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# New Tax Twists for FICs

by  
Jonathan L. Gans†

American investors<sup>1</sup> have long used offshore companies to further their investment objectives and to minimize their tax burdens. The fact that international debt, equity, and commodity markets are expanding is evidence of an increase in the amount of such activity. It is not surprising, then, that the United States Department of Treasury (hereinafter the Treasury) continues to revise and update its methods for taxing the American investor's use of these offshore companies.

Section 1246 of the Internal Revenue Code (hereinafter the Code), which prescribes the treatment of gain on the sale or exchange of foreign investment company stock, was amended by the Tax Reform Act of 1984.<sup>2</sup> Substantial changes were made in the definition of foreign investment company as well as in the section 1246 attribution rules. While these changes promise to hold implications for most foreign companies, their greatest impact should be experienced by certain types of holding companies and commodity investment funds.

This Article will discuss the operation of section 1246 and the possible effects of the 1984 amendments. Part I of this paper will review briefly the legislative history of section 1246. Part II will discuss the changes made by the 1984 Act. Part III will discuss the function of section 1246 within the framework of provisions for taxing foreign corporations.

## I LEGISLATIVE HISTORY

Prior to the enactment of section 1246, United States investors were able to avoid United States income tax<sup>3</sup> through the use of foreign entities known as foreign investment companies (FICs). Two basic schemes were commonly employed to reduce or to eliminate United States taxation. The first involved investment in Canadian investment corporations registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of

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1. The term "American investors" refers to those individuals and entities which are subject to United States taxation. See the definition of "United States person", *infra* note 17.

2. Tax Reform Act of 1984, Pub. L. No. 98-369.

3. S. Rep. No. 1881, 87th Cong., 2d Sess. 101 (1962) [hereinafter cited as SENATE FINANCE COMMITTEE, REVENUE ACT OF 1962].

1940 (hereinafter the Investment Company Act).<sup>4</sup> The Canadian corporations would invest in U.S. securities offering high dividend or interest yields. The corporations could then use the U.S.-Canada tax treaty to limit the U.S. withholding on interest and dividends paid by the U.S. companies to the Canadian corporations to fifteen per cent, as well as to eliminate any tax on capital gains.<sup>5</sup> Since Canadian law imposed only a small tax on investment companies owned and managed by foreigners, these Canadian companies accumulated considerable amounts of income which were not subject to U.S. income tax unless and until the Canadian corporations distributed the income to American investors.<sup>6</sup> Instead of receiving distributions taxable as ordinary income, American investors were able to redeem their securities at approximately net asset value and pay tax on the gain, if any, at capital gains rates.<sup>7</sup> The American investors thus accomplished the dual goals of converting ordinary income to capital gains and deferring recognition of those capital gains well beyond the time the gains were realized by the investment company.

The second scheme employed by American investors involved the use of unregistered companies<sup>8</sup> which invested in foreign securities to avoid U.S. withholding taxes. If the company was incorporated in one of many suitable tax havens, the investment income would accumulate tax free. The shareholder could enjoy the benefits of conversion and deferral when he sold or redeemed his shares,<sup>9</sup> or achieve permanent recognition avoidance if he held the shares until death.<sup>10</sup> The U.S. accumulated earnings tax<sup>11</sup> would not apply to the foreign corporation because the corporation would have received no U.S. source income.<sup>12</sup> Furthermore, prior to the adoption of Subpart F in 1962,<sup>13</sup> there was no provision for taxing the undistributed income of controlled foreign corporations. Again, this FIC scheme practically guaranteed successful tax evasion.

President Kennedy and Congress considered the tax advantages generated by FICs unjustified and determined that the United States should tax shareholders of FICs no differently than shareholders of United States investment companies.<sup>14</sup> Accordingly, in 1962, Congress added both section 1246

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4. 15 U.S.C. §§ 80a-1 to 80a-52 (1982) [hereinafter cited as Investment Company Act of 1940].

5. Lederman, *Foreign Investment Companies Section 1246*, TAX MGMT. (BNA) No. 405, at A-8 (1979).

6. *Id.* at A-8 to A-9.

7. See Rev. Rul. 60-192, 1960-1 C.B. 142.

8. Corporations not registered with the S.E.C. under the Investment Company Act of 1940. See *supra* note 4 and accompanying text.

9. See Rev. Rul. 60-192, *supra* note 7, at 142.

10. See I.R.C. § 1014 (1984) [All further references in this Article to I.R.C. are to sections of the Internal Revenue Code of 1954 as amended by the 1984 Tax Reform Act, unless otherwise noted].

11. I.R.C. §§ 531-537.

12. Treas. Reg. 1.535-1(b), T.D. 6377, 1959-1 C.B. 125, 134 (1959).

13. Subpart F was added to the Code by Pub. L. No. 87,834, § 12(a), Oct. 16, 1962.

14. SENATE FINANCE COMMITTEE, REVENUE ACT OF 1962, *supra* note 2, at 101-03.

and Subpart F to the Internal Revenue Code. Section 1246 eliminates the conversion benefits of FICs by providing that all gains from the sale or exchange of stock of FICs, to the extent of a shareholder's ratable share of earnings and profits, be taxed at ordinary income rates.<sup>15</sup> Subpart F, meanwhile, acts to curb the deferral benefits of FICs and other foreign corporations.<sup>16</sup> Its relationship to section 1246 will be discussed below in Part III.

