, the Panamanian corporation may act as a sales subsidiary only if the product is made in Panama, or if it is used there.40 The sales income, therefore, with which this provision deals, is the income of a selling subsidiary which has been separated from the manufacturing activities of a related corporation merely to obtain a lower rate of tax for the derived sales income. In addition, the fact that a lower tax rate for such a company is likely to be obtained only through purchases and sales outside the country of incorporation accounts for the fact that the provision is made inapplicable to the extent that the property is manufactured and also used in the country of incorporation.

40 Treas. Reg. § 1.954-3(a)(1).
Also included in foreign base company sales income are operations handled through a branch (rather than a subsidiary) operation outside the country in which the CFC is incorporated. This occurs if the combined effect of the tax treatment accorded the branch by the country of incorporation of the CFC and the country where the branch operations are carried on are mutual in effect. The result then, is to treat the branch substantially the same as if the branch was a subsidiary organized in the country in which it carries on its trade or business.

FOREIGN BASE COMPANY SERVICE INCOME

The third part of Subpart F income encompasses the area of foreign base company service income (FBCRI). FBCRI is income derived from the performance of technical, managerial, engineering, architectural, scientific, skilled or similar service, but only where they are performed for a related person and are performed outside the country in which the CFC is organized. The income may be in the form of compensation, commissions, fees or otherwise, and it may be derived in connection with the performance of services. Excluded, however, are services which are directly related to the corporation's sale of property manufactured by it, if performed before the sale, or which are directly related to an offer of or effort to sell such property.\(^4\)

Among the services performed on behalf of a related person which are includable are those for which the corporation receives substantial financial benefit from the related person, whether by payment, reimbursement, or otherwise; those performed with respect to property sold by the related person, where the performance of the services constituted a condition or a material term of the sale; and, those which the corporation is not capable of performing without personnel, direction, know-how, or other assistance furnished by the related person. As an example, assume that the domestic parent corporation sells machinery requiring installation and maintenance services which its CFC can perform. The subsidiary's income is FBCRI if the parent pays the subsidiary for services rendered to the customer, the parent reduces its price for the machinery sold to a customer, or the parent reduces its price for the machinery sold to a customer who agrees to accept the subsidiary's services. But the income is excluded if the parent's sale contains no such understanding and the customer selects the subsidiary to perform those services from among numerous qualified unrelated persons.\(^4\)

\(^{41}\) Int. Rev. Code of 1954, § 954(c).

\(^{42}\) Treas. Reg. § 1.954-4(b).
If the three factors of Subpart F income, namely, the holding company income, sales income, and service income, were all that was involved in determining foreign base company income, the computation would be relatively simple. However, the complexities of this area of the Revenue Code arise in specific rules and exclusions enumerated within the Code provisions. First, the Code provisions group these three components of FBCI into a single class for the purpose of an "all or nothing" test which is commonly called the 70-30 test. If the total FBCI is less than thirty percent of the gross income of the CFC, no part of the gross income is to be treated as FBCI. On the other hand, if the total FBCI exceeds seventy percent of the gross income, the entire gross income is to be treated as FBCI. In between these two percentages the actual amount of FBCI included in the CFC's gross income qualifies under these provisions. In this computation, FBCI includes the income from a less developed country that is ordinarily excluded and includes exclusions ordinarily allowed for export trade corporation income (hereafter referred to as ETC)—both of which will be discussed below. Also, the gross income of CFC parent excludes distributions actually received from subsidiaries which are included in the income of the parent's shareholders. A branch of the CFC may be treated as a separate subsidiary corporation. In such a case, the 70-30 tests apply separately to income attributable to each such branch.

A second area of specifics and exclusions evolves around the term, "qualified investments in less developed countries (LDC)"; for, although dividends, interests and securities gains are generally classified as FPHCI and therefore as FBCI, an exception is provided where the income is derived from "qualified investments in LDC." The income is excluded, however, only to the extent that it is reflected in an increase in such qualified investments from the close of the preceding tax year to the close of the tax year in which the income was received or in which the sale or exchange occurred. If a reduction in FBCI is granted for an increase in qualified investments in a LDC and then at a later time these investments are decreased, then, to the extent of the FBCI previously excluded from the tax loss to the United States taxpayer, there is to be an increase in the income of the controlled foreign corporation taxable to its United States shareholder. This exception is intended to make it possible for a CFC, which in part is a holding company, to reinvest dividends and interest obtained from a subsidiary in a LDC without the United States shareholder being taxed on this income.

