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AN INVESTIGATION INTO THE TAXATION OF UNDISTRIBUTED INCOME, SECTIONS 951 THROUGH 964 OF THE INTERNAL REVENUE CODE: THE CONTROLLED FOREIGN CORPORATION

University of Oklahoma PH.D. 1981

University Microfilms International 300 N. Zeeb Road, Ann Arbor, MI 48106

THE UNIVERSITY OF OKLAHOMA

GRADUATE COLLEGE

AN INVESTIGATION INTO THE TAXATION OF UNDISTRIBUTED INCOME SECTIONS 951 THROUGH 964 OF THE INTERNAL REVENUE CODE THE CONTROLLED FOREIGN CORPORATION

A DISSERTATION

SUBMITTED TO THE GRADUATE FACULTY

in partial fulfillment of the requirements for the

degree of

DOCTOR OF PHILOSOPHY

BY

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Norman, Oklahoma

1981

AN INVESTIGATION INTO THE TAXATION OF UNDISTRIBUTED INCOME

SECTIONS 951 THROUGH 964 OF THE INTERNAL REVENUE CODE

FOR THE CONTROLLED FOREIGN CORPORATION

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ACKNOWLEDGEMENT

It is never possible for a candidate to mention everyone who has helped in the completion of his dissertation and his doctoral program. I would sincerely like to thank those who gave me their support and continual confidence.

I was extremely fortunate to have a committee that stood with me. Dr. Bill McGrew, my chairman, never gave up on me, or the eventual completion of this study. I thank Dr. John Klingstedt and Dr. Homer Brown for their constructive criticisms of the reading copies. Also, Dr. Jim Kenderdine and Dr. Marion Phillips for their support and guidance throughout the program.

I wish to express graditude to Professor Bill Pietsch and to Patricia Angelo for their excellent suggestions made after reading the first draft of this manuscript.

I want to mention the late Vernon Upchurch who helped lay the preliminary groundwork for my program at Oklahoma.

Thanks must also go to Deloitte, Haskins and Sells, the international accounting firm, for their financial support during the initial stages of my research.

The final scknowledgement must go to my partner in marriage, Norma. I would like to express my heartfelt thanks for her invaluable aid and unyielding confidence which she so graciously gave to me throughout the dissertation stage of the doctoral program.

Lastly, all errors of ommission or commission are those of the author for which he takes full responsibility.

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CHAPTER I

INTRODUCTION

The purpose of this study is to examine the development of tax legislation which provides the basis for the taxation of the undistributed earnings of subsidiaries of U. S. Corporations which are organized under the laws of a foreign country. The tax on the undistributed earnings is levied upon the the U. S. shareholders (the parent corporation) of the foreign corporation, not directly upon the foreign corporation. As of January 1, 1981, these statutes are found in Sections 951 to 964 of Chapter One of the Internal Revenue Code of 1954 amended through December 31, 1980.[1] These sections of the code identify the controlled foreign corporation (CFC) and describe the criteria by which the undistributed earnings of such CFC are subject to taxation through its United States shareholders.

Events leading up to the enactment of the statutes are described and analysed including all changes which took place after enactment and up to December 31, 1980. The significant court cases which tested the legislation are presented, along with an analysis of the effect that the changes had on a firm operating on an international level.

Purpose of the Study

This study was undertaken for the following reasons:

1. To contribute a developmental history of the taxation of undistributed income of a CFC. This history includes a study of the taxation of undistributed income in general as a preface to the study of the foreign statutes. The study attempts to identify the reasons for the introduction, and eventual passing of, the Revenue Act of 1962[2]; and,

2. To present and analyze the significant court cases relating to the taxation of undistributed income of CFCs in order to identify the following three items: (a) the extent to which the law was tested, (b) to determine if any significant changes were made to the legislation as a result of these challenges to the law; and, (c) to determine if the intent of Congress was correctly interpreted in the court's decisions; and,

3. To show the tax effect on the CFC of the various changes made and to compare the overall tax rates for a domestic corporation and its overseas subsidiaries before and after the change.

Scope of the Study

The analysis of tax legislation is limited to the years 1913 through 1980; however, the focal point of the discussion is from the 1961-1962 period when legislation was introduced and enacted which identified the CFC, through 1980, during which period changes were made and cases were tried concerning the legislation.

This study includes an analysis of significant court cases relating to the taxation of undistributed earnings. If the out-come of a particular case was determined by a precedence set by a case already examined, then that case was omitted from the study unless it contributed new findings.

The research was limited to a study of the tax effect upon foreign corporations in general, and not to a specific corporation operating in a given country. A hypothetical firm is used as a model because no one actual company would necessarily have all types of Subpart F income in any one year, nor would any one firm necessarily be operating in both a high tax country and a low tax country in the same year. The model shows the effect of a change on a U.S. firm with a foreign subsidiary in a country with a tax rate that is equal to the U.S. rate, and, at the same time, shows the effect if the subsidiary is operating in a country with a tax rate that is either above or below the U.S. rate. By using this approach, the model is adaptable to any specific country since the three possibilities are demonstrated.

This study is not concerned with the taxation of other legal forms of entities such as partnerships, joint ventures, or trusts; nor does it examine the tax problem of foreign income earned directly by an individual. The taxation of a foreign corporation doing business solely within the United States, and therefore under the jurisdiction of the United States, also will not be addressed.

Significance of the Study

The importance and significance of the study lies in the activity of the international marketplace. Any multinational firm must examine the tax climate outside the borders of its home country before making investment or disinvestment decisions. Any change in the legislation governing the taxation of a particular type of income made after a multinational corporation decided on a course of action could result in negative benefit to the corporation.

As a result of this study, firms investing in the international arena have access to an in-depth review of congressional attempts concerning the taxation of the CFC. The study provides a history of the taxation of the undistributed income of a CFC, along with significant tests of that legislation. The investing public have available a model which can be used to estimate the effect of any new legislation on a U. S. subsidiary operating in a country with a tax rate different from that of the United States.

With the rapid growth in the last two decades of the multinational corporation, the effect of taxation on such a company must be seriously considered whenever tax reform or tax revision is contemplated. Since most, if not every administration, has their own reform plan, this study be helpful in attempting to follow a proposed change in tax legislation concerning the CFC.

Methodology

This research was undertaken utilizing the documentary or historical method of research. Although the approach has been most important in the study of history, literature, linguistics, and the humanities in general, this type of research has universal utility.[3] Historical research is considered to be one of the oldest forms of research, being used by early Greek philosophers. The method is still used extensively in research albeit in a more refined and exact approach today.[4]

A primary problem with the use of the historical method of research is concerned with the authenticity of the documents examined. An appraisal must be made in "an attempt to determine the genuiness or authenticity of the document"[5] After the document is deemed to be authentic, an internal examination should be made to determine the "meaning, accuracy, and general trustworthiness of the statements contained in the document."[6]

This study utilized the following sources in compiling the history of the relevant legislation: (1) Presidential papers, (2) the congressional record, (3) committee reports, (4) published histories, (5) professional publications, (6) newspaper articles, and (7) other government publications, such as congressional hearings and legislative histories.

Although some publications might have been biased in one sense or another, the genuiness of the document and its general trustworthiness was not questioned.

A secondary problem inherent in historical research is the insufficiency of data or the improper selection of data which is available.[7] Since most of the known material written in this area was reviewed, it was felt that both problems were overcome.

Conclusions

The study concluded the validity of the following three statements:

1. The complete elimination of the deferral privilege or complete exclusion of undistributed income of a CFC are not viable solutions to the dichotomy between domestic and foreign tax neutrality;

2. Tax neutrality has been improved but not achieved for a domestic firm operating in the international marketplace; and

3. The outcome of court cases concerning the CFC did not cause or materially influence any changes to be made in the manner in which a CFC is taxed.

Organization of the Study

Chapter I contains a brief introduction to the study and includes the purpose, scope, significance of the study, the methodology employed in conducting the investigation, and the conclusions from the study.

Chapter II is a historical development of the taxation of the foreign corporation controlled by U.S. persons, and contains an investigation into the taxation of undistributed income in general.

Chapter III examines the legislation, and resultant court cases, concerning undistributed earnings of a CFC. Part one is a summary and explanation of Sections 951 to 964 of the tax code as it was enacted in 1962. Part two is the presentation of the significant court cases which were heard in the period after the enactment of Sections 951 to 964. The final part offers an investigation and analysis of the changes that were made to the law during the period 1962 through 1980. The cases are summarized on a section-by-section basis.

Chapter IV presents a case study of the tax problems of a hypothetical United States corporation and its foreign subsidiaries. The effect of the various changes made in the taxation of the income of the corporate group is shown for the period 1913 through 1980.

Chapter V contains a summary of the study, the conclusions reached as a result of this study, and some recommendations for further research.

CHAPTER I FOOTNOTES

[1]Act of August 16, 1954, ch. 736, 68 Stat. 1.

[2]Act of October 16, 1962, ch. , 76 Stat. 834.

[3]Tyrus Hillway, Introduction to Research (Boston: Houghton, Mifflin Co, 1964), p. 141.

[4]Ibid.

[5]Ibid., p. 148.

[6]Ibid.

[7]Ibid., p. 149.

CHAPTER II

HISTORICAL DEVELOPMENT OF CODE SECTIONS 951 TO 964

The Deferral Concept

The passage of the Sixteenth Amendment to the Constitution by Congress on July 12, 1909 and its subsequent ratification early in 1913, established the basis for our present tax income laws. Congress immediately implemented the Sixteenth Amendment by passing the Revenue Act of 1913 in October, retroactive to March 1, 1913.[1]

Congress was initially confronted with a need to choose between two philosophies of taxation: the global versus the territorial systems of taxation. The global or unitary system of taxation has been defined as where "the jurisdictional connection is the personal status of the taxpayer rather than the source of his income. If the taxpayer, whether an individual or a corporation, is a citizen of the country, the country asserts jurisdiction to tax his entire income from all sources."[2] The territorial or schedular system of taxation is defined as: "the jurisdictional connection is the source of the income, not the personal status of the taxpayer."[3]

Congress utilized both philosophies of taxation wherein the global system of taxation underlies the tax income laws affecting the taxation of resident taxpayers, whereas the territorial system of taxation became the basis for tax income laws affecting nonresident taxpayers.

By instituting these two approaches in tax laws, Congress initially created a tax advantage over undistributed earnings held by the foreign subsidiaries of domestic corporations. This advantage is created where a domestic corporation operates a separately created corporation in a foreign country; earnings would therefore be taxed only in the U.S. upon distribution in the form of dividends. However, where a domestic corporation operates a branch office in a foreign country, earnings of that branch would be taxed in the U.S. regardless of remission to the home office. Therefore, the use of these approaches resulted in the creation of the 'deferral tax privilege', wherein the tax on earnings generated by foreign corporations was deferred until remitted in the form of dividends.

The Corporate Advantage

Starting with the initial effort to tax earnings, all U. S. revenue acts have discriminated against the individual and in favor of the corporation as to the rate of tax to be applied to equal amounts of income. The tax philosophy underlying the Revenue Act of June 30, 1864,[4] was to regard the individual as the proper object of taxation, with no tax levied on the corporation.[5] As a result, all subsequent revenue acts have discriminated on the basis of the tax rates against the individual. This tax rate discrimination created the situation where, for the individual taxpayer, it becomes advantageous to prevent some or all corporate after-tax earnings from being distributed in the form of dividends.

The combination of the deferral tax privilege and the corporate advantage made it quite attractive for business entities involved in foreign trade to be organized as a foreign corporation.

Overall Congressional Action on Undistributed Earnings

There have been five major actions taken by Congress relating to taxation of undistributed earnings. The first resulted in the Revenue Act of 1913,[6] the forerunner of the accumulated earnings tax; the second came in 1934, when Congress enacted legislation to tax the personal holding company;[7] the third occurred in 1936 with the passage of the undistributed earning tax applicable to all corporations;[8] the fourth occurred one year late in 1937,[9] when the personal holding company provisions were extended to U.S. owned foreign personal holding companies; and, the final act occurred in 1962[10] with the emergence of tax code Sections 951 to 964, which affected the deferral privilege.

The Accumulated Earnings Tax

The Revenue Act of 1913 instituted a layered taxation system. In Section II (A) (2) of the Revenue Act of 1913 is found the forerunner of the accumulated earnings tax. Section II (A) (2) reads as follows:

> For the purpose of this additional tax, the taxable income of any individual shall embrace the share to which he would be entitled, of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint stock companies, or associations however created or organized, formed or fraudulently availed or, for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint company or association is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax, in such case, unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purpose of the business.[11]

This section provides the first evidence of congressional intent to tax the undistributed income of a corporation. It was not tax legislation which affected the corporation, but an attempt to tax the shareholder for his share of corporate earnings. This legislation did not directly impose a tax on the corporation, but only indirectly, operating through the device of an additional (surtax) tax.

There is also specific reference to the taxation of a holding company. At this time, however, the Revenue Act did not result in much of an impact upon the revenue collection, since dividends were generally taxable to individuals only, and not to corporations.

The last part of Section II (A) (2) makes reference to earnings that might be accumulated 'beyond the reasonable needs of the business'. The mere existance of such an accumulation was to have signaled fraudulent intent, but it was left to the Secretary of the Treasury to determine this condition. This provision prevented effectual enforcement.

The taxation of accumulated earnings was controversial. The argument was that this form of tax was in effect a tax on property, and not on income, therefore it should be subject to apportionment rules. In 1913, Senator Root, in support of the position that undeclared dividends were property, argued:

> It seems quite clear to me that this is not his income; he does not get it; he has no right to get it by law. He may sell his stock, and when those profits come to be divided in future years, they would go the purchaser. . . .if it cannot,by any possibility, in accordance with our existing law, be regarded as income to the stockholder until the directors of the corporation have declared a dividend on it.. . .and if you wish to reach the surplus profits of a corporation which ought to be divided, but are not divided, you must do it by taxing them as income of the corporation, not as income of the individual stockholder because the moment you tax the interest of the individual stockholder in those profits you are taxing the interest represented by his stock, that is to say, you are taxing his principle and not his income.[12]

The Revenue Act of 1913 passed, but not without strong opposition to Section II (A) (2). The disagreement centered on a definition of 'income'. The concept of taxable income had not been clearly defined, as it was to be by the Eisner[13] decision some eight years later.

The Personal Holding Company

In the interim period between sessions of the 73rd Congress, (1933-1934) a sub-committee of the Ways and Means

Committee examined the Federal Tax Code because of congressional discontent with its shortcomings. One historian wrote that:

> . . .at the close of the preceding session much dissatisfaction was expressed with the Internal Revenue taxes. There were criticisms that the burden of the taxes was inequitable, that the new taxes were difficult to administer, and that the income tax receipts were especially inadequate in periods of business depression.[14]

This dissatisfaction was reiterated by President Roosevelt in a message to Congress, when he suggested that additional revenue might be forthcoming simply by tightening up on the administration of the various sections of the tax income law.

The subcommittee[15] identified a major area of concern as the Personal Holding Company (PHC). The PHC was identified as being the prevalent method used by an individual to avoid the payment of taxes on earned income. The subcommittee therefore recommended that a special tax be levied on the undistributed earnings of all PHCs. Although the Treasury Department admitted that PHCs were being used to evade the payment of income taxes, it did not believe that the subcommittee's plan was desirable because it was 'over specific' legislation and 'legal ingenuity' could probably devise some other form of organization and thus provide the opportunity to evade the tax.[16]

In its report to the house,[17] the Ways and Means Committee ignored the Treasury's reasoning. Section 104 (the accumulated earnings tax) was revised into two sections: (1) Section 104 which pertained to all corporations other than PHCs, and (2) Section 351 which identified the PHC and imposed a tax on the undistributed income of these organizations.[18]

Although the PHC provisions changed over the next few decades, much of what was enacted into law by the 1934 Congress is still in effect as of December 31, 1980. This is one of the few enactments of tax legislation by Congress which taxed the undistributed earnings of a corporation.

The Undistributed Earnings Tax
1936 through 1939

The Revenue Act of 1936[19] instituted some unique changes in the method of taxation of corporations with the intent of narrowing the spread in tax rates between the individual and the corporation. Although these changes were in effect for only three years, this represented another attempt on the part of Congress to tax the undistributed income of a corporation: not simply the PHC, nor a corporation formed or availed of for fraudulent purposes, but all corporations. President Roosevelt originally requested of Congress a tax which would replace the ordinary corporate income tax, the capital stock tax, the related excess profits tax, and the exemption of dividends from the normal tax on individual income. The tax rate on undistributed corporate income was to be graduated and to be applied so to yield approximately the same total revenue as would have been generated if corporate profits had been distributed and taxed in the hands of the stockholders.[20]

The object of the proposed revenue measure was not to tell corporate management what proportion of earnings they shall distribute and what proportion they shall retain. A memorandum from the Secretary of the Treasury stated:

> The object was rather to see that, whatever the the decisions of corporate managements, the Federal Government shall not be unreasonably and inequitably deprived of necessary revenues. Likewise, it is not the policy of the administration to dictate whether business shall be carried on as individual enterprises or partnerships on the one hand, or as corporations on the other hand. The present laws go a long way toward doing so by making use of the corporate form unduly expensive for the little fellow and by offering a source of tax avoidance for the big fellow. It is proposed to remove this inequity.[21]

The business community was overwhelmed by the proposal George O. May, a leading accountant of the time, suggested that the closest thing that he could compare the measure to would be the removal of the individual income tax in its entirety, and substituting a rapidly graduated tax on an individual's savings account. In so doing, any individual who spent all their income would thereby have no federal tax liability.[22]

By this legislation, Congress successfully taxed the undistributed income of a corporation and provided the ground work for future tax legislation effecting both domestic and foreign corporations. This legislation resulted not in a direct tax on the shareholders based on their share of the undistributed income, but a tax levied on the corporation earnings. The undistributed earnings tax was in effect in full during 1936 and 1937, but was phased out by the end of 1939.

