

1991

International Commerce through a Foreign Subsidiary: Navigating the Anti-Haven Tax Shoals of the Internal Revenue Code

Ernest R. Larkins

Recommended Citation

Ernest R. Larkins, *International Commerce through a Foreign Subsidiary: Navigating the Anti-Haven Tax Shoals of the Internal Revenue Code*, 9 INT'L TAX & BUS. LAW. 64 (1991).

Available at: <http://scholarship.law.berkeley.edu/bjil/vol9/iss1/2>

This Article is brought to you for free and open access by the Law Journals and Related Materials at Berkeley Law Scholarship Repository. It has been accepted for inclusion in Berkeley Journal of International Law by an authorized administrator of Berkeley Law Scholarship Repository. For more information, please contact jcera@law.berkeley.edu.

International Commerce Through a Foreign Subsidiary: Navigating the Anti-Haven Tax Shoals of the Internal Revenue Code

by
Ernest R. Larkins*

I. INTRODUCTION

Traditionally, one of the advantages of doing business abroad through a foreign subsidiary has been the possibility of using tax havens to minimize foreign income taxes and, at the same time, defer the offshore profits for U.S. income tax purposes. As long as the foreign earnings that accumulated in the tax haven were not remitted to the United States, the U.S. tax bill was delayed. There are several Internal Revenue Code provisions, however, that curb or, in some cases, totally eliminate deferral benefits sought in this manner. Among these are the formidable Subpart F rules for controlled foreign corporations and the passive foreign investment company provisions. Nonetheless, with careful tax planning, foreign subsidiaries that engage in certain types of offshore business activities, notably manufacturing, can still navigate around these anti-haven tax shoals and enjoy substantial deferral benefits. Other foreign subsidiaries, in contrast to traditional wisdom, may set their course directly toward these anti-haven tax shoals in order to secure significant foreign tax credits.

Due to the reduced corporate rates introduced by the Tax Reform Act of 1986, most U.S. multinational companies today find themselves in excess tax credit positions.¹ Accordingly, any foreign taxes they pay above the U.S. statutory rate of 34% are not allowed as a credit against their U.S. tax liability, a fact that directly reduces the company's bottom line, unless it can utilize these "excess" credits during the statutory carryover period. In many cases, companies can capture tax advantages by shifting some overseas operations from high-tax jurisdictions to low-tax jurisdictions. Shifting operations

* Associate Professor, School of Accountancy, Georgia State University; Ph.D. Virginia Polytechnic Institute and State University, 1982; M.Acc. Virginia Polytechnic Institute and State University, 1978; B.S. Bob Jones University, 1977.

1. Benson & Hamburger, *Impact of U.S. Tax Reform on European Subsidiaries of U.S. Companies*, Coopers & Lybrand Tax Topics Advisory 2 (Aug. 16, 1988).

may both lighten the excess credit problem and open up the possibility of achieving substantial tax benefits by deferring foreign income.

This article will examine the U.S. tax aspects of engaging in international commerce through a foreign subsidiary. Though not the sole concern of international tax planning, the focus of this article is primarily on the anti-haven provisions in the U.S. tax law. The anti-haven provisions are intended to thwart any attempt to defer income recognition by U.S. multinationals.² The deferral benefit, if secured, can be significant. Assuming a U.S. tax rate of 34% and a discount rate of 10%, the present value of \$1,000 due in ten years would be \$386. In the simple case where no foreign taxes are paid, a ten-year deferral would mean that the present value of total tax liability is reduced by 61.4%. This analysis, of course, is premised on stable U.S. tax rates, a tenuous assumption at best.

After a brief background review, this article will examine the Internal Revenue Code provisions that complicate attempts to defer income and suggest ways to legally circumvent these provisions. The article also examines circumstances when deferral is not advantageous from a foreign tax credit perspective. Finally, the article will discuss the effect of the anti-haven tax laws on specific types of offshore companies.

II.

BACKGROUND DISCUSSION

Eligibility for tax deferral benefits when engaging in international commerce depends on two general conditions. First, the entity utilized must be a corporation. Second, the corporation must be created or organized on foreign soil.

The United States recognizes a foreign entity as a corporation only if it is a corporation under U.S. law, regardless of its characterization under foreign law.³ Corporations normally have the following six characteristics: associates, business objective, continuity of life, centralization of management, limited liability, and free transferability of ownership.⁴ However, entities lacking

2. Most developed countries have anti-haven legislation similar to that in the United States. See the following Tax Management (TM) publications: Killius, *BUSINESS OPERATIONS IN WEST GERMANY*, TM Portfolio 174-5th (1985); Way, Brockman & Otsuka, *BUSINESS OPERATIONS IN JAPAN*, TM Portfolio 51-7th (1984); and Darlington and Sandison, *BUSINESS OPERATIONS IN THE UNITED KINGDOM—TAXATION*, TM Portfolio 68-8th (1988). The anti-haven provisions of foreign tax systems often are more lax than similar provisions of the U.S. tax system. For example, a company that is controlled by U.K. residents but resides outside the United Kingdom is affected only if the foreign taxes are less than one half the taxes that would have been incurred in the United Kingdom on the same income. TM Portfolio 68-8th, at A-90.