*General Provisions of Section 1246.* The substantive effect of section 1246 is to treat the recognized gain from the sale or exchange of FIC stock by a United States person<sup>17</sup> as ordinary income to the extent of his ratable share of earnings and profits.<sup>18</sup> Such ratable share does not include earnings and profits from any period during which the taxpayer did not hold the stock,<sup>19</sup> any amount previously taxed under section 951 (Subpart F),<sup>20</sup> or any earnings and profits from any taxable year during and before which the corporation was not an FIC.<sup>21</sup> Unless the taxpayer establishes the amount of his ratable share of earnings and profits, all gain from the sale or exchange of FIC stock is deemed ordinary income.<sup>22</sup> Earnings and profits are calculated in accordance with section 312(j) of the Code.<sup>23</sup>

Once a foreign corporation is classified as an FIC, its stock acquires a section 1246 "taint" impossible to eliminate through transfer. For example, if the basis of stock in *any* foreign corporation is determined by reference to the basis of stock in an FIC, the foreign corporation stock is treated as stock of an FIC upon its sale or exchange.<sup>24</sup> Furthermore, even stock in a *domestic* corporation is treated as FIC stock, in the proportion that the domestic corporation's investment in the stock of the FIC bears to the total assets of such domestic corporation.<sup>25</sup> If FIC stock is acquired from a decedent, section 1014 of the Code will apply to adjust the stock's basis to its fair market value. However, because section 1246(e)(1) requires that the basis in turn be reduced by the decedent's ratable share of the FIC's earnings and profits, much, if not all, of this benefit is eliminated.

Because the tax consequences of FIC status are so substantial and persistent, the means by which a corporation is classified as an FIC become of critical concern. It is not surprising, therefore, that the definition of an FIC

15. I.R.C. § 1246.

16. I.R.C. § 951-964.

17. "United States person" includes a citizen or resident of the United States, a domestic corporation, a domestic partnership, and a non-foreign estate or trust. See I.R.C. § 7701(30).

18. I.R.C. § 1246(a).

19. I.R.C. § 1246(a)(2)(A).

20. I.R.C. § 1246(a)(2)(B)(i).

21. I.R.C. § 1246(a)(2)(B)(ii).

22. I.R.C. § 1246(a)(3).

23. I.R.C. § 1246(f).

24. I.R.C. § 1246(c).

25. I.R.C. § 1246(d)(2).

has proven the most controversial feature of section 1246<sup>26</sup> and was, consequently, the target for reform by Congress under the Tax Reform Act of 1984. The section which follows will discuss the controversy surrounding the definition of an FIC and the changes made to this definition by the 1984 Act.

## II

### DEFINITION OF FOREIGN INVESTMENT COMPANY

Prior to the 1984 amendments, an FIC was defined as (i) any foreign corporation registered with the SEC under the Investment Company Act, and (ii) any other foreign corporation: (1) the business of which is trading, investing, or reinvesting in securities; and (2) the voting power or total value of which is fifty percent or more owned by United States persons.<sup>27</sup>

The first part of this two-part definition, section 1246(b)(1), is relatively straightforward and remains unaltered by the Tax Reform Act of 1984. Section 1246(b)(1) includes any foreign corporation registered under the Investment Company Act as either a "unit investment trust" or a "management company".<sup>28</sup> A unit investment trust is an investment company which: (1) is organized under a trust indenture or similar instrument, (2) does not have a board of directors, and (3) issues only redeemable securities, where each such security represents an undivided interest in a unit of specified securities.<sup>29</sup> A management company is any investment company other than a unit investment trust or a "face amount certificate company".<sup>30</sup> Congress initially adopted section 1246(b)(1) in an effort to curb the use of the Canadian investment company scheme described in Part I.<sup>31</sup> However, since very few foreign companies are now registered as unit investment trusts or management companies, this section rarely applies.

The second part of the FIC definition, section 1246(b)(2), presents the most pitfalls for the unwary. Before the 1984 Act, the definition included any foreign corporation which (for taxable years after 1962) was:

engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (*within the meaning of section 3(a)(1) of such [Investment Company] Act*, as limited by paragraphs (2) through (10) (except paragraph (6)(C)) and paragraphs (12) through (15) of section 3(c) of such Act [ICA]) at a time when more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or of the total value of shares of all classes of stock, was held, directly or indirectly

26. *Beware of Sleeper in Foreign Investment Company Provisions of Section 1246*, 22 J. TAX'N 34 (1965) [hereinafter cited as *Beware of Sleeper*].

27. I.R.C. § 1246(b) (1983) (Amended 1984). For the definition of United States person, see *supra* note 17.

28. I.R.C. § 1246(b)(1).

29. Investment Company Act of 1940, *supra* note 4, § 80a-4(2).

30. *Id.* at § 80a-4(3). A "face amount certificate company" is an investment company which is engaged or proposes to engage in the business of issuing face amount certificates of the installment type. *Id.* at § 80a-4(1).

31. SENATE FINANCE COMMITTEE REPORT, REVENUE ACT OF 1962, *supra* note 3, at 100-01.

(within the meaning of section 958(a)), by United States persons (as defined in section 7701(a)(30)).<sup>32</sup>

According to this formulation, FIC status turned not on any intent of the corporation to be an FIC but rather on satisfaction of dual tests relating to the nature of the business conducted and to the possession of the requisite control. As a result, the status of corporations which did not fall squarely within the Investment Company Act definition was unclear.

The 1984 Act amended the definition of an FIC in an attempt to close the loopholes that permitted certain companies to evade its grasp. The amendments also seek to enable the Internal Revenue Service (hereinafter the Service) to employ a more flexible approach in determining whether a company which technically fits the FIC definition should nonetheless be exempt from its provisions. The 1984 amendments involved two basic changes in the nature of the business test: (1) deletion of reference to the Investment Company Act under the "primarily engaged in" standard; and (2) consideration of commodity, as well as security, investment by a corporation. In addition, the 1984 Act amended the attribution rules which determine indirect ownership for purposes of the control test. The following sections will discuss, in turn, the nature and implications of each of these changes.

#### *A. The Investment Company Act and the "Primarily Engaged In" Test*

*Pre-1984 Definitions.* Before the 1984 amendments, section 1246(b)(2) of the Code defined an FIC by reference to the Investment Company Act's definition of an investment company. Section 3(a)(1) of the Investment Company Act provides a subjective definition, inquiring whether the company is, holds itself out to be, or proposes to be engaged primarily, in the business of investing, reinvesting, or trading in securities. In addition, section 3(a)(3) of the Investment Company Act offers an objective test, through which one determines whether the company owns or proposes to acquire investment securities with a value greater than forty per cent of the company's total assets. A corporation which satisfies either or both of these tests is considered an investment company for purposes of the Investment Company Act. Section 1246 of the Code, however, looks only to the subjective inquiry of section 3(a)(1) of the Investment Company Act in determining whether a corporation is an FIC.<sup>33</sup>

The question of "primary engagement" thus becomes critical. Unfortunately, neither the Code nor the Investment Company Act defines "engaged primarily". Reference has been made, therefore, to the meaning given the phrase by the SEC in administering the Investment Company Act. The SEC has stated that the question of the primary business engagement of a company is one which must be resolved with reference to the particular facts of each

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32. I.R.C. § 1246(b)(2) (1983) (Amended 1984) (emphasis added).

