Part 7

Controlled Foreign Corporations

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Chapter 25
Operation of CFC Rules

§ 25.01. Development of Subpart F and Related Provisions

The United States has developed some detailed rules to combat international tax avoidance by U.S.-based multinational companies and other U.S. taxpayers. Those rules, generally referred to as the subpart F rules, are addressed in this chapter. This section provides a brief history of the development of the anti-avoidance rules and presents a policy framework for evaluating those rules. Section 25.02 describes the operation of subpart F. That section explains how U.S. taxpayers operating through controlled foreign corporations (CFCs) are deemed to have received a dividend equal to their pro rata share of the CFC's "tainted income"— typically the income it has deflected to a tax haven. That section also discusses the many technical terms used throughout subpart F.

"Subpart F income" is a major component of the tainted income subject to current taxation under subpart F. The complex definition of subpart F income is explained in chapter 26. Subpart F income includes various forms of passive investment income and other types of income that are likely to be subject to low foreign taxes. It also includes certain types of business income that has been channeled through a tax haven jurisdiction.

Subpart F requires the U.S. owners of a CFC to pay tax on the untainted income of the CFC that has been repatriated indirectly to the United States through the acquisition of certain property located in the United States or through the sale of stock in a CFC. For example, a U.S. parent corporation receiving a loan from a foreign subsidiary would be taxable under subpart F as if it had received the loan proceeds as a dividend. The rules that impose tax on a disguised repatriation of the untainted income of a CFC and the rules governing the disposition of stock in a foreign corporation are discussed in chapter 27.

The subpart F provisions are not the only Code provisions designed to curtail the use of foreign corporations to avoid taxes. The passive foreign investment company (PFIC) provisions, adopted in 1986, are also an important part of the U.S. defense against international tax avoidance. The PFIC provisions are designed to prevent U.S. investors from obtaining deferral benefits through the use of foreign corporations that avoid CFC status by being widely held.

Prior to the adoption of remedial legislation in 1962, Congress had placed few restrictions on the use of foreign corporations by U.S. taxpayers for tax avoidance purposes. Individuals and corporations subject to the residence jurisdiction of the United States were allowed to defer U.S. taxes on income earned through a corporation organized in a tax haven jurisdiction until that income was repatriated to the United States through payment of dividends. The Revenue Act of 1962 curtailed such tax avoidance by adding sections 951 to 964 to the Code. Those sections, contained in subpart F of part III of subchapter N of chapter 1 of the Code, are commonly referred to as the subpart F provisions. They impose substantial limitations on the ability of U.S. taxpayers to use foreign corporations to defer taxes. Deferral is generally retained, however, for income derived by U.S. taxpayers from normal business activities conducted through foreign corporations under their control.

In enacting subpart F, Congress rejected a proposal of the Kennedy administration for the elimination of tax deferral for most income earned by foreign corporations controlled by U.S. interests. The Kennedy administration's proposal was defended on the ground that it would improve the fairness of the income tax

by subjecting U.S. residents earning income through a foreign corporation to the same tax burdens as otherwise similarly situated persons earning income through a domestic corporation.

An additional major argument made for the Kennedy administration's proposal was that it would promote capital export neutrality. That is, it would eliminate a tax incentive for U.S. residents to make investments in foreign countries rather than in the United States. Representatives of some major labor unions favored an end to deferral because they believed that many investors were being induced by the opportunities for tax savings to make investments in foreign countries that would otherwise have been made in the United States. They feared that such foreign investment would weaken the competitive position of the United States and would reduce the long-term productivity and bargaining position of American workers.

The proposal of the Kennedy administration for an end to deferral was opposed by some commentators and by some U.S. business interests. They asserted that U.S.-based multinationals could compete abroad successfully only if they were subject to the same tax rate on their undistributed foreign profits as their foreign competitors. In their view, the United States should make capital import neutrality rather than capital export neutrality the goal of the U.S. system of international taxation.

A tax jurisdiction achieves capital import neutrality when all taxpayers earning income within that jurisdiction are subject to uniform effective tax rates, imposed without reference to the taxpayer's country of origin. Economic analysis indicates that capital import neutrality is not an appropriate goal for a tax system except on the unrealistic assumption that the demand for capital is fixed both in the capital exporting country and in the capital importing country.[1]

An argument for capital import neutrality with some currency in the business community rests on the premise that profits taxes imposed on a taxpayer are passed on to customers through higher prices for the taxpayer's goods and services. On that premise, the higher U.S. corporate income taxes resulting from an end to deferral would cause goods and services sold by foreign affiliates of U.S.-based multinationals to be more costly, and thus less appealing to customers, than the goods and services sold by competing firms based outside the United States.

The logic of the above argument is fine, but the premise underlying it is dead wrong. There is simply no evidence that a tax on corporate profits typically is passed on to consumers in the form of higher prices. The common view among economists is that the burden of the tax falls primarily on corporate profits in the short run and on business profits generally in the longer run.[2] In the competitive marketplace postulated by the proponents of capital import neutrality, moreover, a profits tax imposed on some but not all competing firms almost certainly would reduce the profits of taxpayers liable for the tax without affecting the price of their goods and services. That is, under competitive conditions, a profits tax imposed by the United States on the foreign affiliates of U.S.-based multinationals is likely to have its intended effect of reducing their after-tax profits. For precisely that reason, the tax is unappealing to U.S.-based multinational companies.

Whatever its merits as a tax policy goal, capital import neutrality cannot be achieved unilaterally by the United States. Other countries may provide subsidies for foreign investment, or they may impose

[1] See Thomas Horst, "A Note on the Optimal Taxation of International Investment Income," 44 Quarterly Journal of Economics 793 (1980).

[2] The higher taxes resulting from an end to deferral might increase the costs of capital for a foreign affiliate of a U.S.-based multinational but only to the extent that those taxes increased the cost of equity capital in the affiliate's country of operation. The costs of borrowed capital generally would not be increased by a profits tax because those costs generally are deductible as interest. Because the corporate tax does not reach all forms of business activity, some commentators believe that some part of the tax may be shifted through competitive forces to all business enterprises. For the classic presentation of this theory, see Arnold C. Harberger, "The Incidence of the Corporate Income Tax," 70 Journal of Political Economy 234 (1962).

discriminatory taxes on U.S. or other investors. The most that the United States could do unilaterally to achieve capital import neutrality would be to exempt all foreign source income from U.S. taxes, whether earned by U.S. residents or by controlled foreign corporations. Congress has not seriously considered the adoption of such a tax regime, nor should it. The effect would be to stimulate various forms of harmful tax competition without any predictable economic or social benefits.

Congress was unwilling to embrace fully the arguments for capital export neutrality, although it recognized that they had some merit. Nor was it prepared to reject the arguments for capital import neutrality that were advanced with great insistence by lobbyists for the multinational companies. It opted instead for a compromise. The 1962 legislation left deferral intact for income earned by foreign corporations from normal business operations. It also allowed deferral to continue with respect to certain foreign operations deemed worthy of a tax incentive.[3] Deferral was eliminated, however, for income from transactions that Congress believed were structured to facilitate tax avoidance. The resulting legislation was exceedingly complex, and it has grown more complex over the years.

Following the example of the United States, several countries, including Canada, Germany, and Japan, adopted legislation in the 1970s and early 1980s that limited the ability of their taxpayers to defer taxes through the use of controlled foreign corporations (CFCs).[4] In subsequent years, many of the remaining major industrial countries and several developing countries adopted anti-tax-haven legislation.[5] The adoption of such legislation by major trading partners of the United States has reduced whatever competitive disadvantage the subpart F provisions may have created for U.S.-based multinationals.

Since 1962, Congress has repeatedly amended the subpart F provisions, usually to close perceived loopholes or to extend current taxation to additional categories of income. A few amendments have been made that narrow the reach of subpart F in an attempt to promote exports.[6] In 1978, the Carter administration revived the proposal of the Kennedy administration for an end to deferral for income earned through a controlled foreign corporation.[7] Congress did not give that proposal serious consideration. A new proposal to end deferral was put on the table for discussion by the House Ways and Means Committee in 1992. In 1993, Congress curtailed deferral on earnings held abroad to earn passive income. That reform was rolled back in 1997.

In 2000, the Clinton Treasury Department issued a lengthy report on subpart F in response to industry charges that the anti-deferral rules had not kept up with the times. The report found that some changes in subpart F are needed to prevent taxpayers from avoiding it, due in part to the use of hybrid entities and the check-the-box regulations. It concluded that an "anti-deferral regime continues to be needed to prevent

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[3] The 1962 legislation retained deferral for certain income earned from business activity in a less developed country and for certain income earned from shipping operations. The exception for income from less developed countries was repealed in 1975. The exception for income from shipping operations was repealed in part in 1975; what was left of the exception was repealed in 1986.

[4] See Brian J. Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Foundation (1986) (describing and analyzing the rules limiting deferral through the use controlled foreign corporations that have been adopted by Canada, France, Germany, Japan, the United Kingdom, and the United States).

[5] Current members of the CFC club, with their date of entry in parenthesis, include: Argentina (1999), Australia (1990), Canada (1972), Denmark (1995), Estonia (2000), Finland (1995), France (1980), Germany (1972), Hungary (1997), Indonesia (1995), Italy (2000), Japan (1978), Mexico (1997), New Zealand (1988), Norway (1990), Portugal (1995), South Africa (1997), South Korea (1997), Spain (1995), Sweden (1990), United States (1962), United Kingdom (1984).

[6] When subpart F was enacted in 1962, a major objective was to impose current tax on export operations channeled through a tax haven. Since 1971, however, Congress has sought to encourage exports through a variety of incentive schemes. Under current law, the vehicle for providing an export incentive is the Extraterritorial Income Exclusion Act of 2000 (ETI). ETI was found to be an illegal trade subsidy by the World Trade Organization and has been repealed.

[7] See Treasury Department, The President's 1978 Tax Program, (1978), pp. 282-297.

significant disparity between the rates of tax on U.S. and foreign income, thereby promoting efficiency, preserving the tax base and promoting equity."[8]

The overarching policy of subpart F seems to be to subject U.S. taxpayers to current tax whenever a significant purpose of earning income through a foreign corporation is the avoidance of U.S. or foreign income taxes.[9] That policy advances the goal of economic efficiency by reducing the tax incentive for choosing foreign investment over domestic investment. It also promotes horizontal equity by equalizing the tax burdens imposed on U.S. taxpayers operating through foreign corporations and on those taxpayers operating through domestic entities. By limiting the reach of subpart F to tax avoidance situations, however, Congress has tolerated an inequality in treatment between those taxpayers subject to current taxation and those taxpayers that continue to be able to defer tax on income earned through a foreign corporation.

Taxation of all foreign corporations controlled by U.S. interests under subpart F, as proposed by the Kennedy and Carter administrations, would reduce the violations of horizontal equity. Even that proposal, however, would continue deferral benefits for those U.S. taxpayers holding shares of a foreign corporation controlled by foreign interests. An expansion of the Kennedy Administration proposal is warranted, therefore, on horizontal equity grounds.

A major reform of the subpart F regime established in the early 1960s is highly desirable. The current regime is conceptually unstable, reflecting an inappropriate compromise between the advocates of full taxation of income earned through a foreign corporation and the proponents of unlimited deferral for such income. It imposes high compliance costs on U.S. taxpayers. The complexity of the regime makes enforcement difficult for the U.S. tax authorities. The adoption of the check-the-box regulations in 1996 has opened up major loopholes. Many of the problems with the current regime can be fixed. In the short run, piecemeal reform of the current system may be the best available option. It is not the best option for the long term.

There are at least three directions that major reform might take. One direction would be backwards, to the pre-1962 world of unfettered international tax avoidance. Advocates of this approach assert that the United States should adopt a "territorial" tax system, by which they mean a system in which the United States relinquishes its jurisdiction to tax based on the residence of the taxpayer. A territorial system is inconsistent with a basic fairness principle of income taxation—that differences in the source of income do not reflect differences in ability to pay. It would promote inefficient investment patterns, as taxpayers avoided sound investment practices to chase opportunities for tax avoidance. In addition, territorial taxation of this type is anachronistic. In the global economy of the twenty-first century, national boundaries have significantly less economic importance than they did in 1962. A territorial system would put enormous pressure on the transfer pricing rules and the source rules, for those rules define territorial boundaries for tax purposes. Those rules, however, cannot bear the pressure they are now receiving.

One promising alternative reform approach would be to go beyond the proposals of the Kennedy administration and eliminate deferral entirely. This approach is conceptually sound and, if successful, would promote fairness and economic efficiency. It would allow a major simplification of many international tax rules, such as the foreign tax credit rules. In addition, it would take pressure off some other rules, such as the transfer pricing rules and the check-the-box entity classification rules. To fully end deferral, the United States

[8] Department of the Treasury, The Deferral of Income Earned Through U. S. Controlled Foreign Corporations: A Policy Study (2000).

[9] General Explanation of the Tax Reform Act of 1986 (1987) at 964. Anti-avoidance legislation, to be coherent, should be designed to achieve certain specified positive goals rather than the negative goal of eliminating avoidance opportunities.

would need to treat foreign entities as conduits to the extent that they were being used by U.S. persons to earn foreign source income. The passive foreign investment fund (PFIC) rules already in place generally adopt this conduit approach.[10]

Another approach would be for the United States to adopt, in cooperation with its major trading partners, a worldwide combined reporting system. In that system, corporate groups would file consolidated returns and their entire worldwide income would be allocated among the various participating tax jurisdictions by formula.[11] Participating countries would need to cooperate extensively to make this system work well. A formulary apportionment approach might be viewed, in some respects, as a territorial system because each country participating in the system would tax only the income allocated to it under the formula. This form of territorial system, however, would promote fairness, efficiency, and administrative economy.

§ 25.02. Operation of Subpart F Provisions

Code section 951 is the basic operative provision of subpart F. It requires, under some conditions, that certain profits of a controlled foreign corporation (CFC) be included as a deemed dividend in the gross income of the "United States shareholders" of the CFC.[12] Section 25.02.1, below, sets forth the general rules governing subpart F. Section 25.02.2 describes the mechanism for taxing U.S. shareholders on a deemed dividend. The terms "United States shareholder" and "controlled foreign corporation" are given highly technical meanings for purposes of subpart F. The definitions of these terms are presented in sections 25.02.3, below. Section 25.02.4 explains the rules that determine who is the owner of shares of stock in a CFC under the indirect and constructive ownership rules of Code section 958.

§ 25.02.1. General Rules

The amounts taxable under subpart F are the earnings and profits of a CFC deemed to arise from certain tax avoidance transactions. The earnings and profits of a CFC must be computed according to the accounting principles that would be applicable if the CFC were a domestic corporation.[13] Gross income and deductible expenditures stated on the books of a CFC in foreign currency must be translated into U.S. dollars in computing the income of the CFC for purposes of subpart F.[14]

A CFC is not a taxpayer under subpart F. Instead, CFCs are treated, for limited purposes, as conduits. That portion of the income of a CFC deemed to arise from tax avoidance transactions is taxable in the year earned to the U.S. shareholders of the CFC. The tax treatment afforded to U.S. shareholders of a CFC is roughly comparable to the treatment they would have received if they had earned the tax avoidance income through a foreign partnership.

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[10] For a detailed proposal for ending deferral by adopting a PFIC model for taxing Americans on income earned through foreign entities, see Robert J. Peroni, J. Clifton Fleming, and Stephen E. Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income," 52 SMU Law Review 455 (1999).

[11] For discussion of a combined reporting system with formulary apportionment, see Michael J. McIntyre, The Use of Combined Reporting by Nation States, in chapter 8, Arnold, Sasseville, & Zolt, eds., The Taxation of Business Profits Under Tax Treaties (2003); see also Michael J. McIntyre, "Design of a National Formulary Apportionment Tax System," 1991 NTA-TIA Proceedings 118-124 (1991).

[12] The term "U.S. shareholder" generally is used as an abbreviation for the term "United States shareholder" in this book.

