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INTERNATIONAL TAXATION:
A GUIDE FOR U.S. CORPORATIONS

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I. Introduction

Many decisions regarding the international operations of a U.S. corporation have profound tax consequences under the U.S. Internal Revenue Code. This Article is intended to acquaint the reader with the principal U.S. tax implications of international sales and operations. This Article is not intended to serve as a comprehensive tax planning manual. Business objectives vary dramatically among corporations, as do the facts which must be addressed when planning to meet those objectives. I strongly suggest, therefore, that readers discuss their specific situations with an international tax specialist before expanding into the international market.
II. Overview

A. Taxing Jurisdiction and the Problem of Double Taxation

One of the most fundamental issues in international taxation is whether a particular country has jurisdiction to tax an item of income. Jurisdiction to tax is most often based upon the citizenship or residence of the taxpayer, the source of the income being taxed, or some combination of the two. The United States exercises residence jurisdiction to tax the worldwide income of U.S. citizens, resident aliens, and domestic corporations. The United States also uses source jurisdiction to tax the U.S. source income of non-resident aliens and foreign corporations.

Often, in the case of multinational businesses, more than one country will assert jurisdiction to tax an item of income. For example, if a U.S. corporation establishes a branch in a foreign country, the United States generally will exercise its residence jurisdiction to tax the income of the branch. In addition, the foreign country may exercise its source jurisdiction, or if those branch operations are significant, its residence jurisdiction, to tax the same income of the branch. The obvious result is a tremendous potential for double taxation. Avoiding, or at least minimizing, this double taxation is one of the most common tax challenges facing U.S. multinational corporations today.

B. General Tax Planning Objectives for U.S. Multinationals

The primary tax planning objective for U.S. multinationals is, very simply, to minimize their worldwide tax burden. Difficult enough in a purely domestic context, achieving this goal is tremendously complicated in the international setting, where tax planning typically involves the interplay of the tax laws of one or more foreign countries and those of the United States.

For U.S. multinationals, particularly those just entering foreign markets, it may be useful to refine the general tax minimization objective. There are a number of ways in which the worldwide tax burden can be reduced.

2. Id. §§ 871-881.
3. Id. §§ 881-898.
1. Reduce U.S. Tax on Foreign Source Income

There are essentially two sets of provisions in the Code that are intended to provide a permanent reduction of U.S. taxes on foreign source income. These are the possessions corporation and foreign sales corporation (FSC) provisions.5

The United States allows a special tax credit to U.S. corporations doing business in U.S. possessions.6 The possessions tax credit is an elective provision7 that effectively exempts from U.S. tax, income derived from the active conduct of a trade or business in a U.S. possession, as well as certain possession-source investment income.8 In addition, the deduction for dividends received applies to exclude from taxable income 100% of the dividends received from an 80%-or-greater owned possessions corporation.9 In the typical situation, a U.S. parent corporation has a wholly-owned U.S. subsidiary which has elected to be treated as a possessions corporation. The possessions subsidiary is not taxed by the U.S. trade or business income. In addition, the subsidiary is able to distribute its earnings to the U.S. parent without generating U.S. tax at the parent level.

Puerto Rico has also enacted special tax incentives for possessions corporations. The statutory tax rate in Puerto Rico is currently 42% for non-export corporations, but manufacturers typically are able to secure an exemption of up to 90% of manufacturing income,10 thereby dramatically reducing their effective tax rate.11 The maximum period for such an exemption is

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4. Id. § 936.
5. Id. §§ 921-927.
6. Id. § 936(d)(1). Section 936 applies to both Puerto Rico and the U.S. Virgin Islands, but most corporations that take advantage of the provision operate in Puerto Rico.
7. The benefits of § 936 are obtained by filing Form 5712 with the IRS Service Center in Philadelphia by the due date, including extensions, of the possessions corporation’s tax return (Form 1120) for the year the election is effective. The election generally remains in effect until revoked, and cannot be revoked during the corporation’s first 10 years without the consent of the Secretary of the Treasury. Id. § 936(e)(2)(A).
8. Id. § 936(a)(1).
9. Id. §§ 243(a)(3), (b)(1), 1504(a)(1), (2).
10. This exemption applies to the pre-1987 statutory tax rate of 45%.
Puerto Rico also imposes a withholding tax on dividends paid by the possessions corporation to its U.S. parent. The rate of withholding tax is normally 10%, although this may be reduced to 5-7% for dividends paid out of tax-exempt earnings if certain requirements are met prior to payment of the dividend.

The FSC provisions of the Code provide an exemption for a portion of the export-related income of a U.S. corporation. While a detailed discussion of the FSC provisions is beyond the scope of this article, a brief summary of the qualification requirements and tax benefits of using an FSC for export sales may be helpful.

An FSC is a foreign corporation, typically wholly owned by a single U.S. corporation, that meets a number of qualification requirements, and that has elected to be treated as an FSC by timely filing Form 8279. Most FSCs operate as a commission agent, earning a commission on qualifying export sales of the U.S. parent or other members of the U.S.-affiliated group. Because of restrictive rules regarding the deductibility and creditability of foreign taxes paid by FSCs, they generally are incorporated in foreign countries that impose little or no tax on FSC earnings.

In general, U.S. exporters using an FSC as a commission agent on export sales are able to exclude from U.S. tax 15% of the income (foreign trade income) generated from those export sales (foreign trading gross receipts). The tax savings on this exempt income is often referred to as the "FSC benefit." In addition, distributions by the FSC to its U.S. parent out of earnings attributable to foreign trading gross receipts are exempt from U.S. taxation.

The first step in determining the FSC benefit is to quantify the foreign trading gross receipts of the FSC and its "related

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12. Id. § 256b(d).
13. Id. § 256b(c).
14. Id. § 256b(b).
15. Id. §§ 921-927 (1988).
16. Id. § 922.
17. See id. § 922(a)(1)(A). The IRS publishes a list of qualifying foreign countries and U.S. possessions in which a FSC may be incorporated. The most common countries of incorporation are Barbados and the U.S. Virgin Islands. Puerto Rico is not a qualifying location for incorporation of a FSC. See Treas. Reg. § 1.922-1(d) (1987).
19. Id. § 245(c).
supplier(s)," which generally includes the U.S. parent corporation and any other members of the affiliated group that pay the FSC a commission in connection with the export of products. Foreign trading gross receipts can be derived only in connection with the transactions involving "export property." Export property generally is limited to goods that are manufactured, produced, grown, or extracted in the United States, and held primarily for sale or lease in the ordinary course of business for direct use, consumption, or disposition outside the United States. The sale of a product to a U.S. purchaser will satisfy the foreign use, consumption, or disposition requirement if the FSC or related supplier is able to confirm that the U.S. purchaser exported that property within twelve months of the date of purchase.

The income attributable to foreign trading gross receipts is then split between the FSC and its related supplier based upon either an arm's length transfer price or one of two administrative pricing methods. The gross receipts allocated to the related supplier are subject to U.S. tax. The income of the FSC attributable to foreign trading gross receipts is referred to as foreign trade income. A portion of this foreign trade income will be exempt from U.S. tax. The remaining foreign trade income will be taxed currently at regular U.S. corporate income tax rates.

2. Defer U.S. Taxation of Foreign Source Income

As discussed above, U.S. corporations generally are subject to U.S. tax on their worldwide income, including the earnings of a foreign branch. Foreign corporations, on the other hand, ordinarily are subject to U.S. tax only on U.S. source "fixed or

20. Foreign trading gross receipts are defined as gross receipts of the FSC which are from the sale, exchange, or other disposition of the export property; the lease or rental of export property for use by the lessee outside the U.S.; services which are related and subsidiary to the sale or lease of export property; and certain other services. Id. § 924(a).
21. Id. § 927(a)(1). In addition, not more than 50% of the fair market value of the property may be attributable to articles imported into the United States. Id.
24. Id. § 923(b).
25. Id. § 923(a).
26. Id. § 921(d).
determinable annual or periodical income,'" and income that is effectively connected with the active conduct of a U.S. trade or business. The foreign source, noneffectively connected income of a foreign corporation is not subject to U.S. tax. The United States also generally does not tax U.S. shareholders on the noneffectively connected income of a foreign corporation until those earnings are repatriated in the form of a dividend or the stock in the foreign corporation is sold.

These rules provide a significant opportunity for U.S. investors, both individuals and corporations, to defer U.S. taxation of foreign source income simply by conducting foreign operations in subsidiary, rather than branch, form. Such deferral generally is beneficial when operating profitably in a foreign country with a tax rate lower than that of the United States. This is because the United States ordinarily will tax foreign branch earnings at an effective rate equal to the difference between the statutory U.S. rate and the rate paid in the foreign country.

For example, assume P, a U.S. corporation, owns 100% of the stock of F, a foreign corporation. F earns $100,000 of taxable income on which it pays $20,000 of foreign tax. If the after-tax income is not repatriated, it will not be subject to current U.S. tax, and the effective tax rate on F's earnings remains at 20%. If, however, F were a foreign branch of P, the full $100,000 of F's earnings would be subject to U.S. tax currently. The resulting $34,000 of tentative U.S. tax could then be reduced by a foreign tax credit of $20,000 (subject to the foreign tax credit limitations), leaving a net incremental U.S. tax of $14,000. The result, however, is an effective tax rate of 34%.

27. Id. § 881(a)(1).
28. Id. § 882(a)(1).
29. See id.
30. It is important to note that various anti-deferral provisions override this general rule. See infra Part VI.
31. $20,000 of foreign tax ÷ $100,000 of earnings.
32. Generally, the taxable income of every corporation with taxable income exceeding $75,000 is 34%. Id. § 11.
33. The $80,000 dividend will be increased (grossed-up) by the $20,000 of foreign taxes paid on the underlying income. The United States will then tax the full $100,000 at 34%, for a tentative U.S. tax of $34,000. P should then be able to claim a foreign tax credit of $20,000, subject to the foreign tax credit limitation. The result is net incremental U.S. tax of $14,000. See id. § 55(c)(1).
34. ($20,000 of foreign tax + $14,000 of U.S. tax) ÷ $100,000 of earnings.
By using a foreign subsidiary in the above example, P has an additional $14,000 of after-tax net income to reinvest in its foreign operations. This is not a permanent benefit, as the incremental U.S. tax will be paid when and if F’s earnings are repatriated, but it can be a significant timing benefit.

As the above example illustrates, one of the basic objectives of international tax planning for U.S. multinationals with operations in relatively low-tax foreign countries is to structure foreign operations in a manner that will provide opportunities for the taxpayer to defer U.S. taxation of foreign source income.

3. Minimize Foreign Taxation of Foreign (or U.S.) Source Income

Another objective of international tax planning is to minimize the worldwide tax on multinational operations. From the perspective of a U.S. multinational, this typically means trying to achieve a worldwide tax rate that is no higher than the U.S. rate. A challenge in almost any multinational setting, this objective is even more difficult to achieve if significant operations are located in high-tax jurisdictions such as Japan, Canada, Germany, or Australia.

III. Selecting a Structure for International Operations

A. Foreign Sales Office of a U.S. Corporation

For many U.S. corporations, the first venture into a foreign market is in the form of a foreign sales office. Often, this “sales office” is little more than one or two individuals, typically citizens of the local country, working on a commission basis soliciting orders on behalf of the U.S. corporation.

Such an operation generally raises few U.S. tax issues. As always, the U.S. corporation will be taxed on its worldwide income, including income (net of deductions) attributable to the foreign sales solicited on its behalf by the sales office. Of much greater concern are the tax consequences in the foreign country.

It is, of course, generally desirable to avoid taxation in the local country, if at all possible. This may be possible in some

35. *Id.* § 11.
36. From a tax perspective, the U.S. corporation should be able to claim a for-
countries by limiting the activities and authority of the foreign office or, if those activities can be characterized as auxiliary or preparatory to the establishment of a trade or business. The extent of those limitations will vary considerably from country to country, depending upon local tax law, and whether there is an income tax treaty in place between that country and the United States.

As a rule, most of the income tax treaties negotiated by the United States provide that the treaty partners can tax the profits of a U.S. corporation only if that corporation conducts its business in the foreign country through what is known as a "permanent establishment."37 The definition of a permanent establishment varies somewhat from treaty to treaty, but generally includes a place of management, a branch, an office, and a factory.38 In addition, a "dependent agent" of the U.S. corporation generally will constitute a permanent establishment if the agent has the authority to conclude contracts in the name of the U.S. corporation and habitually exercises this authority in the foreign country.39

B. Foreign Branch of a U.S. Corporation

As the volume of business from a foreign market increases, business considerations may dictate that the U.S. corporation establish a local presence staffed with employees from the

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38. See, e.g., id. art. 4.

39. Most income tax treaties distinguish between dependent and independent agents. The activities of an independent agent generally will not result in a permanent establishment for its principal. Unfortunately, there does not appear to be a consensus as to how to determine whether an agent is dependent or independent under rules of the Organization for Economic Cooperation and Development (OECD). The commentary to article 5 of the 1977 OECD Model Income Tax Treaty states that an agent will be independent only if the agent is independent both legally and economically, and acting in the ordinary course of business. The commentary then states that the agent's status will be determined, at least in part, by the degree of control the U.S. corporations have over the agent's activities. These appear to be two separate tests; the agent must pass both to be considered independent. See generally Klaus Vogel et al., United States Income Tax Treaties, pt. III (1991). For a discussion of this issue, see Joel Nitikman, The Meaning of "Permanent Establishment" in the 1981 U.S. Model Income Tax Treaty (pts. 1 & 2), 15 Int'l Tax J. 159, 257 (1989).
home office of the corporation. Referred to as a branch of the U.S. corporation, this presence may be limited to sales and marketing functions, or it may involve manufacturing, assembly, or distribution operations. In either case, there typically is little doubt that the branch will be subject to local taxation.

Unlike a foreign subsidiary, a foreign branch is not a separate legal entity. As a result, it is treated, for U.S. tax purposes, as part of the U.S. corporation, and its income or loss generally is included currently with that of the U.S. corporation.\textsuperscript{40} From a tax planning perspective, this current inclusion for U.S. tax purposes suggests that if foreign operations are expected to result in losses during the start-up period, it may be beneficial to operate as a foreign branch, rather than a foreign subsidiary, of the U.S. corporation.

Special rules, known as the dual consolidated loss rules, however, may prevent the U.S. corporation from using foreign branch losses to offset U.S. income.\textsuperscript{41} Moreover, if the branch operation is subsequently incorporated, the U.S. corporation may be required to recapture previously deducted branch losses.\textsuperscript{42}

\section*{C. Foreign Subsidiary of a U.S. Corporation}

As mentioned above, the primary tax benefit of operating in low-tax foreign markets through a wholly or majority-owned foreign subsidiary is the potential for deferral of U.S. tax on the income of the foreign corporation.\textsuperscript{43} However, the advantage of deferral is meaningless if it is expected that the subsidiary will consistently distribute its earnings on a current basis, because the income of the subsidiary will be subject to U.S. tax when distributed as a dividend. Also, the anti-deferral provisions\textsuperscript{44} may result in current taxation of a foreign subsidiary's

\textsuperscript{40} I.R.C. § 11 (1988).
\textsuperscript{41} See infra part IV.B. 2. for a discussion of the foreign branch loss recapture rules.
\textsuperscript{42} The local country tax consequences of incorporating a foreign branch should also be considered, as this is a taxable event in some countries.
\textsuperscript{43} This deferral, or the economic benefit of deferral, may be lost if the foreign subsidiary falls within the foreign personal holding company provisions. See I.R.C. § 551 (1988). Similarly, the benefit may be lost via the controlled foreign corporation, subpart F provisions. See id. §§ 951-964. The passive foreign investment company provisions are yet another area where the deferral benefit may be lost. See id. § 1375.
\textsuperscript{44} See infra Part VI.
earnings even if those earnings are not actually distributed.