33. See I.R.C. § 1246(b)(2), *supra* text accompanying note 32.

case.<sup>34</sup> Relevant factors may include the company's historical development, its public representation of policy, the activities of its officers and directors, the nature of its assets, and the source of its income.<sup>35</sup> In more than one instance, the SEC has simplified interpretation of section 3(a)(1) by finding that a corporation is "primarily engaged" in the investment business if it has no other operations or business at all.<sup>36</sup>

More specific guidelines for interpreting section 3(a)(1) of the Investment Company Act, and, consequently, section 1246(b)(2) of the Code, may be found in the decisions regarding applications to the SEC for *exemption* from section 3(a) under section 3(b) of the Investment Company Act. The SEC will only grant an exclusion under section 3(b) if it finds that the company is engaged primarily in a business *other* than that of trading or investing in securities.<sup>37</sup> Consequently, these decisions suggest the outer contours of the conduct that will bring a company within section 3(a) of the Investment Company Act and section 1246(b)(2) of the Code.

Section 3(b)(1) of the Investment Company Act provides an *automatic exclusion* for "any issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading securities." Section 3(b)(2) provides a similar exception, upon application to the SEC by the company, for an issuer "primarily engaged in a business or businesses other than investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries or (B) through controlled companies conducting similar businesses." The difference between the section 3(b)(1) and section 3(b)(2) exclusions is that a company which does business through wholly-owned subsidiaries obtains an automatic exclusion while a company which has less than one hundred percent ownership of its subsidiaries must apply to the SEC for an order granting an exclusion, based on either majority ownership or effective control.

*The M.A. Hanna Company*<sup>38</sup> presented the SEC with an application for exclusion from section 3(a) of the Investment Company Act under section 3(b)(2). The SEC granted the exclusion even though seventy-two percent of the company's assets consisted of "investment securities" as defined by the Investment Company Act.<sup>39</sup> The exclusion was based on a finding that most of the investment security assets constituted substantial minority interests in a

34. Tonopah Mining Company of Nevada, 26 S.E.C. 426 (1947); Gray Line Corporation, 44 S.E.C. 314, 317 (1970).

35. *Tonopah*, 26 S.E.C. at 427; *Gray Line*, 44 S.E.C. at 317.

36. *Gray Line*, 44 S.E.C. at 317; Haven Industries, Inc., SEC no-action letter, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,769.

37. Investment Company Act of 1940, *supra* note 4, § 80a-3(b)(1),(2).

38. 10 S.E.C. 581 (1941).

39. *Id.* at 583. Section 80a-3(a)(3) of the Investment Company Act of 1940 defines investment securities as: "all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies."

group of companies in related industries (coal and steel), so that the company controlled, within the meaning of section 3(b)(2)(B), other companies.<sup>40</sup> In addition, the SEC found that Hanna exercised some managerial and directorial functions for those companies which it effectively controlled. This degree of control and participation in managerial activities was sufficient for a finding that the company was primarily engaged in a business *other* than that of investing in securities.

Control of and managerial participation in an operating business alone will not assure an exclusion under section 3(b). The *source* of the income earned by the business must also be considered. For example, in *Tobacco Products Exports Corporation*,<sup>41</sup> the SEC denied an exclusion from section 3(a)(3) under section 3(b) of the Investment Company Act, while conceding that almost all of the time of the applicant's *personnel* was devoted to the tobacco business. Since approximately eighty percent of Tobacco Products' net income was derived from its securities portfolio (which consisted of small minority interests in other tobacco concerns, including Tobacco Products' parent), the SEC found that the company was an investment company under section 3(a)(3) of the Investment Company Act.

The SEC stated that the "dominant position of the portfolio as a basis of earnings and its dominant position in percentages of total assets . . . indicate that the primary business of the company is its ownership of its portfolio."<sup>42</sup> The *Tobacco Products* decision suggests that the existence of an operating business incidental in stature to a securities investment business will not prevent characterization of the business as a securities investment business for purposes of the Investment Company Act.

*Tobacco Products* points out a crucial difference between section 3(a)(3) and section 3(a)(1) of the Investment Company Act: in addition to the words used to describe business activities in section 3(a)(1), section 3(a)(3) includes the words "owning" and "holding" with respect to securities. As a result, the definition of investment company in section 3(a)(3) of the Investment Company Act will encompass a greater class of companies than the definition found in either section 3(a)(1) of the Investment Company Act or section 1246(b)(2) of the Code. The consequences of the distinction are illustrated in *Atlantic Coast Line Company*.<sup>43</sup> In that case, the company's assets consisted

40. 10 S.E.C. at 589. Section 80a-2(a)(9) of the Investment Company Act of 1940 defines "control" as:

the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Additionally, any person who owns beneficially, either directly or through one or more controlled companies, more than twenty-five per cent of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than twenty-five per cent of the voting securities of any company shall be presumed not to control such company.

41. 12 S.E.C. 743 (1943).

42. *Id.* at 745.