[13] IRC § 964(a) and Reg. § 1.964-1 (2009).

[14] IRC § 985 et seq. and Reg. §§ 1.964-1(a)(2) and (3) (2009).

The taxable income of a CFC that is subject to current taxation under subpart F typically would be foreign source income subject to low foreign taxes. In some cases, the deemed dividend would be treated as general limitation income, for purposes of the limitations on the foreign tax credit, under the look-through rules of Code section 904(d)(3).[15] If the U.S. shareholders receiving such a deemed dividend have excess foreign tax credits attributable to their general-basket income, they may not have any increase in their tax liability as a result of the deemed dividend under subpart F. The definition of passive income, for purposes of the passive income basket, is coordinated with the definition of foreign personal holding company income under subpart F. Thus most passive income taxable under subpart F would be included in the passive basket, and the U.S. tax on that income would not be offset by excess tax credits in the general limitation basket.

§ 25.02.2. Taxation of Deemed Dividends

For a shareholder of a corporation to be taxable under Code section 951, three conditions must be met.[16] First, the corporation must qualify as a controlled foreign corporation (CFC) for an uninterrupted period of 30 days or more during the taxable year. Second, the shareholder must qualify as a U.S. shareholder. Among other requirements, a person must own 10 percent or more of the voting stock of a foreign corporation to be a U.S. shareholder. Third, the U.S. shareholder must own its shares of stock in the CFC on the last day of the taxable year that the foreign corporation qualifies as a CFC. Ownership of stock is determined after application of the indirect and constructive ownership rules of section 958(a).

If the three conditions set forth above are met, the U.S. shareholders of a CFC are required to include certain types of income of the CFC in their gross income as a deemed dividend from the CFC. The amount of income subject to taxation under Code section 951 is referred to in this book as "section 951 income." Subject to limitations set forth below, the section 951 income taxable to a U.S. shareholder as a deemed dividend is the shareholder's pro rata share of the three categories of income described below.

The first, and most important, category of section 951 income is the CFC's subpart F income for the taxable year.[17] A detailed discussion of the complex definition of subpart F income is presented in chapter 26. Net income from passive investments and sales income artificially shifted away from the country of manufacture and the country of sale are important examples of subpart F income.

The second category of section 951 income is the amount of income of a CFC that has been repatriated indirectly to its U.S. shareholders through an increase for the taxable year in the CFC's earnings invested in United States property.[18] By subjecting an increase in the amounts invested in U.S. property to current taxation, the Code prevents a CFC from converting the deferral of tax on its earnings to a permanent exemption.

The third, and least significant, category of section 951 income is the "previously excluded subpart F income" of the CFC that is withdrawn during the taxable year from certain qualified investments.[19] The amounts withdrawn from qualified investments typically would remain in the CFC or in a related CFC but would be used for nonqualifying purposes. Under prior law, a CFC could exclude from its subpart F income certain amounts invested in less developed countries and in foreign base company shipping operations. To

[15] Base company sales income and base company services income typically would be included in the general limitation basket.

[16] See IRC § 951(a)(1).

[17] IRC § 951(a)(1)(A)(i).

[18] IRC § 951(a)(1)(B). The statutory term "United States property" is abbreviated as "U.S. property" in these materials.

[19] IRC § 951(a)(1)(A)(ii) and (iii).

prevent abuse of these tax incentives, the Code has required that the shareholders of a CFC include in their income as a deemed dividend any amounts no longer invested in the favored activities.

The definition of previously excluded subpart F income is contained in Code section 955. These are two types of income: certain subpart F income invested, prior to 1976, in a less developed country[20] and certain subpart F income invested, prior to 1987, in foreign base company shipping operations.[21] The 1975 tax act eliminated the exclusion from subpart F income for qualified investments in developing countries, and the 1986 tax act eliminated the exclusion for qualified investments in shipping operations. The general rule for measuring the amount of previously excluded subpart F income withdrawn from qualified investments during the taxable year is to subtract the amount of qualifying investment as of the end of the taxable year from the amount of qualifying investment as of the last taxable year for which the exemption was available.[22]

Only the U.S. shareholders of a CFC are taxable under Code section 951. That is, foreigners and U.S. persons that do not qualify as U.S. shareholders are not subject to taxation under subpart F on the section 951 income attributable to them. A U.S. shareholder is taxable on its pro rata share of the section 951 income of a CFC if it directly owns shares of the CFC or if it owns the shares indirectly through its ownership of some other foreign entity.

The amount taxable to a U.S. shareholder as a deemed dividend under Code section 951 is the shareholder's pro rata share of the section 951 income of the CFC. That amount generally will not exceed the amount that would be taxable as a dividend if an actual distribution had been made. Thus a CFC (or related CFCs) must have earnings and profits in order to support a deemed dividend. The example below illustrates the operation of the deemed dividend rule.

Example 25.1: Taxation of Deemed Dividend

PCo and Q Co are corporations organized under the laws of the United States. XCo and RCo are foreign corporations. XCo has outstanding 25 shares of voting common stock and has no other class of stock. PCo and QCo each own 10 shares of XCo stock; RCo owns the remaining 5 shares of XCo stock. PCo owns all of the stock of RCo. All of the corporations use the calendar year as their taxable year.[23]

For year 1, XCo has earnings and profits of $1,000. Of that amount, $600 is net passive income that fits the definition of subpart F income. XCo has no increase in its investment in U.S. property for the year and has no withdrawals from qualified investments of "previously excluded subpart F income." That is, XCo has section 951 income of $600.

[20] Prior to the 1975 tax act, IRC § 954(b)(1) [repealed, 1975] permitted a CFC to exclude from its subpart F income certain dividends, interest, and gains derived from qualified investments in less developed countries to the extent that the CFC increased its qualified investments in less developed countries. The intent of § 954(b)(1) was to give a tax incentive for investments in less developed countries by continuing to allow deferral of tax on the profits from such investments. The incentive was widely thought to be ineffective and unduly complex.

[21] Prior to the 2004 tax act, a component of subpart F income was "base company shipping income." Prior to the 1986 tax act, taxpayers could exclude from base company shipping income an amount equal to the increase for the taxable year in their qualified investments in foreign base company shipping operations. See IRC § 954(b)(2) [repealed, 1986].

[22] For a detailed explanation of the taxation of withdrawals of qualified investments, see Reg. §§ 1.955-1 (1983) (withdrawals from investment in less developed countries) and 1.955A-1 (1983) (withdrawals from investment in foreign base company shipping operations).

[23] An additional calculation is also necessary if the CFC distributed dividends during the taxable year to persons other than those U.S. shareholders who are holding shares of the CFC at the time of the deemed dividend. IRC § 951(a)(2).

Under these conditions, PCo and QCo would be classified as U.S. shareholders of XCo because they are U.S. corporations and they each own more than 10 percent of the stock of XCo. XCo would qualify as a CFC because more than 50 percent of its stock is owned by U.S. shareholders. PCo would be taxable on a deemed dividend from XCo of $360, and QCo would be taxable on a deemed dividend of $240, computed as follows:

(1) Section 951 income of XCo *$600*

(2) P'Co s pro rata share of section 951 income from stock of XCo owned directly (10/25 × $600) *240*

(3) PCo's pro rata share of section 951 income from stock of XCo owned indirectly through ownership of RCo stock (5/25 × $600) *120*

(4) Total of PCo's pro rata share of section 951 income ($240 + $120) *360*

(5) QCo's pro rata share of section 951 income (10/25 × $600) *240*

In the typical case, illustrated by the example above, a U.S. shareholder's pro rata share of the CFC's section 951 income is the amount that the shareholder would have been entitled to receive if an actual distribution of the section 951 income had been made by the CFC at the end of its taxable year. An additional calculation must be made in determining a U.S. shareholder's pro rata share of the section 951 income of a CFC if the CFC has qualified as a CFC for only part of the taxable year. Code section 951(a)(2) limits the amount of subpart F income of a foreign corporation taxable to a U.S. shareholder to the shareholder's pro rata share of such income attributable to the period that the foreign corporation qualified as a CFC.[24] A similar rule applies in computing the amount of a deemed dividend paid out of other categories of section 951 income.[25]

Under Code section 951, the U.S. shareholders of a CFC are taxable on the entire amount of their pro rata share of section 951 income of the CFC, even if some or all of that income has been distributed. Assume, for example, that PCo, a domestic corporation, owns all of the stock of F*Co*, a foreign subsidiary that qualifies as a CFC. During the taxable year, F*Co* earns subpart F income of $1,000, which it distributes to PCo. Assuming that FCo has earnings and profits of $1,000 or more, the entire $1,000 of subpart F income will be taxable to PCo under section 951. Double taxation is avoided, however, because PCo is allowed to receive the actual distribution of $1,000 tax free under section 959. PCo would not be taxable on the section 951 income of FCo to the extent that the earnings and profits of FCo were inadequate to sustain a dividend.

§ 25.02.3. Definitions of U.S. Shareholder and Controlled Foreign Corporation (CFC)

The definition of the term "United States shareholder" limits the application of subpart F to U.S. citizens, residents, and domestic entities owning 10 percent or more of the voting stock of a controlled foreign corporation (CFC).[26] That term also specifies the class of persons whose ownership interests in a foreign corporation are to be taken into account in determining whether a foreign corporation is a CFC.[27] The definition of a U.S. shareholder is discussed below.

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[24] For illustrations of the operation of this rule, see Reg. § 1.951-1(b) (2006).

[25] See IRC § 951(a)(3) and (4). For illustrations of the operation of these rules, see Reg. § 1.951-1 (2006).

[26] IRC § 951(b).

[27] IRC § 957(a).

Section 25.02.3.2, below, discusses the definition of a CFC. That term establishes the class of foreign corporations whose income is subject to taxation under subpart F.[28] The paradigm example of a CFC is a wholly owned foreign subsidiary of a U.S. corporation. An anti-avoidance provision designed to impose a current income tax on income earned by certain corporations that have avoided CFC status is discussed in section 25.02.3.3.

§ 25.02.3.1. United States Shareholder

A U.S. shareholder must be a "United States person," as defined in Code section 957(c).[29] Section 957(c) incorporates by reference the definition of a U.S. person contained in section 7701(a)(30). Section 7701(a)(30) defines a U.S. person to be any of the following: a citizen or resident of the United States, a domestic corporation, a domestic partnership, a domestic trust, and an estate other than a foreign estate. As an exception to the definition of section 7701 (a)(30), section 957(c) provides that shareholders of certain corporations organized in Puerto Rico, Guam, American Samoa, and the Northern Mariana Islands who are residents of one of those jurisdictions are not treated as U.S. persons with respect to those corporations.[30]

To qualify as a U.S. shareholder of a foreign corporation, a U.S. person must own, directly, indirectly, or constructively, 10 percent or more of the voting power of all classes of stock of the foreign corporation.[31] In determining whether or not a shareholder meets the 10-percent ownership test, the indirect ownership rules of Code section 958(a) and the constructive ownership rules of section 958(b) are applicable. Those rules are explained in section 25.02.4, below.

§ 25.02.3.2. Controlled Foreign Corporation (CFC)

The definition of the term "controlled foreign corporation" (CFC) is provided in Code section 957(a). To meet that definition, an entity must be classified as a "foreign corporation." Section 7701(a)(5) states that a business entity is foreign if it is not domestic.[32] A domestic corporation is a corporation "created or organized in the United States or under the laws of the United States or of any state."[33] A foreign corporation, therefore, is a corporation organized under the laws of a foreign jurisdiction.

Whether an entity is treated for federal tax purposes as a corporation is determined under the check-the-box regulations. With some exceptions, a taxpayer may elect whether to treat a foreign entity as a corporation, a partnership, or a branch. A foreign entity is treated as a branch if the taxpayer elects to treat it as a disregarded entity under the check-the-box rules. Prior to the adoption of the check-the-box regulations in 1996, an entity was classified as a corporation for federal tax purposes if it possessed at least three of the following characteristics: (1) continuity of life, (2) centralized management, (3) limited liability,

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[28] IRC § 951(a)(1).

[29] IRC § 951(b).

[30] Because of this exception, certain corporations controlled by residents of the enumerated possessions of the United States may avoid CFC status. See IRC § 957(c). An exclusion from CFC status for a broader class of possessions corporations, defined without reference to the residency of the shareholders, was repealed by the 1986 tax act on the ground that it "did not appear to provide incentive for the type of substantial economic activity that is needed to promote employment and economic development in the possessions." General Explanation of the Tax Reform Act of 1986 (1987) at 992.

[31] IRC § 951(b). For the purpose of taxing the related person insurance income of certain captive insurance companies, a U.S. person owning any stock in a foreign corporation is treated as a U.S. shareholder. See IRC § 953(c)(1)(A).

[32] See also Reg. § 301.7701-5 (2006).

[33] IRC § 7701(a)(4).

and (4) free transferability of ownership interests. Whether a foreign entity constituted a foreign corporation within the meaning of the regulations was often unclear.[34]

A foreign corporation will be classified as a "controlled" foreign corporation under Code section 951 if it satisfies either the voting control test or the ownership test.[35] A foreign corporation satisfies the voting control test if U.S. shareholders own more than 50 percent of the combined voting power of all classes of its voting stock on any day during its taxable year.

The ownership test was added by the 1986 tax act, primarily to prevent foreign corporations from avoiding CFC status by shifting voting control to foreign holders of voting preferred stock.[36] That test is satisfied if more than 50 percent of the total value of the stock of a foreign corporation is owned by U.S. shareholders on any day of the taxable year of the foreign corporation. The indirect ownership rules of Code section 958(a) and the constructive ownership rules of section 958(b) are applicable in determining whether a foreign corporation satisfies either the voting control test or the ownership test.[37]

The regulations under Code section 957 state that an arrangement to shift formal voting power away from U.S. shareholders will be ignored in determining whether the voting control test is met unless actual voting power is transferred.[38] For example, a foreign corporation constitutes a CFC if 49 percent of its voting stock is owned by a U.S. corporation and another two percent is owned by a person who has agreed, informally, to vote his stock as directed by the officers of the U.S. corporation.[39] A foreign corporation also constitutes a CFC if U.S. shareholders have the power to elect, appoint, or replace a person who has powers traditionally exercised by a board of directors of a domestic corporation.[40]

Several cases have supported the position of the Internal Revenue Service that arrangements to shift voting power away from U.S. shareholders of a foreign corporation will not be effective if in reality voting power is retained. For example, in *Koehring Co.,* a foreign corporation was classified as a CFC despite the fact that 55 percent of the voting stock was held by foreign persons.[41] Taxpayers can successfully resist a claim by the Service that a transfer of 50 percent or more of the voting stock of a CFC did not result in a shift in control by showing that the recipients of the voting stock exercised the normal shareholder powers.[42]

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[34] See New York State Bar Association, Tax Section, Committee on Foreign Activities of United States Taxpayers, "Report on Foreign Entity Characterization for Federal Income Tax Purposes," 35 Tax Law Review 167 (1980) (discussing in detail the various public and private letter rulings of the IRS relating to the classification of foreign entities).

[35] IRC § 957(a) and Reg. § 1.957-1(a) (1997).

[36] See General Explanation of the Tax Reform Act of 1986 (1987) at 988.

[37] In determining whether a captive insurance company is a CFC for purposes of taxing its shareholders under subpart F on its related person insurance income, the more-than-50% test is replaced with a 25%-or-more test.

[38] Reg. § 1.957-1(b)(2) (1997). Congress assumed the validity of this regulation in rejecting a provision passed by the House of Representatives in 1986 that would have decreased the U.S. ownership requirement for CFC status from more-than-50% to 50%-or-more of total ownership. See General Explanation of the Tax Reform Act of 1986 (1987) at 988-989.

[39] See Reg. § 1.957-1(c)(Exs. 5-7) (1997).