3. For examples of Internal Revenue Service determinations of corporate status, see Gen. Couns. Mem. 34,376 (Nov. 13, 1970); Gen. Couns. Mem. 36,910 (Nov. 4, 1976); Rev. Rul. 77-214, 1977-1 C.B. 408; Internal Revenue Manual (CHH) (1989) at Part IV, Chapter 4200, Exhibit 500-4.

4. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983).

specific characteristics may still be considered a corporation for U.S. tax purposes. For example, a foreign partnership in which only one of the corporate characteristics above is absent will be treated as a corporation in applying U.S. tax law.⁵

A domestic corporation is subject to U.S. income tax on its worldwide earnings.⁶ With three general exceptions, the earnings of many corporations organized outside the United States (i.e., foreign corporations) are not taxed by the United States. First, foreign corporations are taxed on income from U.S. sources and income that is effectively connected with the conduct of a trade or business in the United States.⁷ Second, foreign corporations with branch operations in the United States may be subject to a 30% tax on their earnings and profits from income that is effectively connected with a U.S. trade or business, adjusted for changes in net equity investments in the United States. This branch profit tax is in addition to the normal tax on foreign corporations with "effectively connected" income.⁸ Third, the U.S. shareholders of foreign corporations are taxed on dividends actually received.⁹

III.

THE ANTI-HAVEN TAX SHOALS

In addition to the general exceptions above, the United States taxes the earnings of five specific types of foreign corporations. The first three, controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies, are formidable obstacles to the erudite professional versed in international tax planning. The provisions that modify the U.S. tax treatment of these special entities and their shareholders are intended to curb the use of tax havens. The remaining two types of entities that might be subject to U.S. taxation on their foreign earnings are the personal holding company and any corporation that unreasonably accumulates its earnings. However, despite these statutory barriers erected by Congress to discourage tax haven activities, carefully devised strategies still can preserve the deferral of income in appropriate situations. As discussed below, extreme caution is in order, however, given the numerous and potent weapons at the disposal of the Internal Revenue Service.

5. *Id.* § 301.7701-2(a)(3). *Contra*, Rev. Rul. 88-8, 1988-1 C.B. 403 (a British unlimited company was held to be a partnership under U.S. tax law because it lacked the corporate characteristics of limited liability and free transferability of interests).

6. Treas. Reg. § 1.11-1(a) (as amended in 1976).

7. I.R.C. §§ 881(a), 882(a)(1) (1988).

8. *Id.* § 884(a).

9. *Id.* § 61(a)(7).

A. Controlled Foreign Corporations

A controlled foreign corporation (CFC) is any foreign corporation in which U.S. shareholders own more than 50% of the voting power or stock value.¹⁰ For purposes of determining a CFC, a U.S. shareholder includes any U.S. citizen, U.S. resident, U.S. partnership, U.S. estate, U.S. trust, or U.S. corporation that owns at least 10% of the foreign corporation's voting power.¹¹ Thus, a domestic corporation that decides to establish a wholly-owned foreign corporation creates a CFC. However, eleven unrelated domestic corporations that own equal 9.09% shares of the foreign corporation's voting power is one arrangement that avoids CFC status. By definition, none of these owners are considered U.S. shareholders and, therefore, U.S. shareholders do not own more than 50% of the foreign corporation. An elaborate concoction of indirect and constructive ownership rules is used to test for both the 50% and the 10% thresholds.¹²

Because of jurisdictional and enforcement problems inherent in the direct taxation of a foreign corporation, an alternate route has been devised. The U.S. shareholders of a CFC are treated as though they have received a constructive dividend of their pro rata share of the CFC's "tainted" earnings, so-called Subpart F income, after reduction by allocable deductions.¹³ The U.S. shareholders are taxed on the profits of the foreign subsidiary, even if all earnings are retained and reinvested in operations abroad. In a sense, the foreign subsidiary is treated like a partnership; part of its earnings (but not losses) are passed through to its owners. In theory, Subpart F income results only from transactions with no real business connection to the country where the CFC is organized. In other words, if the foreign subsidiary is organized in a country for no apparent reason other than the tax benefits, it is presumed that the country is a tax haven and, accordingly, certain transactions generate tainted earnings.