From a business perspective, a foreign subsidiary may be used to help insulate the assets of the U.S. parent corporation. The same result, however, generally can be accomplished by establishing a U.S. subsidiary with a foreign branch.

IV. ESTABLISHING OPERATIONS IN A FOREIGN COUNTRY

A. Overview

Quite often, the movement by a U.S. corporation into a foreign market is an evolutionary process. Initially, there may be a representative office, which later becomes a branch of the corporation. At some point, business or tax considerations may lead to the incorporation of the branch. Because a foreign subsidiary is a separate legal entity, some of the concerns which must be addressed upon incorporation include which of the branch assets should be transferred to the new corporation, and how the tax cost of such a transfer can be minimized.

A number of provisions in Subchapter C of the Internal Revenue Code generally provide for nonrecognition of gains or losses on transactions involving one or more U.S. corporations. For example, it generally is possible to transfer assets to a U.S. corporation in exchange for stock in a tax-free transaction, provided the transferors are in control of the transferee corporation immediately after the transfer.

In the transactions covered by Subchapter C, the realized gain or loss is simply deferred, not permanently forgiven. Accordingly, in each case the deferred gain ultimately is recognized upon the occurrence of a subsequent taxable transaction. However, it is important to note that once assets have been transferred to a foreign corporation, limitations on U.S. taxing jurisdiction may hamper the ability of the United States to tax any subsequent transaction. Consequently, the normal operation of Subchapter C could result in a forgiveness or deferral

45. See id. § 351 (incorporation of assets); id. §§ 332, 337 (liquidation of a subsidiary); id. §§ 361, 368 (transfer of assets by one corporation to another corporation pursuant to a reorganization); id. § 354 (exchange of stock of a corporation that is a party to a reorganization for stock in another corporation that is a party to the reorganization); id. § 355 (distribution by a corporation of stock of a controlled corporation in a qualifying spin-off or similar transaction).

46. Id. § 351. To establish control, the transferors must own 80% or more of the stock of the transferee corporation. Id.

47. See supra note 45.
of U.S. taxation that would not occur if only U.S. corporations were involved.

Section 367 addresses these issues by establishing special rules that apply to the general nonrecognition provisions of Subchapter C when a transaction involves a foreign corporation. In general, the rules apply to two different types of transactions: "outbound" transactions, and "inbound" or "foreign-to-foreign" transactions.48

B. Outbound Transactions

Outbound transactions involve the transfer of property by a U.S. person49 to a foreign corporation in what would otherwise be a nonrecognition transaction under Subchapter C.50 Sections 367(a) and 367(e) are intended to prevent deferral of gain recognition beyond what would be available in a purely domestic context.

For example, if a U.S. person transfers appreciated assets to a U.S. corporation, and the transferee subsequently sells those assets, the transferee ordinarily will be subject to U.S. tax on any gain from the sale.51 If, however, the appreciated assets are transferred to a foreign corporation, the foreign transferee generally will not be subject to U.S. tax on a subsequent disposition.52 In addition, the U.S. transferor generally will not be subject to current U.S. tax on its share of the gain until it sells the foreign corporation stock received in exchange for the assets, or the transferee distributes the sale proceeds as a dividend.53

The general rule of section 367 is that when a U.S. person transfers property to a foreign corporation, that foreign corporation will not be considered to be a "corporation" for purposes of determining the extent to which gain is recognized on the transfer.54 Because the nonrecognition provisions of Subchapter C provide for nonrecognition treatment only in the case of transactions involving corporations, section 367 effec-

49. The Code defines "U.S. persons" to include a citizen or resident of the United States as well as domestic partnerships and corporations. Id. § 7701(a)(30).
50. See supra note 45.
52. See notes 25-28 and accompanying text.
53. Id.
54. Id. § 367(a)(1).
tively requires recognition of gain or loss on the outbound transfer of property.\footnote{55}{\textit{Id.} \S 367(a)(1).} There are, however, a number of exceptions to this general rule.

1. \textit{Property Used in the Active Conduct of a Trade or Business}

For example, one such exception applies to property used in the active conduct of a trade or business outside the United States. It allows a U.S. person to incorporate a foreign branch without recognizing the gain either inherent in the goodwill and going concern value of the branch or the appreciated assets that are not likely to be sold soon after the incorporation.\footnote{56}{\textit{Id.} \S 367(a)(3)(B)(iv).} This exception does not, however, allow the tax-free transfer of appreciated assets that reflect income which has already been earned by the U.S. transferor, or property that is likely to be sold shortly after transfer.\footnote{57}{The following types of property are subject to immediate gain recognition upon transfer to a foreign corporation, even if they would otherwise qualify for the active trade or business exception: (1) inventory; (2) copyrights; (3) installment obligations, accounts receivable, and similar property; (4) foreign currency and other property denominated in foreign currency; (5) intangible property, not including foreign goodwill or going concern value; and (6) property with respect to which the transferor is a lessor at the time of the transfer, unless the transferee is the lessee. \textit{Id.} \S 367(a)(3)(B); see also Temp. Treas. Reg. \S 1.367(a)-5T (1986).}

2. \textit{Foreign Branch Loss Recapture Rules}

Much of the benefit of operating in branch form disappears once the foreign operations become profitable. At that point, the opportunity to defer U.S. tax on the income of the foreign operation becomes more important, and many corporations that initially operated as a branch in a foreign market will decide to form a foreign subsidiary.

Typically, upon incorporation, the assets of the branch are transferred to the newly formed subsidiary. Notwithstanding the nonrecognition treatment generally allowed for transfers of property used in the active conduct of a trade or business,\footnote{58}{\textit{I.R.C.} \S 367(a)(3) (1988).} the U.S. corporation will be required to recognize gain on the transfer if it has previously deducted losses of the foreign branch.\footnote{59}{\textit{Id.} \S 367(a)(3)(C).} Without this limitation, U.S. corporations would be able to use start-up losses to offset U.S. income by operating...
initially as a branch and then, once the foreign operations became profitable, to defer U.S. taxation of that income simply by incorporating the branch. To eliminate this potential double benefit, the Code requires U.S. corporations to recognize gain on foreign branch assets transferred to the newly formed foreign corporation.\textsuperscript{60}

In general, the amount of gain that must be recognized is the sum of the "previously deducted branch ordinary losses" and "previously deducted capital losses," reduced by (i) any taxable income of the foreign branch recognized through the close of the taxable year of the transfer, whether before or after the year of the loss; (ii) amounts recognized as income under section 904(f)\textsuperscript{61} as a result of the transfer; and (iii) gain recognized under section 367(a)(1), other than by reason of the provisions of section 367(a)(3)(C).\textsuperscript{62} The amount of gain required to be recognized is limited to the gain that would have been recognized on a taxable sale of the transferred property, computed as though each of the transferred assets were sold separately, and without offsetting losses against gains.\textsuperscript{63}

The effect of these branch loss recapture rules is illustrated in the following example. X, a U.S. corporation, has operated foreign branch FB for three years. In year 1, FB incurred a loss of $100,000, and X earned other foreign source income of $40,000. In year 2, FB earned a profit of $30,000, all of which was recharacterized by X as U.S. source income pursuant to section 904(f)(1)(B). At the end of year 2, X incorporates FB, and transfers to it assets with an adjusted basis of $10,000 and a fair market value of $200,000. The taxable gain on the transfer of the assets to the new corporation is computed as follows:

\textsuperscript{60} Id.
\textsuperscript{61} Id. § 904(f). This section establishes a very complicated set of rules which require, for purposes of computing the foreign tax credit limitation, that a portion of an overall foreign loss that has offset U.S. source income be recaptured as U.S. source income.
\textsuperscript{62} Temp. Treas. Reg. § 1.367(a)-6T(b), (d), (e) (1986).
\textsuperscript{63} Temp. Treas. Reg. § 1.367(a)-6T(c)(2) (1986).
Previously deducted FB ordinary losses: $100,000
Less taxable income of FB through the year of transfer: -30,000
Cumulative foreign branch loss: 70,000
Less amount recharacterized as U.S. source upon incorporation under § 904(f)(3): -30,000
Gain recognized on transfer of assets under § 367: $40,000

3. Transfers of Intangible Property

The transfer of intangible property by a U.S. person to a foreign corporation is subject to special rules that can have a very significant impact on the tax cost of doing business in a foreign market.65 The Code's broad interpretation of intangible property includes items not generally considered assets.66 Consequently, it is extremely important to consider which assets should be transferred from the U.S. corporation to the new subsidiary. Generally it is not advisable for a U.S. person who has developed intangible property to transfer that property to a foreign corporation in a tax-free transaction.

Intangible assets generally were eligible for the active trade or business exception prior to 1984.67 As a result, U.S. corporations often would develop intangibles in the United States, incurring significant research and development costs that were

64. In Year 1, X incurred an overall foreign loss of $60,000 ($100,000 FB loss — $40,000 of the other foreign source income). Because this foreign loss offset U.S. source income of X in year 1, the overall foreign loss rules of § 904(f)(1) would cause the $30,000 of FB foreign source income in Year 2 to be recharacterized as U.S. source income. (Under § 904(f)(1)(b), X is required to recharacterize only $15,000 in Year 2, but may elect to recharacterize the full $30,000. In this example, the amount recharacterized in Year 2 will affect only the timing and not the final result.) As a result, $30,000 of the overall foreign source loss remains to be recharacterized as U.S. source income upon disposition under § 904(f)(3)(A)(i).
66. Intangible property includes any:
(i) patent, invention, formula, process, design, pattern, or know-how; (ii) copyright, literary, musical or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (vi) any similar item, which has substantial value independent of the services of any individual.
Id. § 936(h)(3)(B).
deducted in determining U.S. taxable income.\textsuperscript{68} Once those intangibles began to generate income, the U.S. corporation typically would transfer them to a low-tax foreign subsidiary in a tax-free transaction.\textsuperscript{69} The subsequent income generated by the intangibles would then be income of the foreign subsidiary, and typically would not be subject to U.S. tax until distributed as a dividend or until the U.S. parent sold the stock of the subsidiary.\textsuperscript{70}

Congress enacted section 367(d) in 1984 to remove some of the incentive for U.S. corporations to develop intangibles and then transfer them to foreign subsidiaries.\textsuperscript{71} Accordingly, when a U.S. person transfers intangible property to a foreign corporation in an exchange described in section 351 (transfer in exchange for stock) or section 361 (transfer pursuant to a reorganization), the transferor is treated as having sold that property in exchange for a series of payments that are contingent upon its productivity, use, or disposition.\textsuperscript{72} The transferor will be treated as having received annual payments in amounts equal to the annual benefits that would have been received during the useful life of the intangible.\textsuperscript{73} These deemed payments will be characterized as U.S. source income,\textsuperscript{74} which may make it more difficult for the transferor to fully utilize foreign tax credits. If the transferor disposes of its stock in the transferee, or the transferee disposes of the intangible, before the end of its useful life, the transferor will be treated as having received a final lump-sum payment.\textsuperscript{75}

An actual license agreement, which allows the foreign subsidiary to use the intangible in exchange for an arm's length royalty, generally is preferable to a deemed royalty under section 367(d). The most obvious benefit is that an actual royalty generally will give rise to a deduction in computing the foreign tax of the subsidiary.\textsuperscript{76} In addition, an actual royalty generally

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{68} Id.
\item \textsuperscript{69} Id.
\item \textsuperscript{70} Id.
\item \textsuperscript{71} Id.
\item \textsuperscript{73} Id. § 367(d)(2)(A)(ii)(I).
\item \textsuperscript{74} Id. § 367(d)(2)(C).
\item \textsuperscript{75} Id. § 367(d)(2)(A)(ii)(II).
\item \textsuperscript{76} The income inclusion required under § 367(d) does not result in a corresponding deduction at the foreign subsidiary level because § 367 is entirely a U.S. concept.
\end{enumerate}
\end{footnotesize}
will be foreign source income. Additional foreign source income will increase the foreign tax credit limitation, generally enabling a U.S. taxpayer to take a larger credit against its pre-credit U.S. tax liability.

C. Inbound and Foreign-to-Foreign Transfers

Generally, inbound and foreign-to-foreign transfers are transfers by foreign corporations, whether to a U.S. corporation (inbound) or another foreign corporation (foreign-to-foreign), that do not involve a transfer by U.S. persons to a foreign corporation. This would include the liquidation of a foreign subsidiary into its U.S. or foreign parent corporation, a reorganization in which a controlled foreign corporation transfers assets to a U.S. or foreign corporation, and the transfer by a U.S. shareholder of stock in a controlled foreign corporation in exchange for stock in another corporation under section 354.

While the general rule is that outbound transfers are taxable, inbound and foreign-to-foreign transfers generally are tax-free, except to the extent provided in the regulations. There are, however, a number of significant exceptions to the general rule. In addition, tax-free treatment under the regulations may be conditioned upon complying with certain requirements.

77. Royalty income is sourced by reference to the location where the underlying intangible is used. For example, if the licensed intangibles are used by the foreign subsidiary outside the United States, the royalty income will be foreign sourced. Id. § 862(a)(4).

78. See infra Part IV for a discussion of the foreign tax credit.

79. I.R.C. § 367(b) (1988). Both the temporary and proposed regulations under § 367(b) are extremely complicated and contain detailed rules for a number of specific types of transactions. A brief description is provided to alert the reader to potential U.S. taxation resulting from these transactions. A complete discussion of these rules is beyond the scope of this article.

80. Id. § 367(a).

81. Id. § 367(b). Temporary regulations under § 367(b) address the taxability of inbound and foreign-to-foreign transfers. A thorough discussion of these regulations is beyond the scope of this paper. Nonetheless, it should be noted that proposed regulations under § 367(b) were issued on August 23, 1991, and these proposed regulations differ significantly from the temporary regulations.

82. See id. § 367(a).
V. THE FOREIGN TAX CREDIT

A. Introduction

U.S. persons are subject to U.S. tax on their worldwide income. Foreign source income may also be subject to tax in the jurisdiction in which it is earned, creating the potential for double taxation. The foreign tax credit, which is intended to minimize such double taxation, generally allows U.S. taxpayers to reduce their U.S. tax by the amount of foreign income taxes paid or accrued during the year.\(^{83}\) However, because the foreign tax credit is intended to minimize double taxation of foreign source income, the credit is allowed to offset U.S. tax on foreign source income only.\(^{84}\) This is accomplished through the foreign tax credit limitation of section 904, which is discussed in more detail below.\(^{85}\)

B. Threshold Issues

1. Credit vs. Deduction

A U.S. taxpayer generally may deduct foreign income, property, and other taxes in computing U.S. taxable income.\(^{86}\) There is also an alternative credit mechanism for foreign income taxes, but not for property or other taxes.\(^{87}\) Under the foreign tax credit provisions of the Code, U.S. taxpayers may elect to reduce their U.S. tax liability by the amount of foreign income taxes paid or accrued during the year.\(^{88}\) However, the credit usually is preferable to the deduction because it results in a dollar-for-dollar reduction in U.S. tax rather than simply a reduction in U.S. taxable income.