[40] Reg. §§ 1.957-1(b)(1)(iii) (1997) and 1.957-1(c)(Ex. 4) (1997). In some cases, a taxpayer may want its foreign affiliate to be classified as a CFC (to obtain a better result, for example, under the separate-basket limitation rules of IRC § 904(d)). If the statutory control tests are not met, however, the foreign affiliate will not be treated as a CFC even if the taxpayer exercises effective control over it. *Framatome Connectors v. Comm'r*, 118 T.C. 32 (2002).

[41] *Koehring Co. v. U.S.,* 583 F.2d 313 (7th Cir. 1978). For other cases finding transfer of voting control to be illusory, see *Garlock v. Comm'r,* 489 F.2d 197 (2d Cir. 1973), aff'g 58 T.C. 423 (1972), cert. denied, 417 U.S. 911 (1974); *Kraus v. Comm'r,* 490 F.2d 898 (2d Cir. 1974), aff'g 59 T.C. 681(1973); *Estate of Weiskopf v. Comm'r,* 64 T.C. 79 (1975), aff'd without opinion, 538 F.2d 317 (2d Cir. 1976).

[42] See *CCA v. Comm'r,* 64 T.C. 137 (1976), nonacq. 1982-1 C.B. 1 (transfer to foreign persons of voting preferred stock representing 50% of the voting power of the company was adequate to shift voting control). CCA, Inc. apparently would be classified as a CFC

(continued...)

§ 25.02.3.3. The Stapled Stock Rule

An anti-avoidance rule, referred to as the stapled stock rule, is contained in Code section 269B. That provision treats a foreign corporation as a domestic corporation, subject to current taxation by the United States, if its stock has been paired with the stock of a domestic corporation so that the shareholders cannot trade the stocks separately. Prior to the adoption of the stapled stock rule in 1984, some widely held domestic corporations sought to sidestep the anti-avoidance rules of subpart F by organizing a widely held sister corporation in a tax haven jurisdiction. Under current law, the tax haven corporation would be fully taxable as a U.S. corporation, and its domestic parent would be held responsible for collecting the tax.[43] The following example illustrates the tax avoidance scheme that the stapled-stock rule was designed to defeat.

Consider, for example, PCo, a U.S. corporation. Its stock is widely held and traded on the New York Stock Exchange. It forms FCo, a foreign corporation located in a tax haven country. As a wholly owned subsidiary, FCo constitutes a CFC with respect to PCo. To avoid that result, PCo distributes all of the stock of FCo to its shareholders, with each holder of a share of PCo receiving one share of FCo. The FCo stock includes a legend that states that the share of FCo stock may only be sold in conjunction with the sale of the PCo stock with respect to which it was distributed. This "stapling" of the FCo stock to the PCo stock guarantees that the shareholders of PCo and FCo will remain identical. As a result of that identity of ownership. PCo can artificially shift profits to FCo without violating its fiduciary obligations to its shareholders. The stapled-stock rule, by taxing FCo as a domestic corporation, prevents this tax avoidance scheme from operating successfully.

§ 25.02.4. Indirect and Constructive Ownership Rules

U.S. persons are treated for certain purposes as the owners of stock that they are deemed to control under the indirect ownership rule of Code section 958(a) and the constructive ownership rules of Code section 958(b). The indirect ownership rules, described in section 25.02.4.1, below, are designed to tax U.S. persons on the tainted income earned by a foreign corporation that is owned indirectly through a foreign corporation or other foreign entity under their control. That is, a person who indirectly owns stock in a CFC is subject to tax with respect to the tainted income of that CFC.

The constructive ownership rules apply to U.S. persons that may have divided up their holdings of stock in a foreign corporation among domestic and foreign legal entities or among close family members. Persons are treated as the owners of stock under the constructive ownership rules in determining whether they are U.S. shareholders and whether the foreign corporation is a CFC. A constructive owner of stock in a CFC is not taxed with respect to the tainted income of the CFC as a result of that ownership link. The constructive ownership rules are described in section 25.02.4.2., below. The relationships between the indirect and constructive ownership rules are illustrated in section 25.02.4.3., below.

§ 25.02.4.1. Indirect Ownership Rules

The indirect ownership rule contained in Code section 958(a) provides that stock owned directly or indirectly by or for a foreign entity shall be treated as owned proportionally by its shareholders, partners, or beneficiaries.[44] For example, if P, a U.S. corporation, owns 75 percent of the stock of R, a foreign corporation, and R owns 80 percent of the stock of S, then P will be treated as the owner of 60 percent (80% of 75%) of

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[42] (...continued)
under current law because of the addition of the ownership test to IRC § 957(a) by the 1986 tax act.

[43] See IRC § 269B(b).

[44] See Reg. § 1.958-1(b) (2001).

the stock of S. Similarly, if A is the sole beneficiary of T, a foreign trust, and T owns 50 percent of the stock of Q, a foreign corporation, then A will be treated as the owner of 50 percent of the stock of Q.[45]

Because of the indirect ownership rule, U.S. persons cannot avoid the impact of subpart F by transferring the stock of a foreign corporation to a foreign entity or to a chain of foreign entities under their control. The indirect ownership rule applies in determining the ownership of stock for most purposes under subpart F.[46] A person that is treated as a U.S. shareholder of a CFC under the indirect ownership rule of Code section 958(a) will be taxable under section 951 on its pro rata share of the section 951 income of the CFC.

A shareholder that indirectly owns stock in a CFC is taxable on a deemed dividend from that CFC without the dividend passing through any intermediary foreign entities. Thus the section 951 income of a second-tier foreign affiliate would be taxable to the U.S. parent as a deemed dividend without the first-tier foreign affiliate being treated as having received the deemed dividend. Commentators refer to this method of taxing persons that indirectly own stock of a CFC as the hopscotch rule.

§ 25.02.4.2. Constructive Ownership Rules

The constructive ownership rules are contained in Code section 958(b). Under those rules, taxpayers are treated, for certain limited purposes, as the owners of stock held by certain trusts, corporations, and other legal entities and by certain close relatives. Those rules apply for purposes of determining whether a foreign corporation qualifies as a CFC under section 957, whether a U.S. person is a U.S. shareholder under section 951(b), whether a person is a related person within the meaning of section 954(d)(3),[47] and whether stock of a domestic corporation should be treated as owned by a U.S. shareholder of a CFC for purposes of section 956(b)(2).[48] In addition, some Code sections explicitly invoke the constructive ownership rules.[49] In contrast to the indirect ownership rides, the constructive ownership rules do not cause a person to be treated as the owner of stock for purposes of being taxed on deemed dividends under section 951.

Code section 958(b) incorporates by reference, with some modification, the complex constructive ownership rules contained in section 318(a). The rules under section 318(a) apply to transactions governed by subchapter C of the Code, relating to the taxation of corporations and shareholders. In summary, the constructive ownership rules of section 958(b) provide as follows:

(1) Individuals are treated as the owner of shares of stock owned, directly or indirectly, by their spouse, children, grandchildren, and parents, except that stock owned by a foreign individual will not be treated as owned by a U.S. citizen or resident.[50] Thus an individual who directly owns 25 percent of the stock of a corporation, with the remaining 75 percent owned by his wife and children, will be treated as the owner of

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[45] See Reg. § 1.958-1 (d)(Ex. 3) (2001).

[46] It does not apply for purposes of IRC §§ 955(b)(1)(A) and (B) (taxation of base company shipping operations) or 960(a)(1) (foreign tax credit on deemed dividends from a CFC. It also does not apply for purposes of IRC § 955(c)(2)(A)(ii) (taxation of investments in less developed countries), as in effect prior to its repeal in 1975. Special rules apply in the case of a foreign mutual insurance company. See IRC § 958(a)(3) and Reg. § 1.958-1(c) (2001).

[47] The definition of related person under IRC § 954(d)(3) is crucial for determining the amount of base company sales income of a CFC. Base company sales income is an important component of subpart F income.

[48] Under IRC § 956(b)(2), a purchase by a CFC of domestic stock owned by a shareholder of that CFC is treated as an investment in U.S. property. A U.S. shareholder's pro rata share of a CFC's increase in earnings invested in U.S. property is taxable as a deemed dividend under IRC § 951(a)(1)(B).

[49] See, e.g., IRC § 1248(a)(2) (incorporating by reference the indirect and constructive ownership rules for purposes of taxing certain dispositions of stock at ordinary income rates).

[50] IRC §§ 318(a)(1) and 958(b)(1).

100 percent of the stock of the corporation, assuming that the wife and children are U.S. citizens or residents. The wife and children also will be treated as the owner of 100 percent of the stock of that corporation.

(2) Stock owned, directly or indirectly, by or for a partnership or an estate will be treated as owned proportionally by its partners or beneficiaries.[51] Similarly, stock owned, directly or indirectly, by or for a trust shall be treated as owned by its beneficiaries in proportion to their actuarial interest in such trust.[52]

(3) Stock owned, directly or indirectly, by a corporation will be treated as owned by the shareholders of that corporation in proportion to their direct and indirect ownership interests in the corporation, but only to the extent that the shareholders own, directly or indirectly, at least 10 percent or more of the value of the stock of that corporation.[53] For example, assume that X and Y are corporations. X owns 50 percent of the only class of stock of Y. A, an individual, owns 20 percent of the only class of stock of X, and B, another individual, owns 5 percent of the stock of X. Under these conditions, A will be treated as owning 10 percent (50% of 20%) of the stock of Y. B will be treated as owning none of the stock of Y because B owns less than 10 percent of the stock of X.

(4) Stock owned by partners of a partnership, by beneficiaries of an estate or trust, or by persons owning 50 percent or more of the shares of a corporation shall be treated as owned by the partnership, estate, trust, or corporation, except that stock owned by a person that is not a U.S. person shall not be treated as owned by a U.S. person.[54] Shares constructively owned by an entity under this rule shall not be further attributed to the partners, beneficiaries, or shareholders of that entity.[55]

(5) In applying the rules set forth in paragraphs (2) and (3) above, if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the voting stock of a corporation, it shall be treated as owning all of the stock of that corporation. For example, if an individual, A, owns 60 percent of the stock of corporation X and X owns 80 percent of the stock of corporation Y, then X will be treated as owning all of the stock of Y. A will be treated as owning 60 percent of the stock of Y by application of the rule set forth in paragraph (3), above.

(6) A person owning an option to buy a share of stock is treated as the owner of that share.[56]

§ 25.02.4.3. Example of Operation of Indirect and Constructive Ownership Rules

The example below illustrates the operation of the indirect and constructive ownership rules.

Example 25.2: Stock Ownership Rules

D and his spouse E are U.S. citizens. JCo, KCo, and LCo are foreign corporations, and XCo is a domestic corporation. The ownership rights of these persons are as follows:

D owns 10 percent of the stock of JCo;

E owns 9 percent of the stock of KCo;

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[51] IRC § 318(a)(2)(A).

[52] IRC § 318(a)(2)(B).

[53] IRC §§ 958(b)(3) and 318(a)(2)(C).

[54] IRC §§ 958(b)(4) and 318(a)(3).

[55] See IRC § 318(a)(5)(C) and Reg. § 1.958-2(f)(1)(iii) (2001).

[56] IRC § 318(a)(4).

XCo owns 35 percent of the stock of KCo;

JCo owns 10 percent of the stock of KCo;

KCo owns 100 percent of the stock of LCo.

Under these facts, D, E, and XCo are all U.S. shareholders of LCo. Under the indirect ownership rules of Code section 958(a), XCo indirectly owns 35 percent (35% of 100%) of LCo, and E indirectly owns 9 percent (9% of 100%) of LCo, due to their ownership of stock in KCo. Similarly, D owns 1 percent (10% of 10%) of LCo through his ownership of stock in JCo.

Under the constructive ownership rules of Code section 958(b), E, as D's spouse, is treated as owning D's 1 percent interest in LCo, and D is treated as owning E's 9 percent interest in LCo. Thus E indirectly owns 9 percent of LCo and constructively owns 1 percent, for a total of 10 percent; D indirectly owns 1 percent of LCo and constructively owns 9 percent, for a total of 10 percent.[57]

The stock owned by D, E, and XCo is not adequate to make LCo a CFC under the above facts because the stock owned by both D and E under the indirect and constructive ownership rules cannot be counted twice in determining whether U.S. shareholders own more than 50 percent of the stock of LCo. D, E, and XCo would be treated as owning a total of 45 percent (35% + 1% + 9%) of LCo.[58]

LCo would be a CFC if F, an unrelated U.S. citizen, indirectly owns 10 percent of the stock of LCo by owning 10 percent of the stock of KCo. On the assumption that LCo is a CFC, then D, E, F, and XCo would be taxable under Code section 951(a) on their pro rata share of the section 951 income of LCo. D and E would be taxable with respect to deemed distributions attributable to the stock they owned directly and indirectly under section 958(a), but they would not be taxable with respect to deemed distributions attributable to the stock they owned constructively under section 958(b). That is, for purposes of determining the amount taxable to them under Code section 951, D would be treated as the owner of 1 percent of LCo and E would be treated as the owner of 9 percent of LCo.

The indirect ownership rule and the several constructive ownership rules may overlap. Conflicts among the stock attribution rules are to be resolved so as to maximize the reach of subpart F.[59] Assume, for example, that C, a U.S. citizen, owns 10 percent of the stock in NCo, a foreign corporation. NCo owns 60 percent of the stock in SCo, a foreign corporation. Under the indirect ownership rules, C is considered as owning 6 percent (10% of 60%) of the stock in SCo. Under the constructive ownership rules, NCo is considered as owning 100 percent of the stock in SCo and C, as a 10-percent owner of SCo, is considered as owning 10 percent of the NCo stock. For purposes of determining whether C is a U.S. shareholder with respect to SCo, C is treated as owning 10 percent of NCo, not 6 percent.

An interesting issue arises when a U.S. person uses a grantor trust to hold the stock of a CFC. In that event, the trust is treated as the owner of the stock for purposes of being taxed on the CFC's tainted income under Code section 951(a)(1) because it owns, directly or indirectly, the stock of the CFC. Under the constructive ownership rules, the U.S. person would be treated as owning the CFC stock, but constructive ownership is not enough to make someone taxable on the tainted income of a CFC—the ownership must be "direct or indirect." The U.S. person does not escape taxation, however, because of the operation of section

[57] See Reg. § 1.958-2(g)(Ex. 6) (2001).

[58] See Reg. § 1.958-2(f)(2)(Ex. 1) (2001).

[59] See Reg. § 1.958-2(f)(2) (2001).

677(a), which taxes the income of a grantor trust to the grantor. Under that section, the U.S. person is taxable on the income of the trust, including the tainted income included in the trust's income under section 951.[60]

§ 25.02.5. Choice of Taxable Year

Prior to reforms adopted in 1989, a U.S. shareholder in a CFC could defer paying tax on a deemed distribution from the CFC for up to a year by having the CFC adopt a taxable year that ended just after its taxable year. To block this avoidance scheme, Code section 898 generally requires a CFC, for federal tax purposes only, to conform its taxable year to the taxable year of its majority shareholder.[61] As an alternative to full conformity, the CFC may make a valid election to use a taxable year that ends one month before the end of the taxable year of its majority U.S. shareholder.[62] In 1986, Congress restricted the ability of taxpayers to select taxable years of certain related domestic entities for tax avoidance purposes. The adoption of section 898 is simply an extension of the 1986 policy to the international arena.

The Code refers to a CFC subject to the taxable-year conformity rule of Code section 898 as a "specified foreign corporation." A CFC generally is a specified foreign corporation if a U.S. shareholder owns, by vote or value, more than 50 percent of its stock[63] after application of the indirect and constructive ownership rules of section 958.[64] Foreign personal holding companies having a majority U.S. shareholder also are specified foreign corporations.[65]

A corporation's status as a specified foreign corporation is generally tested as of the first day of the corporation's taxable year, determined without reference to Code section 898.[66] The tax authorities may require testing at additional times. For example, regulations are likely to provide that a foreign corporation would be tested to see if it was a specified foreign corporation after a transfer of its stock for tax avoidance purposes.[67]

In the typical case, a specified foreign corporation would have only one majority shareholder. The stock attribution rules, however, may treat some shares of stock of a foreign corporation as being owned by more than one U.S. person, resulting in more than one U.S. person qualifying as a majority U.S. shareholder. In such circumstances, regulations are expected to provide that the taxable year of the foreign corporation will be determined so as to minimize the aggregate amount of deferral available to its U.S. shareholders.[68]

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[60] See *Textron v. Comm'r*, 117 T.C. 67 (2001).