Special treatment is required when a U.S. shareholder recognizes gain from a sale or exchange of shares in a CFC. The gain is included in gross income as a dividend to the extent of the pro rata share of earnings and profits accumulated during the period the foreign corporation was a CFC and the U.S. shareholder held the stock.¹⁴ A five-year look-back rule applies to determine whether the transferor is a U.S. shareholder.¹⁵ Thus, ownership of less than 10% of the voting power on the date of sale or exchange does not necessarily preclude dividend treatment if U.S. shareholder status can be established for at least one day during the previous five years. Accordingly, a

10. *Id.* § 957(a).

11. *Id.* § 951(b).

12. *Id.* § 958.

13. *Id.* §§ 951(a), 953(b)(3), 954(b)(5).

14. *Id.* § 1248(a).

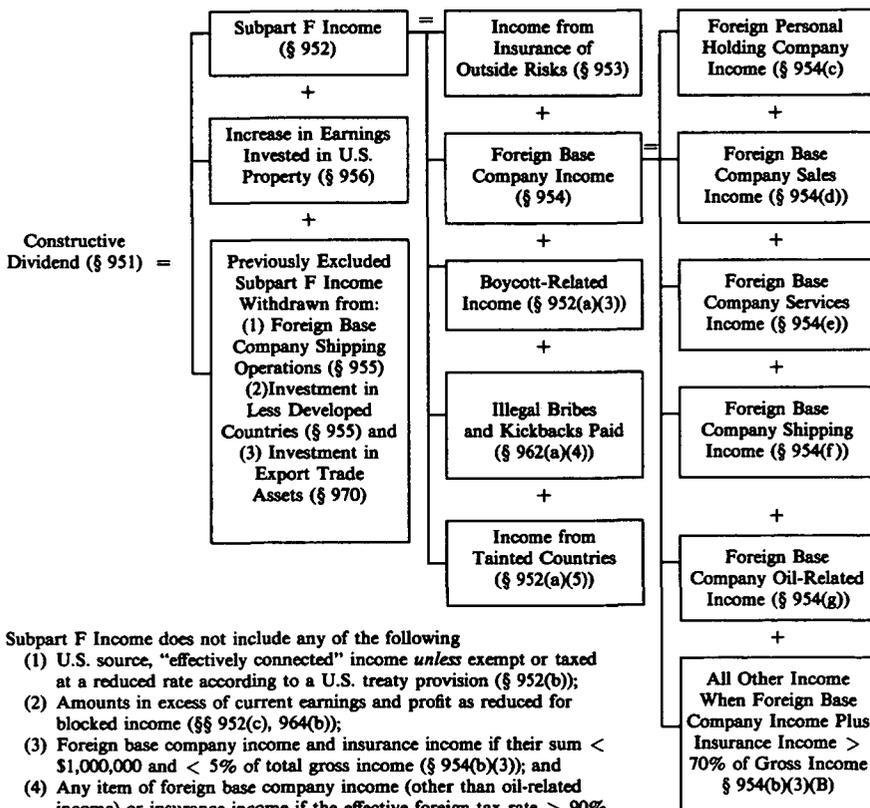
15. *Id.* § 1248(a)(2).

deemed paid foreign tax credit may be available to corporate transferors of CFC stock.¹⁶

1. Subpart F Income

Once CFC status is attained, Subpart F income arises from several different sources. Exhibit 1 summarizes the various forms Subpart F income can assume. The reader may find it helpful to periodically refer to this exhibit.

EXHIBIT 1
SUBPART F FRAMEWORK



Income derived from insuring or reinsuring certain risks outside the foreign country in which the CFC is organized may result in Subpart F income. Premiums earned from insuring property located outside the CFC's country, activities carried on outside the CFC's country, and the lives or health of individuals residing outside the CFC's country all result in tainted (Subpart

16. Treas. Reg. § 1.1248-1(d)(1)(i) (as amended in 1984).

F) income.¹⁷ To avoid tainting business profits, groups of multinational corporations sometimes pool their underwriting activities with other captives to form one super-captive insurance company¹⁸ that does not generate Subpart F income. However, the restrictions enacted by the Tax Reform Act of 1986 have eliminated the tax benefits of most offshore captives.