43. 11 S.E.C. 661 (1942). See also discussion in *Beware of Sleeper*, *supra* note 26.

almost solely of securities of three railway lines. The company did not trade the securities. The company argued that the inactivity of the portfolio exempted the company from both sections 3(a)(1) and 3(a)(3) of the Act. The SEC, after finding that the company had not held itself out as an investment company, agreed that inactivity of the portfolio did exempt the company from investment company status under section 3(a)(1).<sup>44</sup> Presumably, the company would have escaped FIC classification as well. The SEC did *not*, however, accept the contention that such inactivity exempted the company from section 3(a)(3), citing, in its decision, the material difference in wording between the two sections.<sup>45</sup> This interpretation of the difference between sections 3(a)(1) and 3(a)(3) was later reaffirmed in *Gray Line Corporation*.<sup>46</sup>

One may conclude from these cases that, prior to the 1984 Act, a holding company with an inactive portfolio of securities, which did not hold itself out as primarily engaged in investing, reinvesting, or trading in securities and which exercised a significant degree of managerial participation and control in any less than wholly-owned subsidiaries, would not be caught by section 3(a)(1) of the Investment Company Act and consequently would not have been considered an FIC by virtue of section 1246(b)(2) of the Code.

*The 1984 Amendment.* The 1984 Tax Reform Act changed the definition of an FIC in section 1246(b)(2) of the Code to eliminate any reference to the Investment Company Act in determining the primary business engagement of the corporation.<sup>47</sup> The Service therefore, is now entirely free to apply its own interpretation of the phrase "engaged primarily in the business of investing, reinvesting, or trading." Because it is not clear to what extent the Service will continue to rely on the SEC's interpretation, it may be useful to examine the ways in which the views of the Service might differ from those expressed by the SEC.

The set of provisions taxing accumulated income of corporations<sup>48</sup> constitutes the most analogous area of tax law in which a determination of "investment company" status is sometimes required. Within these provisions, section 533 of the Code sets out evidentiary considerations for proving that the purpose of a corporation is to avoid the income tax with respect to its shareholders. According to section 533, the fact that a corporation is a "mere holding or investment company" is *prima facie* evidence of such purpose. The regulations offer independent definitions of holding and investment companies: a holding company is defined as a corporation having practically no activities except holding property and accumulating income therefrom.<sup>49</sup>

44. 11 S.E.C. at 663.

45. *Id.* at 663-64.

46. 44 S.E.C. 314 (1970).

47. Tax Reform Act of 1984, *supra* note 2, at § 134(a) (amending I.R.C. § 1246(b)(2) (1983)). See *infra* text accompanying note 68 for the full text of I.R.C. § 1246(b)(2).

48. I.R.C. §§ 531-537.

49. Treas. Reg. § 1.533-1(c) (1953).

An investment company, meanwhile, is defined as a corporation whose activities include or substantially consist of: buying and selling stocks, securities, real estate, or other investment property . . . so that the income is derived not only from the investment yield but also from profits upon market fluctuation.<sup>50</sup> A corporation may therefore be both an investment and a holding company, as in a situation where a corporation holds some property for income and trades other property for capital gain.

The courts have taken these definitions a step further to determine whether a corporation is *primarily* a holding or investment company rather than a *mere* holding or investment company. For instance, in *Golconda Mining Corp.*,<sup>51</sup> the court found that the taxpayer was a corporation that owned several mining claims and also owned and traded securities of other corporations. The court considered the fact that the company had registered as an investment company under the Investment Company Act as an acknowledgement that the company was an investment company for the purpose of section 533.<sup>52</sup> The court also found that over ninety percent of Golconda's assets were investment securities, some of which the company had purchased on margin, which indicated further that the company was *primarily* an investment company.<sup>53</sup> The court stated, however, that being "primarily" a holding and investment company is not the same as being a "mere" holding and investment company for the purpose of section 533 of the Code.<sup>54</sup> The distinction is drawn, therefore, between "mere" holding or investment companies that have only passive activities, and other corporations that engage in some measure of *bona fide* business activity.<sup>55</sup>

The case law indicates that, as with section 3(a)(1) of the Investment Company Act, some kind of *trading* activity is necessary before a corporation will be classified as an investment company for purposes of section 533 of the Code. In *Dahlem Foundation, Inc.*,<sup>56</sup> for example, the court found that the taxpayer was a corporation which owned and managed several parcels of real property. The court held that since the company was not in the business of trading property in order to derive a profit from market fluctuations, the corporation was not an investment company.<sup>57</sup> Neither was the corporation found to be a "mere" holding company, as it had substantial business activities.<sup>58</sup>

*Dahlem* and *Golconda* suggest that, although the determination as to whether a company is an investment company for the purposes of section 533

50. *Id.*

51. *Golconda Mining Corporation v. Comm'r*, 58 T.C. 139 (1972), *rev'd on other grounds*, 507 F.2d 594 (9th Cir. 1974).

52. *Id.* at 159, n.12.

53. *Id.*

54. *Id.* at 159.

55. See also *H. C. Cockrell Warehouse Corp. v. Comm'r*, 71 T.C. 1036, 1046 (1979).

56. *Dahlem Foundation, Inc. v. Comm'r*, 54 T.C. 1566 (1970).

57. *Id.* at 1575.

58. *Id.* at 1576.

of the Code is a question of fact, a company will normally be considered primarily an investment company if: (1) the corporation trades or invests in the prescribed investment vehicles; and (2) such trading or investing activities are substantial enough for a finding that the investment activity is the *primary* business of the company.

While these general criteria might feasibly be applied in determining FIC status under section 1246 of the Code, a few changes would be necessary in the interest of consistency. One major difference between section 533 investment companies and those described in section 1246 of the Code is that section 533 investment companies exist regardless of the type of trading vehicle employed.<sup>59</sup> Section 1246, on the other hand, is limited to those investment companies engaged in the trading of securities, commodities, or interests (such as futures or options) in securities or commodities.<sup>60</sup> Thus, a company which trades real estate, for example, will be a section 533 investment company but not an FIC. The Service could easily remedy this definitional problem, however, by adapting the section 533 definition to the trading vehicles prescribed by section 1246 of the Code.

Second, a section 533 investment company does not necessarily include a section 533 holding company, such as a company which buys long term bonds and holds them to maturity. Such a corporation would nevertheless qualify as an FIC because its business would be investing in securities. The Service could easily solve this small problem by including section 533 holding companies in the definition of investment company when and if it applies the definition to section 1246.

As the foregoing discussion illustrates, a move by the Service to abandon its adherence to the SEC's definition of an investment company will probably not produce significantly different results, as long as the Service adopts a definition consistent with its prior interpretations of section 533.