[61] IRC §§ 898(a) and 898(c)(1)(A). A U.S. person owning shares in a foreign captive insurance company may be treated by the Service as a U.S. shareholder without regard for the 10-percent ownership requirement of IRC § 951(b). IRC § 898(b)(3).

[62] IRC § 898(c)(1)(B).The Service has provided procedures under IRC § 442 "to establish a business purpose and obtain approval to adopt, change, or retain an annual accounting period." See Rev. Proc. 2002-39, 2002-1 C.B. 1046.

[63] IRC § 898(b)(1).

[64] IRC § 898(b)(2)(B).

[65] IRC § 898(b)(1)(A)(ii). An FPHC cannot made an election to use a taxable year ending one month before the end of the taxable year of its majority U.S. shareholder unless it is also a CFC. Typically an FPHC having a majority U.S. shareholder would be a CFC. Differences in the stock attribution rules under IRC § 958 (relating to CFCs) and under IRC §§ 551(f) and 554 (relating to FPHCs), particularly as they apply to the attribution of stock owned by foreign corporations to U.S. persons, make it possible for an FPHC to have a majority U.S. shareholder and not be a CFC.

[66] IRC § 898(c)(1)(C)(ii).

[67] IRC § 898(c)(1)(C)(ii)(11). See Prop. Reg. § 1.898-3(a)(5)(v) (1993) (perhaps withdrawn; see REG-108523-00.

[68] Prop. Reg. § 1.898-3(a)(4) (1993) (perhaps withdrawn; see REG-108523-00. See Senate Finance Committee, Report on S. 1750, 100th Cong., 1st Sess. (Oct. 4, 1989) at 140-141.

§ 25.02.6. Character of Deemed Distributions

For purposes of applying the limitation on the foreign tax credit, the look-through rules of Code section 904(d)(3) are applicable in determining the character of a deemed distribution under subpart F. In general, specific tracing rules apply in determining the character of amounts taxable as subpart F income.[69] Amounts taxable as an increase in a CFC's investment in U.S. property are treated as actual dividends under the look-through rules.[70] Dividends retain the character of the earnings and profits out of which they were paid.[71]

[§§ 25.03 and 25.04 omitted]

§ 25.05. Justifications for Subpart F Provisions

Subpart F and the related PFIC provisions impose a current tax on U.S. taxpayers that earn certain types of foreign source income through a foreign corporation. In enacting and amending these provisions, Congress has typically asserted that its goal is to prevent tax avoidance. Every tax system needs protection against the tax avoidance machinations of clever taxpayers. Anti-avoidance measures must be justified, however, by reference to substantive policy goals. This section examines three substantive goals that might justify, in whole or in part, the taxation of foreign source income under subpart F and related provisions.[72]

One substantive goal served by subpart F and related provisions is to support the transfer price rules of Code section 482 by taking away the tax benefits otherwise obtainable from the manipulation of prices charged on transactions with related parties. Section 25.05.1, below, examines the case for subpart F and related provisions as a backstop to section 482.

Another goal of subpart F and related provisions is to remove the tax incentive that U.S. investors otherwise would have for investing in foreign countries through a foreign entity rather than in the United States. Section 25.05.2, below, examines the case for protecting U.S. source jurisdiction by imposing U.S. taxes on the foreign source passive income of U.S. persons earned through a foreign corporation.

A third goal of subpart F and related provisions is to tax the foreign source income earned by U.S. persons through a foreign corporation under rules comparable to those applicable to income earned through a domestic corporation. Section 25.05.3, below, develops a case for full taxation of income earned by U.S. persons through foreign entities, subject to whatever exceptions may be warranted on tax expenditure grounds.

§ 25.05.1. Subpart F as a Backstop to the Transfer Pricing Rules

For reasons explained in detail in chapter 6, the income allocation rules of Code section 482 are exceedingly difficult to administer. A major reason for adopting the subpart F rules in 1962 was to relieve some of the pressure on the section 482 rules by taking away the tax benefits that could be derived from deflecting income to a tax haven country. The foreign base company sales income provisions, the foreign base company services income provisions, and the foreign base company oil related income provisions do

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[69] IRC § 904(d)(3)(B) and Reg. § 1.904-5(c)(1) (2011).

[70] Reg. § 1.904-5(c)(4)(i) (1999) (last sentence).

[71] IRC § 904(d)(3)(D) and Reg. § 1.904-5(c)(4)(i) (2011).

[72] Many of the subpart F and related provisions are designed to prevent the use of foreign entities to convert ordinary income into capital gains. That aspect of those provisions is not addressed in this section.

relieve that pressure by eliminating tax deferral on certain income derived from transactions with related parties. The remaining subpart F provisions, which do not depend for their application on dealings with a related party, do not backstop the pricing rules.

Backstopping the transfer pricing rules is only a subsidiary goal of subpart F. That goal may explain, however, the narrow scope of the FBC sales and services income rules. Why should sales income or services income deflected to a tax haven country from dealings with unrelated parties be immune from challenge? Consider, for example, a U.S. person that establishes a corporation in a tax haven to purchase goods from unrelated parties in one country and sell them to unrelated parties in another country. Why is the tax avoidance practiced by that taxpayer less objectionable than the tax avoidance practiced by taxpayers that deal with related parties? The answer seems to be that Congress is willing to indulge the assumption that transactions among unrelated parties typically serve a legitimate business purpose. That assumption is quite strained, however, when taxpayers are channeling income to countries that once were known outside their own regions only to diplomats and stamp collectors.

In theory, the subpart F rules, in order to function as an effective backstop to the pricing rules, should impose a substantial penalty on taxpayers that deflect income to a tax haven in violation of the subpart F rules. To be effective in curtailing avoidance and evasion, the penalty would need to be high enough, discounted for the chances of not getting caught, that a rational taxpayer would forgo transfer price manipulations. The problem with a penalty provision, however, is that the line between legitimate business transactions and tax avoidance transactions is difficult to draw. Explicit transfer-pricing penalties were adopted in 1990 and strengthened in 1993. The penalties are not applicable, however, to taxpayers acting in good faith and with reasonable cause.

§ 25.05.2. Protecting U.S. Source Jurisdiction

To impose an effective tax on income derived by its citizens and residents from moveable capital, a country must adopt some provisions to block tax avoidance through the use of corporations located in tax havens. Without such provisions, domestic taxpayers could transfer their moveable capital to a foreign entity organized in a tax haven and escape current tax on the income generated by that capital. Subpart F and the PFIC provisions are designed to curtail the tax incentive for exporting the income from moveable capital by imposing a current tax (or its economic equivalent) on the foreign personal holding company income of certain foreign corporations.

The taxation of income from moveable capital under subpart F and related provisions increases the relative attractiveness of U.S. investment over foreign investment. A likely consequence is an increase in the amount of U.S. source income earned by U.S. persons. In some sense, therefore, the taxation of income from moveable capital under subpart F and related provisions may be seen as protecting U.S. source jurisdiction. Indeed, even countries that generally are prepared to exempt income derived outside their borders are required to tax their residents on investment income earned through foreign entities unless they are prepared to also exempt their residents on income from capital.

Under the traditional concept of source, however, U.S. taxpayers who actually invest outside the United States through a foreign entity are not earning U.S. source income. They have elected, perhaps for tax reasons, to earn income that has traditionally been classified as foreign source income. To claim the right to tax such income based on its source, the United States would need to take the novel position that the place of residence of the beneficial owner of moveable capital should determine the source of income generated by that capital.

The United States and other countries that are serious about taxing income from moveable capital should rethink traditional source concepts. Something is obviously wrong with source rules that assign the source of such income to countries that have conspired with taxpayers to defeat the legitimate tax claims of other countries. Perhaps the subpart F and related provisions, as they apply to FPHC income, should be viewed as a back door reform of outdated source rules.

§ 25.05.3. A General Elimination of Deferral

The subpart F provisions adopted in 1962 are a watered down version of a proposal made by the Kennedy administration to end deferral of tax on all income earned by U.S. persons through foreign entities under their control. Supporters of an end to deferral contend that U.S. persons should be taxed uniformly on their worldwide income, without regard for formal differences in the manner of earning that income. In their view, deferral violates horizontal equity by allowing U.S. persons earning income through a foreign corporation to pay lower taxes than other U.S. persons earning the same amount of income through other investment vehicles.

Although the traditional argument against deferral has some intuitive appeal, it is incomplete. The crux of the argument is that certain foreign corporations controlled by U.S. interests should be treated as conduits for their U.S. shareholders. Perhaps they should. The problem is to square that position with the general recognition under the Code of corporations as separate taxpayers and with the rules defining the limits on U.S. source and residence jurisdiction. The concept of horizontal equity does not determine the proper treatment of U.S. persons earning income through a foreign corporation because that concept implicitly assumes that there are no jurisdictional limitations on the power to tax and that all legal entities, not just foreign entities, would be treated as conduits in fixing tax burdens.

The current rules under subpart F and related provisions generally permit deferral on income arising from normal business operations, subject to some limited exceptions. Some commentators have asserted that deferral for income derived from normal business operations is necessary to allow U.S.-based businesses to be competitive in foreign countries. No organized evidence supports that position. Nor is there any organized evidence tending to show that the costs in forgone revenue of allowing deferral are commensurate with the benefits to the U.S. economy. In any event, many of the technical provisions that permit taxpayers to avoid the bite of the subpart F rules cannot be justified by reference to competitive factors. Thus the traditional case against deferral is at best unproved.

In form, subpart F and related provisions are compatible with the traditional concept of residence jurisdiction. The formal taxpayers under those provisions are U.S. persons. The foreign corporation is simply a conduit for its shareholders, just as a foreign partnership is a conduit for the partners in a partnership. In substance, however, a conduit theory is inadequate to justify subpart F. A coherent income tax system that treated certain foreign corporations as conduits for their shareholders would treat all comparable corporations and entities as conduits.

Subpart F and related provisions would be an appropriate exercise of residence jurisdiction if foreign corporations owned by U.S. persons are properly treated as U.S. residents. The general principal would be that the residence of a corporation should be determined by reference to the residence of the individual human beings who own, directly or indirectly, its shares.

A residence-of-the-shareholders test would represent a marked departure from international practices. Under the Code, reinforced by bilateral tax treaties, a corporation is resident of the country where it is incorporated. The place of incorporation test, however, is obviously arbitrary, chosen more for

administrative convenience than for reasons of principle. The other rule with some international support is the place of management test. That rule is also arbitrary, and it presents quite serious problems of administration.

A workable residence-of-the-shareholders test would have some arbitrary aspects and would present some problems of administration. That test, nevertheless, has some advantages over its chief rivals. First, it is more difficult to manipulate than the place-of-incorporation and place-of-management tests because many shareholders of corporations engaged in transnational operations would be unwilling to take up residency in a foreign country simply for tax avoidance reasons. Countries could not function as tax haven jurisdictions under the residence-of-the-shareholders test unless they were able to attract the owners of prospective tax haven corporations as residents.

Second, a residence-of-the-shareholders test would promote fairness. A corporation is a formal legal structure. Its claims to fair treatment under an income tax system are derived from the legitimate fairness claims of the human beings bearing the burdens of the corporate income tax. An ideal tax system, therefore, would coordinate the corporate income tax and the individual income tax, at least to some degree. A country cannot systematically coordinate individual and corporate income taxes, however, unless the corporations controlled by its resident individuals are also subject to its residence jurisdiction. Otherwise resident individuals could avoid a country's residence jurisdiction by deflecting their income to a foreign corporation under their control.

In many respects, the jurisdictional reach of the subpart F provisions is compatible with the residence-of-the-shareholders test suggested above. In general, the 50 percent or more control test of Code section 957, operating in conjunction with the indirect and constructive ownership tests of section 958, subjects foreign corporations to U.S. tax jurisdiction if a majority of their shares are owned by citizens or resident aliens of the United States, or by legal entities resident in the United States. In broad terms, therefore, the subpart F rules are a proper exercise of the U.S. residence jurisdiction, assuming the legitimacy of a residence-of-the-shareholders test.

For corporations controlled exclusively by the residents of one country, the residence-of-the-shareholders test provides intuitively appealing results, assuming that the test was adopted by the United States and most of its trading partners. The results would be less appealing if a corporation had some shareholders resident outside the country where the controlling shareholders were located. The country of residence of a corporation would be indeterminate under a residence-of-the-shareholders test whenever the shareholders of a corporation were not all residents in any one country.

For the residence-of-the-shareholders test to be workable, it would need to be refined to deal adequately with corporations having shareholders resident in more than one country. One possible refinement would be to apportion residence jurisdiction among countries with competing residence claims according to the percentage of ownership of their shareholders in the stock of the corporation. For example, if X, a corporation, has 10 shares outstanding, 6 owned by residents of Country M and 4 owned by residents of Country N, then Country M would be allowed to exercise residence jurisdiction over 60 percent of the income of X, with the balance of the income subject to the residence jurisdiction of Country N.

The PFIC rules of current law tax the U.S. shareholders of the PFIC with respect to their share of the income of the PFIC. In effect, a PFIC is treated as having multiple countries of residence. In principle, each country having a residence claim over the income of the PFIC is permitted to exercise residence jurisdiction in proportion to the ownership rights of its residences in the PFIC. This approach is identical to treating the PFIC as a conduit entity. That is, the jurisdictional claim is the same whether the United States asserts the

right to tax a proportionate share of the income of the PFIC, based on the residence of its shareholders, or it ignores the separate-entity status of the PFIC and taxes its U.S. residents on their share of the income of the PFIC.

Chapter 26
Subpart F Income

The subpart F income of a CFC is taxable as a deemed dividend to the U.S. shareholders of the CFC under Code section 951(a)(1)(A)(i). Section 952(a) defines subpart F income as the sum of the following five categories of income obtained by a CFC: (1) insurance income; (2) foreign base company income; (3) income attributable to compliance with an international boycott (international boycott income); (4) illegal payments made to an official, employee, or agent of a foreign government (foreign bribe income); and (5) income arising in certain unfriendly foreign countries (unfriendly foreign country income).[73] This section sets forth the requirements that must be met for an item of income to fall into one of these categories.

Section 26.01, below, discusses the definition of foreign base company income. In general terms, foreign base company income is net income that has been shifted, presumably for tax avoidance purposes, to a CFC organized in a tax haven jurisdiction. The definition of insurance income is discussed briefly in § 26.02, [omitted]. The taxation under subpart F of income from insurance operations has been greatly expanded by the Tax Reform Act of 1986, in large part to limit tax avoidance opportunities from captive insurance companies. Section 26.03, [omitted], describes the three remaining types of subpart F income.

Items of income classified as one of the categories of subpart F income are not necessarily subject to taxation as subpart F income because of the many relief provisions contained in subpart F. Some of those relief provisions are discussed in § 25.03 [omitted]. Section § 26.04, [omitted], explains three additional rules that affect the computation of foreign base company income. One of those rules provides an exclusion from certain categories of subpart F income for earnings and profits subject to an effective foreign tax rate greater than 90 percent of the maximum U.S. corporate rate. The other two rules are *de minimis* rules—one operating to benefit the taxpayer and the other operating to benefit the U. S. government.

Some items of income are taxable under subpart F only if they arose out of a transaction with a related person. The definition of "related person" is presented below in section § 26.01.2.2.