43 Treas. Reg. § 1.954-1(d)(3).
44 Treas. Reg. § 1.954-1(d)(3).
45 Treas. Reg. § 1.954-1(d)(4).
46 INT. REV. CODE of 1954, § 954(b)(1), (f).
A "qualified investment" consists of stock or obligations of another foreign corporation which is at least ten percent owned by the CFC or obligations of the country itself. The ten percent voting power must result from direct ownership of the stock and is based upon the total combined voting power of all classes of stock. A corporation obligation must bear interest and be issued at a discount, unless there is a legal, governmental, or business reason to the contrary. The obligation must further have a maturity of at least one year at the time of acquisition. A corporation's stock or debt is a qualified investment only if: the corporation is engaged in the active conduct of one or more trades or businesses; it meets an eighty percent test for income and assets; and, at least eighty percent of its gross income for the tax year is derived from sources within the LDC. The assets in which "eighty percent of the assets" must be invested are:

1. Property used by it in a trade or business in a LDC.
2. Money and bank accounts.
4. An obligation of a LDC.
5. An investment which is required because of a restriction imposed by the LDC.
6. Certain United States property such as government bonds, money, property purchased in the United States for export which, although having a United States situs, are excluded from the definition of "United States property."

Also, it may be noted that another type of LDC corporation is that of being a shipping or aircraft corporation.

A less developed country is defined as a foreign country (other than areas within the Sino-Soviet Bloc) or possession of the United States which has been designated by the President as a country or possession economically less developed. However, there are certain countries which in no event are to be considered as a LDC. Once a country has been designated as a less developed country the President may not terminate that designation without giving thirty days' prior notice to the Senate and House of Representatives of his intention to do so. Moreover, if at the time of acquisition, property was a qualified investment in a LDC, the property is to continue to qualify thereafter even if the country ceases to be classified as a LDC.

A third major relief provision under these statutory rules is that Subpart F income is not to be taxed to the United States corporation if a schedule of

47 INT. REV. CODE of 1954, § 955(b)(1).
48 INT. REV. CODE of 1954, § 956(c)(1).
49 INT. REV. CODE of 1954, § 955(c)(3): Australia, Austria, Belgium, Canada, Denmark, Germany, Hong Kong, Italy, Japan, Liechtenstein, Luxembourg, Monaco, Netherlands, New Zealand, Norway, Union of South Africa, San Marino, Sweden, Switzerland, and United Kingdom.
50 INT. REV. CODE of 1954, § 955(b)(2), (c)(3).
minimum distributions is met. The minimum distributions required vary with the effective foreign country tax rate of the country in which the CFC is incorporated.\textsuperscript{51} The purpose of this provision is to forgo any tax on the United States shareholder with respect to the undistributed income of the CFC in those cases where the combined foreign and United States tax is not substantially below the United States corporate tax rate. The lower the foreign tax rate, of course, the greater the distribution must be, and the greater the proportion of the total which must be subject to the United States tax rate. Taxpayers are permitted to apply the minimum distribution rules to each separate CFC, to each CFC in the chain among other chains, and to all CFCs together.\textsuperscript{52}

A special rule applies where the foreign tax rate differs for corporate income which is distributed and for income which is not. In determining the effective rate, the foreign tax actually paid or accrued is discarded in favor of what would have been the tax if no dividends had been paid. However, the minimum distribution must be altered accordingly and an algebraic equation is necessary.\textsuperscript{53}

A fourth major relief provision under the Code is that foreign base company income in the case of an export trade corporation is to be reduced by the amount of its income which consists of export trade income. Thus, the United States shareholder of a controlled foreign corporation will not be taxed on the undistributed income of these corporations if the CFC is a ETC having export trade income. However, the exclusion of FBCI representing export trade income may not exceed the lesser of one and one-half times the export promotion expenses or ten percent of the gross receipts of the ETC from the sale, installment, operation, maintenance, or use of the property from which it derives the income which is otherwise excluded.\textsuperscript{54}

\textsuperscript{51} INT. REV. CODE of 1954, § 963(b)(3)—for taxable years. Beginning after December 31, 1964—