The Foreign Personal Holding Company

In June of 1937, a joint congressional committee was established to investigate the problem of tax evasion and avoidance. When the committee opened the hearings, the Treasury Department was the first witness. They called attention to the following three factors that encouraged tax avoidance: (1) the development of a group of clever attorneys and accountants who exercised every ingenuity in circumventing the law; (2) the fact that tax advoidance, as opposed to tax evasion, was considered by many a legitimate aim; and, (3) the difficulty of distinguishing between tax advoidance which was supposed to be proper, and tax evasion which was supposed to be immoral.[23]

The committee eventually identified eight areas where serious tax loopholes existed[24] The domestic and the foreign PHC are the only two subjects significant to this study. On the domestic front, the tax provisions of the PHC were being abused and changes were made in the domestic PHC taxation provisions to correct those areas. These changes appeared to effectively control the PHC problem. A historian wrote that "the act virtually resulted in a death sentence upon the use of a domestic personal holding company for tax avoidance."[25]

The foreign PHC presented a unique problem. In a letter to President Roosevelt, Treasury Secretary Morgenthau enumerated some of the principal devices employed by taxpayers with large incomes to avoid taxes. One of these devices was that of "evading taxes by setting up Foreign Personal Holding Companies (FPHC) in the Bahamas, Panama, Newfoundland, and other sites where taxes are low and corporation laws lax."[26]

Corrective tax legislation was drafted and swiftly passed through both Houses of Congress. A precedent was established in that Congress had applied tax legislation to effect the earnings of a foreign corporation by taxing the earnings of the individual stockholder, not the income of the foreign corporation over which the U.S. Government has no jurisdiction.

Congressional Action on the Taxation of the Foreign Corporation

As indicated previously, Congress created the deferral tax privilege when it used the territorial system of taxation in creating tax legislation affecting nonresidents. In so doing, the income of a corporation, owned by U. S. shareholders and organized under the laws of a foreign country, would not be taxed at the time it was earned. Its income would be taxed only when distributed in the form of dividends. Where no dividends are distributed, the tax on the income would be deferred indefinitely.

The territorial system of taxation resulted in the creation of a set of tax inequities. In many instances the corporation was subject to taxation of its income to the country in which they were organized, and then again subject to taxation of that same income when those profits were remitted to the United States in the form of dividends. Congress had adopted legislation to provide some relief from this in 1918.[27] A tax credit was allowed against the company's U. S. income tax for any foreign income tax paid. Section 220 (C) allowed the credit on a deemed paid basis; that is, the shareholder was assumed to have paid the foreign tax due on his share of the income and therefore was allowed the foreign tax credit. The intent of Congress was two fold: to alleviate the double tax burden; and to encourage U. S. corporations to distribute its foreign earnings to its shareholders. During the years between 1918 to 1980, there have been many adjustments to the foreign tax credit.

The next major legislation affecting the taxation of foreign income was initiated in 1942,[28] when Congress created the Western Hemisphere Trade Corporation (WHTC). Congress passed tax legislation to encourage foreign investment by making it more attractive for U. S. companies to operate outside the United States when organized as a domestic corporation. Since most of the foreign trade was within the western hemisphere, Congress created the WHTC. The provisions for a WHTC allowed the corporation to take advantage of a fourteen point reduction in their tax rate if the corporation met certain criteria. The WHTC was completely eliminated under the phase out provisions of the Tax Reform Act of 1976.

During the period immediately after the Second World War, the United States provided twenty-eight billion dollars of aid materials to Western Europe and its dependencies to forestall post-war economic and social disaster.[29] By 1951 most of the war damage had been repaired and European industrial production was on the rise.[30] Congress therefore considered the promoting of direct investment by American corporations in foreign markets. However, under the tax laws in effect there were some major deterents to any sizable flow of U. S. private capital overseas, especially where the investment was to be made in a branch of a U. S. corporation rather than a foreign subsidiary.

Congress had been successful in its efforts to promote foreign investment with the WHTC tax provisions. The increase in foreign investment during the years 1943 to 1950 after the passage of the WHTC legislation resulted in seventy percent of that investment being made in countries of the western hemisphere.[31] The incentive had worked, but it channeled American investment only to countries in the Western Hemisphere, rather than to countries in Europe.

What Congress wanted was a set of tax provisions which would help promote foreign investment by American companies in Europe and other countries of the western world. The first attempt to provide such incentives was made by the Ways and Means Committee when it sent its version of the Revenue Act of 1954 to the House for discussion.[32] The bill contained Sections 951 to 958 of the code which would have provided tax deferral of foreign branch earnings of a domestic corporation. Although there was much interest in promoting direct private investment in the foreign market, the Senate was not quite ready for such a novel departure as taken by the House.[33] Interest did not wane completely, even after the Senate killed these two measures.

Scholars from Harvard[34] conducted a study in 1954 into the policies and attitudes of American corporations toward foreign investment and the effect of taxation on their investment decision. The study found that businessmen rated a reduction in tax rates on earnings as a relatively unimportant criteria in foreign investment decision making. Therefore, legislation similar to the WHTC Act of 1942 would seemingly have had little or no effect on foreign investment decisions. This stands in sharp contrast to the Commerce Department study made on this same topic only four years later.

A number of recommendations were made in the Harvard study. One recommendation proposed the creation of a new corporate form which would be used by all enterprises engaged in export, or operating directly or through foreign subsidiaries; the enterprise would be known as a Foreign

Business Corporation (FBC). An earnings tax would be imposed and reported, but would not be payable until the income was distributed, or used in the U.S. The recommendation established the FBC to be the vehicle used in all foreign operations. Thereby doing away with the WHTC, the China Trade Act Corporation, and all the special tax incentives given to some of the possessions of the United States.

The concept of creation of the FBC was further advanced in 1958 when Ralph I. Straus prepared a report entitled "Expanding Private Investment for Free World Economic Growth." One of his major recommmendations was:

> . . .that the Internal Revenue Code be amended to give special tax treatment to domestic corporations known as Foreign Business Corporation (FBC), such special treatment to have the effect of deferring payment of U.S. income taxes on the profits of a FBC arising from foreign investment and operations until those profits are actually distributed to U. S. stockholders or otherwise diverted from foreign uses.[35]

Straus believed that the FBC would: (1) stimulate foreign investment; (2) allow management to decide without regard to tax considerations whether or not to operate through a domestic branch or foreign subsidiary; and (3) to allow the transfer of their foreign earnings from one country to another without tax liability. Straus pointed out that it was presently possible to achieve similar objectives using a foreign subsidiary in a "tax haven" country.

Straus recommended the tax deferral approach instead of a tax reduction approach to encourage private investment in the foreign market. He believed that a tax reduction would hasten the return of foreign source income to the United States, because of the lower tax rate, whereas the deferral approach would promote reinvestment overseas.

During this period, President Eisenhower appointed 'the Committee on World Economic Practices' to study new ways in which the government and private sector could effectively join to combat the Sino-Soviet economic offense. As part of their study, the committee looked at the use of tax incentives to help in providing a solution to this problem. As in the case of the Harvard and Straus reports, the committee recommended the use of the deferral concept through the mechanics of a FBC.[36]

In 1958 the Commerce Department conducted a study of the views of business leaders.[37] One question asked: "what in your opinion will be necessary to encourage greater participation by private individuals and corporations in foreign investments, contracts for management, engineering, or other services, where those projects are of the type that private investment would normally undertake?" Sixty-seven percent of the respondents cited tax incentives as the most important inducement to encourage greater participation. It overshadowed other inducements such as investment guarantees, loans, direct financial assistance, and a clarification of anti-trust laws. The majority of the group supported the tax deferral concept as the most significant incentive.

Hale Boggs, as Chairman of the Subcommittee on Foreign Trade Policy of the House Ways and Means Committee investigated these many studies and concluded that foreign trade policy could not be divorced from other aspects of U. S. foreign economic policy. After conducting hearings on the subject,[38] Boggs introduced legislation[39] which became known as the Foreign Investment Incentive Act of 1959. The measure did not make it to the House until mid 1960,[40] and was killed by the Senate Finance Committee by mid August.[41]

President Kennedy proposed legislation in 1961 which would have eliminated the deferral privilege on all foreign corporations owned by U. S. shareholders.[42] The legislation attempted to assure equal treatment for those in similar situations, and to promote tax policy which would be neutral in its effect upon corporate investment plans and economic decision making. As an ideal revenue tax, this legislation would accomplish the following: (1) provide money for the government, (2) be neutral in its consequences for the private economy, and (3) be equitably applied among all taxpayers.[43]

The measure was sent to the House Ways and Means Committee immediately, but did not come to the House floor for a vote until March of 1962. The bill was in a much revised form from what President Kennedy had requested, but passed the House on a narrow vote,[44] and was sent to the Senate.[45]

As the bill was reported out of the Senate Finance Committee, it had some major amendments to the House measure. When passed by the Senate the measure was referred to the Joint Conference Committee because of these changes.[46] After minor adjustments,[47] the bill was returned to both houses where it was enacted into law.[48]

CHAPTER II FOOTNOTES

[1]Act of October 3, 1913, ch. 16, 38 Stat. 114.

[2]Martin Noor, "Jurisdiction to Tax and International Income," Tax Law Review 17 (1961-62):433-434.

[3]Ibid.

[4]Act of June 30, 1864, ch. 173, sec. 116-122.

[5]George Lent, The Impact of the Undistributed Profits Tax, (New York: Ams Press Inc., 1968), p. 9.

[6]38 Stat. 114.

[7]Revenue Act of May 10, 1934, ch. 277, 48 Stat. 680.

[8]Act of June 22, 1936, ch. 690, 49 Stat. 1648.

[9]Revenue Act of August 26, 1937, ch. 815, 50 Stat. 813.

[10]Revenue Act of October 16, 1962, 76 Stat. 960.

[11]Act of October 3, 1913, sec. II (A)(2).

[12]U.S. Congress, Senate, Senator Root speaking against the taxation of undistributed income during the discussion of H. R. 3321, 63rd Cong., 1st sess. Congressional Record, vol. 50, 3774-75.

[13]Eisner v. Macomber, 1 USTP, 32,252 (U.S.), 189 (1920)

[14]Roy G. Blakely and Gladys C. Blakley, The Federal Income Tax (New York: Longman, Green & Co., 1940), p. 347.

[15]U.S. Congress, House, Ways and Means Subcommittee on Tax Revision, Prevention of Tax Advoidance, unnumbered rept., 73rd Cong., 2nd sess.

[16]Blakey , p.351.

[17]U.S. Congress, House, Ways and Means Committee. Report on H.R. 7835, H. Report 704, 73rd Cong., 2nd sess., p. 6-8.

[18] Act of May 10, 1934, ch. 277, 48 Stat. 680, sec. 104.

[19] Act of June 22, 1936.
[20] Blakey, 401.

[21] Randolph E. Paul, _Taxation in the United States_, (Boston: Little, Brown & Co., 1954), p. 194.

[22] Ibid., 196.

[23] Blakey, 428.

[24] U.S. Congress, _Report of the Joint Committee on Tax Evasion_, 75th Cong., 1st sess.

[25] Paul, 207.

[26] Robert W. Wales, "Tax Policy in Relation to Foreign Business Income," _The Tax Magazine_, December 1962, p. 961.

[27] Act of February 24, 1918, ch. 18, 40 Stat. 1057.

[28] Act of October 21, 1942, ch. 619, 56 Stat. 798.

[29] U.S. Congress, _The Mutual Security Program for Fiscal Year 1954_ (Washington D.C.: Government Printing Office, 1953), p. 83.

[30] E. S. Kerber, "US Foreign Aid in 1952," _Survey of Current Business_, March 1953, p. 16.

[31] Joseph A. Zettler and Frederic Cutler, "US Direct Investment in Foreign Countries," _Survey of Current Business_, December 1953, p. 7.

[32] U.S. Congress, House, _Report by the Ways and Means Committee on HR 8300_, 83rd Cong., 2nd sess.

[33] U.S. Congress, Senate, _Report by the Finance Committee on Foreign Provisions, HR 8300_, 83rd Cong., 2nd sess.

[34] Ira T. Wender and G. T. Barlow, _Foreign Investment and Taxation_ (New York: Prentice Hall, 1955).

[35] Ralph I. Straus, _Expanding Private Investment for Free World Economic Growth_ (Washington D.C.: Government Printing Office, 1958).

[36] U.S. Congress, House, _Report of the Ways and Means Committee Hearings on HR 5_, 86th Cong., 1st sess., p. 80.

[37]Ibid.

[38]U.S. Congress, House, Ways and Means Committee, Report by Subcommittee on Foreign Trade Policy, 85th Cong., 2nd sess., p. 2.

[39]Hearings on HR 5, p. 231.

[40]The Wall Street Journal, May 19, 1960, p. 10.

[41]The Wall Street Journal, September 1, 1960, p. 4.

[42]U.S. Congress, House, Our Federal Tax System, H. Doc. 140, pp. 6-7.

[43]Ibid., p. 16.

[44]Ibid., pp. 1654-56.

[45]U.S. Congress, Senate, Report of Hearings by the Finance Committee on HR 10650, 87th Cong., 2nd sess.

[46]U.S. Congress, House, Report by the Ways and Means Committee on the Comparative Analysis of Differences in the House and Senate Versions of HR 10650, 87th Cong., 2nd sess.

[47]U.S. Congress, House, Conference Report of the Ways and Means Committee, H. Rept. 2508, 87th Cong., 2nd sess., p. 7.

[48]U.C. Congress, House, Ways and Means Committee, Legislative History of HR 10650, 87th Cong., 1st and 2nd sess., vol. 4, pp. 4524 and 4558.

Chapter III

A REVIEW OF SECTIONS 951 TO 964 FROM 1962 THROUGH 1980 BY STATUTE, IN THE COURTS, AND BY CONGRESS

This chapter will consist of three parts. In the first part, Sections 951 to 964 of the Revenue Act of 1962 will be summarized by section number. The next part will present a discussion of the various court cases that have been heard which tested the application of the law. The last part traces the Congressional changes and some of the attempted changes made to these sections from 1962 through 1980. A glossary of terms is located on page 123 for the convenience of the reader.

The Law Covering Sections 951 to 964

Section 12 of the Revenue Act of 1962 added Subpart F to part III of Subchapter N of Chapter 1 of the Internal Revnue Code of 1954, amended to 1962.[1] Subpart F included fourteen separate sections numbered from 951 through 964.[2] Each of those sections are presented below with a brief explanation as to the content of each section.

Section 951 Amounts Included In Gross Income of United States Shareholders

Section 951 stated that where the foreign corporation was deemed to have Subpart F income, as defined in Section 952, a shareholder, as per Sections 957 and 958, must include in his gross income the sum of the following: (1) his prorata share of the Subpart F income of the corporation; (2) his prorata share of Subpart F income which had previously been excluded because of investment in Less Developed Countries (LDC); and (3) his prorata share of earnings which had been invested in the United States. A stockholder would, however, have to own 10 percent or more of the outstanding stock before he would be subjected to the provisions of Section 951.

Prorata was defined as the amount of Subpart F income which could have been distributed on the last day of the fiscal year to each shareholder. If the corporation was not a Controlled Foreign Corporation (CFC) for the entire year, then the prorata share would be reduced to an amount reflecting an equivalent percentage for the period of time that the corportion was a CFC. This was determined by the following calculation;

$$\frac{\text{No. of Days Corporation is a CFC}}{365} \quad x \quad \text{Prorata Share}$$

This amount would then be reduced by any dividends actually distributed.

There were some exceptions provided to minimize the possibility of double taxation. If the Subpart F income was also Foreign Personal Holding Company (FPHC) income, the taxpayer would only be subject to tax under Section 551. Section 551 through Section 555 contains the statutes regarding the taxation of personal holding company income for foreign corporations. The taxpayer would not be subject to a double tax under the two sections.

Section 952 Defined Subpart F Income

Section 952 defined Subpart F income as basically the sum of two parts; (1) income derived from insuring U. S. risks, as described in Section 953; and, (2) foreign base company income, as defined in Section 954. The total amount of Subpart F income could never be more than earnings and profits for the current year. Also, if the income were such that it was considered to be from within the United States, Section 951 would not apply.

Section 953 Income From Insurance of United States Risks

Section 953 defined the term, "income derived from the insurance of U.S. risks," which made up one part of Subpart F income. This phrase meant that where the CFC had income that was attributable to the reinsurance or the issuing of any insurance in connection with the property or liability of residents of the United States, then that income was subject to Section 951. The CFC was required to include this amount in income only when it amounted to more than 5 percent of their gross income.

Section 954 Foreign Base Company Income

Section 954 defined the other part of Subpart F income, Foreign Base Company Income (FBCI). FBCI is composed of the Foreign Base Company Sales and Service Income (FBCSI) (FBCSVI) and any FPHC income that a CFC might have.

FBCSI included income earned in connection with the purchase or sale of personal property from or to a related person, wherein the property in question had been manufactured, produced, grown, or extracted outside the country under the laws of which the CFC had been organized, and the property was sold for use outside the foreign country. If the sole purpose of the CFC was to act as a conduit for the paperwork from such a purchase or sale, then the income derived from these transactions would be taxed currently. For the purpose of Section 954, a related person was defined as one who controlled, either directly or indirectly, the CFC in question. Control was defined as possessing more than 50 percent of the outstanding voting stock.

A similar definition existed for FBCSVI, which included income derived from services performed for a related party outside the country of incorporation.

Several exceptions were made in implementing Subpart F income. The CFC could exclude from Subpart F income, any

FPHC income that was received from qualified investment in LDCs (Section 955). Also, certain shipping income was excluded from FBCI. A special rule stipulated that if any corporation's total FBCI ws less than 30 percent of its gross income, then no part of its income would be considered as FBCI. However, if 70 percent or more represented FBCI, then all the income of the corporation would be considered Subpart F income which was taxable under Section 951. There was also a very general exclusion in Section 954 which exempted the CFC from taxation under the statutes, which stated that FBCI did not include:

> Any item of income received by a CFC 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 CFC 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, excess profits taxes, or similar taxes.

Section 954 also included some definitions or adjustments to previously accepted definitions. FPHCI was expanded to include all rents without regard to the 50% limitation under Section 553, which specified that rent would be included as PHCI only if it amounted to more than 50% of gross income. However, the rental income could be excluded if it were received in the active conduct of a trade or business and not received from a related party.