§ 26.01. Foreign Base Company Income

Neither the Code nor Treasury regulations define the term "base company." It usually designates a holding company or similar corporate shell organized in a tax haven jurisdiction for the purpose of receiving income deflected from business operations or investment activities conducted in other countries. Foreign base company income is defined in great detail by Code section 954 and the accompanying Treasury regulations. It is comprised of foreign personal holding company income,[74] foreign base company sales income,[75] foreign base company service income,[76] and foreign base company oil related income.[77] Prior to an

[73] See IRC § 952(a)(1)-(5).

[74] See IRC § 954(c) and Reg. § 1.954-2 (2011).

[75] See IRC § 954(d) and Reg. § 1.954-3 (2011).

[76] IRC § 954(e) and Reg. § 1.954-4 (2002).

[77] IRC § 954(g) and Reg. § 1.954-8 (1991). Rules for coordinating the definitions of types of subpart F income are provided by Reg. § 1.954-1(e)(4) (1999).

amendment to the Code made in 2004, foreign base company income also included foreign base company shipping income.

Section 26.01.1, below, discusses the definition of foreign personal holding company (FPHC) income, and § 26.01.2 discusses the definition of foreign base company (FBC) sales income. The remaining three categories of foreign base company income are addressed briefly in § 26.01.3, § 26.01.4, and § 26.01.5. In general terms, the purpose of the foreign base company income rules is to eliminate the tax benefits that U.S. shareholders of a CFC otherwise would obtain from shifting their earnings from a corporation subject to U.S. or foreign income taxes to a CFC organized in a low-tax jurisdiction having no natural business nexus with those earnings.

Foreign base company income is defined as gross income arising from certain specified transactions, reduced by deductions and exclusions properly allocable to such income.[78] That is, base company income is a net income concept, although the various categories of foreign base company income are defined initially in terms of gross income from certain transactions. The regulations make this point by using the term "adjusted net foreign base company income" for the statutory term "foreign base company income" (FBC income).[79] Section 26.01.6, below, describes the rules for reducing gross foreign base company income to adjusted net foreign base company income.

§ 26.01.1. Foreign Personal Holding Company Income

Foreign personal holding company (FPHC) income is comprised of eight categories of passive investment income.[80] The first of these categories, corresponding roughly to portfolio income, is addressed in section § 26.01.1.1, below. The remaining categories are addressed in section § 26.01.1.2. The definition of foreign personal holding company income under subpart F is a substantially modified version of the definition of foreign personal holding company income previously found in Code section 553. The tax on foreign personal holding companies previously contained in code sections 551-558 was repealed by the 2004 tax act, with amendments to Code section 954 to eliminate the impact of the repeal on the subpart F rules.

§ 26.01.1.1. Dividends, Interest, Rents, Royalties, and Annuities

In the first category of FPHC income are dividends, interest, royalties, rents, and annuities.[81] "Interest" includes any amount treated as interest under the Code or Treasury regulations, including stated and unstated interest, original issue discount, and related person factoring income treated as interest under Code section 864(d)(1) and (6).[82] The regulations also provide that exempt interest is included in FPHC income.[83] Some important exceptions apply, however, to exclude income items from this category that are likely to have been received by a CFC in the ordinary course of its business or that otherwise do not seem to present a serious threat of tax avoidance.

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[78] IRC § 954(b)(5) and Reg. §§ 1.954-1(a)(5) (2002) and 1.954-1(c) and (d) (2002).

[79] Reg. § 1.954-1(a)(5) (2002).

[80] IRC § 954(c)(1)(A)-(G) and Reg. § 1.954-2(a)(1) (2002) (listing only first 5 categories). Prior to the 1986 tax act, the definition of FPHC income found in IRC § 553 was the formal starting point in defining FPHC income for subpart F purposes.

[81] IRC § 954(c)(1)(A) and Reg. §§ 1.954-2(a)(1)(i) (2002) and 1.954-2(b) (2002).

[82] Reg. § 1.954-2(a)(4)(i) (2002).

[83] Reg. § 1.954-2(a)(4)(i) (2002) and Reg. § 1.954-2(b)(3) (2002). This rule applies for taxable years beginning after March 3, 1997.

One exception applies to dividends received by a CFC that have previously been taxed under subpart F.[84] This rule simply avoids a double inclusion of an amount in subpart F.

A second exception is for rents and royalties that a CFC receives from unrelated persons in the active conduct of its trade or business.[85] For example, income derived from conducting a rental car business would not be FPHC income.[86] Royalties earned by a CFC from patents that it developed or added substantial value to in the ordinary course of its business also would be excluded from FPHC income.[87]

A third exception applies to certain rents and royalties received by a CFC from a related person if those rents and royalties were received for the use of property within the country in which the CFC is organized.[88] Of course, the taxpayer must make an appropriate allocation of income if the CFC uses rental property only partly within its country of organization.[89]

Consider, for example, X, a CFC organized under the laws of Country A. X owns an office building located in Country A, which it rents to Y, a related person organized in Country B. Y uses the office building in its business. The rental fees received from Y would not be FPHC income. This exception does not apply to the extent that the related person was able to reduce its own subpart F income (or other tainted income) by the payment of the rent or royalty.[90] Assume, for example, that Y had sublet the office building to Z, a related person, and that the rental fees that Y received from Z were FPHC income. In that event, the rental fee received by X from Y would be FPHC income.

A fourth exception applies to certain dividends and interest received from a related person. For this exception to apply, the CFC and the related person must be organized under the laws of the same country.[91] In addition, the related person must have a substantial part of the assets used in its trade or business located in the country in which it is organized.[92] In the case of interest, the related payor must not have reduced its own subpart F income by the payment of the interest to the CFC.[93] Interest is also not excluded from FPHC income if it is related person factoring income or portfolio interest.[94] In the case of a dividend, the related person must have accumulated the earnings and profits out of which the dividend was paid during a period when its stock was owned, directly or indirectly, by the CFC.[95]

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[84] Reg. § 1.954-2(b)(1)(i) (2002). As an export incentive, export finance interest derived from the conduct of a banking business is excluded from FPHC income. IRC § 954(c)(2)(B) and Reg. § 1.954-2(b)(2) (2002).

[85] IRC § 954(c)(2)(A) and Reg. § 1.954-2(b)(6) (2002).

[86] Reg. §§ 1.954-2(c)(1)(iv) (2002) and 1.954-2(c)(3)(Ex. 2) (2002).

[87] See Reg. §§ 1.954-2(d)(1)(i) (2002) and 1.954-2(d)(3)(Ex. 1) and (Ex. 3) (2002).

[88] IRC § 954(c)(3)(A)(ii) and Reg. § 1.954-2(b)(5)(i)(A) (2002). Whether a payor is engaged in a trade or business in its country of incorporation is determined, with important exceptions, under the principles of IRC § 367(a) (dealing with reorganizations of foreign corporations). Reg. § 1.954-2(b)(4)(iii) (2002).

[89] Reg. § 1.954-2(b)(5)(ii)(B) (2002).

[90] IRC § 954(c)(3)(B) and Reg. § 1.954-2(b)(5)(ii)(A) (2002).

[91] IRC § 954(c)(3)(A)(i) and Reg. § 1.954-2(b)(4)(i)(A)(*2*) (2002).

[92] IRC § 954(c)(3)(A)(i)(II) and Reg. § 1.954-2(b)(4)(i)(A)(*3*) (2002). Reg. § 1.954-2(b)(4)(iv)–(xi) (2002) provides detailed rules for determining whether a CFC has used a substantial part of its assets within its country of incorporation.

[93] IRC § 954(c)(3)(B) and Reg. § 1.954-2(b)(4)(ii)(B)(*1*) (2002).

[94] Reg. § 1.954-2(b)(4)(ii)(C) (2002). For discussion of related person factoring income, see section § 26.01.1.2, below, and IRC § 864(d).

[95] IRC § 954(c)(3)(C) and Reg. § 1.954-2(b)(4)(ii)(A)(*1*) (2002).

§ 26.01.1.2. Look-thru Rule for Related CFCs

A major exception to the definition of first category of FHPC income was adopted in 2004. Under that exception, dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person generally shall not be treated as foreign personal holding company income to the extent attributable or properly allocable to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States.[96] That is, the character of the dividends, interest, rents, and royalties as FPHC income is determined by looking through the entity making the payment to see the character of the income out of which these payments were made. The effect is to prevent the subpart F rules from reaching most CFCs used as foreign holding companies. The provision currently applies to taxable years beginning before January 1, 2012.

The proponents of the look-thru rule argued that the taxation of subpart F income in the case of foreign holding companies primarily limited the ability of CFCs to avoid foreign income taxes, not U.S. taxes. Congress apparently believed that the United States might gain a competitive advantage over its trading partners by facilitating the avoidance of their income taxes by U.S.-owned CFCs. The revenue impact of the 2004 amendment is unclear because the same benefit could be obtained in many cases through use of the check-the-box rules.

§ 26.01.1.3. Other Categories of FPHC Income

The additional seven categories of FPHC income are described briefly below. In some cases, these income items are substitutes for the income items included in the first category.

Gain or Loss from Certain Property Transactions. The second category of FPHC income is for net gains derived from the sale or exchange of certain investment property.[97] Included in that category are certain gains from assets producing dividends, interest, royalties, rents, and annuities,[98] plus gains from assets producing no current income.[99] Also included are gains from the sale of an interest in a partnership, trust, or REMIC.[100] If a CFC owning 25 percent or more of a partnership sells an interest in that partnership, the CFC shall be treated as selling its proportionate share of the assets of the partnership.[101]

Excluded from this category are gains from the sale of assets that produced rental or royalty income that is not FPHC income because it arose from transactions with unrelated persons in the active conduct of a trade or business.[102] Gains from the sale of inventory assets and assets otherwise held for sale are also excluded from this category of FPHC income.[103]

Commodity Transactions. The third category of FPHC income is for net gains from transactions in commodities.[104] A commodity is generally tangible personal property of a kind that is actively traded (on a commodity exchange or elsewhere), or a contractual interest in such property. Gains from commodity

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[96] IRC § 954(c)(6).

[97] IRC § 954(c)(1)(B). Reg. § 1.954-2(a)(1)(ii) (2002).

[98] IRC § 954(c)(1)(B)(i). Reg. § 1.954-2(e)(1)(i)(A) (2002). See *Seagate Technology, Inc. v. Comm'r*, T.C. Memo 2000-361 (2000) (holding that gain derived from the sale of stock acquired from a prior sale of operating assets is FPHC income).

[99] IRC § 954(c)(1)(B)(iii) and Reg. § 1.954-2(e)(1)(i)(C) (2002).

[100] IRC § 954(c)(1)(B)(ii) and Reg. § 1.954-2(e)(1)(i)(B) (2002). A REMIC is a real estate mortgage investment conduit. See IRC §§ 860A – 860G.

[101] IRC § 954(c)(4).

[102] IRC § 954(c)(1)(B)(i) and Reg. § 1.954-2(e)(1)(ii)(C) (2002).

[103] IRC § 954(c)(1)(B) (last sentence) and Reg. § 1.954-2(e)(1)(ii)(A) and (B) (2002). Under some circumstances, these gains might constitute base company sales income.

[104] IRC § 954(c)(1)(C) and Reg. § 1.954-2(f)(1)(i) (2002).

transactions include gains derived from the purchase or sale of rights or obligations relating to a commodity. Thus, gains derived from forward or futures contracts, from actual delivery of a commodity, from notional principal contracts indexed to commodity prices, or from dealings in commodity options would constitute FPHC income.[105]

Gains from certain sales of commodities are excluded from FPHC income if they arise out of a commodities hedging transaction.[106] Also excluded are certain active business gains or losses from the sale of commodities[107] and certain foreign currency gains or losses.[108]

Foreign Currency Gain or Loss. The fourth category of FPHC income is for gains from transactions in foreign currency.[109] Exceptions apply for certain commodity gains and foreign exchange gains arising from normal business operations.[110] Taxpayers may elect to include net currency gains or losses in another category of FPHC income if the gain or loss relates to income in that other category.[111] For example, the taxpayer may elect to treat a currency gain relating to the sale of inventory as foreign base company sales income rather than FPHC income,[112] thereby producing a better result under the separate basket limitation rules of Code section 904(d). Alternatively, taxpayers may elect to treat all net foreign currency gains and losses (with some exceptions) as FPHC income, including, for example, business-related currency losses that otherwise would be excluded from FPHC income.[113]

Income Equivalent to Interest. The fifth category of FPHC income is for income equivalent to interest.[114] Included in this category are a grab bag of items, most of which reflect payments due to the time value of money. Under specified circumstances, the category includes factoring income (other than amounts included in the first category of FPHC income as interest), income derived from notional principal contracts (*e.g.,* interest-rate swaps), imputed interest arising from a delay in making payment for services, and commitment fees paid to a lender to provide financing (whether or not the financing is actually provided).[115]

Related person factoring income typically is income obtained by a foreign corporation after acquiring a trade or service receivable at a discount. Assume, for example, that P, a U.S. parent corporation, sells machinery to unrelated buyers on credit and sells the resulting trade receivable to X, a CFC, for 80 percent of the face amount of the receivable. The profit obtained by X on receiving payment of the face amount of the receivable would be related person factoring income. A broad definition of "related person" is provided in Code section 864(d)(4).

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105 Reg. § 1.954-2(f)(2)(ii) (2002).

106 IRC § 954(c)(1)(C)(i). A commodity hedging transaction is defined in IRC § 954(c)(5) (incorporating by reference the definition found in IRC § 1221(b)(2).

107 IRC § 954(c)(1(C)(ii).

108 IRC § 954(c)(1(C)(iii).

109 IRC § 954(c)(1)(D) and Reg. § 1.954-2(g) (2002).

110 See IRC § 954(c)(1)(C)(i)-(iii) and (D) and Reg. § 1.954-2(g)(2)(ii) (2002).

111 Reg. §§ 1.954-2(g)(1) and (3) (2002).

112 Reg. § 1.954-2(g)(3)(iv) (2002).

113 Reg. §§ 1.954-2(g)(4) (2002) (general rule) and 1.954-2(g)(5) (2002) (exceptions).

114 IRC § 954(c)(1)(E) and Reg. § 1.954-2(h) (2002).

115 Reg. § 1.954-2(h)(2)(i) (2002).

Income from Notional Principal Contracts. The sixth category, added by the 1997 tax act, is income from notional principal contracts, such as interest-rate swaps.[116] This income, like interest, is highly mobile and easy to shift to a tax haven.

Payments in Lieu of Dividends. The seventh category, also added by the 1997 tax act, is payments in lieu of dividends.[117] The latter category is necessary to prevent taxpayers from avoiding subpart F by "lending" dividend-producing stock to some person and receiving payments from that person in lieu of the dividends paid on that stock.

Personal Service Contracts. The eighth category was added by the 2004 tax act. It provides that FPHC income includes income derived by a corporation from a personal service contract, including the sale of such a contract, if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or the individual who is to perform the services is designated (by name or by description) in the contract.

This provision is designed to prevent entertainers, athletes, professionals, and other self-employed taxpayers from avoiding U.S. tax by deflecting income derived from their services to a foreign corporation. For example, if Mr. B, a famous movie star, is offered $10 million to perform in a movie, he might arrange for the movie producer to enter into a contract with his offshore corporation for his services, with the offshore corporation paying him some small fraction of the contract price. This type of tax avoidance was addressed in 1937 by the enactment of the foreign personal holding company provisions. When those provisions were repealed in 2004, Congress decided to treat income derived from personal service contracts as a type of subpart F income.

§ 26.01.1.3. Priority of Categories

An item of income, gain, or loss may fall into more than one of the eight categories of FPHC income described above. In such circumstances, the income, gain, or loss is treated solely as FPHC income from the category having the highest ranking.[118] The rankings are applied without reference to the various special exceptions provided for certain income items in those categories. For example, foreign currency gain is ranked ahead of gain or loss from certain property transactions whether or not the currency gain might be excluded from FPHC income as being directly related to the business needs of the taxpayer.