<table>
<thead>
<tr>
<th>Effective foreign tax rate</th>
<th>Min. distribution of earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 9%</td>
<td>83%</td>
</tr>
<tr>
<td>9 to 18</td>
<td>79</td>
</tr>
<tr>
<td>18 to 26</td>
<td>76</td>
</tr>
<tr>
<td>26 to 32</td>
<td>69</td>
</tr>
<tr>
<td>32 to 36</td>
<td>63</td>
</tr>
<tr>
<td>36 to 39</td>
<td>51</td>
</tr>
<tr>
<td>39 to 41</td>
<td>37</td>
</tr>
<tr>
<td>41 to 42</td>
<td>25</td>
</tr>
<tr>
<td>42 to 43</td>
<td>13</td>
</tr>
<tr>
<td>43 or over</td>
<td>0</td>
</tr>
</tbody>
</table>

\textsuperscript{52} INT. REV. CODE of 1954, § 963(a)(2), (3); (c)(2)(3); (d)(2).

\textsuperscript{53} Treas. Reg. § 1.963-5(b), (c)(1), (4).

\textsuperscript{54} INT. REV. CODE of 1954, § 970(a)(1).
The purpose of these limitations is to prevent a diversion of United States income to the CFC. The term "export promotion expense" includes compensation for services, rentals for property, depreciation, and any other ordinary and necessary expense reasonably allocable to the receipt or production of income.

The qualifications of a corporation as an export trade corporation involve a complex sequence of definitions. At least ninety percent of the corporation's gross income must be derived from sources outside the United States. Moreover, at least seventy-five percent of its gross income must be export trade income, except that this percentage is reduced to fifty percent if the income is derived from agricultural products grown in the United States. All of these percentages are to be determined for a three year period immediately preceding the close of the tax year.\textsuperscript{55}

Export trade income is net income derived from dealing in export property, which in turn is defined as any property or interest in property manufactured, produced, grown, or extracted in the United States.\textsuperscript{56} The income is derived from several sources. The sale of export property to an unrelated person for use, consumption or disposition outside the United States is considered export trade income, as are commissions, fees, and other income from commercial, industrial, or other services performed by an unrelated person outside the United States in connection with patents, copyrights, secret processes and formulas, goodwill, trademark, trade names, franchises, etc. which are acquired, developed and owned by the domestic corporation involved. Also included are commissions, fees, rentals and other income for the use of export property by an unrelated person or attributable to the use of export property in rendering technical, scientific, or engineering services to an unrelated person. Another income source is interest in certain obligations which are the type of property in which export trade income must be re-invested if its taxation is to be deferred.\textsuperscript{57}

Additional relief is found in the form of an escape provision whereby individual items of FBCI may be eliminated if the incorporation in the foreign country does not have the effect of a "substantial" reduction of over-all income taxes.\textsuperscript{58} This credit varies with the three components of FBCI. As to investment income, the foreign tax paid is compared with the United States corporate tax. There will be no substantial tax reduction if, considering only that item of income and assuming that the shareholder is entitled to elect the relief granted for intercorporate dividends, no minimum distribution

\textsuperscript{55} INT. REV. CODE of 1954, § 971(a)(1).
\textsuperscript{56} INT. REV. CODE of 1954, § 971(e).
\textsuperscript{57} INT. REV. CODE of 1954, § 971(b).
\textsuperscript{58} INT. REV. CODE of 1954, § 954(b)(4).
would be required. This exclusion test does not apply to a corporate shareholder if the foreign tax rate imposed on the CFC’s distributed income is less than the rate imposed on its undistributed income, unless the foreign effective tax rate is at least ninety percent of the corporate shareholder’s United States tax rate for the year.\textsuperscript{59}

As to sales income, the substantial tax reduction test depends upon a comparison of the effective foreign tax rate of a hypothetical tax imposed by either the country in which the property is made or by the country in which it is used, whichever is less. Exclusion is granted if the paid tax is at least ninety percent of the hypothetical tax; and, all of the income of the corporation is to be considered subject to the taxing country’s jurisdiction.\textsuperscript{60} Finally, regarding service income, the relief test for items of service income is the same ninety percent test used for sales income, except that the comparison can only be made with the effective tax rate of the country in which the services are performed.\textsuperscript{61}

**Ramifications of Less Developed Country and Export Trade Corporation Rules**

Now that the tax aspects of a LDC and a ETC have been discussed, certain ramifications must be set forth. Generally, Subpart F income may include items which were previously excluded as income from a LDC, or because of the qualification as a ETC, assets which have been withdrawn from such use. The taxable income may also include other untaxed earnings invested in United States property, other than classes which are treated as temporary investments in normal commercial transactions.