*The Section 3(c) Exclusions.* The elimination of all reference to the Investment Company Act in the section 1246 definition, however, has another potentially serious consequence. Prior to the current amendments, the section 1246 definition of an FIC specifically incorporated the exclusions authorized under section 3(c) of the Investment Company Act. While some of these exclusions are of minor import, others provided substantial safe harbor potential. For example, section 3(c)(2) of the Investment Company Act excludes underwriters, dealers, and brokers. Under the changes made by the Tax Reform Act of 1984, these businesses are no longer automatically excluded from FIC treatment. Second, the section 3(c)(3) automatic exclusions for banks, insurance companies, savings and loan associations, and similar institutions will also no longer be available under the Code's new section 1246(b)(2). Third, a person "not engaged in the business of issuing

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59. I.R.C. § 533(b).

60. I.R.C. § 1246(b). See *infra* text accompanying note 68.

redeemable securities, face amount certificates of the installment type, or periodic payment plan certificates," and who is primarily engaged in consumer or sales financing,<sup>61</sup> is also no longer excluded from the new Code definition. Finally, employees' stock bonus, pension, or profit sharing trusts, any collective trust fund maintained by a bank consisting solely of assets of such trusts, and even certain separate accounts consisting of certain trust assets<sup>62</sup> are no longer excluded. The unavailability of these exclusions could result in a considerable expansion of the definition of an FIC. Companies previously safe under one of these exceptions must now reconsider their positions. Other section 3(c) exclusions which have now been deleted from section 1246 of the Code,<sup>63</sup> not mentioned above, may also be relevant in individual circumstances.

### B. Commodity Funds

Prior to the 1984 amendments, section 1246 of the Code, like the Investment Company Act, defined an investment company as one primarily engaged in the business of investing in *securities*. Corporations formed for the purpose of trading *commodities*, which are usually not defined to be securities, were therefore not investment companies and thus not subject to section 1246 or the Investment Company Act.<sup>64</sup> This distinction between securities and commodities created a loophole in the definition of an FIC: a foreign trading corporation wishing to avoid section 1246 could simply have confined its trading activities to commodities.

This method was used to avoid the consequences of the Investment Company Act in *Reavis & McGrath*.<sup>65</sup> In a request for a "no-action" letter from the SEC regarding its failure to register under the Investment Company Act, the company disclosed that it was a foreign corporation formed for the purpose of trading in commodities and commodity futures contracts. While acknowledging that a company which did not trade any *securities* would not be subject to the Investment Company Act, the SEC maintained that some commodities were also securities. Futures contracts on securities, such as Treasury Bills or Treasury Bonds, were, in the opinion of the SEC, securities as well as commodities. Consequently, the SEC advised Reavis & McGrath that so long as the corporation traded in non-security commodities or non-security commodity futures contracts, the corporation would avoid investment company status under the Investment Company Act.<sup>66</sup>

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61. Investment Company Act of 1940, *supra* note 4, § 80a-3(c)(5).

62. *Id.* at § 80a-3(c)(11).

63. See *id.* §§ 80a-3(c)(2) to -3(c)(8) (except -3(c)(5)(C) & -3(c)(10) to -3(c)(13)).

64. H. REP. No. 98-432, part II, 98th Cong., 1st Sess., at 1731 (1983).

65. Reavis & McGrath, SEC no-action letter, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,1555 at 82,084 (April 17, 1979).

66. *Id.*

The Tax Reform Act of 1984 amended section 1246(b)(2) of the Code to include in the definition of an FIC the type of company formed in *Reavis & McGrath*. The definition now includes any foreign corporation:

engaged (or holding itself out as being engaged) primarily in the business of investing or trading in—

- (A) securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended),
- (B) commodities, or
- (C) any interest (including a futures or forward contract or option) in property described in subparagraph (A) or (B).<sup>67</sup>

Even after the amendment, however, there may still be issues involving the definition of the term "commodity". Although not specifically defined in section 1246, "commodity" is defined in section 864 of the Code as only "of the kind customarily dealt in on an organized commodity exchange," not including "goods or merchandise in the ordinary channels of commerce."<sup>68</sup> The Commodity Futures Trading Commission Act of 1974 (hereinafter the CFTCA)<sup>69</sup> defines commodities as basic agricultural and industrial commodities plus "all other goods and articles, . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in."<sup>70</sup> Under this definition, an item or interest, unless specifically referred to in the CFTCA, does not become a commodity until futures trading in it is initiated. The term "commodity" thus describes a form of economic activity more than it describes the attributes or character of the underlying subject.<sup>71</sup> This interpretation of the term "commodity" explains why the term can include such intangible items as futures contracts on a stock index or foreign currency. Given this expansive interpretation of the term "commodity", it is very probable that the amendments made under the Tax Reform Act of 1984 will effectively plug the loophole previously existing in section 1246(b)(2) of the Code.

Certain common investment vehicles may not, however, fit either the definition of "security" or "commodity". For example, in *CoinVest, Inc.*,<sup>72</sup> a company proposing to invest solely in coins, silver bullion, and other metals applied to the SEC for a no-action letter regarding the company's desire not to register under the Investment Company Act. The SEC ruled that the coins and metals were not securities, although an option to buy or sell, or other contract to deliver such items, would be a security.<sup>73</sup> Such coins and metals, if not specifically mentioned in the CFTCA definition and not traded on an

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67. See Tax Reform Act of 1984, *supra* note 2, at § 134(a).

68. I.R.C. § 864(b)(2)(B)(iii) (1984); Treas. Reg. 1.864-2(d)(3) (1968).

69. Codified in 7 U.S.C. §§ 1-22.

70. 7 U.S.C. § 2. See also Futures Trading Act of 1982, Pub. L. 97-444, § 2, 96 Stat. 2294 (1983).

71. P. JOHNSON, 1 COMMODITIES REGULATION 4 (1982).

72. [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,823 at 84,225 (April 8, 1974).