Section 955 Withdrawal of Previously Excluded Subpart F Income From Qualified Investment

Section 955 of Subpart F was concerned with the withdrawal of previously excluded income from investment in LDCs. A qualified investment was defined and rules were given to determine the amounts to be included in Subpart F income for the current taxable year. To qualify, the investment had to be in the form of either stock or long term debt of a LDC Corportion (LDCC) and the CFC had to own at least 10% of the voting power in that LDCC. Investments in obligations of an LDC were also considered qualified. Just as the nontaxable portion was determined by comparing the increase in investment from the beginning to the end of the year, the taxable portion was determined by computing the decrease in investment during a taxable year.

Section 955 also listed countries which could not be considered LDCs and defined a LDCC. This section stipulated that the President had the power to terminate such designations, but only upon 30 days notice to both the House and the Senate. However, any investment made in an LDC which subsequently lost its classification would still be considered as a qualified investment. An LDCC was defined as where 80% of the income was derived from sources within the LDC, and where 80% or more of the value of the firms assets were located in the country. If the LDCC was involved in shipping, 80% or more of its income had to be derived from shipping by either sea or air and 80% or more of its assets had to be used in connection with the production of shipping income.

Section 956 Investment of Earnings in United States Property

Section 956 presented the rule for determining the amount of earnings invested in the United States. Under Section 951, in addition to Subpart F income, a U. S. shareholder of a CFC had to include in his gross income his prorata share of any increase in U. S. investment during the year. The amount was simply determined by comparing the amount of investment at the beginning to that at the end of the year. Any increase would be considered a dividend and therefore taxable to the shareholders. United States property included: (1) tangible property located in the United States; (2) stock of a domestic corporation; (3) an obligation of an United States person; and, (4) any right to patents, copyrights, and other such items if they were acquired by the CFC for use in the United States.

Section 957 Controlled Foreign Corporations: United States Persons

Section 957 defined the terms "control" and "United States person". The 50 percent rule was applied to determine ownership control, unless the CFC in question was an insurance company with more than 75% of its gross income derived from insurance or reinsurance of U.S. risks. If the 75% maximum was surpassed, then control for the purpose of Subpart F was considered to be achieved with 25 percent of voting stock. United States persons included individuals, corporations, and fiduciaries with some minor exceptions which concerned U. S. possessions.

Section 958 Rules For Determining Stock Ownership

Section 958 listed the rules to follow in determining whether a person owned the stock used in determining control. If the stock of the CFC was owned by another foreign corporation, controlled by U. S. shareholders, that corporation would be considered as being owned collectively by its shareholders. The normal constructive ownership rules also applied.

Section 959 Exclusions From Gross Income of Previously Taxed Earnings And Profits

Section 959 of Subpart F explained how previously taxed earnings and profits would be excluded from gross income when they were distributed. Whenever there was a distribution, the amounts so distributed were first deemed to have come from earnings and profits taxed to the shareholders as a result of earnings being invested in United States property. Additional amounts were deemed to have come from earnings and profits taxed as Subpart F income, and the remainder, if any, would be deemed to have come from other earnings and profits. Any distribution made from the remainder would be taxed to the shareholders since no previous tax had been paid.

Section 960 Special Rules for the Foreign Tax Credit

Section 960 described the special rules to use in applying the foreign tax credit. If the shareholder was a domestic corporation, the taxpayer was allowed a foreign tax credit on a deemed paid basis against any U. S. tax that would have to be paid as a result of including income under Section 951. However, the credit was disallowed on subsequent distributions from previously taxed Subpart F income or from earnings and profits which were invested in United States property.

Section 961 Adjustments to Basis of Stock in Controlled Foreign Corporation and of Other Property

To eliminate the possibility of double taxation, Section 961 allowed the taxpayer to increase the basis of his stock in the CFC by an amount equal to the amounts included under Section 951. However, the basis had to be decreased by any distributions made under Section 959 if they were deemed to have come from previously taxed income.

Section 962 Election by Individuals to be Subject to Tax at Corporate Rates

Section 962 provided special rules when an individual shareholder of a CFC elected to be taxed at the coporate rates. By electing to be taxed at corporate rates on the income included under 951, the individual shareholder could take advantage of the foreign tax credit on a deemed paid basis.

Section 963 Receipt of Minimum Distributions By Domestic Corporations

Section 963 provided the rules regarding the minimum distribution escape clause. This section identifies some exceptions and special rules.

Section 964 Miscellaneous Provisions

Section 964 included the miscellaneous provisions covering Subpart F. It explained that earnings and profits were to be determined under rules in the code which were applicable to domestic corporations. An exception from Subpart F taxation was provided if the secretary or his delegate was satisfied that the earnings of the CFC were in fact blocked, and could not be distributed because of currency or other restrictions imposed by the laws of any foreign country.

Summary

In summary, Section twelve of the Revenue Act of 1962, which added Subpart F to the code, eliminated the deferral privilege as it applied to certain types of income if that income was earned by a corporation which was organized under the laws of a foreign country and controlled (over 50% ownership) by taxpayers under the jurisdiction of the United States tax laws. If the corporation had FPHC income, or if it earned part of income from sales of personal property purchased in one country but sold in another, or if some of its previously earned income was invested in U. S. property then the tax would come due on that income as if it had been distributed to its U. S. owners. The tax was levied on the shareholder, and not the corporation. It was a tax levied however, on the undistributed earnings of a corporation. The application of Section 951 through 964 is depicted in the flow chart on page 40.

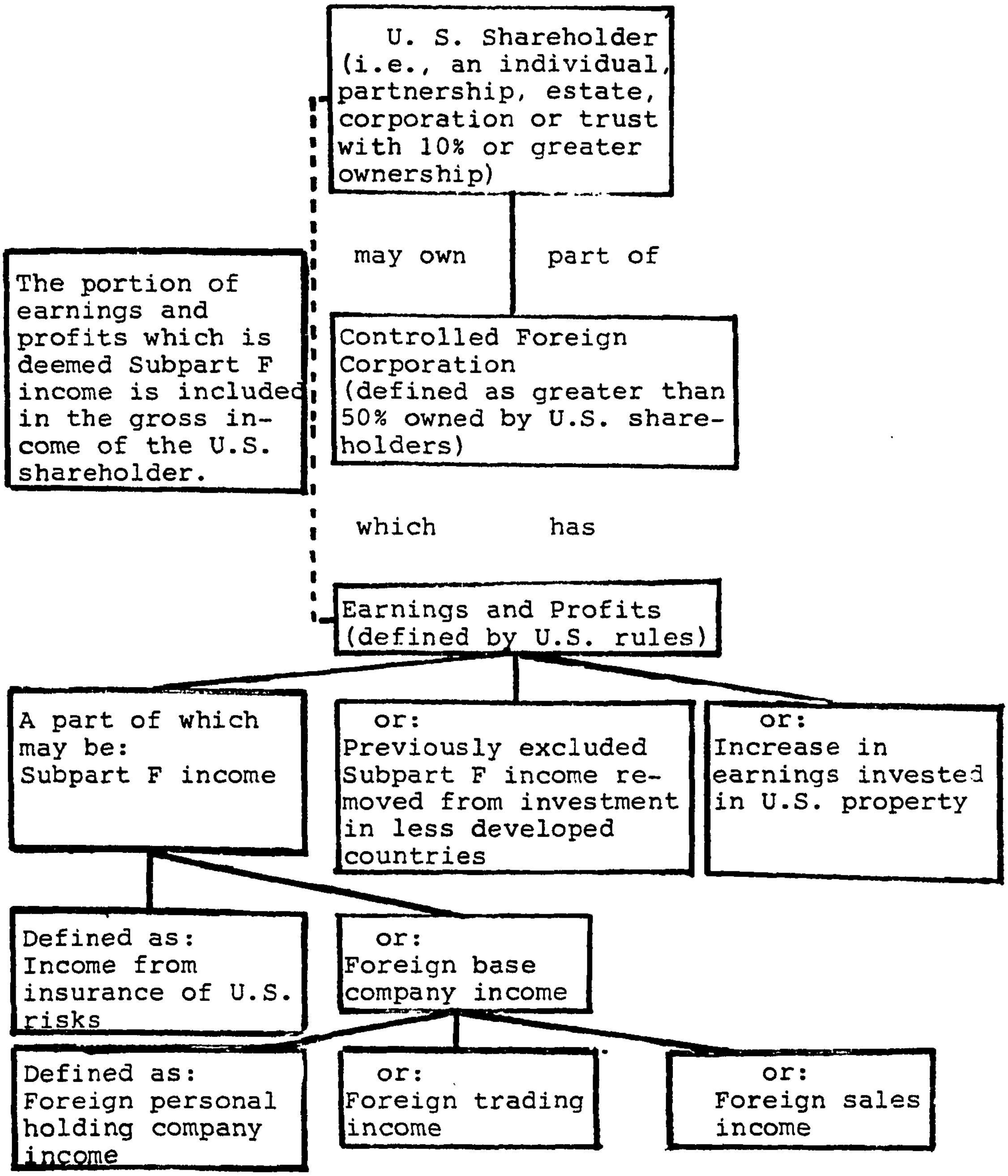
Tests of the Law Through the Judicial Branch

During the years from 1962 to the present, Subpart F of the Internal Revenue Code has been tested numerous times. Not all the Various parts have been tested since some are merely introductory sections. For example, Section 952 introduces Subpart F income, defines it, and limits it, while the law is fully explained in Section 953 and 954. The second part of this chapter will discuss some of the more important court cases which have tested the law. This will be presented by section number, rather than by case, since many times, a case will affect more than one section. A section by section approach will also group like cases together. With appeals and other delays, some cases arising from the 1963-1964 period were not settled until the late seventies.

The Legislative Background of the Constitutional Question on Subpart F Income

Before examining some cases which tested the constitutionality of Section 951, a brief synopsis of the

Subpart Income



Source: Baker, Richard C."A New Look at Subpart F" <u>Taxes, The Tax Magazine</u> 54 (September 1976): 575.

discussion which took place during the enactment of Subpart F will be reviewed.

A major argument against President Kennedy's request to tax the undistributed earnings of all foreign corporations owned by U. S. Shareholders, was that involving the constitutional question, "can domestic shareholders be taxed on foreign earnings prior to distribution?"[3] President Kennedy, in his message to Congress stated that "the undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland.. .agreements (made) in order to reduce sharply or eliminate completely their tax liabilities at home and abroad."[4] In using statements such as that quoted above, Kennedy made it appear that the proposals were merely to close some loopholes evident in the tax law. However, the true importance of this proposal was that it made a complete departure from the accepted principles that were applicable to the taxation of federal income. Although personal holding companies had been taxed in the past on their undistributed income, the corporate veil had not been pierced for a bona fide operating company.

The Treasury had continually argued that the FPHC statutes in Section 551 had established the constitutionality of Subpart F. This analogy was not valid in the original proposal because President Kennedy had wanted to completely eliminate the deferral privilege in order to improve the balance of payment problem while Section 551 was established to stop a tax avoidance measure. Therefore the opponents to Subpart F said that there was no comparison between the two taxing measures. However, as Subpart F evolved through Congress, it became a tax avoidance measure, making it comparable to 551 and thereby giving it a precedence to answer the constitutional question.

On the other hand, as the proposal was originally submitted, one of its main purposes was to make the immediate balance of payments more favorable to the United States. At that time, there was a very convincing argument advanced stating that the power of Congress to regulate foreign commerce was applicable. Therefore, Congress could exercise this power by means of a tax measure, and not be subject to the constitutional limitations on pure revenue measures. When Subpart F evolved as a tax avoidance measure, this argument lost its validity.

Article VI Clause 2 of the constitution reads as follows: "All treaties made. . .under the authority of the United States, shall be the supreme law of the land...."[5] Had the Treasury decided to tax the foreign corporation rather than the stockholders, the constitutional question would have been answered immediately, it would be unconstitutional. The Treasury bypassed this problem by taxing the income directly to the shareholders.[6]

The Eisner[7] decision was cited most often in discussing the constitutional question on Subpart F, in that case, the court had defined income as something "proceeding from the property, severed from the capital."[8] It was upon this distinction that most of the doubts were predicated. In some later decisions such as Helvering v. Bruun,[9] where capital had been taxed as income, the court noted that Eisner retained its validity only when there was need to distinguish between stock dividends and ordinary dividends. However there have been far more recent cases than Bruun, where the court had described Eisner as useful in distinguishing gain from capital.[10]

The Court's Interpretation of the Constitutional Question on Subpart F Income

It was evident that the constitutional question would not be settled until the courts were handed some cases testing the specifics of the law. One of the early cases which tested the constitutional question was the Whitlock case.[11] The petitioners, Whitlock Oil Services, contended that the tax imposed upon the corporation under Section 951 (A) (1) (B) (earnings invested in United States property), was unconstitutional. According to the petitioners, the following parts of the constitution were relevant to their arguments:

Article I, Section 2, Clause 3

Direct taxes shall be apportioned among the several states which may be included within this union, according to their respective numbers;

Article I, Section 8, Clause 1

The Congress shall have power to lay and collect taxes;

Article I, Section 9, Clause 4

No capitation or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken.

Amendment V

Nor shall any person be deprived of life, liberty, or property, without due process of law;

Amendment XVI

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

The court ruled that the petitioners would have to show that the tax was both a direct tax unapportioned among the states and a tax on something that does not constitute income. The court stated that if they failed to show either one, then they would fail altogether.

Although the petitioners placed heavy reliance upon the precedence in Eisner V. Macomber,[12] the court did not side with them. The court did not say that the Eisner decision was no longer effective, but that the reasoning of the Supreme Court in Eisner was based on the decision that the accumulated earnings constitued a share of captial, and not income. Since the petitioners' current earnings and profits were greater than the increase in the amount of earnings that the corporation invested in U.S. property, the latter would constitute a repatriation of income to the shareholders. The court also noted that the majority in the

Eisner decision had remarked that a court has the power and duty to look through the form of the corporation to determine the question of stockholders rights in order to ascertain whether a stockholder had received income that would be taxable by Congress under the constitution.

The petitioners also argued that by attributing the undistributed income directly to the shareholder, then the basic concept that a corporation is an entity separate and distinct from its owners is violated. The court noted, "whatever may be the validity of that concept, the history of U. S. income taxation shows that Congress has for decades been drafting income tax statutes which have bypassed the corporate entity." The court continued, "the Supreme Court's pronouncements have been to the effect that taxation of undistributed current corporate income at the stockholder level rather than at the corporate level is within the Congressional power." The court pointed out that in the past the IRS has reached out and taxed the undistributed earnings of corporations formed or availed of for the purpose of avoiding taxes. Whereas the *Eisner* decision was addressed to situations where the shareholders did not have the control that is exercised by shareholders with respect to Subpart F income, the court was now directing itself to the situation of the tightly controlled corporation where stockholders are able to manipulate the corporation's profits and capital at will. Thus, in matters of income taxation, even the *Eisner* decision would not prohibit disregard of the corporate entity if a stockholder's actual rights and powers over the corporation's income were sufficiently great.

In answering the constitutional question in the Dougherty[13] case, the Eisner, Whitlock[14], and Garlock[15] cases were cited. The petitioners relied on the Eisner decision claiming that the CFC had no income, within the meaning of the 16th Amendment which could be taxed to its shareholders under Section 951, since all of the CFCs income had been realized and retained in the business prior to the time Subpart F became effective. However, the court decided that the Sections were, in fact, constitutionally applied in the Dougherty case based upon the precedence of Whitlock and Garlock.

The court noted some of the observations that were made in previous cases: one being that the Eisner decision did not preclude Congress from bypassing the corporate entity in determining the incidence of federal income taxation. The court noted that this principle had special application in the case of a CFC, since the shareholders of such tightly controlled corporations are able to manipulate the undistributed income at will. The court also quoted from the report accompanying the bill through Congress, "the objective of 951 (A) (1) (B) is to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation" [16] and also from the Senate report, "generally, earnings brought back to the U. S. are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them."[17]

The court enlarged on the _Whitlock_ decision. In _Whitlock_, the taxable event was the investment of current earnings of a CFC, while in _Dougherty_, the court took the additional step of holding that there were not constitutional barriers to the application of Section 951 in respect to the pre 1963 earnings and profits of a CFC.

The court held for the respondent in saying that

> . . .Because of the shareholder's control over the corporation, the corporate entity is bypassed for taxation purposes and such income is taxed directly to the taxpayer. In the case of Section 951 (A) (1) (B), Congress has decided that certain income realized by the corporation should not be taxed to the shareholder until something more occurs--the repatriation of that income in the form of an increase in earnings invested in U. S. property."

Therefore, the taxable event was the investment and not the earning of the income, and the investment came in a year subject to the operation of the statute.

Although there were more tests to the constitutional question than the two presented above, the _Whitlock_ and the _Dougherty_ cases are continually cited as precedent decisions. These cases were decided in favor of the government. Although the _Eisner_ decision remains a viable precedent in similar situatins, the constitutionality of Subpart F income remains sound. In the _Eisner_ decision, the shareholders had no control over the distribution of dividends while in the case of a CFC, the shareholders in question are the owners, and are able to exercise complete control over the distribution of income.

The Court's Interpretation of Subpart F Income Other Than The Constitutional Question

Section 951

Since Section 951 contains a summary for most of the sections under Subpart F, the cases will be examined under the respective section number. However, Section 951 (D) attempts to diminish the possibility of double taxation where a CFC is also classified as a FPHC under Section 951. Congress did not intend for both Subpart F and the FPHC statutes to apply to the same income at the same time.

Section 951 (D) reads as follows:

> A United States shareholder who, for his taxable year, is subject to tax under Section 951 (B) (relating to foreign personal holding company income included in gross income of United States shareholders) on income of a controlled foreign corporation shall not be required to include in gross income, for such taxable year, any amount under subsection (A) with respect to such company.

The case most cited concerning this point is the Whitlock[18] case, previously cited in the discussion of the constitutional question. Whitlock Oil Services Inc. (Petitioner) was considered to be both a CFC and a FPHC for the years 1964 thru 1967 and only a CFC for the year 1963. The Internal Revenue Service had assessed deficiencies against the stockholders on some income which had been invested in the United States in 1963 and for additional increases in U. S. property from 1964 thru 1967. During those years that the petitioners had declared themselves as a FPHC, they had paid a timely tax on the undistributed earnings. However, the IRS contended that the taxpayer was also liable under Section 956 which stated that the taxpayer must include his prorata share of the increase in earnings invested in the United States. The petitioners countered that the wording in 951 (D) precluded them from being liable under both sections.