The rankings, from first to fifth, are as follows: (1) dividends, interest, rents, royalties, and annuities; (2) income equivalent to interest; (3) foreign currency gain or loss; (4) gain or loss from commodity transactions; and (5) gain or loss from certain property transactions.[119] The regulations do not yet provide a ranking for the two categories of FPHC income added by the 1997 tax act or the category added by the 2004 tax act. It should be anticipated, however, that income from notional principal contracts and payments in lieu of dividends will be ranked below the first category (dividends, interest, rents, royalties, and annuities) and ahead of the current fifth category (gain or loss from certain property transactions).

The rankings can matter in determining whether an item of income ends up being taxable under subpart F. For example, if a gain derived from a commodity transaction also constitutes foreign currency gain, it would be treated solely as a foreign currency gain under the ranking rules. As a result, the gain would be included in FPHC income as a foreign currency gain. If currency gain had a lower priority than gain from

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[116] IRC § 954(c)(1)(F).

[117] IRC § 954(c)(1)(G).

[118] IRC § 954(c)(1)(E) and Reg. § 1.954-2(a)(2)(i) (2011).

[119] Reg. § 1.954-2(a)(2)(ii) (2011).

commodity transactions, then the income item would have escaped subpart F treatment if it qualified for the active business exception under the rules governing commodity transactions.

§ 26.01.1.4. Coordination with PFIC Regime

United States persons that escape taxation under the subpart F foreign personal holding company (FPHC) rules—either because they do not satisfy the 10-percent requirement for being a U.S. shareholder or because the foreign corporation is not a CFC—may be taxable under the passive foreign investment company (PFIC) rules of Code sections 1291 through 1297. A person taxable under subpart F is not taxable again under the FPHC rules or the PFIC rules.

§ 26.01.1.5. Special Rules for Financial Services Firms

Income otherwise constituting FPHC income will not be so treated if the income is earned by a financial services business from the active conduct of a banking, financing, or similar business.[120] This escape hatch out of subpart F was adopted in 1997, given a line-item veto by President Clinton, reinstated after the Supreme Court held that the line-item veto statute was unconstitutional, and then revised somewhat to reduce some of the opportunities for tax avoidance that it was thought to provide. It is formally a temporary measure; it was extended by Congress in 1999 for taxable years beginning before January 1, 2002. This short period is due primarily to the high cost in forgone revenue of permanent relief. It was extended again in 2002 for taxable years beginning before January 1, 2007, at an estimated revenue loss, according to the Joint Committee on Taxation, of over $9 billion. The measure was extended to taxable years beginning before January 1, 2010, and then again to taxable years beginning before January 1, 2012.

§ 26.01.2. Foreign Base Company Sales Income

Foreign base company (FBC) sales income is defined in Code section 954(d). According to that provision, the profits, commissions, fees, or other gross income of a CFC derived from transactions in personal property with a related person constitute FBC sales income under certain conditions. These conditions are explained below in section § 26.01.2.1.

Section § 26.01.2.2 discusses the definition of a related person. That definition is central to the definition of FBC sales income and FBC services income. It is also used, however, in the definition of the other three categories of FBC income and in the definition of subpart F insurance income.

Under certain conditions, the Code and Treasury regulations provide that a branch of a CFC will be treated as a separate corporation for purposes of determining the FBC sales income of the CFC. The effect of characterizing a branch as a separate corporation is that deemed transactions between a branch and the remaining part of a CFC can constitute a transaction between related persons. The characterization of a branch as a separate corporation is referred to as a branch rule. The sales branch rule and the manufacturing branch rule are explained in section § 26.01.2.3, below.

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[120] IRC § 954(h).

§ 26.01.2.1. Identifying FBC Sales Income

For gross income of a CFC to constitute FBC sales income, it must have arisen from a transaction with a related person. A CFC may generate FBC sales income by buying or selling personal property on its own account or by acting as a commission agent. The following four types of transactions entered into by a CFC may qualify as transactions with a related person:

(1) the purchase of personal property from a related person and its sale to any person;

(2) the sale of personal property to any person on behalf of a related person;

(3) the purchase of personal property from any person and its sale to a related person; and

(4) the purchase of personal property from any person on behalf of a related person.[121]

A purchase of personal property from a related person and its sale to a related person would be a transaction described in both (1) and (3) above.

Consider, for example, a CFC, LCo, organized under the laws of Country L, a low-tax country. LCo purchases goods manufactured by FCo, a related party, in Country F and sells those goods to unrelated customers in Country G. The profits earned by LCo from the purchase and sale would be FBC sales income. If LCo had sold the goods for FCo on commission, LCo's commission fees would be FBC sales income. LCo would also have FBC sales income if it bought goods from UCo, an unrelated party, and sold the goods in Country G to GCo, a related party. If LCo had made the purchases from UCo as a commission agent for GCo, its commission fees would be FBC sales income. LCo would not have FBC sales income, however, if it bought goods from UCo, the unrelated party, and sold the goods to unrelated parties in Country G.

Income of a CFC arising from a sale or purchase of personal property will not constitute FBC sales income if the personal property sold or purchased is manufactured, produced, grown, or extracted within the country in which the CFC is created or organized.[122] Assume, for example, that X and Y are wholly owned subsidiaries of P, a U.S. corporation. X and Y are both organized under the laws of Country T. X manufactures widgets, which it sells to Y for resale outside of Country T. Y sells the widgets to P. Y's income from its sales of widgets to P will not constitute FBC sales income because Y is organized in the country where the widgets are produced.[123]

Income is also excluded from FBC sales income of a CFC if the CFC is organized in the country where the property is sold.[124] The country of sale is determined by employing a destination test rather than a passage of title test. That is, personal property is deemed to be sold in the country where the goods have been used, consumed, or disposed of.[125] Goods sold by a CFC to an unrelated person are presumed to be sold in the country where the goods have been shipped unless the CFC has reason to know that the goods would not be used, consumed, or disposed of in the country of destination.[126]

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[121] IRC § 954(d)(1) and Reg. § 1.954-3(a)(1)(i) (2011).

[122] IRC § 954(d)(1)(A) and Reg. § 1.954-3(a)(2) (2011).

[123] See Reg. § 1.954-3(a)(2)(Ex. 1) (2011).

[124] IRC § 954(d)(1)(B) and Reg. § 1.954-3(a)(3)(i) (2011).

[125] Reg. § 1.954-3(a)(3)(ii) (2011).

[126] Id.

In summary, income arising from the purchase of personal property produced in one country and sold in another country is not taxable under subpart F unless that income has been deflected to a CFC organized in a third country.[127] The example below illustrates the reach of the FBC sales rules.

Example 26.1: Foreign Base Company Sales Income

Corporation LCo, a CFC, is organized under the laws of Country L, a tax haven jurisdiction. LCo purchases goods manufactured in the United States by PCo, its U.S. parent corporation. LCo sells the goods to a related corporation, MCo, organized in Country M, and MCo resells the goods to unrelated customers in Country M. Assuming, as is likely, that none of the escape provisions of subpart F are applicable, then the income received by LCo from the purchase and sale of goods manufactured by PCo will be FBC sales income. The same result would apply if LCo had purchased the goods from any related manufacturer, as long as the manufacturing activity was not carried on in Country L, the tax haven jurisdiction.

If LCo purchased the goods from a related manufacturer and sold them directly to customers in Country M, its income still would be FBC sales income, assuming no escape provisions are applicable. As long as LCo is able to avoid taxation in Country M—by arranging the sale outside Country M or otherwise having minimal contacts with Country M—none of the escape provisions are likely to be applicable.

LCo's income would constitute FBC sales income if LCo purchased the goods from an unrelated manufacturer rather than from PCo and sold them to a related person for resale to customers located outside Country L. LCo would have FBC sales income even if it acted as a commission agent for a related person on the purchase of goods from an unrelated manufacturer and the sales were made to unrelated buyers located outside Country L.

A CFC can escape taxation under the FBC sales rules by becoming the manufacturer or producer of the goods that it sells.[128] In such circumstances, it is deemed not to have made a purchase of personal property from any party, even if the goods it has sold were manufactured or produced from property it had purchased. Assume, for example, that X, a CFC, purchases wood pulp from its U.S. parent and transforms the pulp into paper, which it then sells. The income from the sale of paper would not be FBC sales income, even if the paper was sold to related persons and even if the manufacturing and sale of the paper took place outside the country where X is incorporated.[129]

Packaging, repackaging, labeling, or minor assembly of property purchased from another person can never constitute manufacturing.[130] Major assembly, however, can constitute manufacturing under some circumstances. For example, a CFC that assembles automobiles from purchased components would be treated as the manufacturer of those automobiles.[131]

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[127] In addition, IRC § 954(d)(1) (last sentence) exempts from FBC sales income amounts obtained from the sale of bananas, coffee, crude rubber, and other agricultural products not grown in the United States in commercially marketable quantities. See Reg. § 1.954-3(a)(1)(ii) (2011). This exception is simply a tax preference with no relationship to the general policy goals of the FBC sales rules. In contrast, income derived from the sale or milling of unprocessed timber is explicitly included within the definition of FBC sales income. IRC § 954(d)(4).

[128] Reg. § 1.954-3(a)(4) (2011).

[129] Reg. § 1.954-3(a)(4)(ii)(Ex. 1) (2011).

[130] Reg. § 1.954-3(a)(4)(iii) (2011).

[131] Reg. § 1.954-3(a)(4)(iii)(Ex. 2) (2011). As a safe-harbor rule, Reg. § 1.954-3(a)(4)(iii) (2011) provides that a CFC generally will be treated as the manufacturer of goods sold if its actual expenditures in converting the purchased components of those goods (continued...)

Income of a CFC that constitutes foreign trade income, as defined in Code section 923, is not included in FBC sales income.[132] Nor is income from the sale of securities or from futures transactions taxable as FBC sales income if it is taxable as foreign personal holding company income or as foreign base company shipping income.[133] Income derived by a CFC from the sale of tangible personal property to an unrelated person is excluded from FBC sales income if the property has been used substantially by the CFC in the active conduct of a trade or business.[134] Also excluded are gains from the sale of business assets, other than inventory, if the sale was made pursuant to the discontinuation of the CFC's business.[135]

§ 26.01.2.2. Definition of Related Person

A person is a related person with respect to a CFC under either of the following two rules. Under the first rule, a corporation, trust, partnership or estate is a related person if that person controls or is controlled by the CFC. For example, if PCo, a U.S. corporation, owns all of the stock of XCo, a CFC, then PCo is a related person with respect to XCo. Similarly, if FCo, a foreign entity characterized as a partnership under U.S. tax concepts, is controlled by XCo, then PCo is a related person with respect to XCo.[136] An individual (whether or not a U.S. citizen or resident) is a related person with respect to a CFC if he controls the CFC.[137]

The second rule states that a corporation, partnership, trust, or estate is a related person with respect to a CFC if that person is controlled by the same person or persons that control the CFC.[138] For example, if A, B, and C own all of the stock of XCo, a CFC, and also own all of the stock of YCo, a domestic corporation, then XCo and YCo are related persons. Similarly, a foreign partnership controlled by A, B, and C will be a related person with respect to XCo. The most common example of related persons under this rule are brother-sister foreign subsidiaries of a common U.S. parent corporation.

Control of a person is determined under Code section 954(d)(3) by applying either a voting control test or an ownership test. The 1986 tax act, as amended by TAMRA (1988), provides that a person or group of persons constituting a control group satisfies the voting control test with respect to a corporation if they own, directly or indirectly, more than 50 percent of the voting stock of that corporation. The ownership test is satisfied if the person or control group owns more than 50 percent of the total value of the stock of that corporation.[139] In determining ownership of stock, the indirect and constructive ownership rules of section 958 are applicable.[140]

A trust or estate is controlled by a person or control group if the person or control group owns, directly or indirectly, beneficial interests in that trust or estate representing more than 50 percent of the

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131 (...continued)
represent 20% or more of the total inventory costs of those goods.

132 See IRC § 951(e) (stating that foreign trade income and the deductions properly allocable to such income "shall not be taken into account under this subpart").

133 Reg. § 1.954-3(a)(1)(i) (2011).

134 Id.

135 Id.

136 IRC § 954(d)(3)(A) and Reg. § 1.954-1(f)(1)(ii) (2002).

137 Id. IRC § 954(d)(3)(A) provides that an individual is a related person with respect to a CFC if the CFC controls it. The definitions of control contained in the Code and regulations, however, would prevent a CFC from controlling an individual.

138 IRC § 954(d)(3)(B) and Reg. § 1.954-1(f)(1)(ii) (2002).

139 Reg. § 1.954-1(f)(2)(i) (2002). See Staff of the Joint Committee on Taxation, *Description of the Technical Corrections Act of 1988* (H. R. 4333 and S. 2238), March 31, 1988, at 278-279.

140 Reg. § 1.954-1(f)(2)(iv) (2002).

total value of the beneficial interests outstanding.[141] A partnership is controlled if the person or control group owns, directly or indirectly, more than 50 percent of the value of the capital or profit interest in the partnership.[142] Rules similar to the stock attribution rules of Code section 958 are to be applied in determining direct and indirect ownership of beneficial interests in a partnership, trust, or estate.[143]

The 1986 tax act modified the definition of a related person by introducing the ownership test and by adding legal entities other than corporations to the list of related persons. Prior to those changes, taxpayers routinely avoided having sales to a related person through the use of buffer entities, such as foreign partnerships and foreign trusts.

For an example of the use of buffer entities, assume that PCo, a U.S. parent corporation, manufactures goods in the United States for sale in Canada. PCo establishes XCo, a CFC, organized in a tax haven, to which it wishes to deflect the profits from its Canadian sales. If PCo sells its manufactured goods to XCo, and XCo resells in Canada, XCo will have FBC sales income because it purchased the goods from PCo, a related person. Prior to the 1986 changes, however, XCo could establish a trust in a tax haven and have the trust purchase the manufactured goods from PCo. The trust would not be considered a related person under the pre-1986 law. XCo could then purchase the goods from the trust and sell them in Canada without having made a purchase from or a sale to a related person.

The 1986 tax act still leaves open some opportunities for the use of buffer corporations. Assume that PCo, in the example above, arranges for a nonresident alien individual, N, to organize a corporation, LCo, under the laws of the tax haven jurisdiction, with N the sole shareholder of LCo. LCo would not be a related person with respect to PCo or XCo. The plan would be for PCo to sell its manufactured goods to L, and L would sell the goods to XCo at a small markup for resale in Canada. Assuming that the sale to LCo is not a sham, XCo would not be taxable under subpart F because XCo purchased goods from an unrelated person and sold those goods to unrelated persons.

To prevent the use of buffer entities as in the example above, Congress could use a less mechanical definition of control, such as the definition used under Code section 482 for policing transfer pricing, abuses.[144] A completely flexible test of control would be undesirable, however, because of the uncertainty it would create.

The buffer problem illustrated above could be solved with a mechanical rule. That rule would treat a person who purchases goods for resale as a related person with respect to a CFC if it purchases goods from a person who is a related person with respect to the CFC and sells those goods to another person who is a related person with respect to the CFC. Given the variety of ways that buffer entities might be employed, however, it may be desirable to buttress the mechanical tests with a rule that gives the Internal Revenue Service some flexibility in identifying an entity as a related person.

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[141] Reg. § 1.954-1(f)(2)(iii) (2002).

[142] Reg. § 1.954-1(f)(2)(ii) (2002).

[143] Reg. § 1.954-1(f)(2)(iv) (2002).

[144] See Reg. § 1.482-1(i)(4) (2012) (The term "'controlled' includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised").

§ 26.01.2.3. Branch Rule

In applying tests for identifying FBC sales income, a branch or similar establishment of a CFC located outside the country of incorporation of the CFC may be treated as if it were a wholly owned subsidiary of the CFC, organized under the laws of the country where the branch is located.[145] There are two branch rules. One of those rules is called the sales branch rule[146] and the other is called the manufacturing branch rule.[147] Both rules are designed to impose taxes under subpart F on the foreign sales income of a CFC. The operation of those rules is illustrated in this section.

