Notes on the Answers
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Question 1

To have effectively connected income, BCo must be engaged in business in the United States and must have either U.S. source income (not including periodical income not effectively connected) or certain narrow categories of foreign source income. Under the facts, it appears that BCo is managed in the United States, which would cause it to be engaged in business in the United States. Its only employee is Miss J, and she conducts all of the business of BCo from the United States. In particular, she arranges for PB to design the book in the United States and for CCo to print it in China. She also arranges all of the sales of the books by BCo.

The question then becomes whether BCo has any U.S. source income. BCo has investment of $50,000 income from its capital of $1 million. We are not told the source. If it is U.S. source income, as a result of very bad tax planning, then it might be part of BCo's working capital and thus it could be ECI. If the income is foreign source income, it would not be ECI.

BCo also has sales income from the sale of books in the United States and Europe. Presumably title passes to the books sold in Europe outside the United States. On the U.S. sales to independent distributors, the income is U.S. source income, and, therefore, ECI, if title passes in the United States. If title passes outside the United States, the income still could be U.S. source income if sold through a U.S. office. Although Co has a place of business in the United States, it has a sales office only if the office of Miss J is attributed to it. I think it is not clear, under the law or facts, whether Miss J's office could be considered the sales office of BCo. In light of the fact that Miss J arranged the sale to independent distributors from her U.S. office, however, I would concluded that her office is also the office of BCo and that BCo has ECI on the U.S. sales.

Question 2

The issue is whether BCo has any subpart F income that would be taxable to Miss J and Mr. K. First of all, BCo is a controlled foreign corporation (CFC). It is a corporation and is foreign, so the only issue is whether it is controlled by U.S. shareholders. Miss J and Mr. K are U.S. persons owning at least 10 percent of the voting stock of BCo. As a result, they are U.S. shareholders. Since they each own 50 percent of the stock of BCo, it follows that the U.S. shareholders of BCo own more than 50 percent of the voting stock of BCo.

It is unclear from the facts whether the $50,000of income earned by BCo from the investment of its $1 million in capitalis U.S. source ECI. If so, it is not subpart F income. More likely, it is foreign course passive income, taxable as subpart F income.

The sales income of BCo does not appear to be subpart F income. The issue is whether it is foreign base company sales income. If the income from sales in the United States is ECI, then it is not subpart F income. The sales income from the European sales will be base company sales income only if BCo purchased the property sold from a related party because it is selling to unrelated parties (independent distributors). CCo, which prints the books, is not a related party. In any event, BCo does not purchase the books from CCo — it simply uses CCo as a printer. PB is a related party, but BCo does not make any purchase of books from PB. I conclude, therefore, that the sales income is not subpart F income.

Question 3.

Except for the possibility of GCo getting a refund, the tax paid by GCo would be creditable to PCo when the income with respect to which the tax was paid is distributed to PCo as a dividend. PCo cannot get a current foreign tax credit for the tax paid by GCo, however, because GCo apparently has not paid out any of its income as a dividend.

One issue is whether the tax paid by GCo should qualify as a tax for U.S. tax purposes. In some respects, the tax is voluntary because GCo can avoid the tax by not paying a dividend. That fact, however, does not make a tax actually paid voluntary. for example, a withholding tax on dividends is not viewed as voluntary simply because the tax could be avoiding if no dividend were paid.

Note that GCo would pay out its income as a dividend and still qualify for a partial rebate. The rebate is lost pro rate of capital, not income, so GCo will qualify for a partial rebate as long as it keeps its $100 million of capital in Greece for the 5-year period.

If GCo does refrain from making a distribution for the 5-year period and gets a rebate of some or all of its taxes, then the amount rebated will not qualify as a tax. One might ask whether PCo could treat the tax as a tax when paid and then give the government a refund when the tax is rebated. Note that, as discussed above, PCo can only get a credit for the tax paid by GCo if GCo pays out a dividend. As a result, there is no difficulty for PCo to claim the credit for the portion of the tax paid that will not be rebated. Under these facts, I think that the potential rebate, which is reasonably likely, will keep PCo from claiming a credit for the portion of the tax that might be rebated. If the likelihood of the rebate was remote (e.g., rebate offered after 50 years), I think PCo could take the credit and repay the amount if the contingency occurred. I am not aware of any specific guidance from the IRS on this issue.

Question 4

The Treasury regulation does two things. First, it creates a facts and circumstances rule that allows a U.S. person to avoid having U.S. source income on income derived from an ocean or space activity if the income is attributable to activities conducted in a foreign country. Second, it creates a variation of the inventory rule that allows U.S. taxpayers to avoid having U.S. source income on the sale of inventory property when the title passes on the high seas or in space if the goods end up in a foreign country or in the United States. In both cases, the result would be favorable to the taxpayer in that it would result in a higher limitation on the foreign tax credit.

The first rule strikes me as a plausible reading of the statute, in that the statute explicitly gives Treasury the authority to write regulations. It is plausible that Congress expected the Treasury Department to allow space and ocean income to be foreign source income if there was a source country that could make a good claim to tax that income. The second rule is unlikely to be consistent with the Congressional intent. The passage of title test was widely viewed as an incentive to export goods from the United States. Congress preserved the rule in 1986 under pressure from industry. It seems unlikely to me that Congress intended also to extend the rule to income from space and ocean sales, since Congress introduced the space and ocean source rule in 1986 and made no mention of any intended incentive. Nevertheless, the matter is not clear. Congress may not have focused on the issue but expected that passage of title would be made available generally to sales of inventory goods.

Neither of the rules is a good source rule in my view. The rule for foreign presence seems appropriate in principle, but it is rather vague and likely to create a lot of line-drawing problems. It resembles the rules for transfer pricing, which have been difficult to enforce. The rule extending the passage of title test to space and ocean activities has all the defects of the passage of title test generally. It puts control of the source of income in the hands of the taxpayer and allows income to be allocated to a state where no significant income-producing activity takes place.