The election to claim the foreign tax credit is made annually by attaching Form 1118 to the U.S. income tax return of the corporation. The election applies to all of the taxpayers' creditable foreign taxes paid, deemed paid, or accrued during the year.\(^{89}\) Thus, a taxpayer may not credit some of the creditable

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83. Id. § 901(a).
84. See id. § 901(b).
85. See infra Part V. D.
86. Id. § 164(a).
87. Id.
88. Id. §§ 901(a), 27(a).
foreign taxes and deduct the remainder. The taxpayer may, however, deduct creditable foreign taxes in one year and elect the credit in the next. Moreover, the taxpayer may file an amended U.S. income tax return to change its treatment of foreign taxes (deduction versus credit) at any time within a special ten year statute of limitations.

2. Taxpayers Eligible for the Credit

The foreign tax credit is intended to minimize double taxation of the foreign source income of U.S. taxpayers. Accordingly, it generally is available only to U.S. citizens, residents, and corporations. In addition, nonresident alien individuals and foreign corporations may, subject to certain restrictions, claim the credit against U.S. tax on foreign source income that is effectively connected with a U.S. trade or business.

3. Creditable Foreign Taxes

The foreign tax credit is limited to foreign income, war profits, and excess profits taxes, or taxes in lieu of such taxes. Once the decision has been made to credit rather than deduct a foreign tax, and it has been determined that the taxpayer is eligible to claim the credit, the next issue to be addressed is whether the foreign tax in question is a creditable tax for U.S. purposes.

In general, a foreign levy will be creditable only if it is a tax and the predominant character of that tax is that of an income tax in the U.S. sense. To be considered a “tax,” a foreign levy must require a compulsory payment pursuant to the authority of the foreign country to levy taxes. Penalties, fines, interest, and customs duties are not “taxes” for purposes of the foreign tax credit, nor are payments made in exchange for

90. Id. Election of the credit does not, however, affect the deductibility of non-creditable foreign taxes.
91. Id. § 1.901-1(d).
92. I.R.C. § 901(b) (1988). The credit is also available to individuals who are bona fide residents of Puerto Rico during the entire taxable year. Id.
93. Id. §§ 901(b)(4), 906.
94. Id. § 901(b). In practice, the primary concern is whether a particular foreign tax constitutes an income tax or a tax in lieu of an income tax. It is very uncommon to encounter issues involving war profits and excess profits taxes.
a specific economic benefit.\textsuperscript{97} Whether a tax is, in fact, compulsory and pursuant to the taxing authority of the foreign country are determined under U.S. law.\textsuperscript{98} The characterization of the levy by the foreign country is largely irrelevant.\textsuperscript{99}

One of the most difficult issues in determining whether a particular foreign levy constitutes a "tax" for U.S. foreign tax credit purposes is whether the tax, or a portion of the tax, is actually a payment made in exchange for a "specific economic benefit."\textsuperscript{100} To the extent a person subject to the foreign levy receives, or will receive, directly or indirectly, an economic benefit that is not made available on substantially the same terms to substantially all persons to which the levy applies, the levy will not be treated as a creditable tax for U.S. purposes.\textsuperscript{101}

A specific economic benefit may be as obvious as property, a service, a fee, or other payment received directly or indirectly by the taxpayer from the foreign government. More subtle specific economic benefits include the right to use or extract natural resources or the right to use property owned or controlled by the foreign government.

As mentioned above, a specific economic benefit may be received either directly or indirectly and includes benefits received by any entity owned or controlled, directly or indirectly, by the payor.\textsuperscript{102} This includes contractual relationships under which a person with whom the payor deals receives a benefit from the foreign government, but only if, under the terms and conditions of the agreement, the payor effectively receives all, or a part of, the value of the specific economic benefit.\textsuperscript{103}

The fact that a payor receives an economic benefit in exchange for payment of a foreign levy does not, by itself, lead to the conclusion that the foreign levy is not a creditable tax. Only payments which lead to a specific economic benefit—one that is not made available on substantially the same terms to substantially all persons to which the levy applies—are non-creditable.\textsuperscript{104}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{97} Id.
\item \textsuperscript{98} Id.
\item \textsuperscript{99} Id.
\item \textsuperscript{100} See id.
\item \textsuperscript{101} Id. \S 1.901-2(a)(2).
\item \textsuperscript{102} Id. \S 1.901-2(a)(2)(E)(1).
\item \textsuperscript{103} Id. \S 1.901-2(a)(2)(E)(2).
\item \textsuperscript{104} Id. \S 1.901-2(a)(2)(ii)(B).
\end{enumerate}
\end{footnotesize}
A person who is subject to a foreign levy and who also, directly or indirectly, receives, or will receive, a specific economic benefit is referred to as a dual capacity taxpayer.\textsuperscript{105} Often it is possible, at least in theory, to separate payments made by dual capacity taxpayers into two components; one which is a non-creditable payment in exchange for a specific economic benefit, and another which could qualify as a creditable foreign tax. If the taxpayer is able to segregate the levy into these two components, it may claim a foreign tax credit for that portion of the levy that is not in exchange for a specific economic benefit.\textsuperscript{106} The taxpayer clearly bears the burden of proof on this issue.\textsuperscript{107} Failure to establish the amount of the levy that is a tax will result in a denial of the foreign tax credit for any portion of the levy.\textsuperscript{108} There are two proscribed methods by which the taxpayer may establish what portion of a levy is a creditable tax: the facts and circumstances method and the safe harbor method.\textsuperscript{109} The facts and circumstances method, as its name indicates, requires that the taxpayer demonstrate, based upon all relevant facts and circumstances, the amount of the levy which qualifies as a creditable tax.\textsuperscript{110} The safe harbor method is a fairly complicated formulaic approach which must be elected by filing a statement with the taxpayer's U.S. tax return.\textsuperscript{111} The election must identify, by country, the levy or levies to which it applies.\textsuperscript{112} Once this method is elected, it applies to all levies of those foreign countries\textsuperscript{113} unless revoked with the consent of the Commissioner of the Internal Revenue Service.\textsuperscript{114}

A foreign tax has the predominant character of an income tax in the U.S. income tax only if it is likely to reach net gain in the normal circumstances in which it applies.\textsuperscript{115} A foreign tax is likely to reach net gain only if it satisfies the realization,
gross receipts, and net income requirements.\textsuperscript{116} To satisfy the realization requirement, the foreign tax generally must be imposed only on, or after, an event that would result in realization of income under U.S. tax principles.\textsuperscript{117} The gross receipts requirement provides that the foreign tax must be imposed upon gross receipts or a reasonable estimate of gross receipts.\textsuperscript{118} The net income requirement is satisfied only if the foreign tax allows gross receipts to be reduced by deductions for significant costs and expenses incurred to generate those receipts, or provides for an allowance which effectively compensates for those costs.\textsuperscript{119}

4. U.S. Taxes Which May Be Offset by the Foreign Tax Credit

The foreign tax credit generally offsets the mainstream U.S. income tax, whether corporate or individual. The credit, however, cannot be used to reduce either the accumulated earnings tax or the personal holding company tax.\textsuperscript{120}

A separate foreign tax credit calculation is done for purposes of the alternative minimum tax (AMT). In general, the AMT foreign tax credit is computed using the regular foreign tax credit rules with a number of adjustments. Those adjustments include applying the limitation calculation of section 904 on the basis of alternative minimum taxable income rather than regular taxable income, and using the AMT rate in determining whether any income is subject to the high-tax kick-out rule.\textsuperscript{121} In addition, the AMT foreign tax credit may offset no more than 90\% of the AMT liability, before applying the AMT net operating loss deduction.\textsuperscript{122} Foreign taxes in excess of this limitation may be carried back and forward for AMT purposes under the general foreign tax credit carryback and carryfor-

\begin{itemize}
  \item \textsuperscript{116} Id. § 1.901-2(b)(2).
  \item \textsuperscript{117} Id. § 1.901-2(b)(2). A foreign tax imposed upon the occurrence of a pre-realization event may satisfy the realization requirement if certain conditions are met. See id.
  \item \textsuperscript{118} Id. § 1.901-2(b)(3)(i).
  \item \textsuperscript{119} Id. § 1.901-2(b)(4)(i). It is not necessary that the timing for recovery of those costs and deductions under foreign law follow U.S. tax principles. Id.
  \item \textsuperscript{120} I.R.C. §§ 901(a), 26(b) (1988). Section 26(b) also prevents the foreign tax credit from being used to offset the environmental tax, id. § 59A, the tax on recoveries of foreign expropriation losses, id. § 1351(d)(1), the tax on certain built-in gains, id. § 1374 and passive investment income of Subchapter S corporations, id. § 1375, as well as certain other taxes.
  \item \textsuperscript{121} Id. § 902(d)(2).
  \item \textsuperscript{122} Id. § 59(a).
\end{itemize}
ward rules.\textsuperscript{123}

C. Direct and Indirect Foreign Tax Credit

The Code provides for two types of foreign tax credit: the direct and indirect credit. The direct credit is available to U.S. taxpayers who have paid or accrued foreign income taxes.\textsuperscript{124} For example, a U.S. corporation with a foreign branch generally is eligible to claim a direct credit for foreign taxes paid by that branch because the corporation is considered to have paid those taxes. A U.S. corporation that receives foreign source dividend, interest, or royalty income generally may claim a direct credit for any withholding taxes imposed on that income by the country in which the payor is located.\textsuperscript{125}

In addition to the direct credit, an indirect credit also is available to corporations.\textsuperscript{126} A U.S. corporation that receives, or is deemed to receive, a dividend from a foreign corporation may generally claim an indirect credit, also referred to as a "deemed paid credit," for foreign income taxes paid or accrued by that foreign corporation provided certain ownership requirements are satisfied.\textsuperscript{127}

Prior to the Tax Reform Act of 1986, the deemed paid foreign tax credit was calculated on an annual basis.\textsuperscript{128} Dividends received from a foreign subsidiary in a particular year were considered to carry with them at least a portion of the foreign taxes paid or accrued by the subsidiary in that year.\textsuperscript{129} Dividends paid during the first 60 days of a taxable year are treated as having been paid from prior year's earnings. If dividends paid in a particular year exceeded the earnings and profits of the foreign subsidiary for that year, they were deemed to have been paid from prior year earnings, and to carry with them for-
eign taxes paid or accrued in that earlier year.\textsuperscript{130}

In certain situations, this year-by-year approach to the indirect credit could result in either the taxpayer or the IRS being "whipsawed." For foreign subsidiaries that experienced significant variations in their effective tax rate from one year to the next, it often was advantageous to pay dividends in years when the effective rate was high, and to retain the earnings in years when the effective rate was low. Because the foreign tax credit was calculated on an annual basis, this relatively simple planning technique resulted in a larger foreign tax credit than would have been available had the effective rate for a period of years been used.

Prior to the Tax Reform Act of 1986, the annual foreign tax credit calculation could be detrimental to taxpayers. For example, in some situations, a foreign subsidiary would have no accumulated profits, a calculation based upon U.S. tax concepts, in a particular year and yet, for foreign purposes, have taxable income and a resulting foreign tax liability. Because the foreign subsidiary had no accumulated profits from which to declare a dividend, the foreign taxes paid in that year could never be assessed as a foreign tax credit. More commonly, a foreign subsidiary might have taxable income and accumulated profits in one year and a loss in the following year.

Under U.S. tax principles, the loss in the second year would be carried back to the first year, thereby reducing or eliminating accumulated profits for that year. As long as one dollar of accumulated profits remained in the profitable year, the foreign taxes paid in that year could be accessed as a foreign tax credit. However, if the loss carryback was large enough to completely offset prior year accumulated profits, the remaining foreign taxes, those that had not already been deemed paid as a result of a prior dividend or subpart F inclusion, would never be creditable.\textsuperscript{131}

In an effort to address these problems with the annual approach to the foreign tax credit calculation, Congress, as part of the Tax Reform Act of 1986, adopted a "pooling" approach to determining the accumulated profits and foreign income

\textsuperscript{130} Id.

taxes of foreign corporations. Under the pooling system, all post-1986 earnings and related foreign taxes are grouped into a pool; dividends are treated as having been paid from that pool. This approach prevents the distortions which resulted under the annual approach and results in a deemed paid foreign tax credit that more closely reflects the long-term effective foreign tax rate of the foreign subsidiary.

Under the pooling approach, which applies to post-1986 years, the amount of foreign taxes deemed to have been paid by the U.S. corporation is determined by the following fraction:

\[
\frac{\text{Dividend Received}}{\text{Post-1986 Undistributed Earnings & Profits of the Distributing Foreign Corporation}} \times \frac{\text{Post-1986 Foreign Income Taxes}}{\text{(Paid and Deemed Paid by the Foreign Corporation)}}
\]

There are, however, a number of significant limitations on the availability of the indirect credit. First, the U.S. corporation must own directly, at the time it receives the dividend, at least 10% of the voting stock of the foreign corporation from which it receives the dividend. Non-voting stock is not considered in determining whether the 10% ownership test has been met. However, if the ownership test is satisfied, dividends (and deemed dividends) on non-voting stock are also eligible for the indirect credit.

Assume, for example, that a U.S. parent corporation, P, owns 100% of the voting stock of S, a U.S. corporation, with which it files a consolidated U.S. income tax return. S, in turn, owns 100% of F, a foreign corporation. Assume further that F issues fifty shares of non-voting preferred stock. If the preferred shares are issued to S, dividends on those shares will carry with them an indirect credit because S has satisfied the 10% voting stock ownership test of section 902. If, however, the preferred shares are issued to P, they will not carry with
them an indirect credit because P has not met the 10% ownership test. The ownership test must be applied when the dividend is received from the foreign corporation. This is the date on which the dividend is "unqualifiedly made subject to the demands of the distributee." With regard to deemed distributions under subpart F, the testing date is the last day of the foreign corporation's taxable year.

When determining the percentage of stock owned, only stock owned directly by the corporation claiming the credit is considered. The constructive ownership rules of sections 958 and 318 do not apply. Thus, for example, if a U.S. parent corporation, P, owns two U.S. subsidiaries, X and Y, each of which owns 5% of the voting stock of a foreign corporation, F, neither X nor Y will be eligible for the indirect credit because neither owns directly at least 10% of the voting stock of F.