The branch rules were designed to fill a gap in the coverage of subpart F created by the practice of some governments of exempting their resident corporations from taxation on income earned through a foreign branch. Because of that practice, U.S. taxpayers would be able, in the absence of the branch rules, to avoid current foreign and U.S. taxes on their sales income, thereby obtaining the tax advantage that the FBC sales rules were designed to block.

A branch rule is triggered if the use by a CFC of a sales branch or a manufacturing branch "has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation" of the CFC.[148] The tax effect of using a branch is deemed to be substantially the same as the tax effect of using a subsidiary if the foreign taxes actually paid with respect to the sales income of a CFC are less than 90 percent of, or at least 5 percentage points lower than, the taxes that would have been paid if that income had been fully taxable in the country where the CFC is organized. If the sales income was not taxed at all, a branch rule would apply as long as the normal corporate rate in the country where the CFC is organized is 5 percent or more.

The sales branch rule prevents U.S. taxpayers from avoiding taxation under subpart F on income arising from the sales operations of a branch of a CFC located in a tax haven jurisdiction. Under that rule, a branch of a CFC that is located outside the country where the CFC is organized and that carries on purchasing or selling activities will be treated as a separate corporation for purposes of applying the FBC sales rules. The example below illustrates its operation.

Example 26.2: Sales Branch Rule

MCo is a CFC organized under the laws of Country M. It has a branch office in Country L, a tax haven jurisdiction. Country L has no income tax. Country M does not tax income earned by its domestic corporations, such as MCo, to the extent that the income is attributable to a foreign branch, but it otherwise taxes income of a domestic corporation at a rate of 30 percent. MCo manufactures goods in Country M, which it sells outside of Country M and Country L through its branch office in Country L. The income MCo obtains from the sale of those goods is not taxed by Country M because it is earned through a foreign branch.

But for the branch rule, the profits that MCo earns through its Country L branch office would not be taxable under subpart F as FBC sales income because the goods sold were manufactured by MCo and not purchased from any person.[149] The sales branch rule would apply, however, because the foreign tax imposed on the sales income of the branch was zero, which is 30 percentage points lower

[145] IRC § 954(d)(2). See also Reg. § 1.954-3(b)(2)(ii)(a) (2012) (stating that a branch of a CFC will be treated as a subsidiary of the CFC for purposes of computing FBC sales income).

[146] See IRC § 954(d)(2) and Reg. § 1.954-3(b)(1)(i) (2012).

[147] Reg. § 1.954-3(b)(1)(ii) (2012). The Code provides no explicit authority for the manufacturing branch rule.

[148] Reg. §§ 1.954-3(b)(1)(i)(a) and (ii)(a) (2012).

[149] See Reg. § 1.954-3(a)(4) (2012).

than the tax that would have been applied if that income had been earned in Country M through a subsidiary corporation.

Under the sales branch rule, the branch of MCo would be treated, for the limited purpose of determining MCo's FBC sales income, as a separate corporation, organized under the laws of Country L. The income attributable to the branch would be treated as income arising from the purchase of personal property from a related person and the sale of that property outside the country in which the branch is deemed to have been organized. Consequently, the income would qualify as FBC sales income under Code section 954(d)(1).

The manufacturing branch rule is a creature of the regulations. It is designed to prevent a CFC that is manufacturing goods through a branch located outside the country where the CFC is organized from avoiding taxation under subpart F. Under certain specified circumstances, the manufacturing branch rule requires that a branch of a CFC conducting manufacturing operations and the remaining part of the CFC be treated as separate corporations. The remaining part of the CFC will be deemed to have purchased goods from the manufacturing branch, with the result that the sales income attributable to the remaining part of the CFC will be classified as FBC sales income. The example below illustrates the operation of the manufacturing branch rule.

Example 26.3: Manufacturing Branch Rule

LCo, a CFC, is organized under the laws of Country L, a tax haven jurisdiction. It has a manufacturing branch located in Country M. The branch manufactures products in Country M for sale by LCo in Country N to unrelated persons. Country M taxes the income of LCo attributable to the manufacturing activities of its branch at a substantial tax rate, but it does not tax the income of LCo attributable to sales of goods outside of Country M.

The branch rule will apply under these conditions because the foreign taxes paid by LCo with respect to its sales income are substantially below the foreign taxes that LCo would have paid with respect to that income if (1) the income had been earned by a corporation organized in Country M (the country where the manufacturing branch is located) and (2) the income had been subject to the normal corporate tax rates of that country. Under the manufacturing branch rule, the manufacturing branch of LCo and the remaining part of LCo are treated as separate, related corporations for purposes of determining the FBC sales income of LCo. Because LCo's sales income would be deemed to have arisen out of the purchase of personal property from a related corporation and the sale of that property to unrelated persons, that income would be taxable under subpart F as FBC sales income.[150]

§ 26.01.2.4. Contract Manufacturing

The Internal Revenue Service has attempted to invoke the branch rule to prevent taxpayers from avoiding subpart F through the use of contract manufacturers. A contract manufacturer may be a related or unrelated party that produces goods under a cost-plus contract. In Rev. Rul. 75-7,[151] the Service ruled that a CFC that contracted to have iron ore processed for it by an unrelated person would be treated as the manufacturer of the refined ore for purposes of subpart F. As a result, a sale of the refined ore by the CFC did not produce subpart F income under the manufacturing exception. The Service also stated that the contract manufacturer could be treated as a related person with respect to the CFC under the branch rule. If the branch rule applied, the branch would be treated as having acquired the refined ore from the CFC, a

[150] This example is based on Reg. § 1.954-3(b)(4)(Ex. 2) (2012).

[151] Rev. Rul. 75-7, 1975-1 C.B. 244.

related person, and a sale of the refined ore by the branch would constitute base company sales income. Under the facts of the ruling, however, the branch was located in a high-tax country, so the branch rule did not in fact apply.

Many schemes have been developed by tax specialists for using contract manufacturers to defeat the policy goals of subpart F. Under one scheme, illustrated in *Ashland Oil,* reproduced below, a U.S. parent company established a sales affiliate in a tax haven country (Liberia) that would acquire goods from an "unrelated" contract manufacturer located in Belgium. The contract manufacturer produced goods for Ashland Oil's product line, using Ashland Oil's technology and patents, under the close supervision of the sales affiliate. The sales affiliate purchased the goods from the contract manufacturer. The price of the goods was the costs incurred by the contract manufacturer, plus a fixed profit markup. The sales affiliate then sold the purchased goods to unrelated distributors, earning for itself all of the entrepreneurial profits derived from the production and sale of the goods.

The sales affiliate claimed that it did not have base company sales income because it had neither purchased from nor sold to a related party. The tax authorities argued, consistent with Rev. Rul. 75-7, that the activities of the contract manufacturer on behalf of Ashland Oil and its affiliate constituted a branch of the sales affiliate for purposes of the branch rule. The Tax Court sided with the taxpayer, although it recognized that the result the taxpayer was attempting to achieve directly conflicted with the policy of subpart F. In the court's view, the Service was attempting to use the branch rule as a general loophole-closing provision, contrary to congressional intent.

In the *Vetco* case, the Tax Court rejected the Internal Revenue Service's invocation of the branch rule in the case of an affiliated contract manufacturer.[152] In response to its defeats in *Ashland Oil* and *Vetco*, the U.S. tax authorities have withdrawn Rev. Rul 75-7.[153] The current position of the Service is that a CFC can avail itself of the manufacturing exception from base company sales income only if it has performed the manufacturing activities itself.[154] It is no longer willing to be whipsawed by taxpayers arguing that the activities of a contract manufacturer can be attributed to a CFC for purposes of the manufacturing exception but not for purposes of the branch rule.

[§§ 26.01.3-2601.5 omitted]

§ 26.01.6. Deductions from Foreign Base Company Income

The U.S. shareholders of a CFC are taxable under Code section 951 on what the Code refers to as foreign base company (FBC) income and what the regulations call adjusted net foreign base company income. To compute adjusted net FBC income, a CFC must first determine the amount of its "net foreign base company income." The regulations set forth a four-step procedure for reducing gross FBC income to net FBC income.[155]

Step One. The first step in that procedure is the sorting of gross FBC income into "items of income."[156] Deductions are then allocated and apportioned to those "items of income" under steps two, three and four.

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[152] See *Vetco Inc. v. Comm'r,* 95 T.C. 579 (1990).

[153] Rev. Rul. 97-48, 1997-2 C.B. 89.

[154] Id. Proposed regulations embodying the result of Rev. Rul. 97-48 were issued in conjunction with the hybrid-entity regulations. They were withdrawn when the Service was forced by Congress to withdraw the hybrid-entity regulations.

[155] Reg. § 1.954-1(c) (2002).

[156] Reg. § 1.954-1(c)(i)(A) (2002).

The section 1.954-1 regulations define the term "item of income" in a way that makes good sense in terms of the goals of the regulations but that is inconsistent with the dictionary meaning of that term. An "item," according to *Webster's Third International Dictionary,* is "an individual particular or detail singled out from a group of related particulars or details." The section 1.954-1 regulations define an item of income to be a specified class of income, and the regulatory rules defining items of income are classification rules. The point of the classification rules is to subdivide the class of FBC gross income into the various subclasses that have tax significance under the separate basket limitation rules of Code section 904(d) or under Code section 954 itself.[157]

The following rules apply for sorting gross FBC income into "items of income." First, FBC income is divided into two broad categories: (1) passive FPHC income, and (2) FBC income that is not passive FPHC income. FPHC income generally is "passive" if it constitutes income includable in the passive income basket under Code section 904(d)(1)(A), determined after application of the look-through rules of section 904(d)(3).[158] Passive FPHC income is subdivided into the various groupings that are relevant for purposes of applying the passive basket limitation rules.[159] Those groupings are further subdivided into the seven categories of FPHC income set forth in section 904(c)(1)(A)-(G) and discussed in section § 26.01.1, above. Thus, one of those categories is "dividends, interest, rents, royalties and annuities;" a second is "gains from certain property transaction." Each of the resulting subcategories of passive FPHC income constitutes an "item of income."[160]

FBC income that is not passive FPHC income is likewise broken down into the categories that are relevant for purposes of the separate basket limitation rules and the rules of Code section 954. Those categories are: (1) FPHC income that is not passive; (2) FBC sales income; (3) FBC services income; (4) FBC shipping income; (5) FBC oil related income; and (6) full-inclusion FBC income.[161] That final category is comprised of income otherwise not considered FBC income that is so treated under the 70-percent full-inclusion rule of section 954(b)(3)(B). The first of these categories is further broken down into the seven categories of FPHC income described in section 904(c)(1)(A)-(G) and discussed in section § 26.01.1, above. Each of the resulting subcategories of income constitutes a single "item of income."[162]

Step Two. After determining the various "items of income" in step one, the CFC must allocate and apportion to those items of gross income the expenses "definitely related to less than all gross income as a class" in accordance with the principles of Code sections 861, 864, and 904(d).[163] In general, the deductions allocated and apportioned in this step are expenses other than interest expense.[164] For example, the salary

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[157] Thus, an "item of income" under Reg. § 1.954-1(c)(iii) (2002) is what might generally be thought of as a grouping of various items of income. The special terminology apparently is used to conform with the language of IRC § 954(b)(4), which provides that the high-tax exception is to apply to "items of income." The same grouping scheme used for allocation and apportioning deductions is also used in applying the high-tax exception.

[158] See Reg. § 1.954-1(c)(1)(iii)(B) (2002) and Reg. § 1.904-4(b)(1)(i) (2011).

[159] For example, Reg. § 1.904-4(c)(5)(i) (2011) provides that "[a]ll items of rent or royalty income to which an item of rent or royalty expense is directly allocable shall be treated as a single item of income and shall not be grouped with other amounts." The word "item" is used here in the conventional manner, not with the special gloss of Reg. § 1.954-1(c)(1)(iii) (2002).

[160] Reg. § 1.954-1(c)(1)(iii)(B) (2002).

[161] Reg. § 1.954-1(c)(1)(iii)(A) (2002).

[162] Reg. § 1.954-1(c)(1)(iii)(B) (2002). As of November, 2012, the regulations have not been updated to reflect the addition of two additional categories of passive income by the 1997 tax act.

[163] Reg. § 1.954-1(c)(1)(i)(B) (2002).

[164] Personal expenses and certain interest expenses not allocated and apportioned under the asset method would be allocated under step two.

of a sea captain that was incurred to earn FBC shipping income would be attributed to gross FBC shipping income under this step.

Step Three. The third step is to a reduce the gross income in the various categories of passive FPHC income (determined before application of the high-tax kick-out rule) by the related person interest expense attributable thereto.[165] Related person interest expense is interest paid by a CFC to its U.S. shareholders (or to other related persons) to which the look-through rules of Code section 904(d)(3) apply.[166]

Step Four. The final step is to allocate and apportion the remaining deductions to each of the items of income identified in step one.[167] For most CFCs, the important remaining deduction is the deduction for interest expenses that was not allocated and apportioned to an item of gross income in steps two and three.

In some circumstances, the application of steps two, three, and four to an item of gross subpart F income will result in a net loss. Any such resulting losses generally cannot be netted off against any net gains that may result from application of the four-step procedure.[168] Assume, for example, that F, a CFC, has a gain of $300 from FPHC dividend income that is not passive and also has a loss of $100 from passive FPHC royalty income. F has net income of $200 that does not constitute subpart F income and has earnings and profits of $400 ($300 – $100 + $200). F cannot offset the subpart F gain of $300 by the subpart F loss of $100. Thus the U.S. shareholders of F will be taxable under Code section 951(a)(1)(A)(i) on their share of F's gain of $300.

A CFC showing a loss in one item of income may be able to avail itself of the rule that limits the amount taxable as net adjusted subpart F income to the earnings and profits of the CFC. Assume, for example, that F in the example above did not have any income other than the subpart F gain of $300 and subpart F loss of $100, and had earnings and profits of only $200 ($300 – $100). In that event, the earnings-and-profits limitation would apply. Thus the U.S. shareholders of F would be taxable only on their share of $200.

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[165] Reg. § 1.954-1(c)(1)(i)(C) (2002). See IRC § 954(b)(5).

[166] Reg. § 1.954-1(c)(1)(i)(C) (2002). See Reg. § 1.904-5(c)(2)(i) (2011).

[167] Reg. § 1.954-1(c)(1)(i)(D) (2002).

[168] Reg. § 1.954-1(c)(1)(ii) (2002). For an exception to the general rule, applicable to foreign currency transactions, see Reg. § 1.954-2(g)(4) (2011).