The Internal Revenue Service cited Regulation 1.951-3 in which the phrase "any amount attributable to earnings and profits of that year" was substitued for the phrase "any amount under Subsection (A)" found in the code, based upon this, the court held that since the regulation was inconsistant with the statute in the code, the code must be followed and that the regulation was invalid. The minority opinion held that example (5) in the regulation described this very set of circumstances, and that the regulations were designed to stop such an abuse of the law.

The IRS appealed and the lower court's decision was reversed. It was shown that the earnings that were being repatriated were from earnings and profits which were accumulated prior to the FPHC classification and that the petitioner was simply repatriating income on a tax free basis. The court also noted that most of the investments in U.S. property were either accounts receivable or notes receivable from members of the petitioners family. The Appelate Court pointed out that the spirit of the law in

Section 951 (D) was to prevent double taxation of income and that this was definitely not the case in Whitlock.

Section 952

There were no cases testing the statutes found in

Section 953

Section 953 describes income from insuring U. S. risks which is part of Subpart F income taxable under Section 951. Congress was attempting to stop the flow of insurance premiums to overseas insurance companies in an attempt to strengthen the balance of a payments and to stop some of the tax avoidance schemes that were being used in this area. The Carnation case, which is under appeal as of the end of 1980, is a good example of how a taxpayer attempted to use Subpart F to his advantage.

In the Carnation[19] case the petitioner has purchased a blanket insurance policy from a domestic insurance company and took a $2 million deduction for the premium as an ordinary and necessary business expense. At the same time, the petitioner organized a wholly owned CFC which arranged to reinsure about 90% of the liability undertaken by the domestic insurance company. The premium paid to the CFC for the reinsurance amounted to about $1.75 million which the petitioner included as income for the uear under Section 953. The petitioner then in turn took approximately $8 million as a foreign tax credit on a deemed paid basis. This gave them an $800,000 reduction in taxes in addition to a $250,000 loss on their return (the difference between the $2 million insurance deduction and the $1.75 million Subpart F income).

The court noted that the cornerstone of insurance is the transfer of risks and that in the current case, the petitioner had indirectly assumed 90% of its risk thereby negating the insurance contract. "It is immaterial for the purposes of this Section (953) whether the person insured or the benificiary of any insurance, annuity, or reinsurance contract is, as to such corporation, a related person or a U. S. shareholder."[20] Citing from the LeGierse[21] case, where the court found that no insurance existed, the court's opinion was based upon the principle that an agreement may resemble insurance in form, yet lack an ingredient essential to insurance. "We have decided that to the extent the petitioner's risk was not shifted, the agreement at issue may not be characterized as insurance. To that extent, Sections 952 and 953 and the regulations thereunder have no application to the agreements here because the application of such sections is predicated upon the existance of insurance."[22]

As a result of the court's findings, the petitioner lost its deduction for business expenses. The court also reclassified the reinsurance premium as a capital contribution, thereby, there was no Subpart F income and the petitioner was not entitled to the foreign tax credit. Since this case is still under appeal, the outcome may change.

Section 954

Section 954 details the rules governing FBCSI. This was one of the major avenues of tax avoidance and one that Congress was sure to close with the Revenue Act of 1962. The major abuse came from firms that would sell their goods in trade, mainly personal property to their foreign subsidiaries in low tax countries which would in turn resell those goods to another subsidiary in another country. In defining the FBCSI, Congress seemed to effectively close this loophole. There are few cases testing this area which demonstrates how effective Congress was in detering this type of activity.

In the Fischbein[23] case the IRS claimed that the income earned by Fischbein, a CFC, was FBCSI under Section 954 and would have to be included under Section 951. In the Fischbein case, a Belgium corporation, Compagnie Fischbein SA, was considered to be a CFC within the meaning of Section 956 and 957. Dave Fischbein Co. was the U. S. domestic corporation which was a shareholder in Compagnie. Compagnie received component parts of bag closing machines from the Dave Fischbein Co. which manufactured them. Compagnie then assembled them and derived its income from worldwide sales of these machines.

The court held that under the scheme of the code, the regulations, and the legislative history of Subpart F income, the operations of Compagnie amounted to the manufacture of a product when purchased components consitituted part of the property sold. Consequently, the income generated was not FBCSI. The court claimed that the regulations under Section 1.954-(3) (A):

> Espouses both a substantive and objective test. . .the objective test offers a safe harbor of compliance if the foreign corporation's operations account for 20 percent or more of the total cost of goods sold. Failure to obtain this safe harbor, however, does not prevent compliance through satisfaction of the substantive test.

The substantive test concerned the degree of change made to the property. "If purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation." Section 954 (D) (1) stated that mere packaging, repackaging, labling or minor assembly is not considered manufacturing and therefore would be FBCSI. The court pointed out that the number of steps and the time it took to complete the bag closing machine, in addition to the training and types of tools used to assemble the machine, all led them to hold that Compagnie was definitly into manufacturing, and was not a sham shelter, designed to avoid tax.

Section 954 is the major part of Subpart F income tax legislation. It was designed to stop the tax avoiding schemes utilized by firms operating in a number of countries simply in order to reduce taxes. The legislation effecting Subpart F income was totally effective in stopping this avenue of tax avoidance. Those few cases which have been tried and found in favor of the taxpayer, have done so because, as in the Fischbein case, it was proven that the taxpayer had something more than a sales office and that the product was in fact being manufactured overseas.

Section 955

To date there have been no major cases heard which test this area of the law.

Section 956

In addition to Subpart F, Section 951 also requires U.S. shareholders to include their prorata share of the increase in investment in U.S. property made by the CFC during the year. The intent of Congress with this section was to tax as dividends any such investments under the theory that most investments of this type are in fact constructively received dividends to the U. S. shareholders, Section 956 (B) (1) (C) states that investment in U. S. property is to include "an obligation of a U. S. person". There have been many cases heard covering this area, the Whitlock case discussed under Section 951 and two other cases which are presented here; the Dougherty case, and the Ludwig[24] case.

Part of the Dougherty case affected the increase in investment of U. S. property under Section 956. There was no question that the foreign corporation in this case was a CFC, but the main question was concerned with whether provisions of the Revenue Act of 1962 could be applied on a retroactive basis. The case affected the tax years 1963 and 1964 where there were increases in investment in U. S.

property, but there were no earnings or profits for the years affected. The petitioners claimed that the IRS could not tax earnings and profits retained by the CFC prior to January 1, 1963.

During the years affected there were no dividends paid, however, there were substantial increases in advances and loans to related parties. The IRS focused on the dividends limitation provision of 956 (A) (1), which states that increases in earnings invested in the United States are taxable to the extent that they would have constituted a dividend if it had been distributed. The court agreed with the IRS, but noted that in the original House version of the bill that the petitioner would have been correct because the investment in U. S. property would have been limited to the amount of current earnings and profits and earnings and profits accumulated after December 31, 1962. The court noted that it could not ascribe to the petitioner's argument because that would allow all CFCs in existance at December 31, 1962 to invest all their accumulated earnings and profits tax free in the United States. Since in fact, most of these so called investments in U. S. property are nothing more than loans to related parties, Congress would be allowing a tax free dividend.

The petitioner's main point was that Congress did not intend for the Revenue Act of 1962 to be applied on a retroactive basis. They cited Section 956 (B) (2) (F) in support of their contention that pre 1963 earnings and profits were not to be included. That particular section excludes from tax, under 951, earnings invested in the United States if those earnings were subject to tax under the United States source rules. The section reads, "for the purposes of Subsection (A) of 956, the term United States property does not include. . .an amount of assets of the CFC equal to the earnings and profits accumulated after December 31, 1962, and excluded from Subpart F income under Section 952 (B)," (the source clause). The court countered with the following argument; "the focus of 951 is not whether the foreign corporation has been avoiding tax on its income, but whether the shareholder should be considered as having recovered something akin to a constructive dividend. The two sections have different purposes, and therefore, are not inconsistent." The court concluded saying that the taxable event which activates the operation of 951 is not the increase in a CFC's earnings, but an increase in the investment in United States property. The petitioner definitely had an increase in United States property. The court found for the respondent, which resolved a "question which we did not reach in the Whitlock case."

Although the court argued that there was an increase in earnings invested in U.S. property;, the taxpayer was not required to include the notes as part of the increase in earnings invested in U.S. property. The court noted that they were bonifide notes and that the taxpayer was simply acting as a prudent businessman by waiting until better times to force collection.

In the Ludwig[25] case, the court held that the petitioner, a U. S. citizen who was the sole owner of a CFC, was not a guarantor within the meaning of Section 956 (C). He had borrowed about $100 million from a group of banks and had pledged his stock in the CFC as part of the collateral for the loan. The IRS claimed that this would fall under 956 (C) and therefore, the petitioner had taxable income under Section 951 (A) (1) (B).

Section 956 (C) reads as follows:

> For purposes of subsection (A), a controlled foreign corporation shall, under regulations prescribed by the Secretary or his delegate, be considered as holding a obligation of a United States person if such controlled foreign corporation is a pledgor or guarantor of such obligations.

The loan was made in order to purchase the entire holdings of Phillips Petroleum Company in Union Oil Co. The fair market value of that stock was over $100 million, but under regulation U of the Federal Reserve Board, a loan for a listed security must be secured by collateral having a value equal to or greater than two times the amount of the loan. The banks accepted the Union Oil stock, and 1000 shares (100%) of the stock in the CFC whose fair market value was enough to cover the remainder of the security. The assets of the CFC consisted mainly of all of the outstanding stock of another CFC which was engaged in owning and operating ocean going vessels.

The court noted that in neither the code or the regulations, is there found a definition of guarantor: therefore, in the absence of any such specific technical definition, the term should be given its normal and customary meaning. From previous cases concerning other areas of the code and the regulations where it was necessary for the court to define the term guarantor, they noted two essential elements: (1) there must be an undertaking or promise on the part of the guarantor; and, (2) there must be a liability on the part of the guarantor to make payment if the primary obligator fails to do so. The court determined that both of these critical elements were absent in the Ludwig case. Therefore, the petitioner could not be liable under 956 unless the term guarantor has some unique meaning which would be beyond the normal meaning.

The basic argument between the court and the IRS seemed to be a question of what was collateralized, the stock, or the underlying assets of the CFC. In Revenue Ruling 76-125, the IRS stated that it was the intention of the parties that if the controlling U. S. shareholder defaulted on the loan, the foreign corporation's assets would be available to answer for the debt. The IRS noted the restrictive convenants that both CFCS had to agree to under the terms of the loan. In Ludwig, the court determined that it was the stock and not the assets that supported the collateral. The required convenants were more to protect the value of the stock, rather than to maintain the value of the underlying assets. The court noted that if the petitioner defaulted, it would be foolish to think that the corporate assets would be sold to cover the debt. Instead, the stock would be sold, noting that the company therefore would have no obligation, only new owners.

The intent of Congress in enacting Section 956 was to stop the flow of tax-free dividends to the U. S. owners of CFCs. Since many of the transactions affecting Section 956 clustered around loans and advances to the U. S. owner corporations, most of the court cases involved this type of transaction. Only those cases which contained bonafide loans and advances actually survived the test of the court. Many of the early cases interpreted Section 956 as referring only to earnings and profits retained after the effective date of the legislation. However, taxpayers soon found out that this was not the intent of Congress, since to do so would allow the distribution of all pre 1963 earnings and profits of CFCs through the devise of permanent loans or advances to the U. S. owners.

Although the types of allowed investment in U.S. property was expanded in the Tax Reform Act of 1976, investments made in the U.S. owners of the CFC are still considered investment in U. S. property under Section 956.

Section 957

One of the most tested sections of Subpart F was Section 957 which defined exactly what was meant by a controlling interest. The general rule was stated in

Section 957 (A):

> For purposes of this subpart, the term controlled foreign corporation means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by United States shareholders on any day during the taxable year of such foreign corporation.

The phrase "more than 50 percent" was the part most often tested. There were many cases in this area, but most of them simply rely on the earlier ones. The Garlock[26] and the Kraus[27] cases will be presented since they are the two most cited, along with the Koehring[28] case since it was nothing more than a sham, and the CCA[29] case in which the petitioner proved to the court that they had actually transferred control to outsiders and therefore was not a CFC.

The Garlock case tested Congress's definition of control by issuing voting preferred stock purporting to have equal voting power with the common shares owned by U. S. shareholders. Section 957 (A) of Subpart F defines control as having more than 50% of the total combined voting power of all classes of stock outstanding. With the U. S. shareholders having only 50% of the voting stock, the petitioners claimed that their corporate structure did not satisfy the control statutes, and therefore could not be classified as a CFC. The tax court ruled based upon regulation 1.957-1 (B) (2) which stated that "any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained." Where another class of stock is outstanding, the regulation stated that the voting power ostensibly provided each others classes of stock will be disregarded if:

> (a) The percentage of voting power. . .is substantially greater than its proportionate share of the corporate earnings, (b) the facts indicate that the shareholders of such other class of stock do not exercise such voting rights independently or fail to exercise such voting rights, and (c) a principle purpose of the arrangement is to avoid classification as a controlled foreign corporation under Section 957.

In the Garlock case, cummulative preferred stock was issued to foreign investors who understood the motive involved. There was little risk involved for the preferred shareholders since they could demand that the corporation buy the shares back at par whenever working capital was in excess of 200 percent of par for the first year, and at any time thereafter with only 120 days notice.

In addition, the corporation's bylaws were amended to increase the number of directors from four to five and to manipulate the terms of the directors to preclude any possiblity of the U. S. owners losing their control. The shares could not be transferred without consent of the corporation; however, the dividend rate of eight percent was higher than the going rate of interest. The preferred shareholders did not exercise their voting rights independently and the voting power of the preferred shares was substantially greater than their share of earnings.

The petitioners did appeal, however, and the Appelate Court agreed with the lower court's ruling that the shareholders satisfied Section 957 as to the control provisions of Subpart F and therefore were subject to tax as a CFC.

The Kraus[30] case was similar to Garlock. In this case, the stock of the corporation in question was sold, and the petitioners had classified the gain as a long term capital gain, the IRS claimed it was a CFC and therefore, the gain would be ordinary to the extent of earnings and profits accumulated after December 31, 1962. The petitioners contended that they did not own 50% of the voting stock, and therefore the corporation was not a CFC. The corporation was formed in late 1962 with a capitalization of 1000 shares of $100 par value common stock, and 100 shares of 8% cummulative preferred stock with a $1,000 par value. The voting rights were equal with ten common shares receiving one vote and one preferred share receiving one vote. The preferred stock could not be transferred freely and the shares were sold to close associates. The court demonstrated that the petitioner never intended to lose control of the corporation as evidenced by the many restraints on the transfer of preferred stock. The stock was callable with three months notice, a point not present in the Garlock case, and the court noted that there was "no arrangement made for breaking a deadlock in voting, and in view of the call provisions, the redemption of any dissident stockholders' shares at par value provided an obvious solution to any problem." In the two and half years that the firm was in existance, on only one occasion did one shareholder attend a stockholders meeting, and there was no written record that they participated in either person or by proxy. The lower court found in favor of the IRS, and the higher court affirmed.

In the Koehring[31] case, the control question had to again be answered. In this case, the preferred stock represented 55% of the voting control, while the common stock, owned by the petitioners, represented 45%. The petitioners contended that they were not a CFC and therefore not subject to 951. There were five directors on the board, with three of them representing the preferred stock interests, including the chairman. The preferred majority attended only 40% of the meetings with the chairman attending only one of the ten meetings. The court found that the "actions of the (preferred interests) directors were such as would be expected of sham directors whose real interest lay in protecting (the little they had in the company)." The preferred interest was limited to the nominal value of the stock held and to eight percent of the income. This information was found in the annual report of the CFC. The court found that since thre was an implied agreement between the common and preferred shareholders and that the preferred failed to exercise the voting rights or did not exercise them independently, the corporation was a CFC and liable under Section 951. The petitioners appealed the decision, but the higher court affirmed.

In the CCA[32] case which concerned the question of control, the court held for the petitioners who were part owners of a foreign corporation. The taxpayer had an established foreign subsidiary which was 100% owned by them. Upon the passage of the Revenue Act of 1962, preferred stock of the subsidiary was issued to foreign stockholders who possessed 50% of the voting power. In this case, substantial restrictions were not placed on the preferred stock, and representatives of the preferred holdings had significant powers which could be utilized to alter the course of events of the subsidiary. In citing both the Garlock and Krause cases, the court noted that a "mere technical compliance with Section 957 (A) is not sufficient"; however, in this case, the court found that the petitioners had divested themselves of meaningful voting power and that any restrictions placed on the preferred stock were reasonable.

The IRS pointed out that, as in Kraus and Garlock, the amount paid by the preferred stock holders was significantly less than 50% of net worth. The court agreed, but noted that the other factors in the case mitigated the above point. There was no provisions whereby the petitioners could call in the preferred stock, the Board of Directors were equally divided between preferred and common shareholders, and the stock was sold to non-related persons who took an active part in the operation of the business.

The control aspect was the first tests of the new statutes in the court. Taxpayers in the precedent cases all took the position that they did not have more than 50% interest in the CFC and therefore they were not subject to the statutes under 951. In all the precedent cases, preferred stock was issued to effect the 50% or less ownership by the U. S. interests and in all but one case (CCA) the courts had proven that the issue of the stock was a sham whereby no ownership interests or very little interests were actually transferred to the 'foreign majority.' Even though the taxpayers in the CCA case had issued the preferred stock after passage of the Revenue Act of 1962 and had done so to provide an avenue of escape from the provisions, the court found in their favor since control had actually been transferred.

No changes have been made to the control aspect of the CFC provisions during the period from 1962 through 1980. The intent of Congress was firmly established in the original drafting of the section.

Section 958

Section 958 defines the term "owning more than 50 percent of the stock." The rules center on the constructive ownership concept that is pervasive throughout the code. Any cases decided under this section would be testing a point that is outside the scope of this study.

Section 959

There were no important cases testing this section to date because it offered an exemption from taxation, therefore there would be no advantage for a taxpayer to challenge this section.