73. *Id.* at 84,227.

organized futures exchange, would not be "commodities" either, unless and until trading in the items began on an organized exchange. According to this logic, any other goods or merchandise which are neither traded on an organized commodity exchange nor traded as futures would seemingly fall outside the definition of "commodity" for purposes of section 1246. Precious stones, for example, may also escape classification as either securities or commodities. Investment in such items may allow a foreign corporation to fall "between the cracks" of the definition in sections 1246(b)(2)(A), (B), and (C), and thereby to avoid classification as an FIC.<sup>74</sup>

### C. Attribution Rules

The Tax Reform Act of 1984 also amended the attribution rules which apply in determining whether a corporation satisfies the shareholder portion of the FIC definition. Prior to the 1984 amendment, the Code treated a corporation as satisfying the FIC shareholder test if fifty per cent or more of the voting power or total value of shares of all classes of the corporation's stock was "held, directly or indirectly (*within the meaning of section 958(a)*), by United States persons."<sup>75</sup> The 1984 amendment of section 1246(b) provides that a corporation satisfies the shareholder test if "held directly (*or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)*) by United States persons."<sup>76</sup> The amendment therefore modifies the application of Code section 958 and adds the attribution rules of section 318(a) of the Code.

The modification of the section 958 language appears cosmetic. The previous parenthetical, "within the meaning of 958(a)" had questionable application to section 1246(b) of the Code, because section 958(a)(1) defined stock "owned", and section 1246(b)(2) referred to stock "held".<sup>77</sup> Curiously, Congress retained the stock "held" nomenclature in its amended version of section 1246(b)(2), even though no analog to this wording exists in section 958(a) (or elsewhere in subpart F) or in section 318. For the purposes of indirect "holding" of stock, sections 958(a)(2) and 958(a)(3) presumably apply by reading "held" for "owned" wherever it appears in those paragraphs. Even if stock "held directly" is interpreted as referring to nominal rather than beneficial ownership, the final result is the same in all circumstances, for stock "held indirectly . . . by United States persons" can only refer to beneficial ownership.<sup>78</sup> In fact, the phrase "directly owned" in section 958(a) of the

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74. Given the extent of organized trading in coins and metals (e.g. South African Krugerrand, Canadian Maple Leaf, gold, silver, etc.), the "crack" in the "commodity" definition is likely a narrow one.

75. I.R.C. § 1246(b)(2) (1982) (amended 1984) (emphasis added).

76. See Tax Reform Act of 1984, *supra* note 2 (emphasis added).

77. Gifford, *Controlled Foreign Corporations — Section 958*, TAX MGMT. (BNA) No. 259, at A-18; Alexander, *Controlled Foreign Corporations and Constructive Stock Ownership*, 18 TAX L. REV. 531, 568 (1963).

78. Alexander, *supra* note 78, at 568.

Code is considered to refer to nominal ownership, with "indirectly owned" referring to beneficial ownership. In short, the modification in the language pertaining to section 958(a) does not change the application of that section with respect to the attribution rules of section 1246(b)(2) of the Code.

The amendment's addition of Code section 318(a)(4)<sup>79</sup> to the section 1246 definition represents a more important change. It enables the Service to attribute stock ownership to a person holding an option to purchase that stock. An attributable option includes an option on an option,<sup>80</sup> and quite possibly includes warrants and convertible stock or debentures as well.<sup>81</sup> Thus, this amendment expands potential FIC treatment to the extent that corporations with qualifying investment activities issue options and similar instruments to United States persons.

### III RELATED CODE PROVISIONS

Section 1246 was designed to limit the *conversion* benefits made possible through the use of foreign investment companies. Regardless of FIC classification, other provisions of the Code aimed specifically at eliminating the opportunities presented by foreign corporations for *tax deferral* may apply. A corporation which escapes FIC classification altogether may still suffer the tax consequences engendered by these other provisions.

#### *A. Subpart F: Controlled Foreign Corporations*

In 1962, Congress added Subpart F to the Code to tax shareholders of controlled foreign corporations (CFCs) on their undistributed share of certain kinds of the corporation's income.<sup>82</sup> A foreign corporation is a CFC if a majority of the foreign corporation's voting power is owned, directly or indirectly, at some time during the taxable year, by "U.S. shareholders".<sup>83</sup> For purposes of Subpart F, a U.S. shareholder is a U.S. person who owns, directly or indirectly, ten percent or more of the foreign corporation's voting power.<sup>84</sup>

As mentioned in Part I of this article, Congress designed Subpart F to reduce the deferral benefits available through the use of foreign corporations. The CFC and FIC classifications incorporate different concepts which facilitate different methods of taxing the shareholder.

79. I.R.C. § 318(a)(4) provides:

If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

80. *Id.*

81. Rev. Rul. 68-601, 1968-2 C.B. 124 (1968); Rev. Rul. 77-201, 1977-1 C.B. 250 (1977).

82. Revenue Act of 1962, Pub. L. 87-834.

83. I.R.C. § 957(a).

84. I.R.C. § 951(b).

The CFC category extends to some corporations which escape FIC status. For example, shareholders of FICs are not subject to the provisions relating to constructive ownership of stock found in section 958(b).<sup>85</sup> As a result, foreign corporations which are CFCs by virtue of U.S. shareholders' constructive ownership of stock (through the application of section 958(b) of the Code) will not necessarily be FICs. In this regard, section 958(b)(2) provides that for the purpose of determining the amount of ownership of a lower-tier foreign corporation by U.S. shareholders through a higher-tier foreign corporation, if the higher-tier foreign corporation owns a majority of the voting power of the lower-tier foreign corporation, the U.S. shareholders of the higher-tier corporation are deemed to own the same proportion of the lower-tier foreign corporation as they own of the higher-tier foreign corporation.<sup>86</sup> To illustrate, if a U.S. shareholder owns fifty-one percent of foreign corporation A, which in turn owns fifty-one percent of foreign corporation B, foreign corporation B would be a CFC of which the U.S. shareholder would be deemed to own fifty-one percent, regardless of the constitution of the ownership of the other shares of A and B. Under FIC attribution rules, the U.S. shareholder in our example would own less than twenty-six percent of corporation B, so that B would not be classified as an FIC.