A deemed paid, or indirect, foreign tax credit is also available for foreign taxes paid by second- and third-tier foreign corporations when those corporations distribute dividends up the chain of ownership, and ultimately to the U.S. shareholder in the form of a dividend from the first-tier foreign corporation. To qualify, each tier in the chain of ownership must be joined by direct ownership of at least 10% of the voting stock. For example, the U.S corporation must own directly at least 10% of the voting stock of the first-tier foreign corporation, the first-tier must own directly at least 10% of the voting stock of the second-tier foreign corporation, and the second-tier must own directly at least ten percent of the voting stock of the third-tier foreign corporation. In addition, the U.S. corpo-

136. Id.
138. Id. § 1.902-1(a)(7).
139. Id.
140. Rev. Rul. 85-3, 1985-1 C.B. 222; see also First Chicago Corp. v. Commissioner, 96 T.C. 421 (1991). The court in First Chicago did not, however, resolve the issue of whether stock of a foreign corporation held by a U.S. subsidiary as a nominee for the U.S. parent could be included in determining whether the U.S. parent satisfies the 10% direct ownership requirement. Id.
141. The tax court's analysis in First Chicago leaves unresolved the issue of whether X and Y could be considered to hold the stock of F as agents of P. Under this analysis, P would be treated as the owner of the shares held by X and Y and would satisfy the 10% direct ownership requirement.
143. Id.
ration must indirectly own at least 5% of the voting stock of the foreign corporation paying the dividend.\textsuperscript{144} This indirect ownership is computed by multiplying the percentage of ownership at each level.\textsuperscript{145}

A significant limitation on the indirect credit is that it is available only to U.S. corporations.\textsuperscript{146} Individuals and pass-through entities such as partnerships and S corporations are not entitled to a deemed paid foreign tax credit.\textsuperscript{147}

\textbf{D. Foreign Tax Credit Limitation}

As stated above, the purpose of the foreign tax credit is to minimize double taxation of foreign source income earned by U.S. taxpayers and included in worldwide income. Accordingly, the foreign tax credit is limited to the pre-credit U.S. tax on foreign source taxable income.\textsuperscript{148} The limitation generally is computed as follows:\textsuperscript{149}

\[
\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \frac{\text{Tentative U.S. Tax on Worldwide Taxable Income}}{\text{Worldwide Taxable Income}}
\]

For example, assume that P, a U.S. corporation, earns $100 of U.S. source taxable income. Assume further that P has a branch, B, in foreign country F, and that B earns $100 of foreign source taxable income on which F imposes an income tax of $40. The United States will tax currently P’s $100 of U.S. source income as well as the full $100 of B’s earnings. The result, assuming a 34\% U.S. rate, is $68 of tentative (pre-credit) U.S. tax. If the full $40 of foreign tax were allowed as a foreign tax credit, it would, in effect, offset a portion of the U.S. tax on P’s U.S. source income. The foreign tax credit limitation of section 904 is intended, among other things, to prevent this result. Applying the above formula to these facts, P’s foreign tax credit limitation would be as follows:

\textsuperscript{144} Id. § 902(c).
\textsuperscript{145} Id.
\textsuperscript{146} See id. § 702(a)(b) (determining tax liability for partnerships); id. 1373(a) (stating that S corporations should be treated as partnerships for income tax purposes).
\textsuperscript{147} Id. §§ 702(a)(b); 1373(a).
\textsuperscript{148} See id. § 904(a).
\textsuperscript{149} See id.
$100 (Foreign Source Taxable Income) / $200 Worldwide Taxable Income × $68 (Tentative U.S. Tax) = $34

P would have $6 ($40 less $34) of excess foreign tax credits which first could be carried back two years and then forward five years.

1. *Separate Limitation Calculations (Baskets)*

Sophisticated U.S. multinationals that are able to plan the timing of dividends from their foreign subsidiaries commonly blend low-taxed and high-taxed foreign source income to minimize the incremental U.S. tax on foreign source income. For example, assume that X, a U.S. corporation, has two wholly owned foreign subsidiaries, F1 and F2. X has no income other than distributions received from F1 and F2. F1 is a manufacturing subsidiary located in a relatively high-tax country. F2, on the other hand, is an investment subsidiary located in a tax haven country. During 1991, F1 earned $200 from the active conduct of its business, on which it paid $100 of foreign income tax. F2 earned $100 of passive investment income, on which it paid no foreign income tax.150

Assume that on December 31, 1991, X receives, or is deemed to receive, dividends from F1 and F2 in the full amount of their respective earnings. X is subject to U.S. tax on the full $300 of its subsidiaries’ earnings.151 At a rate of 34%, the resulting U.S. tax, before reduction for the foreign tax credit, is $102. By blending the two items of income, X is able to reduce its U.S. tax liability by the full $100 of foreign taxes paid by F1.152 The result is a net U.S. tax liability of $2 and an effective worldwide tax rate of 34%. If, on the other hand, X is

150. Assume that both F1 and F2 were incorporated in 1991; therefore their 1991 earnings and foreign taxes represent the total amount in their post-1986 earnings and profits and foreign tax pools.

151. X is subject to U.S. tax on the distribution of after-tax earnings of F1 ($100) and F2 ($100). In addition, because X elects to credit deemed paid foreign taxes, the dividend from F1 is “grossed-up” under § 78 by the amount of deemed-paid foreign taxes ($100) attributable to that dividend. See I.R.C. § 78 (1988).

152. The foreign tax credit limitation calculation is as follows:

\[
\frac{[(FST1 ($300)) + (WWT1 ($300))] \times \text{Tentative U.S. Tax ($102)}}{\text{Tentative U.S. Tax ($102)}} = 102.
\]

*See id.* § 904.
required to compute a separate foreign tax credit limitation for each distribution, X's foreign tax credit is limited to $68. This increases the net U.S. tax liability from $2 to $34 and results in a worldwide effective tax rate of almost 45%.

Prior to the Tax Reform Act of 1986, it was not uncommon for U.S. multinationals to establish tax haven foreign investment subsidiaries, such as F2 in the above example, as a means of generating low-taxed foreign source income that could be blended with high-taxed foreign source manufacturing income. This strategy was effectively eliminated by Congress when it expanded the number of foreign tax credit limitation categories, or "baskets," from five to nine.153 By further segregating income into separate baskets, these rules make it even more difficult for taxpayers to average low-taxed and high-taxed foreign source income. In other words, because the foreign tax credit limitation of section 904 must be calculated separately for each of the different baskets in which the taxpayer has income, these additional baskets increase the likelihood that U.S. taxpayers will pay incremental U.S. tax and have excess foreign tax credits.

For purposes of determining the foreign tax credit of a U.S. taxpayer for tax years beginning after December 31, 1986, foreign source income must be assigned to one of the following baskets: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) dividends from each noncontrolled section 902 corporation, (6) dividends from a domestic international sales corporation (DISC) or former DISC, (7) taxable foreign trade income of a foreign sales corporation (FSC), (8) FSC distributions, and (9) general limitation income.154 The Code defines each type of income and provides intricate ordering rules for categorizing an item of income that could fall into more than one basket.155

a. Passive Income

Passive income, for purposes of the separate foreign tax credit limitation, is defined by reference to the foreign per-

153. See infra note 156-181 and accompanying text.
154. Id. § 904(d)(1)(A)-(I), (d)(2).
155. When a foreign tax credit is carried forward or carried back between post-1986 and pre-1987 tax years, complex transitional rules apply to determine the appropriate basket. Id. § 904(a)(2)(I).
personal holding company provisions of subpart F, with some modifications.\textsuperscript{156} Thus, it generally includes dividends, interest, rents and royalties, other than those derived in the active conduct of a trade or business and received from an unrelated person, and the excess of gains over losses from certain sales and exchanges.\textsuperscript{157}

There are a number of special rules that act to exclude certain items of income from the passive basket. For example, export financing interest,\textsuperscript{158} and foreign oil and gas extraction income\textsuperscript{159} are specifically excluded from the definition of passive income for foreign tax credit basketing purposes.\textsuperscript{160} Also, under complex ordering rules, income is excluded from the passive basket if it falls within any of the other baskets.\textsuperscript{161} Perhaps the most important and most complex of these exclusionary rules is the “high-tax” exception.\textsuperscript{162} Under this exception, which has come to be known as the high-tax kick-out (HTKO) rule, items of taxable passive income subject to an effective rate of foreign tax in excess of the highest applicable U.S. rate (currently 34\% for corporations and 31\% for individuals) are “kicked out” of the passive basket into the general limitation basket.\textsuperscript{163} The related foreign taxes are also kicked out of the passive basket into the general limitation basket. This effectively prevents the U.S. taxpayer from blending high-taxed foreign source passive income with low-taxed foreign source passive income, again increasing the likelihood that the U.S.

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{156} I.R.C. § 904(d)(2)(A) (1988).
\item \textsuperscript{157} See id. § 954(c); Temp. Treas. Reg. § 1.954-2T (1988).
\item \textsuperscript{158} Export financing interest is defined as interest income derived from financing the sale, or other disposition, for use or consumption outside of the United States, of property that is manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person, provided not more than 50\% of the fair market value of that property is attributable to products imported into the United States. I.R.C. § 904(a)(2)(G) (1988).
\item \textsuperscript{159} See id. § 907.
\item \textsuperscript{160} Id. § 904(d)(2)(A)(iii)(II), (IV).
\item \textsuperscript{161} Id. § 904(d)(2)(A)(iii)(I).
\item \textsuperscript{162} Id. § 904(d)(2)(A)(iii)(III).
\item \textsuperscript{163} For purposes of determining whether an “item of income” is subject to an effective foreign tax rate in excess of the applicable U.S. rate, passive income generally is grouped into three categories, each of which is tested separately: (1) passive income received during the year that is subject to a withholding tax of 15\% or more; (2) passive income received during the year that is subject to a withholding tax of less than 15\%, but more than 0\%; and (3) passive income received during the year that is subject to no withholding tax. Treas. Reg. § 1.904-4(c)(3) (1988).
\end{enumerate}
\end{footnotesize}
taxpayer will pay incremental U.S. tax and have excess foreign tax credits.

b. High Withholding Tax Interest

A second separate foreign tax credit limitation basket is provided for interest income that is subject to a withholding tax in the payor's country of 5% or more. As with the passive income basket discussed above, export financing income that would otherwise be considered high withholding tax interest income is specifically excluded from this basket.

The U.S. has negotiated income tax treaties with most of its major trading partners. Many of these treaties eliminate withholding tax on interest paid to a U.S. recipient. Other treaties call for a reduced rate of withholding on interest, but generally not below 5%.

c. Financial Services Income

There is also a separate foreign tax credit limitation basket for certain types of income “received or accrued by any person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.” An entity is considered to be predominantly engaged in such a business in a taxable year if, for that year, 80% or more of its gross income is “active financing income,” as that term is defined in the regulations.

d. Dividends from Each Noncontrolled Section 902 Corporation

There is a separate foreign tax credit limitation category for dividends from each “noncontrolled section 902 corpora-

165. Id. § 904(d)(2)(B)(ii).
tion.” Also referred to as “10/50 companies,” noncontrolled section 902 corporations are foreign corporations that are not controlled foreign corporations (not more than 50% of vote or value owned by “U.S. shareholders”), in which the U.S. shareholder in question owns at least 10% of the voting power.

The effect of the separate limitation for 10/50 companies can be illustrated as follows. Assume that X, a U.S. corporation, owns 50% of the vote and value of F1, a first-tier U.K. subsidiary, and 50% of the vote and value of F2, a first-tier German subsidiary. The remaining 50% of each corporation is owned by foreign investors. Because neither F1 nor F2 are more than 50% owned by U.S. shareholders, neither is a controlled foreign corporation (CFC). However, because X owns more than 10% of the voting power of each F1 and F2, X is entitled to a deemed paid foreign tax credit on dividends received from each corporation.

Assume further that X has no income other than dividends received from F1 and F2, and that F1 pays a dividend to X of $180 that carries with it deemed paid taxes of $20 (F1 is subject to an effective foreign tax rate of 10%). Assume also that F2 pays a dividend to X of $120, and that F2's dividend carries with it deemed paid foreign taxes of $180 (F2 is subject to an effective foreign tax rate of 60%). Finally, assume that the underlying income of F1 and F2 is active business income that would otherwise be classified as general limitation income.

X will be subject to U.S. tax on the dividends ($300) plus the related foreign taxes ($200). The resulting tentative U.S. tax is $170 ($500 × 34%). Without the separate limitation for dividends from each 10/50 company, X would be entitled to a deemed paid foreign tax credit of $170, fully offsetting the tentative U.S. tax. By separating the dividends into separate baskets, X’s foreign tax credit is reduced to $122, resulting

171. Id. § 904(d)(2)(E)(i).
172. (500 × 500) × 170 = 170
173. X’s foreign tax credit would be computed as follows:

Dividend from F1: ($200 × $200) × $68 = $68, but is limited to $20 actually paid.

Dividend from F2: ($300 × $300) × $102 = $102. Total deemed paid foreign tax credit = 20 + 102.
in a residual U.S. tax of $48.\textsuperscript{174} The result is an increase in X's worldwide effective tax rate of almost 10%.\textsuperscript{175}

It is important to note, as the example illustrates, that this actually requires a separate foreign tax credit calculation for each 10/50 company rather than one calculation for all 10/50 companies combined. The record-keeping implications of this requirement can be substantial for U.S. corporations that have a 10% interest in a large number of foreign corporations, none of which are CFCs.

The application of the separate 10/50 rules can be exceptionally complex when there have been ownership changes at the foreign corporation level. For example, assume that X, in the above example, wants to avoid the effect of the separate foreign tax credit limitations for dividends from F1 and F2. To do so, X purchases an additional 1% of the stock of F1 and F2, making both CFCs. Presumably, dividends from F1 and F2 would no longer be subject to the separate foreign tax credit limitation for 10/50 companies. Unfortunately, distributions from a CFC are treated as dividends from a 10/50 company to the extent that the distribution is out of earnings and profits accumulated in periods during which the CFC was not a CFC.\textsuperscript{176}

A similar rule addresses the effect of a change in ownership that causes a foreign corporation to shift from a CFC to a non-controlled section 902 corporation. In this situation, dividends paid out of earnings and profits of the foreign corporation accumulated while that foreign corporation was a CFC cannot be treated as dividends from a noncontrolled section 902 corporation.\textsuperscript{177} As originally written, this rule would seem to allow a U.S. shareholder to acquire an interest in a 10/50 company and yet avoid the 10/50 basket on dividends from that corporation, provided those dividends are distributed from earnings and profits accumulated while the foreign corporation was a CFC. Because this was generally viewed as outside the intent of the original provision, section 904(d)(2)(E)(i) was amended to provide the Secretary of the Treasury with regulatory authority to limit look-through treat-

\textsuperscript{174} Tentative U.S. tax of $170, less foreign tax credit of $122.
\textsuperscript{175} 48 additional tax $500 taxable income = 9.6%.
\textsuperscript{176} Treas. Reg. § 1.904-4(g)(3) (1988).
ment to U.S. shareholders which were shareholders at the time the earnings were accumulated. 178

The 10/50 basket is also administratively difficult to apply when lower-tier foreign corporations are involved. If a foreign corporation, whether first-, second-, or third-tier, is a CFC, dividends it pays will be subject to look-through rules. 179

Under these rules, the characterization of the dividend income in the hands of the recipient depends upon the character of the underlying income earned by the payor. Thus, dividends received from a CFC may be allocated, at least in part, to the 10/50 basket if the earnings of that CFC from which the dividend was distributed are attributable to dividends from a 10/50 company. 180

Assume, for example, that X, a U.S. corporation, received a dividend from F1, a first-tier foreign corporation that is a CFC. A portion of F1’s earnings from which that dividend was distributed are attributable to a dividend received from F2, a second-tier foreign corporation that is a 10/50 company. Because a portion of F1’s earnings from which the dividend was distributed are attributable to a dividend from a 10/50 company, and because dividends from F1 (as a CFC) are subject to the look-through rules, 181 a portion of the dividend received by X will be 10/50 basket income.