Section 960

Section 960 allows the foreign tax credit on a deemed paid basis to corporate stockholders. All of the cases decided under this section would be a test of the rules allowing the foreign tax credit under Section 901 and therefore are beyond the scope of this study.

Section 961

Section 961 allows the use of the equity method of accounting for a taxpayer's investment in a CFC. Any amounts which are required to be included under 951 are added to the taxpayers basis in the stock, thereby decreasing his taxable gain upon a subsequent sale. Any amounts which are excluded under Section 959 must be applied to reduce the taxpayers basis. Since the nature of this section is similar to Section 959 (of direct benefit to the taxpayer), there have been no major cases testing the application of Section 961.

Section 962

In general Section 962 allows a taxpayer to elect to be taxed as a corporation in order to take advantage of the foreign tax credit on a deemed paid basis. Although there have been a few changes made to Section 962, there were technical changes required because of changes in other sections of the code. Most of the cases in this area concern the statement in 962 (B) "an election made for any taxable year may not be revoked except with the consent of the secretary or his delegate."

In the Dougherty[33] case the petitioner decided that an election under Section 962 would be beneficial. However, this decision was made only after it became apparent that the IRS would include a substantial amount of income for the tax year 1963 under Section 951. The IRS claimed that no timely election was made. The court ruled that an election was made as soon as it was apparent to them that the election would be necessary, and was therefore timely. However, when the case was finally settled, the IRS sued again, and this time won a deficiency of some $21,000. The petitioner now calculated that the deficiency would only be about $8,000 if his election was revoked. However, the IRS refused to invoke this election and the petitioner sought relief in the court. The findings were in favor of the IRS. The court said, "although Section 962 was intended to afford relief to taxpayers affected by the CFC provisions, it is elective and does not operate automatically whenever it benefits the taxpayer."

Similarly in the Haft[34] case, the court allowed the petitioner the election, even though it was made many years after the year in question since it was made immediately after it be came known to the petitioner that an assessment would be made and it appeared a benefit would be available under Section 962. Subsequently, it was determined that the election should not have been made, and the petitioner attempted to withdraw the choice. The court refused to permit a withdrawal because it was not attempted until the completion of the litigation and the discovery that the taxpayer would be better without it.

Even though the two significant cases under this section were found in favor of the Internal Revenue Service when the section was supposed to operate to the benefit of the taxpayer, Section 962 continues in 1980 to be an elective one. As is true for most of the elections under the code, they must be timely, and they cannot be changed at the whim of the taxpayer. In both of these cases, the taxpayer would have been better without the election, but were denied the right to withdraw their election. The main reason for the courts opinion is that they were allowed to make the election even though it was years after a timely one could have been made. It was only because of the deficiency notices from the Internal Revenue Service that the taxpayer wanted to make the election. To put the taxpayer on an equal basis with the Internal Revenue Service, the courts allowed the election to be made.

Section 963

Section 963 is the escape clause that the Senate wrote into Subpart F. It allows the Subpart F income of a

CFC to be non-taxed where a certain minimum distribution is made to the stockholders. The minimum varies inversely with the effective foreign tax rate in effect in the country of incorporation. _Hewlett Packard_[35] is one of the few cases testing this area since the rules are fairly straight forward with little room for error. In the _Hewlett Packard_ case, which is still under appeal at the end of 1980, the taxpayer, in determining the total taxes paid to see if they satisfied the minimum distributions rules, followed the regulations in effect at the time (1968). During that period a surtax was also in effect. However, the regulations were not formalized until 1971. Accordingly, the petitioner did not take the surtax amount into consideration and, therefore, computed that they qualified under the minimum distribution rules of Section 963 that no income would have to be reported under Section 951. The IRS disagreed, stating that in each Revenue Act that affected the surtax, reference was made to Section 963 and the mnimum distribution rules that would be affected.

There were very few cases testing this section since it is in the code for the benefit of the taxpayer. The minimum distribution escape clause was removed by the Revenue Act of 1975.

Section 964

Under Section 964 (A) the rule for calculating earnings and profits are given. Since, under Section 952, Subpart F income is limited to the CFC's earnings and profits for the current year, The calculation becomes important. The regulations explain how a change in depreciation methods should be handled and the information which must be furnished and to whom it must be furnished.

In the Hewlett Packard[36] case, the Internal Revenue claimed that although the above information was furnished, it was not furnished in the proper manner, nor to the proper department. The court found in favor of the petitioner, citing that the regulations had been published only four days before the petitioner's first taxable year under Subpart F and that as soon as the proper forms and departments were known, the petitioner corrected its filings.

The regulations were specific as to how notification should be made, and the IRS claimed that since the regulations were legislative in character, they should be literally observed. The court cited several cases where the court had rejected the 'literal' argument. The court noted that "in ascertaining whether a particular provision of a regulation stating how an election is to be made, must be literally complied with, it is necessary to examine its purpose, its relationship to other provisions, the terms of the underlying statute, and the consequences of failure to comply with the provisions in question."

The court ruled that since all the informtion was submitted, albeit in various documents to various departments, there were not damaging consequences to the IRS other than some minor delays in processing the documents. The court also noted that, if this was an election made by the taxpayer, the IRS would have insisted that this was an unchangeable election if they had wanted the election to remain valid.

Summary of Judicial Tests of Sections 951-964

Although a number of challenges were made through the courts to Sections 951 through 964 of the code amended to 1962, no case was the basis for any changes made to the applicable sections during the period from 1962 through 1980. The final part of this chapter will present the changes that were effected to the Subpart F statutes as well as the changes which were attempted to be enacted during the period from 1962 through 1980.

Congressional Changes To Sections 951 Through 964

A comparison of the Revenue Code of 1954, amended through 1980, with that amended to 1962, will show relatively few changes. Most of the changes made came during the mid seventies. This is not to say that there were but very few attempts made by Congress to enact changes, since numberous groups had applied pressure in hopes of furthering their point of view. Because of the repetitive nature of the discussions concerning the taxation of CFCs and the elimination of the deferral privilege since 1962, a detailed analysis will not be presented. The usual arguments, such as the constitutional question or the competitive disadvantage, will merely be referred to, while any new arguments presented will be analyzed in detail.

Once the Revenue Act of 1962[37] was enacted, it took a number of years before the court heard cases testing the validity of Sections 951 to 964.

There were three major moves made during the period from 1963 to 1969 to encourage repatriation of U. S. dollars. The first, the Interest Equalization Act, came in 1963.[38] Although Congress enacted it as a temporary measure, the law was extended each year until 1974 when it was finally allowed to die. The Interest Equalization Act basically imposed a tax on the acquisition of stocks, debt, and other obligations of foreign issuers. It was designed to slow down the flow of U.S. capital into portfolio investments of foreign firms. This outflow had significantly increased because the returns on such securities far outweighed the return on domestic investments.

The second move came in 1966 when the Foreign Investors Act[39] was passed into law. This measure made changes to the United States tax policy toward nonresident investors, but effected little change in the manner in which the controlled foreign corporation was taxed.

The third move was instituted by President Johnson in 1968, when he exercised his emergency powers[40] to prohibit investors from making any new transfers of capital out of the United States and strongly encouraged them to repatriate earnings. The balance of payments problem had become acute as a result of the war in Southeast Asia. Although the order lasted less than two years, it did interfer with those taxpayers wanting to make direct foreign investments.

While the Tax Reform Act of 1969[41] was to be an all encompassing tax measure, the legislators soon found themselves with a bill that was much too complex to deal with at one time. As it was enacted, most of the foreign measures dealing with undistributed earnings were deleted. Two changes that were made to Sections 951 through 964 will be mentioned. The wording in Section 954 (B) (4) was changed to read as follows:

> For purposes of subsection (A), FBCI does not include any item of income received by a CFC if it is established to the satisfaction of the secretary that neither--(a) the creation or organization of such CFC under the laws of the foreign country in which it is incorporated (or in the case of CFC which is an acquired corporation, the acquisition of such corporation created or organized under the laws of the foreign country in which it is incorporated), nor (b) the effecting of the transaction giving rise to such income through the CFC, has as one of its significant purposes a substantial reduction of income, war profits, or excess profits of similar taxes.[42]

When Congress had originally written Section 954 (B) (4), they had not intended to eliminate the deferral privilege on income earned by a CFC through operations in the country of its incorporation. Congress hoped that the above insertion of the parentheses and the addition of part B would clarify the matter. The Senate Finance Committee supported this viewpoint by stating "if the income producing activity carried on by a CFC takes place within the country in which it is created, Subpart F treatment will be avoided."[43]

The Revenue Act of 1969 also made some changes to Section 963 concerning the minimum distribution. These changes were caused by the phasing out of the surtax. For a CFC to maintain the 90% relationship which was written into the law in 1962, the percentages of minimum distribution had to be revised when the surtax went into effect. Since the surtax expired during 1970, the code was again amended so that this 90 percent relationship would be maintained.

As the United States entered the seventies, ever increasing activity in international business gave birth to the multinational corporation (MNC) and the Treasury began to take a hard look at what the Secretary of the Treasury called sore spots in the present system of taxing foreign source income. Some general ideas were discussed in January, 1970, many of which eventually became law. The Treasury believed that the current law was far too complex and the manufacturing in this country for export to foreign markets was not treated fairly in relation to manufacturing overseas for foreign markets. Once again, the old standby argument of neutrality questioned the objectiveness of taxing currently the manufacturing income of a domestic corporation while deferring the tax liability until repatriation for a foreign corporation which was controlled by U. S. shareholders. Unlike the situation in 1962 when most of the CFCs were organized for tax avoidance measures, the period of the late sixities and early seventies witnessed numerous manufacturers moving overseas. As testimony bore out, these corporations were going overseas for nontax reasons. Although a variety of reasons were given, mostly, they moved in order to reach competiton on a more equal basis. The MNC was no longer restricted to U. S. corporations doing business overseas, but had spread to a world wide basis, with all of the industrialized nations operating on that same basis, hand-in-hand with U. S. corporations.[44]

There were a number of basic considerations which were thought to deserve attention in developing these proposals for revising the system of taxation of foreign source income. One idea that the Treasury suggested was the creation of a Domestic International Sales Corporation (DISC) which would extend the 1962 provisions of the export trade corporation to all exporting domestic corporations. Under the proposal, the tax on income earned by such a corporation would be deferred until it was paid to shareholders in the form of dividends as long as that income was invested in exporting activities. It was suggested that to qualify for the DISC provisions, a corporation would have to have 95 percent of all its income from the sale of goods manufactured in the U.S. for sale abroad. The DISC provisions were included in the Revenue Act of 1971 and were in effect until they were phased out under the Revenue Act of 1978.[45]

The Treasury also discussed the elimination of the deferral privilege. Again, the problems of jurisdiction were considered, as well as the problems concerning the corporation that was not closely controlled. The constitutional question would surely arise in the case of taxing a CFC with 45 percent minority interest.[46]

Direct investment income was also considered for possible exemption. It was noted that this would follow not only the approach taken by most foreign countries, but also the approach that was recommended in a study completed by the Canadian Government. The greatest advantage to this plan would be the simplification of taxation of foreign income.[47]

The Treasury also questioned some of the provisions of Section 956. Although they recognized the need for the provisions in such cases as quasi-permenant loans by foreign subsidiaries to their U.S. parent, they also believed that the section might be used to encourage the return of U.S. dollars. Accordingly, they suggested that the coverage of Section 956 be somewhat restricted.[48]

Along with the limited change in the Revenue Act of 1969 to the rules of taxing CFCs, and the ideas suggested by the Treasury in early 1970, the literature concerning this area was deluged with thoughts on the subject. Those arguing for a more favorable treatment of foreign investment presented their case on several fronts. First, they argued that the foreign tax credit was not generous enough and that it should be expanded to include sales tax, capital and net worth taxes, and other excise taxes which comprise a much larger percentage of the total tax burden than in the United States. This was putting American firms at a competitive disadvantage with their foreign competitors.[49]

Next, the United States position with respect to the application of the global concept was questioned. Many other countries were taking a more liberal approach of exempting foreign source income from taxation. Exemption of taxation would be one way to avoid the arbitrary distinction between branches and subsidiaries.[50]

Lastly, it was argued that the LDC provisions of Subpart F were ineffective. They did nothing to encourage the reinvestment in less developed countries of income generated by activities in developed countries.[51]

Those arguing that there should be less favorable treatment of foreign investment contended that "the least justifiable aspect of United States taxation of foreign income is the exemption from taxation of foreign subsidiaries, as entities separate from their United States parents."[52] They argued that deferral violated the concept of neutrality because it allowed expansion of foreign operations through reinvestment of untaxed earnings not allowed domestic operations. They again proposed the complete elimination of the deferral privilege. They also requested the repeal of the foreign tax credit, and the substitution of a deduction against income as any other cost of doing business is allowed.[53]

Immediately after the Treasury made its suggestions for changes in the taxation of foreign operations, President Nixon appointed a task force to study the entire area of business taxation. The report of that task force was issued in December of 1970[54] and, as part of its investigation into the taxation of foreign income, the task force stated as its premise that it is of vital importance that American business maintain and, if possible improve its position in international trade; and that changes should be made in the code to reduce the unnecessary tax obstacles to American business in selling goods or services in foreign markets. The territorial approach was discussed at length but rejected as a viable approach. Although the result would be a simplification for those engaged in foreign trade, the approach would result in income from foreign direct investment being taxed at rates lower than the U.S. rate, or not being taxed at all. It was believed that this would encourage the moving of business operations from the U.S. to foreign locations.

The task force did recommend a step toward the territorial approach by recommending that income earned in relatively high income tax countries be exempt from tax. They pointed out that the revenue loss would be slight because the foreign tax credit substantially offsets the

U.S. tax. It was proposed that if the effective tax rate of a given country was at least 75% of the highest statutory rate for domestic corporations, then that country would be designated as a full tax country and firms operating in those countries would enjoy exemption from U. S. taxation.[55]

Consideration was also given to a proposal concerning the complete elimination of the deferral privilege. The task force felt that this would constitute an undue extension of the tax jurisdiction of the United States. Their main argument was once again along the lines that business would be operating at a competitive disadvantage.[56]

The task force also had some recommendations for revisions to Subpart F. The report suggested that Subpart F only apply when there was an unreasonable accumulation of funds beyond the reasonable present and anticipated needs of a business. They suggested that Section 954 be applied only when FBCI was received from related parties. As the law was written, it could apply to situations where the parties were not related.[57]

The report strongly recommended the elimination of Section 951 (A) (1) (B) relating to the taxation of the increase in earnings invested in the United States. They argued that this tended to encourage the retention and investment of funds outside the United States which would appear to be detrimental to the U. S. balance of payments.[58]

The task force also supported the DISC proposal of the Treasury. The report quoted from the Assistant Secretary of the Treasury for tax policy's presentation before the Senate Finance Committee earlier in the year. He had said:

> . . .we make this recommendation because the U. S. tax system presently results in an income tax disadvantage to U.S. export sales as contrasted with foreign production by subsidiaries of U.S. companies, or by foreign owned companies. At a time when the U.S. is making every effort to improve its balance of trade, this disadvantage should be removed.
>
> The DISC proposal provides for deferral of U. S. tax for a domestic corporation engaged in export sales similar to that presently provided for foreign manufacturing subsidiaries of U. S. companies.[59]

To qualify as a DISC, the corporation would have to derive at least 95% of its gross receipts from export sales activities and from qualified export assets, and have a minimum capitalization of $2500 with one class of stock. The corporation would have to elect to be taxed as a DISC. It was hoped that the DISC provisions would bring back home the firms that have gone overseas to manufacture and sell their product. If the operation could be carried on in the United States then this would improve both the export situation and the balance of payments problem.[60]

Although the task force had made some recommendations concerning other areas of foreign taxation, they are not directly related to this study.

As a result of all the activity in 1970, some interesting proposals were made to the Ways and Means Committee in 1971. One such proposal was the Burke-Hartke

Bill.[61] In attempting to provide equity in the tax laws, this bill provided that a United States corporation which owned ten percent or more of the stock of a CFC would be taxed each year on its prorata share of the undistributed earnings of the corporation. The bill defined a CFC as one that was at least 50 percent owned by one or more U.S. shareholders. At that time the bill received wide spread support by labor since it was their feeling that the measure would remove the incentive to establish production abroad and therefore slow the export of U. S. jobs.

Another proposal made to the committee was the DISC provisions. They were presented on the same argument, that the provisions would provide the incentive to bring manufacturing back home and therefore stop the exporting of jobs overseas. This was the only proposal which made it into law in 1971.[62]

The year 1972 was relatively uneventful, but early in 1973, the House Ways and Means Committee[63] called for a panel discussion to be held on the subject of general tax reform with public hearings to be held immediately after the panel discussions.[64] The panel on the taxation of foreign income was held on February 28, 1973 and included both practitioners and academicians. All of the old arguments were presented such as the balance of payments question. The argument between equality and neutrality, and the pros and cons of the elimination of the deferral privilege. There were no new issues, and each panelist defended their position as the Treasury and the public had done in 1961-1962.

Much of the testimony before the committee concerned the Corman Bill,[65] which was in the House Ways and Means Committee during this time. The Corman Bill was almost a carbon copy of the Burke-Hartke Bill of 1971. However, Corman's bill went one step further and would tax an individual shareholder as well as a corporate shareholder.

Immediately after the hearings were concluded, the Treasury submitted some proposals to the House Ways and Means Committee. Among the foreign measures, the Treasury asked for an extension of Subpart F to "foreign tax haven manufacturing corporation."[66] Under this proposal, the earnings of a CFC would be taxed currently to its U.S. shareholders if more than 10 percent of its tangible assets is used in manufacturing or processing, and if it meets either of two alternative tests designed to identify "tax holiday" corporations or "runaway plant" corporations.