As has been previously eluded to, income taxable to shareholders does not include income from qualified investments in a less developed country, to the extent that such income increases the corporation’s total investment in the LDC. Conversely, if any such income has been excluded for any prior tax year, it is added to the corporation’s Subpart F income to the extent that it was withdrawn from investment in the LDC during the current tax year.\textsuperscript{62} The decrease is offset, however, by any net loss on the dispositions of such qualifying investments during the year.

A similar increase in Subpart F income may be required by reason of a decrease in export trade assets if the corporation had previously qualified for an exclusion of income as a ETC. This decrease is given effect by including it in the computation of investments withdrawn from a LDC. The de-

\textsuperscript{59} Treas. Reg. § 1.954-(1)(b)(3)(iii).

\textsuperscript{60} Treas. Reg. § 1.954-(1)(b)(3)(iii)(a).

\textsuperscript{61} Treas. Reg. § 1.954-(1)(b)(3)(iii)(b).

\textsuperscript{62} INT. REV. CODE of 1954, § 951(c).
crease is determined by comparing the investments in export trade assets at the close of the tax year and at the close of the preceding year; but, such a decrease is offset by any net loss on the disposition of such an asset during the year.\textsuperscript{63}

No matter what the nature of the controlled foreign corporation’s income, the shareholder may be taxed on the corporate earnings of the CFC brought back to the United States on the ground that this is substantially equivalent to a dividend being paid to them. Thus, the statute adds to Subpart F for the tax year the corporation’s increase in earnings invested in United States property.\textsuperscript{64}

The first term in this computation is the adjusted basis at the close of the tax year of the corporation’s “United States property,” which is defined as:

(A) tangible personal property located in the United States;
(B) state of a domestic corporation;
(C) an obligation of a United States person; or
(D) any right to the use in the United States of—
   (i) a patent or copyright,
   (ii) an invention, model, or design (whether or not patented),
   (iii) a secret formula or process, or
   (iv) any other similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.\textsuperscript{65}

The United States property must have been acquired by the foreign corporation in the years beginning after 1962, but the corporation need not have been a CFC at the time of acquisition. The statute excepts from United States property specific classes of assets which are treated as temporary assets (investments) in normal commercial transactions. These include money, United States obligations, bank deposits, property purchased for export to or use in foreign cities, and obligations of a United States person arising in connection with the sale or processing of property if not exceeding ordinary and necessary business requirements.\textsuperscript{66}

If no part of the corporation’s income is taxable to the shareholder under any other provisions, the computation of taxable income under this provision is fairly simple. The adjusted basis of the United States property at the close of the tax year is taken into account to the extent that it would have constituted a dividend had it been distributed. An amount is similarly com-

\begin{itemize}
  \item[\textsuperscript{63}] \textsc{int. rev. code} of 1954, \$ 970(c)(3).
  \item[\textsuperscript{64}] \textsc{int. rev. code} of 1954, \$ 951(a)(1)(B).
  \item[\textsuperscript{65}] \textsc{int. rev. code} of 1954, \$ 956(b)(1).
  \item[\textsuperscript{66}] \textsc{int. rev. code} of 1954, \$ 956(b)(2).
\end{itemize}
puted as of the close of the preceding year, but reduced by any distributed amount taxable for that year as an increased investment in United States property. The excess of the amount so computed for the tax year over the amount so computed for the previous year is the taxable increase in earnings invested in United States property, and each shareholder includes in income his pro rata share of this increase.\(^7\)

**COMPUTATION AND INCLUSION OF SUBPART F INCOME**

After the preceding examination of the requirements, exceptions and ramifications of Subpart F, it is hoped that the complexities involved in the Code have been somewhat unwound. The next area which must be considered is the computation and inclusion of Subpart F income to the United States shareholder.

If the controlled foreign corporation has a single shareholder (individual or corporation) that shareholder is basically taxed upon the corporation's Subpart F income, perhaps augmented by the corporation's earnings which represent assets withdrawn from a specific foreign purpose or reinvested in the United States. If there are two or more shareholders at the close of the corporation's taxable year, the income attributable to these shareholders is handled on a pro rata basis; but for this purpose, no constructive ownership is imposed, except by reason of the stock being owned by a foreign corporation, partnership, trust or estate. If the corporation was a CFC for only part of the year, then only a portion of the Subpart F income is allocated—the ratio being determined by the number of days for which it qualified.