2. Look-Through Rules

The purpose of the look-through rules, which were added to the Code by the Tax Reform Act of 1986, is to minimize the impact on the allocation of income among the various foreign tax credit limitation categories of operating as a foreign subsidiary rather than a foreign branch. 182

Application of the look-through rules is limited to U.S.

179. See infra Part V.D.3.
180. See Treas. Reg. § 1.904-4(g)(3).
181. See infra Part V.D.2.
182. Congress noted:
   Look-through rules reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (as through a foreign branch), and the amount of income subject to a particular limitation when a taxpayer earns income abroad through a controlled foreign corporation.

shareholders of CFCs. This limitation is due in part to the conclusion that once the U.S. ownership of a foreign entity drops below 50%, that entity no longer closely resembles a branch of the U.S. shareholder. It is also a recognition of the difficulties that minority shareholders likely would encounter in trying to convince the foreign entity to provide the detailed information needed to apply the look-through rules.

If the recipient of a dividend is a U.S. shareholder, and the distributing foreign corporation is a CFC, the dividend will be sourced to the various foreign tax credit baskets based upon the underlying earnings of the distributing foreign corporation. This is referred to as "look-through" treatment and is illustrated in the example below.

Assume that X, a U.S. corporation, is a U.S. shareholder of F1, a CFC. Assume further that F1's pool of post-1986 earnings and profits is $100, which consists of $60 of general limitation income and $40 of passive basket income. If F1 were to distribute a dividend, 60% of the dividend received by X would be general basket income and 40% would be passive basket income.

The look-through rules apply to dividends, interest, rents, and royalties actually received by a U.S. shareholder from a CFC, as well as subpart F inclusions deemed to have been received from such a corporation. Actual dividends and

185. Congress restricted the scope of look-through treatment in this manner, in part, because . . . a primary function of look-through treatment is to make the foreign tax credit limitation treatment of income earned through foreign branches and income earned through foreign subsidiaries more alike by, in effect, treating income earned by a foreign subsidiary as if it were earned directly by its U.S. parent. When the U.S. interest in a foreign entity falls below a majority interest, Congress believed that such entity frequently no longer substantially resembles a branch operation of U.S. persons. Further, the Act's approach recognizes the difficulty that some shareholders in minority U.S.-owned corporations might have encountered in obtaining the additional income and tax information necessary to apply the look-through rules to payments of such corporations.

Id.
187. Assume this passive income was not subject to U.S. tax under subpart F. See id. §§ 951-964.
188. Id. § 904(d)(3)(A).
189. Id. § 904(d)(3)(B).
deemed dividends arising from investments in U.S. property are allocated to the separate foreign tax credit limitation baskets in proportion to the ratio of the foreign corporation’s earnings and profits in each basket. Subpart F inclusions are allocated to the separate baskets “to the extent the amount so included is attributable to income in such category.” Interest, rents, and royalties generally are allocated among the separate baskets by reference to the type of income which the deduction for those items are offset at the CFC level.

E. Allocating Foreign Taxes

Just as foreign source income must be allocated among the various separate foreign tax credit limitation categories or baskets, the related foreign income taxes must also be allocated among the separate baskets. The regulations provide that foreign income taxes which can be specifically identified with a particular category of foreign source income must be specifi-

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190. “United States property” is defined as:
(A) tangible property located in the United States;
(B) stock of a domestic corporation;
(C) an obligation of a United States person; or
(D) any right to the use in the United States of—
   (i) a patent or copyright,
   (ii) an invention, model, or design (whether or not patented),
   (iii) a secret formula or process, or
   (iv) any other similar property right which is acquired or developed by
       the controlled foreign corporation for use in the United States.
       Id. § 956(b)(1).
191. Id. § 904(d)(3)(D).
192. Id. § 904(d)(3)(B). Although the language differs somewhat from that of § 904(d)(3)(D), which relates to actual dividends, it does not appear that there is any significant practical difference. The General Explanation of the Tax Reform Act of 1986 provides the following example: X, a U.S. corporation, owns 100% of CFC, a controlled foreign corporation. CFC earns $100 of net income, $95 of which is foreign base company shipping income and the remaining $5 of which is subpart F foreign personal holding company income. No foreign tax is imposed on either type of income. All of CFC’s income is subpart F income taxed currently to X. Because $95 of the subpart F inclusion is attributable to income of CFC in the shipping basket, $95 of X’s subpart F inclusion is treated as shipping basket income. Because $5 of the subpart F inclusion is attributable to income of CFC in the passive basket, $5 of X’s subpart F inclusion is treated as passive basket income. See General Explanation of the Tax Reform Act of 1986, supra note 128, at 878.
193. I.R.C. § 904(d)(3)(C) (1988). For example, rental income received by a U.S. shareholder from a CFC would be general limitation income if it were payment for the use of machinery and equipment used in the active conduct of the CFC’s business, and if the deduction for that rent payment were allocated by the CFC against its general limitation income.
cally allocated to that income.\textsuperscript{195} For example, if foreign law provides for a specific rate of tax on an item of income, or allows certain expenses, deductions, or credits only with respect to a particular type of income, those provisions must be considered in determining the amount of foreign income tax imposed on that income.\textsuperscript{196}

Foreign income taxes that relate to more than one category of income must be apportioned among all of the categories in which there is income.\textsuperscript{197} This apportionment is done on the basis of relative net income in each of the baskets.\textsuperscript{198} For purposes of apportioning foreign income taxes among the various separate limitation baskets, gross income is determined under the laws of the foreign country which has imposed the tax.\textsuperscript{199} Subject to certain modifications, foreign law is also used to determine net income in each basket.

1. Source of Income Rules

Virtually every provision of the Code that deals with U.S. taxation of foreign income requires at some point that the income be identified as either U.S. or foreign source income. For example, the first, and arguably most important step in calculating the foreign tax credit limitation detailed above is to determine the amount of foreign source taxable income of the U.S. taxpayer. This step is important because the foreign tax credit is limited to the U.S. tax on foreign source taxable income.\textsuperscript{200} As a result, an increase or decrease in the relative amount of foreign source taxable income will have a direct impact on the foreign tax credit limitation which, in turn, may affect the amount of foreign tax that can be used to offset U.S. tax.

The first step in the process of determining foreign source taxable income is to classify each item of gross income as either U.S. or foreign source, using the source of income pro-

\begin{itemize}
\item \textsuperscript{195} Id.
\item \textsuperscript{196} Id.
\item \textsuperscript{197} Id. § 1.904-6(a)(1)(ii).
\item \textsuperscript{198} Taxes should be apportioned among the various separate limitation baskets by the following formula: (Foreign tax related to more than one separate category $\times$ Net income subject to that foreign tax included in a separate category) \div Net income subject to that foreign tax.
\item \textsuperscript{199} Treas. Reg. § 1.904-6(a)(1)(ii) (1988).
\item \textsuperscript{200} I.R.C. § 904(a) (1988).
\end{itemize}
visions found in sections 861 through 865 of the Code. These source of income rules are not conceptually difficult, nor are they difficult to apply in most cases. However, as with other international provisions of the Code, there are a number of exceptions and special rules which add considerable complexity.

Interest income, for example, generally is foreign source if received from a foreign corporation or nonresident alien individual.\(^{201}\) However, interest paid by a foreign corporation that is 50% or more owned by U.S. persons may be U.S. source income if that interest is allocable to income from U.S. sources.\(^{202}\) Interest that would otherwise be recharacterized as U.S. source under the above exception will remain foreign source if less than 10% of the earnings and profits of the paying foreign corporation are attributable to U.S. sources.\(^{203}\)

Just as interest paid by a foreign corporation ordinarily is foreign source income to the recipient, income paid by a U.S. corporation ordinarily is U.S. source income.\(^{204}\) Again, however, this relatively simple rule is complicated by exceptions. If, for the three-year period ending with the close of the taxable year preceding the year in which the interest is paid, 80% or more of the gross income of the U.S. corporation which is paying the interest is from foreign sources and is attributable to the active conduct of a trade or business in a foreign country, that interest generally will be foreign source income to the recipient.\(^{205}\) For recipients who own 10% or more of the paying corporation, there is an additional exception which provides that the interest received will be foreign source only in proportion to the foreign source gross income of the paying corporation.\(^{206}\)

The rules for sourcing dividend income can be equally complex. Again the general rules are relatively simple: dividends received from foreign corporations are foreign source income;\(^{207}\) dividends received from U.S. corporations are U.S.

\(^{201}\) Id. § 862(a)(1); see also id. § 861(a)(1) (defining gross income from sources within the United States).

\(^{202}\) Id. § 904(g)(3).

\(^{203}\) Id. § 904(g)(5)(B).

\(^{204}\) Id. § 861(a)(1).

\(^{205}\) Id. §§ 861(a)(1)(A), (c)(2)(A).

\(^{206}\) Id. § 861(a)(2).

\(^{207}\) Id. § 861(a)(2).
source income. As with the sourcing of interest income, the complexity results from a number of exceptions to the general rules. For example, a portion of a dividend from a foreign corporation will be recharacterized as U.S. source income if, for the three-year period immediately preceding the taxable year of the dividend, 25% or more of the distributing corporation’s gross income was effectively connected with the conduct of a U.S. trade or business. As with interest, a portion of a dividend received from a foreign corporation will be recharacterized as U.S. source if 50% or more of that corporation is owned by U.S. persons, and 10% or more of its earnings and profits for the year are attributable to U.S. sources.

Having applied the sourcing rules of sections 861 through 865 to determine the amount of foreign source gross income, the next step is to allocate and apportion deductions to that income to arrive at foreign source taxable income. This is generally a two-step process in which deductions are first allocated to a class or type of gross income to which they relate. If the income in that class is entirely U.S. or foreign source, the expenses will be allocated directly against that category of income. If the class of income to which an item of expense is allocated in step one includes both U.S. and foreign source income, it is then necessary to apportion that expense between the two categories of income. In either case, expenses allocated to foreign source income must then be allocated and/or apportioned to the various separate foreign tax credit limitation categories.

There are a number of special rules dealing with the allocation and apportionment of specific deductions, including interest expense, charitable contributions, state income taxes, and research and development expenditures.

2. Effect of Foreign Tax Redeterminations

A foreign tax redetermination is a change in the amount of a foreign tax liability for which the U.S. taxpayer received a for-

208. Id. § 862(a)(2).
209. Id. § 861(a)(2)(B).
210. Id. § 904(g)(4)-(6).
211. Id. § 861(b) (U.S. income); id. § 862(b) (foreign income).
212. Id. § 863(b).
213. See generally id. § 861 and the regulations thereunder. A detailed discussion of these rules is beyond the scope of this Article.
eign tax credit in a prior year.\textsuperscript{214} Such a redetermination can result from a refund of foreign taxes as well as from a difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid due to either an actual change in the liability or fluctuation in exchange rates.\textsuperscript{215} The effect of a foreign tax redetermination depends upon whether the foreign tax was imposed directly on a U.S. taxpayer and therefore claimed as a direct foreign tax credit under section 901, or upon a foreign corporation and subsequently claimed as an indirect foreign tax credit under section 902 (actual dividend) or section 960 (subpart F and section 956).

If the foreign tax was imposed directly on a U.S. taxpayer, that taxpayer generally must redetermine its U.S. tax liability for a prior taxable year in which there is a foreign tax redetermination.\textsuperscript{216} There is a very limited exception, however, for redeterminations caused solely by fluctuations in the exchange rate between the date of accrual and actual payment date. In this situation, if the amount of the redetermination is less than the lesser of $10,000 or 2\% of the total dollar amount of the foreign tax initially accrued with respect to that foreign country for the taxable year, the taxpayer simply adjusts its U.S. tax liability in the year of the redetermination.\textsuperscript{217}

With respect to the redetermination of foreign taxes claimed as an indirect foreign tax credit, the U.S. taxpayer generally does not redetermine its U.S. tax liability for the year of the redetermination.\textsuperscript{218} Instead, the taxpayer adjusts the pools of earnings and profits and foreign taxes of the foreign subsidiary.\textsuperscript{219} As a result, the redetermination will affect the computation of the U.S. shareholder's indirect foreign tax credit only for the years beginning with the year of redetermination.

\textsuperscript{214} Id. § 905(c).
\textsuperscript{216} Id. § 1.905-3T(d)(1).
\textsuperscript{217} Id.
\textsuperscript{218} The U.S. taxpayer must, however, redetermine its U.S. tax liability for the year of redetermination if the foreign tax liability is in a hyperinflationary currency. Id. § 1.905-3T(d)(4)(i). In addition, the IRS has discretionary authority to require a U.S. tax redetermination if the amount of the foreign tax accrued for the taxable year, as measured in units of the foreign currency, exceeds the amount originally paid by 2\% or more. Id. § 1.905-3T(d)(4)(ii).
\textsuperscript{219} Id. § 1.905-3T(d)(2); see also I.R.S. Notice 90-26, 1990-1 C.B. 336.
VI. Anti-Deferral Provisions

U.S. taxpayers generally are not subject to U.S. tax on the earnings of a foreign subsidiary or other foreign corporation in which stock is owned until those earnings are distributed to the U.S. taxpayer as dividends or the stock of the foreign corporation is sold.\(^{220}\) This opportunity to defer U.S. tax, provides a tremendous incentive for U.S. taxpayers to transfer income-producing assets and activities to foreign subsidiaries, particularly those located in low-tax jurisdictions.

To remove this incentive, Congress enacted a number of provisions that override the general rule of deferral. These provisions allow the United States to tax the U.S. shareholders of a foreign corporation on the income of that corporation even though the U.S. shareholders have neither received a dividend from, nor sold the stock of, the foreign corporation. The primary anti-deferral provisions, discussed in detail below, are subpart F,\(^ {221}\) the Foreign Personal Holding Company (FPHC) provisions,\(^ {222}\) and the Passive Foreign Investment Company (PFIC) provisions.\(^ {223}\)

A. Subpart F

Commentators have noted that the anti-deferral provisions of subpart F contain some of the most complicated rules in the Internal Revenue Code.\(^ {224}\) The primary statutory provisions, which define the types of income, shareholders, and foreign corporations affected by subpart F, are not overly difficult to understand. However, the exceptions and limitations to these provisions create a degree of confusion and complexity that is matched by few other areas of the Code.