A "tax holiday" corporation was defined as one in which new investment, or additional investment exceeding 20 percent of existing investment, is made in manufacturing or processing facilities during a period in which a tax holiday, or other significant tax incentive was in effect. Foreign tax incentives would be determined by Treasury regulations and might include in addition to tax holidays, grants, reinvestment reserve deductions, or extra ordinary depreciation allowances. Where the tests were met, deferral would be lost for all future years.[67]

A "runaway plant" corporation was defined as one in which new or additional investment is made, which is subject to an effective foreign tax rate less than 80 percent of the United States rate which is 38.4 percent, and which derives 25 percent or more of its gross receipts from the manufacture or processing of property sold for use or consumption in the United States. These tests would be applied on an annual basis, to determine whether the United States shareholders would be taxed currently.[68]

The Treasury's proposals were attacked in the hearings both by labor and by business. The forces of labor were now becoming quite concerned over the MNC and how the world wide corporations were exporting jobs away from home and increasing the unemployment problem. The public witnesses for business were not empathic with labor's point. They testified that business did not go overseas because of labor and that they were not exporting jobs. There were several studies presented which supported business's testimony.

One such study by the Department of Commerce of 298 MNC, conducted for the period 1966 to 1970, suggested that multinationals have helped rather than hindered the growth of domestic employment. The study showed that while overall U.S. private sector employment grew 1.8 percent a year during this period., domestic employment attributed to MNCs grew to 2.7 percent a year.[69]

In addition, in 1973 the U.S. Tariff Commission found that MNCs create an annual net gain in U.S. employment of about one half million jobs. This study concluded that only on unrealistic assumptions can it be said that MNC operations cause a reduction in total U.S. employment.[70]

In 1973 the U. S. Conference Board prepared a study for the Department of Commerce on reasons why companies invest abroad. Businessmen were interviewed in seventy six companies and the results are presented below:[71]

Reason for Foreign Investment	Mentioned by Number of Companies
Maintain or Increase Market Share Locally	33
Unable to Reach Market from U.S. because of Tariffs, Transportation Costs, or Nationalistic Purchasing Policy	25
To Meet Competition	20
To Meet Local Content Requirements and Host Government Pressure	18
Faster Sales Growth than in U.S.	15
To Obtain or use Local Raw Materials or Components	13
Low Wage Costs	13
Greater Profit Prospects	11
To Follow Major Customers	10

Note that both low cost labor and tax incentives (investment promotion programs) were not a highly rated reason for going abroad.

None of the measures which were proposed in 1973 were passed into law in that year or the next. In 1974 there were several studies conducted on the question as to what the policy of the United States should be toward the MNC. The three studies that were most discussed were conducted by the Department of Commerce, the Department of Labor, and the United Nations. The Department of Commerce came out in favor the MNC and related tax incentives which are needed to strengthen the United States position in the world markets. The Department of Labor, on the other hand, was still concerned that the MNC was exporting U. S. jobs and was definitely against any incentives. They called for the elimination of the deferral concept as a major step in the repatriation of jobs. The United Nations study took more or less the middle position.

The major suggestions that were made during the years 1970 to 1974 were incorporated into the 1974 Tax Reform Bill.[72] The measure called for the elimination of the minimum distributions provisions of Subpart F (Section 963), the elimintion of the provision which allowed CFCs to invest their FPHC income in LDCs without activating Subpart

F, the elimination of the exclusion of shipping income from Section 954, and the restriction of the definition of the U.S. property under Section 956. However, since the major concern of Congress during 1974 was to somehow solve or at least lessen, the energy problem, more emphasis was placed on energy measures and the foreign provisions were eliminated from the legislation.

Within the next two years, all of the foreign provisions which were eliminated from the Tax Reform Act of 1974 became law. The Tax Reduction Act of 1975[73] made a number of the changes. It eliminated the minimum distribution allowance, therefore repealing Section 963 of the Revenue Code. The 1975 act also eliminated the shipping income exclusion from Section 954, and the provisions from 953 which allowed a CFC to exclude from Subpart F income any FPHC income which was invested in qualified investments in LDCs.[74]

The 1975 act also created a number of taxable CFCs when it changed the 30-70 escape clause. The law used to allow a CFC with less than 30 percent of its income classified as Subpart F income to escape Subpart F taxation. The law was now changed so that a CFC could escape only where their Subpart F income was less than ten percent of its total income.[75]

The Tax Reform Act of 1976[76] included the remaining important change, when it amended Section 956. Since 1971, arguments had been presented which favored expanding the types of U. S. property that could be considered investments for CFCs. The Tax Act of 1976 allowed portfolio investments in stock and obligations of U.S. corporations, as long as that corporation was not a shareholder of the CFC, and as long as stock in that corporation is not owned by the CFC to an extent greater than 25%.[77]

The Tax Reform Act also corrected a hardship which had resulted when the Act of 1975 began taxing shipping income. The act inadvertently taxed shipping income earned from transactions between two points within the country of incorporation, which had not been the intent of Congress.[78]

Since the passage of the Reform Act of 1976, the relevant tax code sections have for the most part remained in status quo. President Ford had appointed a task force to study five areas involving the taxation of foreign source income. This task force "decided not to make any recommendations to change the law with respect to the tax treatment of deferred earnings of foreign corporations controlled by U. S. shareholders."

In 1978 President Carter in presenting his tax program for the year, called for the complete elimination of the deferral privilege. The President recommended that the privilege be withdrawn over a three year period. "At least one-third of a foreign subsidiary's earnings will be taxed to the U. S. parents in 1979, at least two-thirds in 1980, and all the subsidiary's earnings after 1980."[79] In presenting the President's tax program to the House Ways and

Means Committee, Secretary of the Treasury, Michael Blumenthal claimed that the fundamental problem with the current law was that:

> . . .it makes tax consequences of foreign investment depend upon the form of an investment, rather than its substance, deferral is an artificial concept that causes the taxation of U. S. taxpayers to depend upon whether a foreign corporate charter has been placed as a screen between the foreign income and the U. S. taxpayer.

Blumenthal continued by saying:

> . . .you will undoubtedly hear some persons argue that the termination of deferral will cause U. S. multinationals to loose their competitive postion in world markets. The vast majority of investment is made in response to real market forces rather than the lure of the deferral preference. and consequently, when deferral is terminated, these overseas investments will continue to be made--and to be competitive--because they are governed not by tax consequences but by basic investment factors such as large and growing markets overseas, high consumer incomes, and a substantial demand for U. S. products.
>
> In short the primary impact of deferral is to grant a tax preference to firms doing what prudent business judgement would dictate in the absence of deferral--investing in profitable foreign markets. There is no sound reason to continue this preference.[80]

This measure also failed to be included in the Tax Reform Act of 1978. The program of President Carter sounded much the same as the words of President John F. Kennedy in 1961 when he called for the complete elimination for the deferral privilege.[81]

Sections 951 through 964 have remained intact for the most part in the eighteen years since it was enacted despite the numerous attacks on it from both sides, with the administration attempting to expand the elimination of the deferral concept, and the taxpayer attempting to expand the deferral. Many of the escape clauses have been tightened or eliminated because of abuses made to them by the taxpayer. More CFCs are identified in 1980 than in 1962 because of the change in the 30/70% escape clause being reduced to 10/70%. The CFC no longer can defer the recognition of Subpart F income because of investment of such income in less developed countries. The minimum distribution clause which caused so much trouble on the floor of each house during debate is now eliminated, not being available since 1975. The Tax Reform Act of 1976 did expand the type of U. S. property that a CFC may invest in without triggering Section 956, but investment in the U. S. corporation which owns the CFC is still off limits and will remain to be so. To allow that type of investment would be the same as allowing tax-free dividends to be paid by the foreign subsidiary to its U. S. owner.

Chapter four will present a numerical study demonstrating the effect of the changes that have taken place during the 20th century regarding the taxation of the CFC. It will show the effect that the changes had on a MNC operating both an operating company and a sales company overseas. The effect of the change will be demonstrated by comparing the overall tax rates for the MNC both before and after the change.

CHAPTER III FOOTNOTES

[1]Act of August 16, 1954, ch. 736, 68 Stat. 1, Amended through 1962.

[2]Act of October 16, 1962, 76 Stat. 834, sec. 12.

[3]John E. Dowdle, Jr., "Can Domestic Shareholders be Taxed on Foreign Corporate Earning Prior to Distribution?", _The Tax Magazine_, June 1962, p.136.

[4]U. S. Congress, House, _Our Federal Tax System_, H. Doc. 140, 87th Cong., 1st sess., p. 147.

[5]U.S. Const. art VI, clause 2.

[6]Richard J. Horwich, "The Constitutionality of Subpart F of the Internal Revenue Code," _University of Miami Law Review_, vol. XIX, 1965, p. 412.

[7]Eisner V. Macomber, 1 USTC P. 32,252 U. S. 189.

[8]Ibid.

[9]Helvering v. Bruun, 309 U. S. 461 (1940).

[10]See for instance Helvering v. Griffiths, 318 U. S. 371 (1942).

[11]Estate of Leonard E. Whitlock v. Commissioner, 59TC 490 (1973), Rev'd 494 F.2D 1297 (10th Cir.), 95 Sup. Ct. 69 (1974).

[12]Eisner v. Macomber, 1 USTC P. 32,252 U. S. 189.

[13]Albert and Charolette Dougherty v. Commissioner, 60 TC 917 (1973), See also related case 61 TC 719 (1961).

[14]Whitlock v. Commissioner.

[15]Garlock, Inc. v. Commissioner, 58 TC 423 (1972), 489 F. 2nd. 197 (2D, Cir. 1973).

[16]U.S. Congress, House, _Report of Ways and Means Committee to Accompany HR 10650_, H. Rept. 1447, 87th Cong., 2nd sess.

[17]U.S. Congress, Senate, _Report of Senate Finance Committee to Accompany HR 10650_, S. Rept. 1881, 87th Cong., 2nd sess.

[18]See Note 11

[19]Carnation Co. v. Commissioner, 71 TC 400 (Pending 9th Cir.) (1978).

[20]See Note 19.

[21]Helvering v. Le Gierse, 312 U. S. 531 (1941).

[22]See Note 20.

[23]David Fischbein and David Fischbein Mfg. Co. v. Commissioner 59 TC 338 (1972).

[24]Danial K. and Gertrude V. Ludwig v. Commissioner, 68 TC 979 (1977).

[25]Ibid.

[26]See Note 15.

[27]Kraus et.al. v. Commissioner, 59 TC 681 (1973), 490 F. 2D 898 (2nd Cir) 1974).

[28]Koehring Co. v. U. S. (DC Wis. 1977) 40 Aftr 2D. 77-5213, 433 F. Supp. 929, (7th Cir,) (1978).

[29]Controls Co. of America (CCA) v. Commissioner, 64 TC 137.

[30]See Note 27.

[31]Set Note 28.

[32]See Note 29.

[33]See Note 13.

[34]Robin Haft Trust et. al. v. Commissioner, 61 TC 398, 62 TC 145.

[35]Hewlett-Packard Co. v. Commissioner, 67 TC 736, (1977).

[36]Ibid.

[37]Act of October 16, 1962.

[38]Act of September 2, 1964, pub. 563, 80 Stat. 809.

[39]Act of November13,1966,pub. 809, 80 Stat. 1539.

[40]U.S. President, Executive Order 11387, Federal Register 33, no. 47 (1968).

[41]Act of December 30, 1969, pub. 172, 83 Stat. 487.

[42]Ibid.

[43]Louis M. Kauder, "Tax Legislation and the Regulations Affecting Foreign Trade and Investment: Recent Changes and Current Problems," The Houston Law Review, vol. 18, 1/71, p. 500.

[44]Edwin S. Cohen, "Treasury Outlines the Shape PF Future Reform for Foreign Source Income," The Journal of Taxation, Feb. 1970, p. 98.

[45]Ibid., p. 100.

[46]Ibid., p. 98.

[47]Ibid.

[48]Ibid., pp. 99-100.

[49]Stanley S. Surrey, "Changes in U. S. Taxation of Business Abroad: The Possible Alternatives," The Journal of Taxation, May 1970, pp. 312-316.

[50]Ibid.

[51]Ibid.

[52]Ibid.

[53]Ibid.

[54]Kenneth S. Reames, "Taxation of Foreign Business Income: Task Force Recommendations," The Tax Adviser, June 1971, pp. 332-336.

[55]Ibid., p. 332.

[56]Ibid., p. 332.

[57]Ibid., p. 334.

[58]Ibid.

[59]Ibid.

[60]Ibid.

[61]HR 10914, 92nd. Cong., 1st. sess.

[62]Act of December10,1971,pub. 178, 85 Stat. 178.

[63]U.S. Congress, House, Ways and Means Committee, Summary of Testimony of Panelists on Tax Reform Topics.

[64]U.S. Congress, House, Ways and Mean Committee, Public Hearings on Subject of General Tax Reform, 93rd. Cong., 1st. sess., parts 4, 10, 11, 12.

[65]Ibid.

[66]Thomas E. Jenks, "Taxation of Foreign Income," George Washington Law Review, vol. 42, pp. 544-546.

[67]Ibid.

[68]Ibid.

[69]Joel M. Forester, "Tax Reform--Foreign Income," Journal of Accountancy, November, 1975, p. 40.

[70]Ibid.

[71]Ibid.

[72]Marianne Burge, "Current Trends in the Taxation of Multinational Enterprises," Taxes the Tax Magazine, December 1974, p. 752-753.

[73]Act of March 29, 1975,pub. 12,89 Stat. 518.

[74]_______________, "The Effects of the 1975 Tax Reduction Act on the Taxation of Subpart F Income," Notes: Vanderbuilt Journal of Transnational Law, vol. 9:377, Spring 1976, pp. 386-390.

[75]Ibid.

[76]Act of August 6, 1976,pub. 455, 90 Stat. 1525.

[77]Ibid., section 956 (B) (2) (G).

[78]Ibid., section 954.

[79]U.S. Congress, House, Ways and Means Committee, The President's 1978 Tax Program, p.33.

[80]Ibid. p. 33 and 34.

[81]U.S. Congress, House, Our Federal Tax System, H. Doc. 140, pp. 146-148.

Chapter IV

THE EFFECT OF CHANGES IN THE TAXATION OF INCOME OF FOREIGN SUBSIDIARIES OF A U. S. CORPORATION

An analysis of the effect of various changes that have been made in the area of the taxation of the foreign corporation which has U. S. owners is presented in this chapter. The effects are demonstrated by comparing the overall tax rates for a model of a domestic corporation and its overseas subsidiaries both before and after the various changes. A three-way analysis will be presented by assuming a range of rates. First, the tax rate in the foreign country will be presented as equal to that of the United States; second, the foreign tax rate will be less than the U. S. rate; and, third, the foreign rate will be greater than the U. S. rate. Within this three-way analysis, the combined tax rates will be shown under two assumptions; a zero dividend payout, and a 100 percent payout. In this manner, the effect of the withholding of dividend distributions may be shown most effectively, by presenting the reader with the effect on a range of tax rates.

To demonstrate the effects of these legislative changes on a firm operating in the international arena, a model of a hypothetical company will be utilized. This is necessary to have some control at a particular point in time over the type of income present, the foreign tax rates in effect, and the country in which the subsidiary is operating. Assuming a range of foreign tax rates relative to the U. S. rate, and a dividend policy ranging from zero to 100% allows the reader to see the effect that dividend policy and the foreign tax rate has on overall tax rates for a corporate group. These assumptions also allow for any given change in the tax code to show its effect on possible managerial decisions.

The U.S. tax rates assumed will approximate the actual tax rates in effect at the time the change became operative, while the foreign tax rates will all be assumed and may have no relationship to the actual rates in effect in a given country at a given point in time.

The hypothetical firm will have the following characteristics:

1. It is a U.S. corporation entitled 'Domestic' whose common stock is widely held with no one stockholder owning more than 10% of the outstanding stock. The firm handles the manufacturing and distributing of the product for all countries in the western hemisphere. 'Domestic' does not sell directly or indirectly to any of its affiliates outside the western hemisphere.

'Domestic' has an overseas operating subsidiary entitled 'overseas' which manufactures and distributes the company's product outside the western hemisphere. None of the foreign income is earned or considered to be earned from U. S. sources, and 'overseas' does not sell its product outside the border of the country in which it operates.

3. 'Domestic' has a sales company organized in a different country from 'Overseas', entitled 'Sales'. This company handles the transactions for the product produced by 'Overseas' outside the country of manufacture, which includes the rest of the free world. Although some sales are made to the Orient and to the countries in Africa, the majority of the sales are made in close geographical proximity to the country in which 'Sales' is located.

4. All of these affiliates of 'Domestic' are wholly-owned subsidiaries which are organized under the laws of the country where located, and all the subsidiaries are subject to the tax laws of their respective countries.

5. For each change in the tax code, effective overall tax rates will be computed assuming a dividend pay out policy ranging from zero to 100 percent. In addition, effective tax rates will be computed for a high tax country, which is defined as one that has a tax rate that is double that of the U.S. rate, and a low tax country, which is defined as one that has a tax rate that is half that of the U. S. rate. The number of percentage points above or below the U. S. statutory rate is not significant, only the fact that the rate is different from that of the U. S. is important.

6. The tax liability and tax rates in the examples to follow are based upon the assumption of $100,000 of taxable income for each firm.

This chapter is subdivided according to the major changes effecting the development of the taxation of a controlled foreign corporation.

Adoption of the First Tax Law Under the Sixteenth Amendment

Revenue Act of 1913

In 1913 Congress incorporated the deferral privilege into the tax law by integrating the territorial approach into the taxation of income earned by entities outside the jurisdiction of the United States. By so doing, none of the earnings of the subsidiaries of 'Domestic' would be subject to the Federal Income Tax until those earnings were remitted in the form of dividends to 'Domestic'. The tax rate in effect in 1913 in the United States for corporations was 1%. In Table 1, on page 98, the individual and combined tax liabilities as well as the overall tax rates are presented for the three corporations.