Chapter 29
Subpart F Planning Problems

§ 29.01. Planning Problem: Collectible Dolls

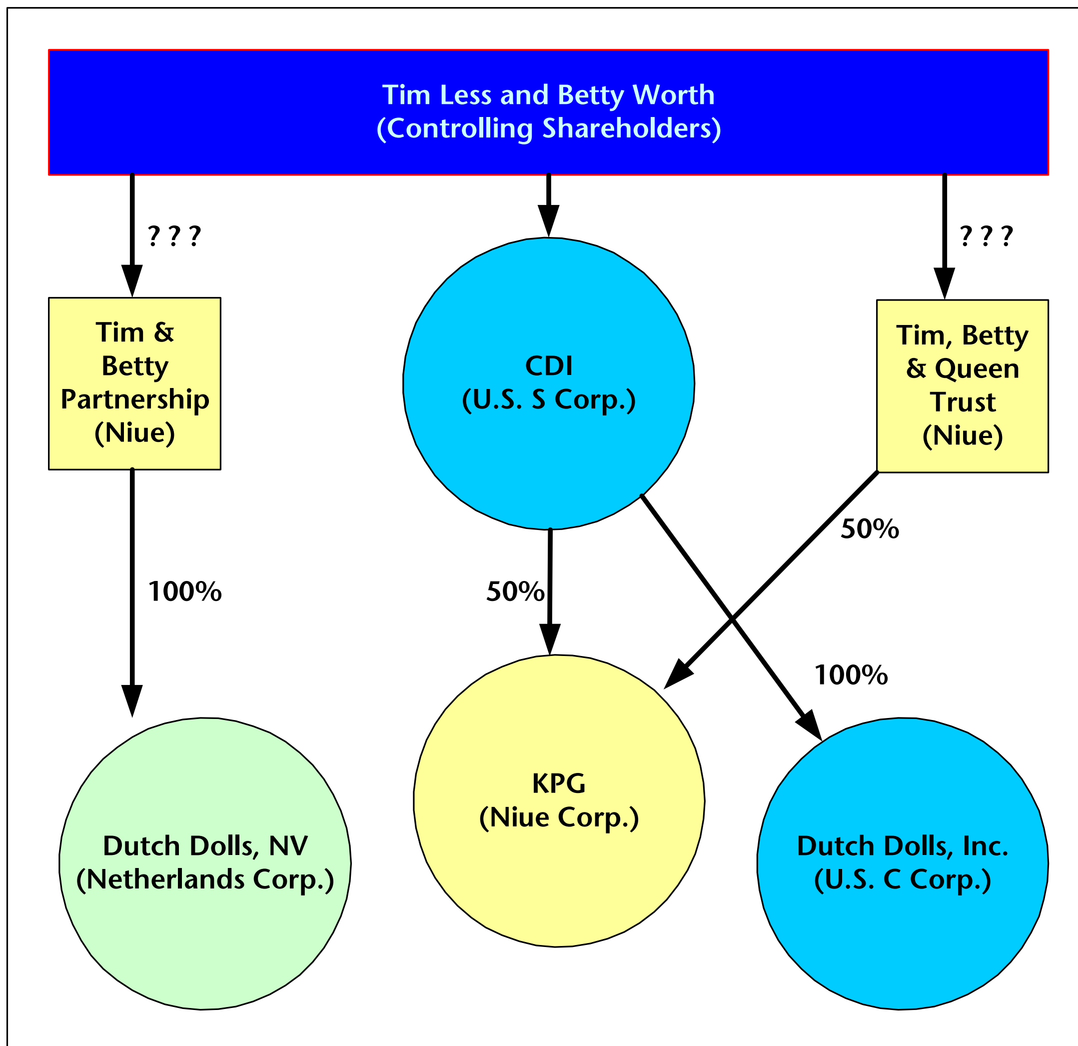
Collectible Dolls, Inc. (CDI) is an S corporation organized in Delaware, MD, and equally owned by Tim Less and Betty Worth, both U.S. citizens and residents. Tim and Betty were law school classmates but otherwise are unrelated. Tim is president of CDI and its chief operating officer; Betty is vice president and chairman of the board of directors. Through a group of enterprises described below, CDI manufactures dolls in China and sells them in the United States and Europe. Last year, the group sold approximately 50,000 dolls at US $30 each to various stores in Europe and the United States. Over half of the sales are typically made in Germany. The dolls are manufactured in China by independent companies in accordance with the detailed instructions of Tim and Betty. Betty and Tim design the dolls, relying heavily (but hopefully not too heavily) on the designs of the leading U.S. and European toy manufacturers. The Chinese manufacturers sell the dolls to the group for approximately $5 per doll.

The doll business is organized as follows. Kleine Puppen, GmbH (KPG), is a corporation organized under the laws of Niue, a small country in the South Seas (see following description of tax rules etc. for Niue). KPG has contracted with two Chinese business groups in Guangzhou, China, to produce the dolls in accordance with the designs of Tim and Betty. Tim and Betty fax the designs to the Chinese manufacturers as soon as they have completed those designs (generally after receiving information from their contacts in the toy industry about the designs of the leading doll manufacturers).

To take advantage of the China/Netherlands income tax treaty, KPG has organized a purchasing company, Dutch Dolls, N.V., under the laws of the Netherlands. All of the stock of Dutch Dolls, N.V., is owned by a partnership organized under the laws of Niue, with Tim and Betty as the partners. Dutch Dolls, N.V., purchases the dolls from the Chinese manufacturers on behalf of KPG. The price of the dolls is set generally at the cost of production plus 20 percent, with certain adjustments typically made for special circumstances. The Dutch company has no authority to bind KPG; in making the purchases from the Chinese manufacturers, Dutch Dolls, N.V., must fax KPG's office in Niue to confirm the contract price. Although KPG has no employees in Niue, it does have a business agent located there who is authorized to confirm all purchase requests received from Dutch Dolls, N.V.

The sales in Europe are made as follows. KPG sells the dolls to Dutch Dolls, Inc., a Delaware corporation with an office in Naples, Italy. The price is typically around $25 per doll. The only shareholder of Dutch Dolls, Inc. is CDI. Dutch Dolls, Inc. resells the dolls to Dutch Dolls, N.V. Dutch Dolls, N.V., makes sales of the dolls to various unrelated stores in Europe and the United States. Dutch Dolls, N.V., does not have a permanent establishment in any of the countries in which it sells the dolls. The Netherlands has a tax treaty with all of those countries.

CDI owns 50 percent of the common stock of KPG (the only class of stock outstanding). The remaining 50 percent is owned by a trust set up in Niue. The trust is administered by an independent trustee bank



operating in Niue. Under the trust agreement, the Queen of England or some other member of the royal family (determined by lot each month by an independent trustee) is the beneficiary of the trust on the first day of each 30 day period (starting on the first day of January). On all other days, the beneficiaries are Tim and Betty. The beneficiaries of the trust have the right to vote the shares of KPG. No one has thought to tell the royal family that they have been named beneficiaries, and they are unlikely to learn of their good fortune, due to the secrecy laws of Niue. Under Niue law, the beneficiary of a trust is determined as of the first day of each month.

Over the past three years, KPG has accumulated profits of US $3 million. Most of that money is held in Canadian government bonds, paying annual interest at 8 percent. It is exempt from Canadian tax. In the current year, KPG paid a dividend to its shareholders (CDI and Niue Trust) of $100,000.

None of the companies described above has been paying income tax to any country (Tim and Betty, however, do expect to pay U.S. tax on the $50,000 dividend received by CDI from KPG).

Questions

Tim and Betty come to you for tax advice. What are the tax risks, if any, that Tim and Betty face? Are there any ways to minimize those risks? What do you think of the general tax plan? Consider the following questions:

1. Is Dutch Dolls, N.V. a controlled foreign corporations?
2. Is Dutch Dolls, Inc. a controlled foreign corporation?
3. Is KPG a controlled foreign corporations?
4. Which of the following persons or entities are related persons under subpart F with respect to CDI? Tim; Betty; Niue Trust; Tim & Betty Partnership; Dutch Dolls, NV; KPG; Dutch Dolls, Inc.
5. Does KPG have subpart F income? In answering that question, consider whether KPG has a branch in China and whether it is subject to the branch rule.
6. Does Dutch Dolls, N.V. have any subpart F income? How much?
7. Does Dutch Dolls, N.V. have a potential transfer pricing problem? Explain.
8. Can KPG claim the benefits of any tax treaty?
9. Can Dutch Dolls, N.V. claim the benefits of the Netherlands-China tax treaty? What problems, if any, do you see under that treaty?
10. Would it make sense to ask the government of Niue to prohibit all payments of royalties to related persons? What would be the objective in asking Niue to adopt such a rule?
11. What happens if Dutch Dolls, Inc. checks to box to have Dutch Dolls, NV treated as its branch? In particular, will the U.S.-China tax treaty govern transactions by Dutch Doll, NV in China?

The Country of Niue

A Jewel in the Crown of the South Seas †

Introducing Niue . . .

Niue is situated in the South Pacific Ocean on the eastern side of the International Date Line, in the heart of Polynesia — a short flight from New Zealand. It shares approximately the same time zone as Hong Kong and other key Far East locations.

Niue is a self governing nation under the authority of the Niue Constitution Act of 1974 which came into force on 19th October, 1974. Niue is a British Commonwealth Associate Member and enjoys the protection of the British Crown. Niue enjoys political stability, and in addition to its very favorable International Business Companies Act, the Niue Government have also enacted comprehensive legislation and regulations regarding Niue Development Bonds; Trust/Trustee Companies; Banks/Off-Shore Banking; and Off-Shore Insurance matters.

The Good News . . .

- Speedy Incorporation procedures / simple ongoing administration
- Reasonable formation and maintenance costs and fees.
- Total secrecy, anonymity, business privacy and confidentiality – no disclosure or annual reporting requirements.
- Full exemption from taxation on any business activity or transaction carried out outside Niue – no capital gains tax, income, or other taxes are levied. No exchange control regulations.
- Minimum registration fee on capital – no minimum or maximum capital requirements.
- Authorized capital can be quoted in U.S. Dollars or any other currency, or a combination of currencies.
- Nominative, Bearer, Non-Par Value shares are permitted at owner's option; or a combination of shares. Shares may be issued (fully paid) in any one or more currencies.
- Various classes of shares; and fractional shares are permitted.
- Companies may engage in any lawful business in any country and may carry on transactions in any chosen currency.
- Member(s) and/or Director(s) may hold their meetings in any country and may attend meetings by proxy or any electronic means.
- Foreign corporations can be redomiciled as Niue IBCs.

† The material on **Niue** is taken verbatim from a promotional brochure distributed in October of 1994 by an association of offshore business representatives. The material does not appear to be copyrighted and is reproduced here without permission.

The Great News . . .

- Corporate names can be incorporated in Chinese characters, as well as Cyrillic script and other accepted language forms (with English translation)
- Name availability is excellent.
- Broad selection of name endings permitted – Limited; Ltd.; Corporation, S.A., Inc. Incorporated; A/S; AG; N.V.; B.V.; GmbH; Aktiengesellschaft; etc. – either the full or abbreviated forms.
- Register of director(s) is optional, and may be kept anywhere in the world.
- The company's books, records, and register of Member(s) may be kept anywhere in the world.
- Register(s) of mortgages and charges are optional; and can be registered if desired.

NIUE CORPORATIONS: FEE SCHEDULE●
(for professional clients only)

A. COMPANY FORMATION

Formation Fee . . . . US $585.00
Includes the registration fee for a company with a standard capital of US $10,000.00; two (2) share certificates and the share register. Our Registered Agent and Registered Office services are free of charge during the remainder of the calendar year of incorporation. *Also includes company name in Chinese characters or other language form in incorporation documents if desired.*

No disbursements will be added (except for courier expenses).

Corporate Seal . . . . US $50.00

B. PURCHASE OF A "SHELF COMPANY"

Acquisition within calendar year of incorporation . . . . US $585.00
Includes A above.

Acquisition of "Vintage Companies"
Please ask for costs of individual companies.

C. ANNUAL FEES (FIXED)

Annual Registered Agent Fee . . . . US $250.00
Annual Registered Office Fee . . . . US $25.00

Annual License Fee
capital not exceeding US $10,000.00 . . . . US $150.00
capital exceeding US $10,000.00 . . . . US $1,000.00
no par value shares . . . . US $350.00

D. OTHER ANNUAL FEES (OPTIONAL)

Provision of Directors and/or Officers . . . . US $400.00
Fixed charge for one or more directors and/or one or more officers

Provision of Shareholders . . . . US $400.00
Fixed charge for one or more shareholders

Use of Post Office Box Facility . . . . US $175.00

Custody of Corporate Books . . . . US $175.00
This charge applies in cases where we provide all the directors, as we then have to retain the company's corporate books.

☐ **(Unnamed) Offshore Representatives, Ltd.**

§ 29.02. Planning Problem: Classic Films, Inc.

Classic Films, Inc. (CF) is a U.S. corporation organized under the laws of Delaware. It is a family business, with all of the common stock owned jointly by John and Mary Classic, a married couple. John and Mary are U.S. citizens and residents. John's father, Fred, owns 1,000 shares of nonvoting preferred stock. No other stock is outstanding.

The company specializes in the reproduction of classic American films (pre-World War II) and the distribution of those films overseas. After getting rights to a film, CF makes a high quality master print, using one or more good quality original copies of the film. It normally has the actual reproduction work done under its general supervision by independent laboratories located in California. When the laboratory has produced a master print, CF makes copies of it at its own offices. That latter work is not complicated. The equipment used is readily available, and the dozen employees who do the work do not need to be highly trained.

One of CF's major functions is to choose good films for reproduction and to bargain for foreign distribution rights. John and Mary, who are both very knowledgeable about films and film making, do this work themselves. The bargaining is often protracted and requires face-to-face meetings not only with the copyright holders but also with the owners of good quality original copies of the films.

The distribution of the films overseas is done through movie clubs organized by CT. The clubs rent the movies from CT for showing to club members. In some cases, the clubs purchase video reproductions of the films from CF. Until now, almost all of CF's activity has been in Japan, where it is grossing about $10 million a year in rental fees and video sales. Its net income (before taxes) in Japan last year was $4 million. It paid Japan taxes of $1.2 million, for an effective tax rate of 30 percent. CF paid U.S. taxes on its income and received a section 901 foreign tax credit for the full amount of the taxes paid to Japan.

The plan now is to start up a distribution network in Brazil, following the same general business plan used successfully in Japan. Marshall Miles, the accountant for CF, comes to you for tax advice. What corporate structure for exports to Brazil do you recommend? Miles is projecting income of $5 million per year from the Brazil operation. In formulating your recommendations, consider the following specific inquiries from Miles.

Note on Brazilian Ta x Rules. For purposes of the questions below, please make the following assumptions about the Brazilian tax system: (1) Brazil taxes a Brazilian subsidiary on its worldwide income at a rate of 25% on net income. (2) A Brazilian branch of a foreign corporation is taxed at the 25% rate on Brazilian source income if it has a PE in Brazil and otherwise it exempt from tax in Brazil. (3) There is no tax treaty between the United States and Brazil.

Questions

(1) Miles is thinking of having CF establish a subsidiary, CCF, in the Cayman Islands. Under his plan, CCF would do as many of the things now being done by CF as possible, but only if those activities would not subject CCF to U.S. taxation. Miles wants to know which of the following activities CCF can engage in without being classified as "engaging in business within the United States" or as having income "effectively connected with a U.S. trade or business":

- (a) Negotiate to acquire (and acquire) the foreign distribution rights to the old films;
- (b) Negotiate to purchase (and purchase) good original copies of the old films;

(c) Arrange for the reproduction of the film master prints in the United States by independent laboratories?

(d) Manage the business from a U.S. office.

(2) Miles is also concerned about the income of CCF being taxable to CF under subpart F. He wants to know about his subpart F exposure if: (a) CCF does not engage in substantial activities in the Cayman Islands, and (b) it rents the films and sells the videos to Brazil movie clubs through a wholly owned Brazilian subsidiary, BCF.

(3) One of the accountants in Miles' office told him that CF could reduce its exposure under subpart F by having CCF treated as the manufacturer or producer of the films or by having the Cayman Islands treated as the place of manufacture. Miles wants to know if that advice is correct and, if so, what steps he should take to follow the advice. You should assume that no facilities are available in the Cayman Islands for making the master prints of the films but that facilities might be arranged for copying the films and videos.

(4) Miles wants advice on whether BCF should elect under the check-the-box rules to be treated as a corporation or as some other type of entity.

(5) One plan that Miles is considering is to establish BCF in Brazil and have CCF lease the films to BCF for a royalty that would be deductible in Brazil. Would the royalty payments received by CCF be subpart F income? Consider the effect of the look-through rule of IRC § 954(c)(6).

(6) One of Miles' assistants, who says she is into creative tax planning, has made the following suggestion. CF would sell the films and videos to CCF, and CCF would do enough in the Cayman Islands to be treated as the manufacturer of the videos (see question 3). CCF then would sell the videos to an independent Brazilian import company. That company would take title and arrange for the import of the goods into Brazil. At that point, it would sell the goods to BCF at a small markup. The price on the sale to the Brazilian importer would be high enough to deflect most of the profits to CCF. Miles wants to know if this plan works to avoid subpart F and what risks, if any, it entails.