Subpart F, which became effective in 1963, was intended to address the use of tax haven foreign subsidiaries that served no business purpose other than obtaining a deferral of U.S. tax.\(^ {225}\)

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220. See supra notes 27-34 and accompanying text.
222. Id. §§ 551-558. This discussion of foreign personal holding companies is current as of April 27, 1992. New regulations affecting FPHC's have since been issued by the Treasury Department. Definition of Resident Alien, 57 Fed. Reg. 15,237 (1992) (to be codified at 26 C.F.R. pts. 1, 31, 301, & 602).
223. Id. §§ 1291-1297.
225. Id. § 3.01[2]; see also S. Rep. No. 1881, 87th Cong., 2d Sess. (1962).
Prior to the enactment of subpart F, it was fairly common for U.S. corporations to establish wholly owned subsidiaries in a low-tax or no-tax foreign jurisdiction to act as intermediaries on sales to foreign customers or as holding companies which would invest excess cash of the U.S.-affiliated group. The objective was to shift profit from the sale, or income investment, from the U.S. parent, where it would be taxed currently by the United States, to the foreign subsidiary, which was not subject to U.S. tax and which typically paid little or no foreign tax. When the U.S. parent needed cash, the foreign subsidiary could either distribute a dividend, at which point the earnings would be subject to U.S. tax, or make a loan to the U.S. parent, creating additional interest deductions in the United States and additional income in the tax haven subsidiary.

Because the United States has neither residence nor source of income jurisdiction, subpart F does not attempt to tax the foreign subsidiary directly. Instead, if the foreign subsidiary is a “controlled foreign corporation” (CFC) and it earns certain types of tainted (subpart F) income, then subpart F requires the “U.S. shareholders” to include in income a “deemed dividend” in an amount equal to their pro rata share of the subpart F income and increase in earnings invested in U.S. property, even if no distributions are actually made.

Because the anti-deferral provisions of subpart F apply only to “U.S. shareholders” of a “CFC” that earns “subpart F income” it is important to understand each of these terms.

1. **U.S. Shareholder**

Not every U.S. person that owns stock in a foreign corporation is a “U.S. shareholder” for purposes of subpart F. Rather, a U.S. shareholder is defined as any U.S. person that owns at least 10% of the total combined voting power of all classes of stock of the foreign corporation that are entitled to vote. This ownership test for determining whether a shareholder is a “U.S. shareholder” focuses solely on voting power; unlike the test for CFC status, the value of the shareholding is apparently

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226. See, e.g., 1 ROADES & LANGER, supra note 224 § 3.01.
227. Id.
228. See infra note 236 and accompanying text.
229. See infra note 231 and accompanying text.
231. Id. § 951(b).
irrelevant. 232 The 10% ownership test is relatively straightforward when the foreign corporation in question has only one class of voting stock outstanding. If, however, the foreign corporation has more than one class of voting stock outstanding, the calculation becomes slightly more complicated. In this situation, a U.S. shareholder’s percentage of voting power ordinarily is measured by reference to the proportionate share of the percentage of the members of the board of directors that the relevant class of stock can elect. 233 For example, assume that F, a foreign corporation, has outstanding two classes of voting common stock, class A and class B. There are eighty shares of class A common stock issued and outstanding, and twenty shares of class B common stock issued and outstanding. Each class of stock is entitled to elect six of the twelve members of F’s board of directors. Assume further that X, a U.S. corporation, owns five class B shares. Although X owns only 5% of the outstanding voting stock of F, those shares entitle X to elect 12.5% of the board of directors. 234 Accordingly, because X can elect more than 10% of the directors, X is a U.S. shareholder of F for purposes of subpart F. 235

2. Controlled Foreign Corporations

A controlled foreign corporation (CFC) is one in which U.S. shareholders own, on any day during the taxable year of the foreign corporation, more than 50% of either the total combined voting power of all classes of stock entitled to vote or 50% of the total value of the stock of the corporation. 236

It is interesting to note that even though a foreign corporation technically will be a CFC if U.S. shareholders own more than fifty percent of the voting power or value of the foreign corporation on any day during the taxable year, those U.S. shareholders will be treated as having received a deemed dividend under subpart F only if the foreign corporation is a CFC for an uninterrupted period of thirty days or more during its taxable

232. See infra note 238 and accompanying text.
234. (5 ÷ 20) x (6 ÷ 12) = 12.5.
235. Additional illustrations calculating the percentage of ownership are provided at Treas. Reg. § 1.951-1(g)(2)(ii) (1988).
236. Id. § 957(a). Ownership may be determined directly, indirectly, or constructively.
year and only if they own stock of the CFC on the last day of its taxable year.\textsuperscript{237}

Complex attribution rules apply in determining whether the ownership thresholds for both U.S. shareholder status (at least 10\% of voting power) and controlled foreign corporation status (more than 50\% of vote or value) have been met.\textsuperscript{238} Shares of the foreign corporation that are owned directly, indirectly, and constructively are included when determining whether a shareholder is a U.S. shareholder and whether U.S. shareholders, in the aggregate, own more than 50\% of the vote or value of the foreign corporation.\textsuperscript{239}

Under the direct and indirect ownership rules, stock owned directly or indirectly by or for a foreign corporation, foreign partnership, or foreign trust or estate is considered to be owned proportionately by the shareholders, partners, or beneficiaries of that entity.\textsuperscript{240} This attribution rule creates a chain of ownership which requires attribution from lower-tier to upper-tier foreign entities, but which stops with the first U.S. person.\textsuperscript{241}

Section 958 also provides constructive ownership rules that incorporate and modify the constructive ownership rules of section 318.\textsuperscript{242} With regard to family attribution, an individual is considered to own the stock owned, directly or indirectly, by his spouse, children, grandchildren, and parents.\textsuperscript{243} The family attribution rules do not extend to brothers, sisters, aunts, or uncles.\textsuperscript{244} In addition, stock owned by a non-resident alien individual is not considered as owned by a citizen or by a resident alien individual.\textsuperscript{245}

The attribution-from-entity rules generally parallel those of section 318, particularly with respect to attribution from partnerships, estates, and trusts.\textsuperscript{246} Stock owned, directly or indirectly, by those entities is considered to be owned

\begin{itemize}
  \item \textsuperscript{237} Id. § 951(a)(1).
  \item \textsuperscript{238} See id. §§ 958, 318.
  \item \textsuperscript{239} See id. § 958(a), (b).
  \item \textsuperscript{240} Id. § 958(a).
  \item \textsuperscript{241} See Treas. Reg. § 1.958-1(b) (as amended in 1983).
  \item \textsuperscript{242} The constructive ownership of stock rules are at I.R.C. § 318 (1988).
  \item \textsuperscript{243} Id. §§ 958(b), 318(a)(1)(A).
  \item \textsuperscript{244} Id.
  \item \textsuperscript{245} Id. § 958(b)(1).
  \item \textsuperscript{246} See id. § 958.
\end{itemize}
There are, however, a number of significant modifications to the rules governing attribution from corporations. One such modification provides that in applying the rules for attribution of ownership from a corporation, the 50% threshold of section 318(a)(2)(C) is lowered to 10%. As a result, shareholders who own, directly or indirectly, 10% or more in value of the stock of a corporation are considered to own a proportionate share of the stock owned directly or indirectly by or for such corporation. In addition, if an entity such as a partnership, estate, trust, or corporation, but not an individual, owns directly or indirectly, more than 50% of the voting power of a corporation, it is considered to own 100%.

The indirect and constructive ownership rules can be illustrated by the following example. Assume that X, a U.S. corporation, owns 60% of the voting power of F1, a foreign corporation. F1, in turn, owns 60% of the voting power of F2, also a foreign corporation. Under the indirect ownership rules, X is treated as owning 36% (60% × 60%) of the stock of F2. However, under the constructive ownership rules, F1 is treated as owning 100% of F2 because it owns more than 50% of F2. As a result, for purposes of determining whether X is a U.S. shareholder of F2 and whether F2 is a controlled foreign corporation, X is treated as owning 60% (60% × 100%) of F2. Note, however, that only direct and indirect ownership is considered for purposes of determining the subpart F inclusion of a U.S. shareholder. As a result, if F2 were to earn $100 of subpart F income, $36, not $60, would be treated as a deemed dividend to X.

One important point which is often overlooked is that ownership of an option to acquire stock, or an option to acquire an option, is treated as ownership of the related stock. This rule can be particularly important for U.S. corporations plan-

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247. Id. § 958(b)(2).
248. Id. § 958(b)(3).
249. Id. §§ 958(b)(3), 318(a)(2)(C).
250. Id. § 958(b)(2).
251. See supra notes 239-241 and accompanying text.
252. See supra notes 242-245 and accompanying text.
255. Id. §§ 958(b), 318(a)(4).
ning to purchase an interest in an existing foreign corporation. For example, in a typical transaction a U.S. investor may purchase 50% of an existing foreign corporation, with the remaining 50% owned by foreign shareholders. Generally such a deal would include either the foreign seller or top management of the foreign corporation. If, in addition to the stock, the U.S. investor receives an option to acquire some or all of the remaining 50%, the foreign corporation will be a controlled foreign corporation and the anti-deferral provisions of subpart F may come into affect.\textsuperscript{256}

3. **Subpart F Income**

Several types of income are subject to the anti-deferral rule of subpart F, the most common of which is referred to as Foreign Base Company Income (FBCI).\textsuperscript{257} FBCI, in turn, includes foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income. This article focuses on the first three types of FBCI, which are by far the most commonly encountered.

\textit{a. Foreign Personal Holding Company Income}

Foreign personal holding company (FPHC) income includes five categories of passive investment income. The first and most common category of FPHC income includes dividends, interest (including original issue discount), royalties, rents, and annuities.\textsuperscript{258} Thus, as a general rule, U.S. shareholders of a CFC will be taxed currently on their pro rata share of dividend, interest, royalty, rental, and annuity income earned by the CFC.\textsuperscript{259} There are, however, a number of exceptions to

\textsuperscript{256.} \textit{Id.} § 958(b)(2).

\textsuperscript{257.} Subpart F income is the sum of (1) insurance income, which is defined under § 953 and is generally income from insuring risks outside of the CFC's country of incorporation; (2) foreign base company income, as determined under § 954; (3) income related to operations in countries associated with an international boycott in which the CFC has participated or cooperated; (4) the sum of any illegal bribes, kickbacks, or other payments paid to an official, employee, or agent of a government by or on behalf of the CFC during the taxable year; and (5) income derived by the CFC from any foreign country the income taxes of which are not creditable under § 901(j). \textit{Id.} § 952(a).

\textsuperscript{258.} \textit{Id.} § 954(c)(1)(A).

\textsuperscript{259.} \textit{Id.} § 954(a).
One such exception applies to dividends and interest received from a related corporation created or organized under the laws of the same foreign country as the CFC. These are excluded from FPHC income and from the anti-deferral provisions of subpart F, provided a substantial part of the payor's assets are used in its trade or business in that country. A "substantial part" of the payor's assets will be considered to be used in a trade or business located in its country of incorporation only if, for each quarter of the taxable year, the average value of its assets located in the country of incorporation and used in the trade or business is more than 50% of the value of the total assets of the payor.

This "same country exception," as it is called, is not available to the extent the interest received reduces the payor's subpart F income or creates or increases a deficit which, under one of the general exceptions to subpart F, might reduce the subpart F income of the payor or another CFC.

For example, assume that X, a U.S. corporation, owns 100% of the vote and value of both F1 and F2. F1 and F2 are foreign corporations incorporated in the United Kingdom. Assume further that F1 lends $100 to F2 at an interest rate of 10%. F1 would earn $10 of interest income each year that would be taxed currently to X as subpart F income. However, because F1 and F2 are both U.K. corporations, the same country exception should allow the interest income received by F1 from F2 to be excluded from subpart F, provided F2 meets the substantial asset test. If F2 itself has earned subpart F income, this same country exception is not available to the extent the interest paid by F2 reduces that income.

There is a similar exception to subpart F treatment for rents and royalties received from a related corporation for the use of, or privilege of using, property within the country in which

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260. Id. § 954(c)(3)(A).
262. See infra notes 268-276 and accompanying text.
264. Id. § 954(c)(1)(A).
265. See supra note 260 and accompanying text.
the CFC was created or organized.\textsuperscript{267} This exception is not available to the extent the rents or royalties reduce the subpart F income of the payor.\textsuperscript{268}

There is also an exception for what are referred to as “active rents and royalties.”\textsuperscript{269} Under this provision, rent and royalty income is excluded from FPHC income if it is derived in the active conduct of a trade or business and it is received from an unrelated person.\textsuperscript{270}

To take advantage of the active rents and royalties exception, the CFC must first establish that the income is derived in the active conduct of its trade or business.\textsuperscript{271} Generally, this exception is determined from the facts and circumstances of each case.\textsuperscript{272} There are, however, specific safe harbor provisions under which rent and royalty income will be considered to be earned in the active conduct of the CFC’s trade or business.\textsuperscript{273} By focusing on the CFC’s involvement in the use or development of the property generating the rent or royalty income, these safe harbor provisions are intended to ensure that there is some substance to the underlying transaction.

Having established that the income is, in fact, derived in the active conduct of its trade or business, the CFC must then establish that the income is received from an unrelated payor. For purposes of this exception, the payor will be considered unrelated to the CFC if the payor neither controls nor is controlled by the CFC, and the payor and the CFC are not controlled by the same person(s).\textsuperscript{274} With respect to payments by one foreign corporation to another, a vote or value test is used to determine control.\textsuperscript{275} Under this test, control is defined as the direct or indirect ownership of more than 50% of the total voting power of all classes of stock entitled to vote for a corporation, or ownership of over 50% of the total value of the stock

\begin{itemize}
  \item \textsuperscript{267} Id. § 954(c)(3)(A)(ii).
  \item \textsuperscript{268} Id. § 954(c)(3)(B).
  \item \textsuperscript{269} Id. § 954(c)(2)(A).
  \item \textsuperscript{270} Id.
  \item \textsuperscript{271} See id.
  \item \textsuperscript{272} Treas. Reg. § 1.954-2T(b)(5) (1988). The frequency of entering into transactions from which rents or royalties will be derived is not itself determinative of whether the rents or royalties are derived in the active conduct of a trade or business. Id.
  \item \textsuperscript{273} Id. §§ 1.954-2T(c), (d).
  \item \textsuperscript{274} I.R.C. § 954(d)(3) (1988).
  \item \textsuperscript{275} Id. § 954(d)(3).
\end{itemize}
of a corporation for a partnership, estate, or trust.\textsuperscript{276}

The second category of FPHC income is gains from the sale of property which generates passive income,\textsuperscript{277} as well as gains from property that does not generate any income.\textsuperscript{278} Net losses from the sale of such property may not, however, offset other types of FPHC income.\textsuperscript{279} Thus, gain on the sale of stock held by the CFC for investment purposes would be FPHC income because stock generates passive income.\textsuperscript{280} However, if the stock were sold at a loss, that loss would not offset any FPHC dividend income that might have been earned prior to the sale.\textsuperscript{281}

It can be difficult to determine whether the property being sold is held as a passive investment or for use in the active conduct of the CFC's trade or business. For example, assume that, in year 1 a CFC purchases a building. The building is held for investment purposes, generating FPHC rental income for 2 years. At the beginning of year 3, the CFC takes over the entire building for use in the active conduct of its business. One year later, the CFC sells the building for a gain.