Section I in Table I presents the individual and combined liabilities under the assumption that the domestic tax rate is 1% and the foreign tax rates are equal to those of the United States. The overall tax rate of 1% under an assumed zero dividend payout policy demonstrates the effect of the territorial approach. With the earnings of 'Overseas' and 'Sales' not taxable to 'Domestic', each firm

TABLE I

Tax Liabilities and Overall Rates Incurred by 'Domestic' and its Overseas Subsidiaries as a Result of the Revenue Act of 1913 (Assume Each Company Has $100,000 of Taxable Income)

	Assumed Dividend Payout Percentage	
	0%	100%
	Income Taxes Paid	Income Taxes Paid
Section I		
Assuming A Foreign Tax Rate Equal to the U.S. Rate of 1%		
'Sales'	$ 1,000	$ 1,000
'Overseas'	1,000	1,000
'Domestic'	1,000	2,980 (A)
Combined Tax Liability	3,000	4,980
Overall Tax Rate	1%	1.7%
Section II		
Assuming A Foreign Tax Rate of 1/2%		
'Sales'	500	500
'Overseas'	500	500
'Domestic'	1,000	2,990 (B)
Combined Tax Liability	2,000	3,990
Overall Tax Rate	.7%	1.3%
Section III		
Assuming A Foreign Tax Rate of 1 1/2%		
'Sales'	1,500	1,500
'Overseas'	1,500	1,500
'Domestic'	1,000	2,970 (C)
Combined Tax Liability	4,000	5,970
Overall Rax Tate	1.3%	2%

Notes:
(A) 1%($100,000+(2($99,000))); (B) 1%($100,000+(2($99,500)));
(C) 1%($100,000+(2($98,500))).

would pay 1% of earnings to their respective country, where it is assumed that each firm had taxable income of $100,00. Each would pay $1,000 in tax and have after tax earnings of $99,000. A total of $3,000 would be paid in tax on a total income of $300,000, a overall tax rate of 1%.

However, where it is assumed that the foreign subsidiaries would distribute 100% of their earnings in dividends to 'Domestic', then 'Domestic's taxable income would be $298,000 and their tax liability would amount to $2,980. With each of the subsidiaries required to pay their respective governments $1,000, the total tax on combined earnings of $300,000 would amount to $4,980, or an overall rate of 1.7%, a rate equal to 170% of the maximum U. S. rate. This illustrates the double taxation effect that was inherent in the 1913 Revenue Act.

Section II of Table I, assumes that the foreign subsidiaries are operating in a country with low tax rates, illustrating that the effective rate can be reduced substantially with a zero or very low dividend policy. However, a maximum or very high dividend policy could offset the low tax rates by increasing the overall tax rate to 1.3% which was above the statutory U. S. rate of 1%.

A firm with subsidiaries operating in high tax countries, as in Section III, of Table I, would support a tax rate that was above the maximum, whether dividends were distributed or not. Table I demonstrates that from the very beginning, a domestic corporation was rewarded in terms of tax liability, where dividend payments were withheld. The maximum overall tax rate was equal to or less than the statutory rate in the United States where the subsidiaries were located in a country which did not have a tax rate higher than that of the United States. However, a firm that withheld dividend payments paid a lower overall tax than the firm that distributed its foreign earnings to its U. S. parent under the Revenue Act of 1913 no matter how high or low the foreign tax rate.

Adoption of the Foreign Tax Credit
Revenue Act of 1918

In 1918 Congress enacted the legislation creating the foreign tax credit which allowed a domestic corporation with foreign subsidiaries to take a credit against their U. S. tax for foreign taxes deemed paid. The credit was allowed for foreign income taxes paid on income which was currently taxable under U.S. law. However, the credit was limited to the foreign tax rate applied to the income included for U.S. purposes if that rate was less than that of the United States. Where the foreign tax rate was above that of the United States, the credit was limited to the U. S. statutory rate applied to the foreign income recognized. Using the 8% rate which was in effect in the United States in 1918 and the same assumptions concerning the taxable income of each of the corporations, the constructed data appears in Table II, on page 101.

TABLE II

Tax Liabilities and Overall Rates Incurred by 'Domestic' And Its Overseas Subsidiaries as a Result of the Revenue Act of 1918 (Assume Each Company Has $100,000 of Taxable Income)

	Assumed Dividend Payout Percentages	
	0%	100%
	Income Taxes Paid	Income Taxes Paid
Section I		
Assuming A Foreign Tax Rate Equal to the U.S. Rate of 8%		
'Sales'	$ 8,000	$ 8,000
'Overseas'	8,000	8,000
'Domestic'	8,000	8,000(A)
Combined Tax Liability	24,000	24,000
Overall Tax Rate	8%	8%
Section II		
Assuming A Foreign Tax Rate of 4%		
'Sales'	$ 4,000	$ 4,000
'Overseas'	4,000	4,000
'Domestic'	8,000	15,680(B)
Combined Tax Liability	16,000	23,680
Overall Tax Rate	5.3%	7.9%
Section III		
Assuming A Foreign Tax Rate of 12%		
'Sales'	$12,000	$12,000
'Overseas'	12,000	12,000
'Domestic'	8,000	8,000(C)
Combined Tax Liability	32,000	32,000
Overall Tax Rate	10.7%	10.7%

Note:	(A)	(B)	(C)
Gross Tax	$22,720(1)	$23,360(3)	$22,080(5)
Foreign Tax Credit	14,720(2)	7,680(4)	14,080(6)
Net Tax Payable	8,000	15,680	8,000

(1) 8%($284,000); (2) 8%(184,000); (3) 8%($292,000); (4) 4%($192,000); (5) 8%($276,000); (6) 8%($176,000).

In Section I of Table II the effect of the enactment of the foreign tax credit can readily be seen in the overall rate paid by 'Domestic' and its subsidiaries. The fact of whether dividends were paid or not had no effect on the overall rate paid by the corporate group. Under the 100% assumption, 'Domestic' taxable income would be $284,000 [$100,000 + 2($92,000)] and would show a tax liability of $22,720. This would be reduced however, by $14,720 [8%(2 x $92,000)], leaving a net tax payable of $8,000 or the statutory rate applied to the U.S. income of 'Domestic'. Therefore, when operating in a foreign country that has a tax rate which approximates the rate in the United States, the foreign tax credit acts to neutralize the effect of the dividiend policy on the overall tax rate paid by a corporate group.

Where it assumed however, that the subsidiaries are operating in a foreign country which has a tax rate less than that of the United States, withholding dividends will lower the overall tax rate paid. In the case of 'Domestic' and its subsidiaries, under the zero dividend policy assumption, 'Domestic' would have no foreign income and therefore, the foreign tax credit would be inoperable, and the overall rate would be 5.3%. Under the 100% dividend policy, 'Domestic' taxable income would be $292,000 [$100,000 + 2($92,000)] and would show a tax liability of $23,360. This would be reduced by the foreign tax credit of $7,680 [4%(2 x $96,000)], leaving a net tax payable of

$15,680. The credit would be limited to the foreign rate of 4% since to allow a credit equal to the U.S. rate, would allow a credit for taxes which were not paid, therefore, the overall rate would approximate the U. S. statutory rate.

Section III of Table II demonstrates the effect of the upper limit on the foreign tax credit. Under the 100% assumption, 'Domestics' taxable income is $276,000 [$100,000 + 2($88,000)], with a tax liability of $22,080. The foreign tax credit would be limited to an amount based upon the U. S. rate, or $14,080 [8%(2 x $88,000)] and a resulting net tax payable of $8,000. Allowing for a credit equal to the actual foreign taxes paid would result in a foreign tax credit of $21,120 [12%(2 x $88,000)] and a net tax payable of $960. This would result in a statutory tax rate of 1% on the U.S. earned income. Section III again illustrates that where a country has a tax rate equal to or greater then that of the U. S., the foreign tax credit neutralized the effect of dividend policy on the overall tax rate paid by 'Domestic' and its subsidiaries.

Congress, in its legislative enactments, allowed foreign taxes paid to be used as both a deduction in arriving at taxable income and as a credit against the tax to be paid to the U.S. Treasury. It was not until the Tax Reform Act of 1962 that dividends paid by a foreign subsidiary to a U.S. parent had to be 'grossed up' and reported as a before tax distribution.

Adoption of the Foreign Personal Holding Company Provisions Revenue Act of 1937

By 1937 when Congress extended the personal holding company provisions beyond the domestic front to foreign corporations which were more than 50% owned by five or fewer U.S. persons the penalty tax had reached the magnitude of 75%. Both of the subsidiaries of 'Domestic' would qualify as a foreign personal holding company (FPHC) where their income was of the passive type. Therefore, in the given illustration, the 'Overseas' subsidiary would not qualify, but 'Sales' might. With a zero dividend policy, the 'Sales' company with low operating needs, would have accumulated income that would be available for investment. If the subsidiary so chose, that income could have been invested in areas which would produce passive income. If this income reached the point where it amounted to more than 60% of total income in any one year, that income would be taxable to the parent under the FPHC provisions of the Revenue Act of 1937. Under the assumption that this was the case with the 'Sales' subsidiary, the tax liabilities and overall tax rates would be developed as appears in Table III on page 105. The assumptions are the same as in previous years.

By 1937, statutory rate for a corporation had reached 15%. Where it is assumed that 'Sales' qualified as a FPHC and that all its undistributed income was subject to the maximum holding company tax rate of 75%, then the

TABLE III

Tax Liabilities and Overall Rates Incurred by 'Domestic' and Its Overseas Subsidiaries as a Result of the Revenue Act of 1937
(Assume Each Company Has $100,000 of Taxable Income)

	Assumed Dividend Payout Percentage	
	0%	100%
	Income Taxes Paid	Income Taxes Paid
Section I		
Assuming A Foreign Tax Rate Equal to the U.S. Rate of 15%		
'Sales'	$ 15,000	$ 15,000
'Overseas'	15,000	15,000
'Domestic'	78,750 (A)	15,000 (D)
Combined Tax Liability	$108,750	$ 45,000
Overall Tax Rate	36.3%	15%
Section II		
Assuming A Foreign Tax Rate of 7½%		
'Sales'	$ 7,500	$ 7,500
'Overseas'	7,500	7,500
'Domestic'	84,375 (B)	28,875 (E)
Combined Tax Liability	$ 99,375	$ 43,875
Overall Tax Rate	33.1%	14.6%
Section III		
Assuming A Foreign Tax Rate of 22½%		
'Sales'	$ 22,500	$ 22,500
'Overseas'	22,500	22,500
'Domestic'	73,125 (C)	15,000 (F)
Combined Tax Liability	$118,125	$ 60,000
Overall Tax Rate	39.4%	20%

Notes:
(A) $15,000+75%($85,000); (B) $15,000+75%($92,500)
(C) $15,000+75%($77,500)

	(D)	(E)	(F)
Gross Tax	$40,500 (1)	$42,750 (3)	$38,250 (5)
Foreign Tax Credit	25,500 (2)	13,875 (4)	23,250 (6)
Net Tax Payable	$15,000	$28,875	$15,000

(1) 15%($270,000); (2) 15%($170,000); (3) 15%($285,000)
(4) 7½%($185,000); (5) 15%($255,000); (6) 15%($155,000)

overall tax rate paid by 'Domestic' and its subsidiaries would be 36.3%, assuming the zero dividend payout. 'Domestic's' tax liability of $78,750 is the sum of 15% normal tax on 'Domestic's' own $100,000 of taxable income, plus 75% of 'Sales' undistributed income of $85,000. Since the FPHC tax did not apply to income that was distributed, the overall tax rate under the 100% dividend payout assumption would be 15% under the equal tax assumption as is shown in Section I of Table III. The overall tax rates decrease and increase respectively when the lower and higher foreign tax rate assumption is made.

Since the advent of the FPHC provisions caused an increase of more than 100% in the overall tax rate paid by the corporate group, this would imply some changes were needed in the investment policies of 'Sales'. If 'Sales' could not change their method of operation, 'Domestic' would probably choose to distribute a sufficient amount of income each year so as to not trigger the provisions governing the FPHC. It will therefore be assumed in future years that 'Domestic' changed the type of investments that 'Sales' made in order to remove the subsidiary from the FPHC classification.

Adoption of the Western Hemisphere Trade Corporation Provisions (WHTC) Revenue Act of 1941

To lessen the tax burden brought on by World War II, Congress enacted the WHTC provisions in 1942. With the corporate tax rate at 40%, firms operating in the international market were at a competitive disadvantage with their foreign counterparts. Since the majority of foreign trade at that time was conducted within the western hemisphere, the legislation was not directed to firms operating outside this area. Basically, the legislation granted a 14 point reduction in the rate of tax paid by a WHTC. To qualify, the WHTC must be an active operating company and obtain 95% or more of its gross receipts from sources outside the U. S. but within the western hemisphere. Therefore, 'Overseas' and 'Sales' would not qualify; but, if a large enough portion of 'Domestic's' gross revenue came from sources outside the U. S. but within the western hemisphere, they might create a WHTC to handle their out-of-country sales. Where it is assumed that one half ($50,000) of 'Domestic' sales were generated from transactions with countries in the western hemisphere, then the tax liabilites and rates for 'Domestic' and its subsidiaries would be as is shown in Table IV on page 108.

Note that in Table IV it was assumed that 'Domestic' took advantage of the new statute and organized a WHTC where one-half of its income flowed through the new corporation. Therefore, with a statutory rate of 40% in effect, the tax liability for 'WHTC' would be $13,000 [26%($50,000)], while the tax liability for 'Domestic' would be $20,000 [40%($50,000)].

TABLE IV

Tax Liabilities and Overall Rates Incurred By 'Domestic' And Its Overseas Subsidiaries as a Result of the Revenue Act of 1942 (Assume Each Company Has $100,000 of Taxable Income)

	Assumed Dividend Payout Percentage 0% Income Taxes Paid	Assumed Dividend Payout Percentage 100% Income Taxes Paid
Section I		
Assuming A Foreign Tax Rate Equal to the U.S. Rate of 40%		
'Sales'	$ 40,000	$ 40,000
'Overseas'	40,000	40,000
'Domestic'	20,000	20,000 (B)
'WHTC'	13,000 (A)	13,000
Combined Tax Liability	113,000	113,000
Overall Tax Rate	37.7%	37.7%
Section II		
Assuming A Foreign Tax Rate of 20%		
'Sales'	$ 20,000	$ 20,000
'Overseas'	20,000	20,000
'Domestic'	20,000	52,000 (C)
'WHTC'	13,000 (A)	13,000
Combined Tax Liability	73,000	105,000
Overall Tax Rate	24.3%	35%
Section III		
Assuming A Foreign Tax Rate of 60%		
'Sales'	$ 60,000	$ 60,000
'Overseas'	60,000	60,000
'Domestic'	20,000	20,000 (D)
'WHTC'	13,000 (A)	13,000
Combined Tax Liability	153,000	153,000
Overall Tax Rate	51%	51%

Notes:

(A) 26%($50,000)

	(B)	(C)	(D)
Gross Tax	$68,000(1)	$84,000(3)	$52,000(5)
Foreign Tax Credit	48,000(2)	32,000(4)	32,000(6)
Net Tax Payable	20,000	52,000	20,000

(1) 40%($170,000); (2) 40%($120,000); (3) 40%($210,000); (4) 20%($160,000); (5) 40%($130,000); (6) 40%($80,000).

In Section I of Table IV the overall rate would be reduced to 37.7% in the equal tax assumption, somewhat below the statutory rate. The amount of reduction would depend on the amount of earnings reported by the 'WHTC' in relation to the other affiliates.

While Sections I and III of Table IV demonstrate the neutrality effect of the operation of the foreign tax credit, Section II again shows that dividend policy will have an effect on the overall tax rates if the subsidiaries are located in a low tax country.

There have been many changes to the provisions since 1942, and the Tax Reform Act of 1976 phased out the provisions for the WHTC entirely by 1980. Since the foreign subsidiaries of 'Domestic' did not operate in western hemisphere countries, the legislation had little impact.

In the analysis that follows, the WHTC assumption will be deleted so as to not distort the effect of too many variables on the overall tax rates.

Adoption of Sections 951 to 964
Revenue Act of 1962

Under Sections 951 to 964 of the Internal Revenue Code of 1954, 'Sales' would be considered a Controlled Foreign Corporation, (CFC) and since most of its income is received from the purchase of personal property from a related party outside the country of organization, and for sale in a country other than the one of organization, its income would be considered Subpart F income, and, if undistributed, would have to be included in the current income of its parent company, 'Domestic'. With the minimum distribution rules in effect, any dividend distribution less than 82% would trigger Subpart F income classification. The tax liabilities and overall tax rates for domestic and its subsidiaries would be as shown in Table V on page 111.

The undistributed income of 'Overseas' would not be taxable to 'Domestic' under the Revenue Act of 1962, but 'Domestic' would have to include all $100,000 of 'Sales' undistributed income as Subpart F income. Its total taxable income under the low tax assumption would be $200,000, and with a statutory rate of 52% in effect in 1962, 'Domestic' would show a tax liability of $104,000 reduced by a foreign tax credit of $26,000 [26%($100,000)], resulting in a net tax payable of $78,000. Without the new law in effect, the overall tax rate would have been 34.7% [2($26,000)+$52,000]/$300,000. Therefore, the new legislation helped to eliminate some of the effect of dividend policy on overall tax rates for firms operating in low tax countries but did not eliminate all of it. The overall tax rate is still below the statutory rate when dividends are withheld by the subsidiary operating in a low tax country. In all other assumptions, the tax laws have made the dividend policy neutral in its effect on overall tax rates for firms operating in the foreign market place.

Note that the gross-up provisions are now reflected in the computations for tax liabilites and rates, the effect

TABLE V

Tax Liabilities and Overall Rates Incurred by 'Domestic' And Its Overseas Subsidiaries as a Result of the Revenue Act of 1962 (Assume Each Company Has $100,000 of Taxable Income)

	Assumed Dividend Payout Percentage 0% Income Taxes Paid	Assumed Dividend Payout Percentage 100% Income Taxes Paid
Section I		
Assuming A Foreign Tax Rate Equal to the U.S. Rate of 52%		
'Sales'	$ 52,000	$ 52,000
'Overseas'	52,000	52,000
'Domestic'	52,000(A)	52,000(C)
Combined Tax Liability	156,000	156,000
Overall Tax Liability	52%	52%
Section II		
Assuming A Foreign Tax Rate of 26%		
'Sales'	$ 26,000	$ 26,000
'Overseas'	26,000	26,000
'Domestic'	78,000(B)	104,000(D)
Combined Tax Liability	130,000	156,000
Overall Tax Rate	43.3%	52%
Section III		
Assuming a Foreign Tax Rate of 78%		
'Sales'	$ 78,000	$ 78,000
'Overseas'	78,000	78,000
'Domestic'	52,000(A)	52,000(C)
Combined Tax Liability	208,000	208,000
Overall Tax Rate	69.3%	69.3%

Notes:	(A)	(B)	(C)	(D)
Gross Tax	$104,000(1)	$104,000(3)	$156,000(5)	$156,000(7)
Foreign Tax Credit	52,000(2)	26,000(4)	104,000(6)	52,000(8)
Net Tax Payable	52,000	78,000	52,000	104,000

(1) 52%($200,000); (2) 52%($100,000); (3) 52%($200,000); (4) 26%($100,000)
(5) 52%($300,000); (6) 52%($200,000); (7) 52%($300,000); (8) 26%($200,000)

can be seen in the low tax, 100% figures in Table V. 'Domestics' tax liability of $104,000 was computed on taxable income of $300,000 resulting in a tax liability of $156,000 [52%($300,000)] less a foreign tax credit of $52,000 [26%(2 x $100,000)]. Without the gross-up provisions, 'Domestics' taxable income would have been $248,000 [$100,000 + 2($74,000)], resulting in a tax liability of $128,960 [52%($248,000)], before reduction by a foreign tax credit of $38,480[26%($148,000)], resulting in a net tax payable of $90,480. The gross-up provisions would not affect the net tax payable under the other assumptions since the foreign tax credit increases by an amount equal to the increase in tax liabilty.