On a more general level of comparison, the nature of the business of a foreign corporation is irrelevant to the question of its status as a CFC. By contrast, a corporation must be primarily engaged in the business of "investing, reinvesting, or trading" in securities in order to be an FIC.

Conversely, not every FIC will meet the criteria for CFC status. First, section 957 completely ignores ownership of stock by U.S. persons owning less than ten percent of the voting power of the corporation, but such ownership is not ignored for FIC status. This implies that if the majority of the stock of a foreign corporation is widely held by U.S. persons, so that the persons holding ten percent or more of the stock constitute less than a majority of the total shares, the corporation will be an FIC but not a CFC.

Second, a determination of FIC status considers a "market value" control test whereby the owners of at least fifty percent of the *value* of all classes of stock are considered to control the corporation.<sup>87</sup> For purposes of the "market value" control test, the allocation of voting power is irrelevant. By contrast, Subpart F concerns itself only with voting power and utilizes no equivalent "market value" test.

Although, as illustrated, FICs and CFCs do not necessarily overlap, a significant number of corporations may possess attributes which trigger the application of both methods of taxation. The consequences of CFC status can prove quite disadvantageous for an FIC which is also a CFC.

85. Compare I.R.C. § 553 with I.R.C. § 957(a).

86. Treas. Reg. § 1.958-2(c)(2) (1966).

87. I.R.C. § 1246(b)(2).

Once a corporation is classified as a CFC, two major consequences ensue. The first, and more serious, consequence is that U.S. shareholders of the corporation are required to report and pay taxes on their pro rata share of "attributable income".<sup>88</sup> Attributable income consists essentially of two components, "subpart F income", and the corporation's "increase in earnings invested in United States property" during the taxable year.<sup>89</sup> Subpart F income constitutes the major part of the CFC's income and includes primarily "foreign-base company income" and certain income derived from insuring U.S. risks.<sup>90</sup> Foreign-base company income, in turn, consists principally of "foreign-base company sales income", "foreign-base company services income", and "foreign personal holding company income".<sup>91</sup> An FIC ordinarily will not have much income in either of the first two categories but may have a substantial amount of foreign personal holding company income.

The inclusion of foreign personal holding company income in a CFC's attributable income imposes a great hardship on an FIC that is also a CFC. Foreign personal holding company income generally consists of dividends, interest, royalties, and similar categories of passive income, including gain from the sale or exchange of stocks, securities, or gain from futures transactions in any commodity on or subject to the rules of a board of trade or

88. See I.R.C. § 951(a)(1). The term "attributable income" is not used in the Code, but is simply a term of convenience. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 17.02, at 17-15 (4th ed. 1979). Income is attributed according to stock ownership calculated pursuant to I.R.C. § 958(a). I.R.C. § 958(b) does not apply for purposes of income attribution.

89. I.R.C. § 951(a).

90. I.R.C. § 952(a).

91. I.R.C. § 954(a). Foreign base company sales income is defined, in pertinent part, as: income . . . derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property on behalf of a related person where—

(A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

(B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

See I.R.C. § 954(d)(1). Foreign base company services income is defined, in pertinent part, as: income . . . derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services, which—

(1) are performed for or on behalf of any related person . . . and

(2) are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

See I.R.C. § 954(e). Foreign personal holding company income is defined, in pertinent part, as: the foreign personal holding company income (as defined in section 553), modified and adjusted as provided in [the following] paragraph[s] . . . .

See I.R.C. § 954(c)(1). For a more detailed discussion of foreign personal holding company income, see *infra* note 93 and accompanying text.

commodity exchange.<sup>92</sup> Such passive income may be excluded from FPHCI if the income is derived through the active conduct of particular businesses and is received from unrelated parties.<sup>93</sup> But, because an FIC probably will have gone to great lengths to avoid such business connections,<sup>94</sup> it will ordinarily find this exclusion useless. Since FICs derive income from many of these sources, the FIC-CFC may find a great deal of its total income subject to taxation in each taxable year.

The second component of attributable income is the increase, during the taxable year, in the amount of the corporation's earnings which are invested in U.S. property. This provision was prompted by the fact that U.S. persons were able to repatriate earnings of foreign corporations in a manner beneficial to themselves (such as through low interest loans or rentals of purchased property) with the result that the repatriation was "substantially the equivalent of a dividend being paid to them."<sup>95</sup> To prevent such tax avoidance, Congress decided to tax shareholders of CFCs on the "taxable year to taxable year" increase in their CFC's investments in tangible property within the United States, stock of a domestic corporation, obligations of U.S. persons, and the right to use in the United States a patent, copyright, invention, model, design, secret formula or process, or any other similar property right which is acquired or developed by the controlled foreign corporation for use in the United States.<sup>96</sup> Although the tax on the increase in investment in U.S. property does not affect the FIC which invests in stocks and securities of unrelated public corporations,<sup>97</sup> it does hold dangers for the FIC that acts as a holding company for or invests in stocks or securities of closely held corporations.<sup>98</sup>

It should be clear that the first consequence of becoming a CFC will prove disastrous for an FIC because it will be taxed on its trading and investment income (and all other foreign personal holding company income) as well as on any increase in its investment in certain U.S. property. Both inadvertent and intentional FICs may have a substantial amount of such income or investments. For this reason, a foreign corporation that is an FIC should avoid CFC classification lest it be subject to taxation under Subpart F.

92. I.R.C. §§ 954(c), 553(a).

93. I.R.C. § 954(c)(3).

94. See, e.g., I.R.C. § 882 which imposes U.S. income taxes on foreign corporations which are engaged in a trade or business within the United States. Since U.S. investors generally employ FICs for the express purpose of deferring such taxes, FICs would normally avoid active trade or business connections. For the definition of "trade or business with the United States", see I.R.C. § 864(b).

95. J. RABKIN & M. JOHNSON, 2A FEDERAL INCOME, GIFT AND ESTATE TAXATION, § 8.12C(7) (1985).

96. I.R.C. § 956(b)(1).

97. I.R.C. § 956(b)(2)(F) provides an exception for stocks or obligations of a domestic corporation if the corporation is not itself a U.S. shareholder of the CFC and U.S. shareholders of the CFC do not own twenty-five percent or more of the domestic corporation's stock, as calculated after the purchase in question.