If the use of the property at, or shortly before, the time of sale were determinative, the gain on the sale of the building would not be treated as FPHC income because it was not at that time generating passive income.\textsuperscript{282} On the other hand, had the building been sold at the end of year 2, while still held as an investment, clearly the gain would have been FPHC income.\textsuperscript{283}

The issue, then, is whether converting the building to use in CFC's active trade or business prior to the sale effectively avoids classification of the gain as FPHC income. The regulations state that in determining the purpose or use for which property is held, the period shortly before disposition, while not determinative, is the most significant period.\textsuperscript{284}

\textsuperscript{276} Id.
\textsuperscript{277} Passive income includes dividends, interest, rents, royalties, annuities. Id. § 954(c)(1)(A).
\textsuperscript{278} Id. § 954(c)(1)(B).
\textsuperscript{280} Id.
\textsuperscript{281} Id.
\textsuperscript{283} Id.
Clearly a rule that considered only the period shortly before the sale would encourage taxpayers to try to avoid subpart F by converting investment property to active use prior to sale. Recognizing this potential for abuse, the regulations provide that if prior to disposition, a CFC changes the use of property from passive to active, the active use will be ignored "unless it was continuously present for a predominant portion of the period during which the CFC held the property." Thus, it is likely that the gain on the sale of the building in the above example would be characterized as FPHC income.

There may also be situations where property is held in part for investment and in part for use in the active conduct of the CFC's trade or business. Gain on such "dual character property" will be split between FPHC and non-FPHC income based upon the method that most reasonably reflects the relative uses of the property. Going back to the building example mentioned above, assume that the building purchased by the CFC had ten floors. Assume further that for the entire period of ownership, six of those floors were used by the CFC in the active conduct of its business and four floors were rented. Any gain on the sale of that building would be split between FPHC and non-FPHC income. Arguably the most reasonable basis for splitting the gain would be relative square footage, resulting in 40% of the gain being characterized as FPHC income.

b. Foreign Base Company Sales Income

The foreign base company sales income (FBCSI) provisions of subpart F are intended to discourage the use of sales subsidiaries established in low-tax or no-tax jurisdictions. Prior to the enactment of subpart F, such subsidiaries were used to avoid or defer U.S. tax, on a portion of the income attributable to sales by U.S. corporations to foreign customers.

For example, assume that a U.S. corporation, X, manufactures widgets for sale to foreign customers at a price of $100 per widget and that the total cost of producing each widget is $80. If X sells a widget directly to the foreign customer, X will

285. Id.
287. Id. § 1.954-2T(e)(1)(ii).
288. Id.
recognize $20 of profit, all of which will be subject to U.S. tax currently. Alternatively, X could route the sale through a wholly owned foreign subsidiary, FS located in a no-tax jurisdiction. By adjusting the transfer price, a portion of the $20 of profit on the sale could be shifted from X, where it would be subject to U.S. tax at a 34% percent rate, to FS, where it would be exempt from tax. Without an anti-deferral provision such as subpart F, the income allocated to the foreign sales subsidiary generally would not be subject to U.S. tax until distributed as a dividend or until the stock of the foreign sales subsidiary was sold.

By requiring the U.S. parent, X, in the above example, to include in income a deemed dividend in an amount equal to the profit realized by the foreign sales subsidiary, the foreign base company provisions of subpart F remove the incentive for U.S. corporations to use tax haven sales subsidiaries.

FBCSI is defined as income derived in connection with the purchase of personal property from a related person and its sale to any person, or the purchase of personal property from any person and its sale to any person on behalf of a related person. FBCSI includes commission income where the CFC arranges a purchase or sale on behalf of a related person. In either case, FBCSI is limited to income from transactions involving related persons.

For purposes of the FBCSI provisions, a person is a related person if it controls the CFC, is controlled by the CFC, or is controlled by the same person or persons which control the CFC. Control, with respect to corporations, is defined as direct or indirect ownership of more than 50% of the vote or value of the stock of the corporation. With respect to partnerships, trusts, or estates, control is defined as direct or indirect ownership of more than 50% of the value of the beneficial interests. In either case, attribution rules similar to those of

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290. Id. § 954(d).
291. Id. § 954(d)(1).
292. Id.
293. Id. § 954(d)(1)-(3).
294. Id. § 954(d)(3)(A).
295. A related person includes individuals, corporations, partnerships, trusts, and estates. Id. § 954(d)(3)(B).
296. Id.
297. Id.
section 958 apply in determining ownership.\textsuperscript{298}

As with other subpart F provisions, much of the complexity in determining the amount, if any, of a CFC’s FBCSI stems from the exceptions to the general rule. FBCSI does not include income from the sale of property which is manufactured, produced, grown, or extracted within the CFC’s country of incorporation.\textsuperscript{299} Similarly, FBCSI does not include income from the sale of property which is sold for use, consumption, or disposition within the CFC’s country of incorporation.\textsuperscript{300}

Another exception applies to property that is “manufactured” by the CFC.\textsuperscript{301} Under this exception, FBCSI does not include income of a CFC derived in connection with the sale of personal property which it manufactured, produced, or constructed, in whole or in part, from personal property which it purchased.\textsuperscript{302} There is no clear, concise rule for determining whether the CFC has in fact manufactured, produced, or constructed the property in question. Instead, the regulations establish an undefined “substantial transformation” test, the scope of which is rather vaguely outlined.\textsuperscript{303} These examples, which rather summarily conclude that transforming wood pulp to paper, or steel rods to screws and bolts, constitute substantial transformation, provide little useful guidance to CFCs whose activities, while substantial, are somewhat less dramatic than those outlined examples.\textsuperscript{304}

4. Exceptions and Limitations to Subpart F

There are a number of exceptions and limitations that provide some relief from the anti-deferral rules of subpart F, at the expense of adding considerable complexity to their application. For example, given that the purpose of subpart F is to prevent deferral of U.S. taxation, it is unnecessary to treat as subpart F income an item of income that is already subject to current U.S. taxation.\textsuperscript{305} Accordingly, U.S. source income that

\textsuperscript{298} Id. See supra notes 240-250 and accompanying text for a discussion of the attribution rules of § 958.
\textsuperscript{300} Id. § 954(d)(1)(B).
\textsuperscript{302} Id.
\textsuperscript{303} See id. § 1.954-3(a)(4)(ii).
\textsuperscript{304} Id.
\textsuperscript{305} I.R.C. § 952(b) (1988).
is effectively connected with a U.S. trade or business and is not eligible for a reduced rate of, or exemption from, tax under an income tax treaty is excluded from subpart F.306

The anti-deferral provisions of subpart F also operate on the presumption that the income to which it applies results from a tax-motivated decision to operate through a particular structure or in a particular foreign country. However, if the taxpayer is subject to a relatively high effective foreign tax rate on its subpart F income, it is assumed that tax considerations were not the primary motivation. Therefore, if the income of a foreign subsidiary is subject to an effective rate of foreign income tax that exceeds 90% of the maximum applicable U.S. rate, the U.S. shareholder may elect to exclude that income from subpart F.307

Subpart F income is also limited to the earnings and profits of the foreign subsidiary for the taxable year.308 Thus, U.S. shareholders of a CFC may not have a subpart F inclusion even though the CFC may have significant subpart F income. Assume, for example, that X, a U.S. corporation, owns 100% of Y, a CFC with $100,000 of subpart F income for the year and a net loss of $200,000 from operations, non-subpart F. Because Y has no current year earnings and profits from which to pay a dividend, X is not taxed currently on Y’s subpart F income. It is important to note, however, that this subpart F inclusion is not permanently excused. A current deficit in earnings and profits which results from non-subpart F operations and is used to reduce current year subpart F income must be recaptured in later years through the recharacterization of non-subpart F income as subpart F income.309 It is also possible to use accumulated deficits from certain categories of subpart F income to offset current year subpart F income in the same category.310

Subpart F includes a de minimis and a full inclusion rule. Under the de minimis rule, if the gross subpart F income of a CFC attributable to base company and insurance income is less

306. Id.
307. Id. § 954(b)(4). This high-tax exception is elective; the election to exclude this income from subpart F must be attached to the U.S. shareholder’s original or amended tax return. Treas. Reg. § 1.954-1T(d)(5) (1988).
309. Id. § 952(c)(2).
310. Id. § 952(c)(1)(B).
than the lesser of 5% of its total gross income or $1,000,000, none of this subpart F income will be taxed currently to the U.S. shareholders.\textsuperscript{311} Alternatively, if the sum of the CFC's gross foreign base company and insurance income for the taxable year exceeds 70% of gross income, all of that CFC's income will be treated as subpart F income.\textsuperscript{312}

5. \textit{Section 956—Investment in U.S. Property}

In addition to the current inclusion of its pro rata share of the subpart F income, a U.S. shareholder of a CFC is also taxed currently on its pro rata share of any increase in the amount of CFC earnings not previously subject to U.S. tax which are invested in "U.S. property" by the CFC.\textsuperscript{313} This inclusion is necessary because the acquisition by the CFC of certain types of U.S. property has essentially the same economic effect as a dividend to the controlling shareholders.

The term "U.S. property" is defined to include tangible property located in the United States, stock and debt obligations of related U.S. corporations, and a number of other items.\textsuperscript{314} A CFC will be treated as holding an obligation of a U.S. person if the CFC guarantees that obligation.\textsuperscript{315} In addition, if the U.S. shareholder pledges the stock of the CFC as security for that obligation, the CFC may be treated as having guaranteed that obligation for section 956 purposes.\textsuperscript{316} In general, the increase in earnings invested in U.S. property is computed by comparing the investment in U.S. property at the end of the CFC's year with the investment at the end of the preceding year.\textsuperscript{317} This calculation can become exceedingly

\begin{itemize}
\item \textsuperscript{311} \textit{Id.} \textsuperscript{§}954(b)(3)(A).
\item \textsuperscript{312} \textit{Id.} \textsuperscript{§}954(b)(3)(B). If the U.S. shareholder organizes two or more CFCs in an effort to take advantage of the de minimis rule, or to avoid the full inclusion rule, the income of those CFCs will be aggregated and treated as the income of a single corporation. Temp. Treas. Reg. \textsuperscript{§}1.954-1T(b)(4) (1988).
\item \textsuperscript{313} I.R.C. \textsuperscript{§}956 (1988).
\item \textsuperscript{314} \textit{Id.} \textsuperscript{§}956(b).
\item \textsuperscript{315} \textit{Id.} \textsuperscript{§}956(c).
\item \textsuperscript{316} Treas. Reg. \textsuperscript{§}1.956-2(c)(2) (as amended in 1988). More specifically, the CFC will be treated as having guaranteed the obligation of the U.S. shareholder if at least 66.67% of the total combined voting power of the CFC stock is pledged to guarantee an obligation of the U.S. shareholder and that pledge is accompanied by one or more negative covenants which effectively limit the CFC's discretion with respect to the disposition of assets and incurrence of liabilities. \textit{Id.}
\item \textsuperscript{317} I.R.C. \textsuperscript{§}956(a)(2) (1988).
\end{itemize}
complex, however, if the CFC has made distributions during the year or if the CFC is a CFC for only part of the year.

6. Previously Taxed Income

Both subpart F and section 956 tax the U.S. shareholder of a CFC on the CFC's earnings, even if the earnings have not actually been distributed. If, at some later time, those earnings are actually distributed to the U.S. shareholder as a dividend they would, absent some relief mechanism, be subject to U.S. tax a second time. This double taxation is avoided through the operation of the previously taxed income rules.318

Under these rules, an actual distribution received from a CFC is excluded from the gross income of the U.S. shareholder to the extent it is attributable to earnings and profits that have already been subject to U.S. tax, under subpart F or section 956. Moreover, there is an ordering rule under which actual distributions are presumed to come first from earnings and profits that were subject to U.S. tax under section 956, then from earnings and profits which were subject to U.S. tax under subpart F, and finally from other non-previously taxed income earnings and profits.319

B. Passive Foreign Investment Companies

The Tax Reform Act of 1986 added the passive foreign investment company (PFIC) provisions to close what was perceived to be a loophole in the anti-deferral rules of subpart F.320 Subpart F applies only to "U.S. shareholders" of "controlled foreign corporations."321 Thus, the anti-deferral provisions of subpart F do not apply unless more than 50% of the stock of the foreign corporation is owned by U.S. persons, each of whom owns at least 10%.322 As a result, U.S. corporations can avoid subpart F by ensuring that the foreign persons own at least 50% of the corporation or that "U.S. shareholders" in the aggregate own less than 50%.323

Congress enacted the PFIC rules because the operation of

318. See id. § 959.
319. Id. § 959(c).
320. See id. § 1296. These provisions generally apply to tax years of foreign corporations beginning after 1986. Id.
321. Id. § 951(a)(1).
322. Id. § 958(b)(2)-(3), see also id. § 902(a) (requiring 10% ownership).
323. Id. § 958(b)(2)-(3) (1988).
the current anti-deferral provisions provided an unjustified incentive for U.S. investors to invest through a foreign corporation.\(^\text{324}\) A U.S. corporation with passive investments could invest directly, in which case it would be taxed currently. Or it could invest through a widely held tax haven corporation, in which case the passive income would escape taxation until ultimately repatriated.

In other words, Congress sought to eliminate the benefit of deferring U.S. taxation of passive income earned by foreign corporations that were, in effect, acting as offshore investment companies. Consequently, the determination of whether a foreign corporation is a PFIC focuses on whether the income of that corporation is primarily passive or whether the majority of its assets are used to generate passive income.\(^\text{325}\)

Under the income and asset tests, a foreign corporation is considered to be a PFIC if it has passive income which amounts to 75% or more of its gross income, or if 50% or more of the average fair market value of its assets are held for the production of passive income.\(^\text{326}\) As with the separate foreign tax credit basket for passive income, the PFIC provisions define passive income by reference to the foreign personal holding company provisions of subpart F.\(^\text{327}\) Thus, passive income generally includes interest, dividends, rents and royalties, and gains on the sale or exchange of certain types of property.\(^\text{328}\)

The PFIC asset test ordinarily is based upon the fair market value of the foreign corporation's assets.\(^\text{329}\) However, the foreign corporation may elect instead to use the adjusted basis of

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Congress did not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. Since current taxation generally is required for passive investments in the United States, Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation. Congress further believed that the nationality of the owners of controlling interests of a corporation which invests in passive assets should not determine the U.S. tax treatment of its U.S. owners.

\(\text{Id.}\)

325. See infra notes 326-341 and accompanying text.


327. Id. § 1296(b).

328. Id. § 954(c).

329. Id. § 1296(a)(2).
its assets. Once made, this election may be revoked only with IRS consent. An asset is considered to be held for the production of passive income if it has generated such income, or is reasonably expected to generate such income in the foreseeable future.

Unlike subpart F, the PFIC provisions do not contain a minimum ownership requirement for U.S. shareholders. As a result, any U.S. person that owns stock in a PFIC is subject to these rules, regardless of the ownership percentage. There is no source of income test for PFIC purposes. Consequently, U.S. source income is included in determining whether the foreign corporation is a PFIC.