The statute precludes duplication of tax upon the shareholder when the corporation's earnings are actually distributed to him. But, instead of the traditional holding company tax techniques of allowing a deduction for the distribution in the computation of constructive income, the present statute requires the full amount to be subject to tax under Subpart F and grants an exemption with respect to actual distributions.\(^8\) It may be noted that the provisions prevent not only the direct tax upon the shareholder's receipt, but also the indirect tax upon repatriation by way of an increase in the corporation's earnings invested in United States property.

A distribution is first allocated to any earnings and profits which were taxed by reason of an increase in earnings invested in United States property, then proportionately to amounts taxed as Subpart F income, and to amounts taxed as withdrawals from investments in a LDC. Allocation is favored and is first made to the most current earnings within each class of taxed earnings until that class is exhausted. Note, however, in the case where

\(^{67}\) **Int. Rev. Code of 1954, § 956(a).**  
\(^{68}\) **Int. Rev. Code of 1954, § 951(a)(3)(4).**
the shareholder is taxed by reason of income of a subsidiary of his directly owned corporation, he is not again taxable when the subsidiary makes an actual distribution to the parent. 60

The timing of the shareholder's tax poses a special problem in connection with his credit for foreign taxes which are imposed upon a subsequent distribution of actual income to him. Under the basic foreign tax credit formula, the shareholder might lose all credit because he pays no United States tax in the year in which the foreign tax is imposed, speaking only of the year in question. The statute, therefore, permits him to compute his credit for the year of the distribution by increasing the limitation under section 904 to the extent of his unused increase in the limitation for the year in which he paid tax on Subpart F income. This relief is allowable only if the taxpayer chose the foreign tax credit, rather than the deduction, with respect to any foreign tax actually incurred in the earlier year. 70

A domestic corporation which owns at least ten percent of the voting stock of a foreign corporation is generally entitled to a pro rata credit for the tax paid by a subsidiary in the ratio of the dividends received from the subsidiary, to the total profits of that subsidiary. In addition, the parent is entitled to a similar credit. The present statute is designed to give the same foreign tax credit with respect to undistributed earnings of the corporation (CFC) which are taxable to the parent. 71 If the CFC is qualified and is in a LDC (thus a LDC corporation), the same basic formula applies, except that the denominator of the credit is increased by the taxes paid by the subsidiary to foreign countries or United States possessions. 72

In order to correlate these provisions with the general provisions and concepts of basis, the statute provides that a shareholder's basis for his stock is increased by any amounts includible in his gross income, and that the basis is correspondingly decreased by additional distributions which are tax exempt by reason of their previous taxability. If the nontaxable distribution exceeds the present basis of the property, they are taxable as capital gains. 73

ESCAPE AND AVOIDANCE

After a sojourn through the quagmire of Subpart F, it can be said that all is not lost. It would appear that the base company concept is not dead as a tax planning tool. Although it is rather senseless to go back through the complex provisions of Subpart F and do just the opposite to avoid the

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60 Int. Rev. Code of 1954, § 959(b).
tax consequences, several general points may here be observed which will totally relieve shareholders from the specific tax consequences.

For example, if the foreign corporation is not controlled by United States persons, then the provisions do not apply. Control for statutory purposes means ownership of more than fifty percent of the voting power of all classes of stock entitled to vote by United States persons who own ten percent or more of the voting power of the foreign corporation’s outstanding stock. Therefore, if six United States persons who are not in any way related each own nine percent of the stock, the corporation (International) will not fall under the statute. Similarly, if a United States corporation, as the only United States shareholder, owns not more than fifty percent of the stock in its foreign subsidiary, directly or indirectly, it will avoid the problem created in Subpart F. Thus, a tax planning approach which may be called “de-control,” may be had if sufficient ownership in the base company can be held by foreign persons. The tax advantage of accumulating income in a low tax or tax haven country will then be available.

Another loophole which can provide substantial benefits in appropriate situations is the so-called 70-30 test. If the United States corporation has a manufacturing subsidiary in a tax haven country, such subsidiary may become a convenient depositary of foreign profits from royalties, dividends, interests, and other types of income covered by the statute; and so long as the gross income derived from the subsidiary’s operation is more than seventy percent from manufacturing, no tax consequences will result under this statute.

One type of income which is subject to the statute is foreign base company sales income. However, if the selling company is located in a country where the product is sold for use and consumption, the income can be accumulated in such country free of United States tax consequence.

Thus it is seen that while the statutory consequences are harsh, they may, with careful planning, be avoided.

Michael Stronberg