Adoption of the Foreign Provisions

Revenue Act of 1969

The Revenue Act of 1969 corrected an inequity in the legislation that was passed in 1962. Congress included as Subpart F income earnings from the sale of personal property purchased from related parties outside the country of organization to related or unrelated parties within the country of organization. The Revenue Act of 1969 corrected this inequity. Since the assumption was made from the very beginning that most of 'Sales' earnings came from sales outside its borders, this provision had little effect on the tax liabilites and overall rates incurred by 'Domestic' and its subsidiaries.

The Revenue Act of 1969 did add an escape clause. A CFC could avoid the Subpart F classification where it could be proven to the commissioner that neither the creation of the CFC nor the transactions giving rise to the foreign base company income had "as one of its significant purposes a substantial reduction of income taxes" since 'Sales' is assumed to be an established company, it might be possible for 'Domestic' to escape Subpart F classification. Were it possible, then the rates and liabilities paid by 'Domestic' and its subsidiaries would be as shown in Table VI on page 114.

By proving that the organization of 'Sales' was not undertaken for tax avoidance measures and taxes were not materially reduced as a result of its organization, 'Domestic' could reduce its overall tax rate to 34.7% under the low tax and zero dividend assumption. Other than in that instance, the changes made in the Revenue Act of 1969 would have no effect on the operation of 'Domestic' and its subsidiaries.

If the assumptions were changed so that less than 30% of 'Sales' income was from sales outside its borders, that Subpart F income was less than 30% of its total income, then 'Domestic' could take advantage of the escape clause under Section 951 and none of 'Sales' undistributed income would be taxable to 'Domestic'. Where this is the case, the results would be identical to those shown in Table VI where

TABLE VI

Tax Liabilities and Overall Rates Incurred by 'Domestic' and Its Overseas Subsidiaries as a Result of the Revenue Act of 1969
(Assume Each Company Has $100,000 of Taxable Income)

	Assumed Dividend Payout Percentage 0% Income Taxes Paid	100% Income Taxes Paid
Section I		
Assuming A Foreign Tax Rate Equal to the U.S. Rate of 52%		
'Sales'	$ 52,000	$ 52,000
'Overseas'	52,000	52,000
'Domestic'	52,000	52,000(A)
Combined Tax Liability	$156,000	$156,000
Overall Tax Rate	52%	52%
Section II		
Assuming A Foreign Tax Rate of 26%		
'Sales'	$ 26,000	$ 26,000
'Overseas'	26,000	26,000
'Domestic'	52,000	104,000(B)
Combined Tax Liability	$104,000	$156,000
Overall Tax Rate	34.7%	52%
Section III		
Assuming A Foreign Tax Rate of 78%		
'Sales'	$ 78,000	$ 78,000
'Overseas'	78,000	78,000
'Domestic'	52,000	52,000(A)
Combined Tax Liability	$208,000	$208,000
Overall Tax Rate	69.3%	69.3%

Notes:

	(A)	(B)
Gross Tax	$156,000(1)	$156,000(3)
Foreign Tax Credit	104,000(2)	52,000(4)
Net Tax Payable	$ 52,000	$104,000

(1) 52%($300,000); (2) 52%($200,000); (3) 52%($300,000)
(4) 26%($200,000)

it was assumed that 'Domestic' was able to prove that 'Sales' was not organized for tax avoidance measures.

Adoption of the Foreign Provisions

Revenue Act of 1975

The Revenue Act of 1975 made the following changes to the statutes in Sections 951 to 964 of the code:

1. The minimum distribution provisions were eliminated from Section 963.
2. The shipping income exclusion was eliminated from Section 954.
3. The Provisions which allowed FPHCI invested in LDC's to be excluded from Subpart F income were eliminated.
4. The escape clause which exempted a firm with less than 30 percent of its gross income classified as Subpart F was changed to 10%.

Although the Revenue Act of 1975 made many changes which led to the creation of many more taxable CFCs, the changes wuld not affect 'Domestic' and its subsidiaries. It has been assumed from the beginning that as 'Sales' was identified as a CFC with Subpart F income, all of its undistributed income was taxable to 'Domestic'. Since 100% of its income was considered taxable, the above changes would not affect the classification of 'Sales'. 'Overseas' makes no sales outside the boundary of its country of organization, therefore, none of the above changes would affect the tax structure of 'Overseas'.

The statutory corporate rate was decreased from 52% to 48% by 1975. The affect on 'Domestic' and its subsidiaries would be to reduce the overall rate to 48% under the equal tax assumption, lower the overall rate under the zero dividend policy low tax country assumption from 43.3% to 40%, while under the 100% assumption, the overall rate would be reduced to the statutory rate of 48%. Under the high tax country assumption, the overall rates would be 64% under both dividend policies since the tax laws have neutralized dividend policy in all but low tax country subsidiaries.

Adoption of the Foreign Provisions

Revenue Act of 1976

While the Revenue Act of 1975 was, taxwise, a disaster to some firms operating internationally, the Revenue Act of 1976 had the opposite effect. Under Section 956, most investments of foreign profits in U.S. property triggered Subpart F treatment, because it was assumed to be a dividend. Investment of any kind in securities of domestic corporations was included in the classification 'U. S. property'. The Revenue Act of 1976 removed the section dealing with investment in securities of U. S. firms and now allows these investments unless it amounts to more than 25% of the outstanding common stock, or unless the investment is made in the corporation which controls the foreign subsidiary. Therefore, it will now be assumed that 'Sales' made qualified investments in U. S. corporations under the zero dividend payout assumption which would qualify 'Domestic' to remove 'Sales' income from the Subpart F claasification. With 'Domestic' no longer burdened with Subpart F income, Table VII on page 117 shows the rates and

TABLE VII

Tax Liabilities and Overall Rates Incurred by 'Domestic' and Its Overseas Subsidiaries as a Result of the Revenue Act of 1976 (Assume Each Company Has $100,000 of Taxable Income)

	Assumed Dividend Payout Percentage 0% Income Taxes Paid	Assumed Dividend Payout Percentage 100% Income Taxes Paid
Section I		
Assuming A Foreign Tax Rate Equal to the U.S. Rate of 48%		
'Sales	$ 48,000	$ 48,000
'Overseas'	48,000	48,000
'Domestic'	48,000	48,000(A)
Combined Tax Liability	$144,000	$144,000
Overall Tax Rate	48%	48%
Section II		
Assuming a Foreign Tax Rate of 24%		
'Sales'	$ 24,000	$ 24,000
'Overseas'	24,000	24,000
'Domestic'	48,000	96,000(B)
Combined Tax Liability	$ 96,000	$144,000
Overall Tax Rate	32%	48%
Section III		
Assuming A Foreign Tax Rate of 72%		
'Sales'	$ 72,000	$ 72,000
'Overseas'	72,000	72,000
'Domestic'	48,000	48,000(A)
Combined Tax Liability	$192,000	$192,000
Overall Tax Rate	64%	64%

Notes:	(A)	(B)
Gross Tax	$144,000(1)	$144,000(3)
Foreign Tax Credit	96,000(2)	48,000(4)
Net Tax Payable	$ 48,000	$ 96,000

(1) 48%($300,000); (2) 48%($200,000); (3) 48%($300,000); (4) 24%($200,000)

liabilites for domestic and its subsidiaries under the above assumptions. The maximum rate in 1976 remained unchanged at 48%.

Table VII demonstrates the effect of the 1976 change in defining investment in U. S. property. If 'Sales' distributes a dividend to 'Domestic', the distribution will be taxable resulting in an overall rate under the low tax country assumption of 48%. On the other hand, if 'Sales' would withhold the payment of dividends, and instead, invest their earnings in securities of a U. S. corporation other than 'Domestic', then the overall rate would be reduced by 16 points to 32%. The rates in the other assumptions would remain unchanged because of the operation of the foreign tax credit.

There were other changes made to Sections 951 through 964 in the Revenue Act of 1976 but they would not affect 'Domestic' and its subsidiaries. The exclusions for shipping income which became part of Subpart F under the Revenue Act of 1975 were broadened, allowable investments made by foreign insurance companies were expanded, and the foreign tax credit was allowed on an expanded basis for third-tier CFCs.

There have been no further changes made to Sections 951 through 964 of the code through 1980. There was some activity in 1978 toward complete elimination of the deferral privilege, but it met with defeat.

If the deferral privilege is ever eliminated in its entirety, only then will tax law achieve complete neutrality in dividend policy and its effect on overall tax rates for domestic corporations operating in the international arena.

In summary, Tables I through VII demonstrated that in all instances where a U.S. corporation is operating a subsidiary in a foreign country with a tax rate lower than that of the U.S., the dividend policy of the firm will have an effect on the overall tax rate paid by the corporate group.

Chapter V

SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS FOR FURTHER RESEARCH

Summary

This study was an investigation into the area of the taxation of undistributed income and the effect that this taxation had upon the enactment of the statutes identifying the controlled foreign corporation. In Chapter II, the taxation of undistributed earnings was traced from 1913 through 1953. Then the taxation of the foreign corporation which was controlled by U.S. owners was traced during the same period. The events during the 1950's were then analyzed, which led to the passing of legislation which was the antithesis of the point of the discussion during the 1950's. That legislation is found in Sections 951 to 964 of the Internal Revenue Code of 1954 amended through 1962.

Chapter III was divided into three parts. The first part was a summary of the legislation passed in 1962 which identified the CFC. The second section of Chapter III reviews the courts' interpretation of the intent of Congress in enacting the legislation. The final section of Chapter III traced the changes to Sections 951 to 964 of the code during the period 1963 through 1980.

Chapter IV showed the effect of the various changes made in the taxation of a domestic firm operating in the international arena. A hypothetical firm was utilized in order to have the flexibility to change the type of income, the foreign tax rates, and the country of operation so that a comparable base was developed which would demonstrate the overall effect of a given change. The effect of the change on the overall tax rate paid by the corporate group was analyzed in terms of the possible affect a change might have on corporate dividend policy.

Conclusions

The Deferral Concept

There have been many attempts made by Congress to reach the undistributed earnings of a corporation. Very few of these attempts have become law and remained as part of the law for any length of time. The personal holding company and the foreign personal holding company provisions have remained the longest, from 1934 and 1937 respectively. These provisions were necessary since taxpayers were using the holding company as a means of avoiding tax on their personal earnings. The CFC provisions of the Revenue Act of 1962 reached the undistributed earnings of some CFCs. It reached income which was being passed from corporation to corporation, and from country to country in order to avoid the payment of U. S. tax. The provisions also taxed purported loans to U. S. parent corporations which were in fact permanent distributions of income.

When Congress passed the undistributed earnings tax in 1936 the measure was designed primarily to increase the revenues of the Federal Government, and secondarily to promote the distribution of dividends. The tax was not designed to stop a particular type of tax avoidance. The effect of the law was to force corporations to distribute needed capital simply to avoid the tax. Since the measure did not stop any particular avenue of tax avoidance, and because the measure had negative results in promoting the economy, it was abandoned in 1939.

On the basis of these findings, it appears that any attempt to eliminate the deferral privilege on a general level will meet with defeat since it would not be designed to stop a tax avoidance scheme. History has supported this conclusion time and time again. Only those measures that are designed to correct a wrongdoing will pass the test of time.

Test of the Legislation

Sections 951 to 964 of the code were tested many times during the period 1962 through 1980. Very few of the cases were found in favor of the taxpayer. Only those cases where tax avoidance was not a factor or where the taxpayer made every attempt to comply with the statutes did the court allow the taxpayers position. Many of the later cases were summarily dismissed based upon precedent cases which had already attempted to test the law.

Since most of the court cases were found in favor of the government, and no change can be specifically traced to the outcome of any particular case, the conclusion can be made that the intent of Congress in passing this legislation was properly interpreted in the court in the period after enactment. This conclusion is further substantiated when the number of cases declined to almost nothing after the initial tests of the law were found in favor of the government.

Effect of Changes on a Multinational Corporation

President Kennedy wanted to see tax policy which was neutral in its effect on managerial decisions. He also wanted to see tax equality in term of like income being taxed at like rates. The deferral privilege does not allow for tax equality however, tax neutrality has become almost a reality when viewed from the point of view of a domestic parent corporation that has a controlled foreign corporation with Subpart F income. Coupled with the operation of the foreign tax credit, the tax statutes in effect at the end of 1980 do allow for neutrality in terms of dividend policy if the CFC is organized in a country with a tax rate which is approximately equal to the U. S. rate or is above the U. S. rate. A domestic parent corportion operating a foreign subsidiary in a country with a tax rate which is less than that of the United States, still is able to affect the overall tax rate paid by the corporate group by its dividend policy.

In order to achieve both neutrality and equality either the deferral privilege must be eliminated in its entirety, or extended to domestic corporations operating through branches in the foreign marketplace. The foreign business corporation which would have extended the deferral privilege to domestic corporations operating internationally failed to be enacted in to law in the late fifties after almost seven years of refining the measure.

If the deferral privilege cannot be extended, and it cannot be eliminated, tax neutrality and tax equality will never be achieved in U. S. tax policy toward international business.

Recommendations for Further Research

An investigation into the historical development of the foreign tax credit is an area of utmost importance to pursue. A vast amount of time has been spent by various administrations making changes to the foreign tax credit provisions which have already been made in the past and reversed when they were found to not produce the desired results. By assembling a historical development of the foreign tax credit, the reasons for these errors of the past might be identified, and thus avoided.

On a macro basis, the time is near for an entire reworking of the Internal Revenue Code. It has been twenty-six years since the current code was written in 1954. An investigation, such as this study, into all major areas of the code would be an invaluable aid to business, Congress, and others who might have an interest in following legislation directed toward rewriting the code.

GLOSSARY OF TERMS

CFC CONTROLLED FOREIGN CORPORATION

Any foreign corporation of which more than 50 percent of the combined voting power of all classes of stock entitled to vote, is owned by United States Shareholders on any day during the taxable year of such corporation.

FBCI FOREIGN BASE COMPANY INCOME

Consists of the sum of: (1) the Foreign Personal Holding Company Income for the taxable year; (2) the Foreign Base Company Service Income; (3) the Foreign Base Company Sales Income; and (4) the Foreign Base Company Shipping Income.

FBCSI FOREIGN BASE COMPANY SALES INCOME

Income (whether profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person, where, (1) the property is acquired outside the country under the laws of which the CFC is created, or (2) the property is sold for use outside such foreign country.

FBCSVI FOREIGN BASE COMPANY SERVICE INCOME

Income derived in connection with the performance of technical, managerial, architectural, scientific, skilled, industrial, commercial, or the like which are performed for or on behalf of a related person and are performed outside the country the laws of which the CFC is created or organized.

FBCSPI FOREIGN BASE COMPANY SHIPPING INCOME

Income derived from, or in connection with the use of an aircraft or vessel in foreign commerce or from or in connection with the performance of services directly related to the use of any such aircraft or vessel, or from the sale, exchange or other disposition of any such aircraft or vessel.

FPHC FOREIGN PERSONAL HOLDING COMPANY

Any foreign corporation if at least 50 percent of its gross income for a taxable year is Foreign Personal Holding Company Income and at least 50 percent in value of its outstanding stock is owned (directly or indirectly) by or for not more than five individuals who are citizens or residents of the United States.

FPHCI FOREIGN PERSONAL HOLDING COMPANY INCOME

That portion of gross income which consists of (1) dividends, (2) stock and securities transactions, (3) commodities transactions, (4) estates and trusts, (5) personal service contracts, (6) use of corporate property by shareholders, and (7) rents.

INCOME FROM THE INSURANCE OF UNITED STATES RISKS

Income which is attributable to the reinsurance or issuing of any insurance or annuity contract in connection with property in or liability arising out of activity in, or connection with the lives or health of residents of the United States.

PRORATA SHARE

The amount which would have been distributed with respect to the stock which such U.S. shareholders own if the CFC would have distributed an amount equal to its subpart F income reduced by an amount actually distributed during the year.

RELATED PERSON

A person is related if: (1) such a person is an individual, partnership, trust or estate controlling the CFC; (2) such a person is a corporation which controls or is controlled by the CFC; or (3) such a person is a corporation which is controlled by the same person or persons which control the CFC.

SUBPART F INCOME

The sum of income derived from the insurance of U.S. risks and FBCI.

TAXATION OF A CFC

If a foreign corporation is a CFC for an uninterupted period of thirty days or more during any taxable year, every person who is a United States shareholder of such a corporation and who owns stock in such corporation on the last day in such year, on which such corporation is a CFC, shall include in his gross income for the year in which the taxable year of the corporation ends, his prorata share of the corporations Subpart F income, the previously excluded Subpart F income withdrawn from investment in less developed countries, the previously excluded Subpart F income withdrawn from foreign base company shipping operations, and, the corporations increase in earnings invested in United States property.

UNITED STATES PERSON

United States persons include a citizen or resident of the United States, a domestic corporation, a domestic partnership, or any domestic estate or trust.

UNITED STATES SHAREHOLDER

A United States person who owns or is considered as owning ten percent or more of the total combined voting power of all classes of stock entitled to vote in a foreign corporation.

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