There is another significant difference between subpart F and the PFIC provisions. Under subpart F, a foreign corporation may be a CFC subject to the anti-deferral provisions of subpart F in one year and, because of ownership changes, not a CFC the next year. PFIC status generally is permanent. If a corporation is a PFIC in one year, generally it will be considered a PFIC in all subsequent years. This classification is made even if the foreign corporation does not meet either the income or the asset test in those subsequent years. It appears that the only way to avoid the effect of the PFIC provisions in this situation is to make the qualified electing fund election. If this election is not made for the first year in which the shareholder owns stock of the PFIC, it is also necessary to make a "purging" election.

Whether a particular asset generates passive income can be of critical importance in determining the status of a foreign corporation. Unfortunately, there is not a great deal of guidance on this issue. Cash and other assets readily convertible into cash are passive assets, even if held only to meet the work-

330. Id. § 1296(a).
331. Id.
333. I.R.C. § 1297(b)(1) (1988) provides:

Stock held by a taxpayer shall be treated as stock in a passive foreign investment company if, at any time during the holding period of the taxpayer with respect to such stock, such corporation (or any predecessor) was a passive foreign investment company which was not a qualified electing fund.

Id.
334. See infra notes 351-370 and accompanying text.
ing capital needs of the corporation.\textsuperscript{336}

The income and asset tests are considerably more complicated when the foreign corporation in question owns an interest in one or more additional foreign corporations. For purposes of the income and asset tests, a so-called "look-through" rule will apply if a foreign corporation owns directly or indirectly 25% or more of the value of the stock of another corporation.\textsuperscript{337} Under the look-through rule, the foreign corporation in question will be treated as holding its proportionate share of the assets, and receiving its ratable share of the income, of the 25% owned subsidiary.\textsuperscript{338}

For example, assume that F1, a foreign corporation, owns 50% of F2, another foreign corporation. Under the look-through rule, F1 will be rated as owning half of the assets of F2. If the fair market value of F2's assets is $1,000, of which $600 is passive, F1 will be treated as owning $300 of passive assets ($600 \times 50\%) and $200 of active assets ($400 \times 50\%). With regard to the income test, assume that F2 has passive gross income of $750 and active gross income of $250. Under the look-through rules, F1 will be treated as earning directly $375 of passive income and $125 of active income.

This look-through rule also applies to second- and lower-tier foreign corporations, provided the foreign corporation in question owns indirectly at least 25% of that corporation.\textsuperscript{339} Again, assume that F1 owns 50% of F2. Assume further that F2 owns 50% of F3, another foreign corporation. Because F1 owns at least 20% of F3 indirectly, the subsidiary look-through rules apply. Although not entirely clear, it appears that the indirect look-through rules should operate to attribute 25% of F3's assets directly to F1, rather than as part of the assets of F2. In addition, F1 should be treated as owning 50% of the assets of F2 other than F2's stock interest in F3.

These look-through rules may work either for or against the taxpayer. In some situations, look-through rules may cause a foreign corporation with substantial active income and assets to be a PFIC because it owns stock of a lower-tier foreign corporation with significant passive income or assets. To avoid

\textsuperscript{336} I.R.S. Notice 88-22, 1988-1 C.B. 489.
\textsuperscript{337} I.R.C. § 1296(c) (1988).
\textsuperscript{338} Id.
\textsuperscript{339} I.R.S. Notice 88-22, 1988-1 C.B. 489.
this result, it generally is not advised that PFICs be organized as first-tier foreign subsidiaries.

Not surprisingly, there are a number of exceptions to the PFIC rules. Newly organized foreign corporations are given a one-year grace period. A foreign corporation will not be treated as a PFIC in its start-up year if it can establish that it did not have a predecessor that was a PFIC, will not be a PFIC in the following two years, and is in fact not a PFIC in those years.\textsuperscript{340} There is also an exception for certain foreign corporations that have passive income from temporarily investing proceeds from the sale of an active trade or business.\textsuperscript{341}

The PFIC provisions do not attempt to tax the foreign corporation itself. Instead, the focus is on U.S. persons that own shares of the PFIC.\textsuperscript{342} The PFIC rules do not impose current U.S. tax on the tainted income of the PFIC. Instead, these provisions attempt to eliminate the economic benefit of U.S. tax deferral by imposing an interest charge on the U.S. shareholder upon receipt of an "excess distribution" or disposal of the PFIC stock.\textsuperscript{343} The interest charge approach was chosen over current taxation of the tainted income because of anticipated difficulties that shareholders might have in gathering necessary information and also because the shareholders of a PFIC generally are less able to force a distribution from the foreign corporation in order to pay the U.S. tax.\textsuperscript{344}

An excess distribution is the sum of distributions in a given year in excess of 125\% of the average amount of distributions for the three preceding years or applicable shorter period.\textsuperscript{345} There can be no excess distributions in the first year the tax-

\textsuperscript{340} I.R.C. § 1297(b)(2) (1988).
\textsuperscript{341} Id. § 1297(b)(3).
\textsuperscript{342} Id. § 1297(a)(1).
\textsuperscript{343} Id. §§ 1292(a), (b), (c).
\textsuperscript{344} See General Explanation of the Tax Reform Act of 1986 supra note 128, at 1023.

Although Congress believed current taxation was more appropriate than continuation of deferral of tax on income derived from passive assets, Congress recognized that current taxation of U.S. investors in passive foreign investment companies could create difficulties for certain investors in cases where the U.S. investors did not have the ability to obtain relevant information relating to their share of the funds’ earnings and profits, did not have enough control to compel dividend distributions, or did not have sufficient liquidity to meet a current tax liability before actual income was realized from their investment.

\textit{Id.}

\textsuperscript{345} I.R.C. § 1291(b) (1988).
payer holds the stock. In general, the interest charge on the sale of PFIC stock or the receipt of an excess distribution, is computed by first spreading the excess distribution or gain on disposition over the post-1986 years of the PFIC during which the recipient held PFIC stock. This amount is then subject to a hypothetical U.S. tax at the highest rate for ordinary income in each year. These hypothetical tax liabilities are then subject to an interest charge similar to that imposed upon actual unpaid tax liabilities. The interest charge assessed is treated as deductible interest for U.S. tax purposes, subject to the limitation on deductibility of personal interest for individuals.

U.S. shareholders can avoid the PFIC interest charge by electing to have the PFIC treated as a qualified electing fund (QEF). The QEF election eliminates the need for an interest charge because the shareholders of a QEF generally are taxed currently on their ratable share of the PFIC's ordinary income (both passive and nonpassive) and long-term capital gain for the electing year. More specifically, each electing shareholder is required to include in income its pro rata share of the PFIC's ordinary earnings and net capital gain. To avoid double taxation, distributions from a PFIC that are attributable to income previously taxed under the QEF rules are not considered taxable income to the shareholder.

The PFIC rules contain a high-tax exception similar to the one found in subpart F. Under this rule, a U.S. shareholder of a QEF that is also a CFC may exclude an item of income from current taxation under the PFIC/QEF provisions if the item of income was subject to foreign tax at a rate in excess of 90% of the maximum U.S. corporate tax rate. An item of income may also be excluded if it is U.S. source income

346. Id.
347. Id. § 1291(a)(1).
348. Id. § 1291(c)(2).
349. Id. § 1291(c)(3).
350. Id. § 1291(c)(1)
351. See id. § 1293. The QEF election is made at the U.S. shareholder level, on a shareholder-by-shareholder basis. Id.
352. Id. §§ 1293(a), (b).
353. Id. § 1293(a).
354. Id. § 1293(c).
355. See id. § 1293(g).
356. See id. § 951(b) (defining a U.S. shareholder for subpart F purposes).
effectively connected with a U.S. trade or business of the PFIC and U.S. tax on that income is neither reduced nor eliminated by an income tax treaty.\textsuperscript{357}

A U.S. corporation that is a shareholder of a PFIC generally is entitled to an indirect foreign tax credit on excess distributions.\textsuperscript{358} For foreign tax credit basketing purposes, a deemed distribution of PFIC income generally is considered passive income, unless the PFIC is a noncontrolled section 902 corporation\textsuperscript{359} or look-through rules apply\textsuperscript{360} to recharacterize some of the income as income in another separate limitation basket.\textsuperscript{361}

Mechanically, the QEF election may be made for any taxable year at any time on or before the due date, including extensions, for the shareholder’s tax return.\textsuperscript{362} In cases of a U.S. chain of ownership, the QEF election is made by the first U.S. person that is a direct or indirect owner of the PFIC shares.\textsuperscript{363} Once made, the election applies to all subsequent taxable years of the corporation.\textsuperscript{364} The election cannot be revoked without the consent of the Commissioner.\textsuperscript{365}

An electing shareholder must obtain from the PFIC, and attach to the shareholder’s U.S. income tax return, an annual information statement.\textsuperscript{366} This statement must include the PFIC’s taxable year and the shareholder’s ratable share of the PFIC’s ordinary earning and net capital gain for the year, as well as the amount of cash and fair market value of other property distributed or deemed distributed to the shareholder dur-

\textsuperscript{357} Id. § 1293(g).
\textsuperscript{358} Id. § 1293(f). The corporation, however, must meet the ownership requirements of section 902.
\textsuperscript{359} Id. §§ 1293(f)(1), 902. A non-controlled section 902 corporation means “any foreign corporation with respect to which the taxpayer meets the stock ownership requirements of section 902(a). . . .” Id. § 904(d)(2)(E)(i). The section 902(a) stock ownership requirements employ the 10% rule. Id. § 902(a).
\textsuperscript{360} Id. § 902(d)(3)(E).
\textsuperscript{361} Id. §§ 904(d)(2)(A)(ii), (d)(2)(E)(iii), (d)(3)(T).
\textsuperscript{362} Id. § 1295(b)(2). A late election is permitted if the failure to timely file was due to a reasonable belief that the foreign corporation was not a PFIC. Id.
\textsuperscript{363} Id. § 1295(b); see also I.R.S. Notice 88-125, 1988-2 C.B. 535-36. Election is accomplished by filing Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.
\textsuperscript{365} Id.
If a QEF election is made, the shareholder may elect to recognize gain as if the shareholder sold the stock for fair market value at the beginning of the year and the foreign corporation became a QEF. As with other PFIC shareholders, the shareholder of a QEF may be unable to compel the PFIC to make actual distributions sufficient to pay the U.S. tax. Accordingly, shareholders of a QEF may, under certain circumstances, elect to extend the time for the payment of tax on undistributed PFIC earnings. However, the shareholders must pay interest on the benefit of the deferral.

There is considerable interplay between the PFIC provisions and other anti-deferral provisions of the Code. For example, if a foreign corporation is both a CFC and a PFIC that is a QEF, the 10% U.S. shareholders are taxed on subpart F income only under the subpart F provisions. It appears that the U.S. shareholders who own less than 10% remain subject to the PFIC rules. Similarly, if a foreign corporation is both a foreign personal holding company (FPHC) and a PFIC that is a QEF, the FPHC rules apply. A shareholder of a PFIC that is also a foreign investment company (FIC) is not taxed under the FIC provisions on gain realized on the sale of the PFIC-FIC stock with respect to post-1986 earnings and profits. Finally, the Code provides that under regulations to be issued by the IRS, proper adjustments will be made for amounts not includable in gross income as previously taxed income under subpart F, FPHC, or QEF provisions.

C. Foreign Personal Holding Companies

Another set of anti-deferral provisions can be found in the FPHC provisions. Under these provisions, each U.S. shareholder of a FPHC is required to include in income each year its
pro rata share of the undistributed foreign personal holding company income of the FPHC.376

A foreign corporation is a FPHC only if it meets both the gross income377 and stock ownership requirements.378 Under the gross income requirement, at least 60% of the gross income of the foreign corporation for the taxable year must be FPHC income.379 FPHC income is generally dividends, interest, rents, royalties, and gains from certain stock and commodity transactions.380 The stock ownership requirement provides that a foreign corporation will be a FPHC if at any time during the taxable year, more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock is owned, directly or indirectly, by or for not more than five individuals who are U.S. citizens or residents.381 Complex constructive ownership rules, generally broader than those under subpart F, apply in determining whether the stock ownership requirement is met.382

There are obvious similarities between the FPHC provisions and the foreign personal holding company category of foreign base company income under subpart F. For example, both sets of provisions require U.S. shareholders to include in taxable income currently their pro rata share of certain items of tainted income.383 Also, the two sets of provisions use similar definitions of foreign personal holding company income.384 To avoid conflict between the two sets of provisions when a foreign corporation is both an FPHC and a CFC in the same year, the subpart F rules control the taxation of income that would fall under both sets of provisions.385 Thus, passive in-

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376. Id.
377. See id. § 552(a)(1).
378. See id. § 552(a)(2).
379. Id. § 552(a)(1). Once a foreign corporation attains FPHC status, the percentage threshold test drops to 50% from the initial 60%. Id.
380. Id. §§ 553(a)(1), (2).
381. Id. § 552(a)(2). The stock ownership test considers only stock owned by U.S. citizens and residents while the income inclusion rules require the current inclusion of undistributed FPHC income on the part of all U.S. shareholders, including domestic corporations and domestic partnerships. Id.
382. See id. §§ 554, 958.
383. See id. §§ 544, 958.
384. See id. §§ 544, 958(a)(2).
385. Id. § 951(d). A similar rule provides that if an amount of income would be included in the income of a U.S. shareholder under both the FPHC and the PFIC qualified electing fund provisions, the FPHC provisions will control. Id. § 551(g).
come of a FPHC that is also a CFC is taxed under subpart F. However, because subpart F generally does not tax the active business income of the FPHC, that income remains taxable under the FPHC provisions.

Despite the similarities between the FPHC provisions and subpart F, there are a number of important differences. The first difference is in the scope of the FPHC provisions. As discussed above, in determining whether a foreign corporation is a controlled foreign corporation, only U.S. shareholders owning at least 10% of the voting power of the corporation are considered. For purposes of the FPHC stock ownership test, on the other hand, all shareholders are included, and the 50% threshold is based on the greater of voting power or value.

Similarly, the anti-deferral provisions of subpart F apply only to "U.S. shareholders" of the controlled foreign corporation. Again, U.S. shareholders, for subpart F purposes, include only those that own at least 10% of the voting power of the foreign corporation. There is no such minimum ownership threshold for application of the FPHC anti-deferral provisions. Thus, if the other tests are met, a U.S. shareholder who owns even 1% of the stock of a FPHC must include its pro rata share of undistributed FPHC income.

In addition, there is no deemed paid foreign tax credit available on the current inclusion of undistributed FPHC income. However, a deemed paid foreign tax credit is available on actual distributions by a FPHC.

VII. Conclusion

United States corporations are faced with a myriad of challenges as they manage and expand their worldwide operations. One such challenge is to minimize the worldwide tax burden...
on those operations. Whether establishing an international presence for the first time, expanding existing international operations, or simply repatriating foreign earnings, the tax considerations can be extremely complicated and can have a very significant impact on the "bottom line."

This article has attempted to provide an overview of the U.S. tax rules that should be considered when planning for international operations. There is, of course, no single approach to international taxation that will fit the facts and meet the objectives of every U.S. multinational. It is strongly encouraged, therefore, that an international tax specialist be consulted prior to making decisions that will effect international operations.