98. I.R.C. § 956(b)(1).

The second major consequence which arises when a corporation becomes a CFC is that the provisions of section 1248 of the Code apply to any U.S. person who is a U.S. shareholder of the corporation (i.e. owns ten percent or more of the stock) at any time within five years of the date he sells or exchanges his stock.<sup>99</sup> Section 1248 provides for ordinary income treatment of any gain from the sale or exchange (including certain liquidations and distributions pursuant to sections 311, 336, or 337 of the Code) of such stock to the extent of the shareholder's ratable share of earnings and profits of the corporation while the corporation was a CFC.<sup>100</sup> If the U.S. shareholder is an individual, section 1248 provides a limit on the tax imposed based on the tax burden that would have been imposed if the CFC had been a domestic corporation.<sup>101</sup>

Section 1248 generally functions as a backstop to subpart F, requiring U.S. shareholders to pay tax on the earnings and profits of the corporation when the shareholder sells his stock only if the earnings and profits were not taxed earlier, when earned or accumulated.<sup>102</sup> Amounts already taxed under Subpart F are excluded from earnings and profits, as is other income previously taxed by the United States.<sup>103</sup>

The application of section 1248 will usually not result in any further damage to the shareholders of an FIC, however, as section 1248 by its terms does not apply to a U.S. shareholder who is taxed on the gain from the sale or exchange of FIC stock pursuant to section 1246.<sup>104</sup> The impact of the first consequence of CFC status is substantial enough to give pause to anyone advising an FIC.

### B. Other Related Code Provisions

Even if an FIC does not fit the definition of a CFC, still other provisions of the Code may apply to its taxation and the taxation of its shareholders.<sup>105</sup> First, an FIC may be a foreign personal holding company. A foreign personal holding company is any foreign corporation that has sixty percent of its income as foreign personal holding company income and a majority of its stock owned directly or indirectly by five or fewer individuals who are citizens or residents of the United States.<sup>106</sup> A U.S. person who is a shareholder

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99. I.R.C. § 1248(a).

100. *Id. See also* I.R.C. § 1248(g).

101. I.R.C. § 1248(b).

102. B. BITTKER & J. EUSTICE, *supra* note 89, ¶¶ 17.31, 17.34 at 17-71 (1979 & Cum. Supp. No. 2 1984).

103. I.R.C. § 1248(d)(1).

104. I.R.C. § 1248(d)(5); Foster, *Controlled Foreign Corporations—Section 1248*, TAX MGMT. (BNA) no. 240-3d, at A-29.

105. A full discussion of these provisions is beyond the scope of this work. This section of the paper is intended to remind the reader that there are other important provisions that may affect these kinds of companies.

106. I.R.C. § 552(a). *See also* I.R.C. § 553 for the definition of foreign personal holding company income and *supra* text accompanying note 93.

in a foreign personal holding company must include in his gross income his proportionate share of any undistributed foreign personal holding company income.<sup>107</sup>

Second, if the foreign corporation is not a foreign personal holding company, but at least one shareholder is a U.S. citizen or resident,<sup>108</sup> the domestic personal holding company provisions<sup>109</sup> may apply. Section 541 imposes on personal holding companies a fifty percent tax on all undistributed personal holding company income.<sup>110</sup> Personal holding company income is much the same as foreign personal holding company income, but does not include capital gains.<sup>111</sup>

Third, the accumulated earnings tax applies to every corporation (except personal holding companies and foreign personal holding companies) "formed or availed of for the purpose of avoiding the income tax" by permitting earnings and profits to accumulate.<sup>112</sup> The fact that a company is a "mere holding or investment company"<sup>113</sup> is *prima facie* evidence of the purpose to avoid income tax with respect to its shareholders.<sup>114</sup> A foreign corporation will be subject to the accumulated earnings tax with respect to any income derived from sources within the United States if any of its shareholders are subject to income tax on distributions of the corporation by reason of being: (1) citizens or residents of the United States; (2) nonresident alien individuals to whom section 871 is applicable; or (3) foreign corporations if a shareholder specified in either (1) or (2) has a beneficial interest therein.<sup>115</sup>

### CONCLUSION

The 1984 amendments, in many ways, broaden the scope of section 1246. First, because all reference to the Investment Company Act has been eliminated, the Service has greater flexibility in assigning a corporation FIC status. Given the Service's approach in analogous situations, however, no radical departure from the previous pattern of results is anticipated. Second, by extending the application of section 1246 to companies which deal in commodities, the 1984 amendments close the loophole created by the exclusion of commodities from section 1246. Nonetheless, companies investing in goods or materials which are not traded on an organized commodity exchange or as futures may still manage to circumvent the section 1246 provisions. Finally, modifications in the attribution rules further expand the definition of an FIC

107. I.R.C. § 551(a). For a discussion of what constitutes foreign personal holding company income, see *supra* text accompanying note 93.

108. I.R.C. §§ 541–547.

109. I.R.C. § 542(a).

110. I.R.C. § 541.

111. I.R.C. § 543(a),(b)(1).

112. I.R.C. § 532(a). The accumulated earnings tax does not apply to personal holding companies or foreign personal holding companies. See I.R.C. § 532(b).

113. See *supra* notes 49–60 and accompanying text.

114. I.R.C. § 533(b).

115. Treas. Reg. § 1.532–1(c) (1960).

by attributing stock ownership to persons holding options to purchase stock as well as stock itself.

Although the overall effect of these changes on the classification of foreign corporations is as yet indeterminate, section 1246 will undoubtedly continue to play a significant role in the Treasury's efforts to foreclose the use of foreign corporations as tax avoidance vehicles for United States investors. The complex relationship between the various provisions which tax foreign corporations, however, requires familiarity with the areas of overlap between section 1246 and Subpart F, as well as with provisions relating to foreign personal holding companies, in order to avoid the onerous tax consequences of dual classification.