Subpart F income also includes income gained by cooperating in an international boycott against any country.¹⁹ Similarly, income derived from dealing with any of the following described countries is tainted: any country the United States does not officially recognize; any country with which the United States has severed, or at least does not conduct, diplomatic relations; and any country that the United States designates as one that repeatedly supports international terrorist activities.²⁰ Subpart F income also includes an amount equal to illegal bribes and kickbacks that the CFC pays to any foreign government.²¹

The largest category of Subpart F income, foreign base company income, is itself a combination of five types of income: 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.²²

Foreign personal holding company income includes most passive income, net gain from transactions involving investment assets, net gain from investment-oriented commodity transactions, and net gain from investment-oriented currency transactions.²³ Special exceptions are carved out for certain rental and royalty income.²⁴ Also, interest and dividends received from a related person or entity that is organized in and holding substantial business assets in the CFC's country are not considered foreign personal holding company income.²⁵

Foreign base company sales income results from the sale of goods that were purchased from a related party (e.g., a U.S. parent corporation) or the

17. I.R.C. § 953(a) (1988).

18. A captive insurance company is generally a wholly-owned subsidiary established for the primary purpose of underwriting some or all of the parent company's risks. When several companies aggregate resources to form a single company that will insure their respective risks, the newly-established company is known as a super-captive insurance company.

19. I.R.C. § 952(a)(3) (1988).

20. *Id.* § 952(a)(5).

21. *Id.* § 952(a)(4).

22. *Id.* §§ 952(a)(2), 954(a).

23. *Id.* § 954(c)(1).

24. Section 954(c)(2)(A) prevents rents and royalties derived in the active conduct of a trade or business from being considered foreign personal holding company income if the rents and royalties are received from unrelated parties. *Id.* § 954(c)(2)(A). Rents and royalties from a related corporation, however, can avoid classification as foreign personal holding company income if received for the use of, or the privilege of using, property within the foreign country where the CFC is organized. *Id.* § 954(c)(3)(A)(ii).

25. *Id.* § 954(c)(3)(A)(i).

sale of goods to a related party that were purchased elsewhere. Agency relationships where the foreign subsidiary purchases or sells on behalf of a related party may likewise cause the commission income or fees to be classified as Subpart F income. To acquire the Subpart F taint, the transaction must meet a two-pronged geographical test. First, the goods must have been manufactured, produced, grown, or extracted outside the CFC's country of organization. Second, the goods must be sold for use outside that country.²⁶

Foreign base company services income is generated whenever technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or similar services are performed for or on behalf of a related party and the services are performed outside the CFC's country of organization.²⁷ For example, suppose that machinery is sold by a U.S. parent corporation to a foreign customer under a contract to install and service the asset. If the parent corporation subcontracts these services to its wholly-owned CFC and the services are performed outside the CFC's country, the income is characterized as foreign base company services income.²⁸ When a CFC sells or exchanges property that it has manufactured, any directly related services performed before the transaction or in conjunction with an offer or effort to sell the property is not foreign base company services income.²⁹

Foreign base company shipping income includes income from transporting persons or property by ocean or air. The Tax Reform Act of 1986 expanded this provision to include transportation income from space activities (e.g., launching a satellite).³⁰ An exception is made when the transportation begins and ends in the CFC's country; such income is not foreign base company shipping income.³¹

Foreign base company oil-related income is defined as any foreign source income from transactions involving oil and gas products.³² However, oil-related income obtained under the following circumstances is not tainted: if the product was extracted from wells within the CFC's country, if the product was used or consumed within the CFC's country, or if the product was loaded on a vessel or aircraft within the CFC's country and used as fuel.³³ An exception also is carved out for small producers, which have an average daily production of less than 1,000 barrels.³⁴

26. *Id.* § 954(d).

27. *Id.* § 954(e)(1).

28. Treas. Reg. § 1.954-4(b)(3) example (1) (as amended in 1983).

29. I.R.C. § 954(e)(2) (1988); Treas. Reg. § 1.954-4(d)(1)-(2) (as amended in 1983).

30. I.R.C. § 954(f) (1988).

31. *Id.* § 954(b)(7).

32. *Id.* § 954(g)(1)(A).

33. *Id.* § 954(g)(1)(B).

34. *Id.* § 954(g)(2).

2. Investment of Deferred Earnings

Even if a CFC has no Subpart F income, the U.S. shareholders of the CFC can still be treated as receiving a constructive dividend if the CFC increases the amount of its earnings invested in U.S. property.³⁵ The purpose of this provision is to impede an end run around the statute. Absent this restriction, the CFC could loan its earnings to its U.S. parent corporation, while, at the same time, preserve the deferral benefits of the foreign earnings. For example, suppose a CFC with no Subpart F income loaned all of its first-year earnings to its sole owner in the United States. Bona fide loans are not considered income and, thus, normally would continue to shield the foreign earnings from U.S. taxation. But in this instance, the loan is viewed as an increase in earnings invested in U.S. property and, accordingly, triggers a constructive dividend to its U.S. shareholder in an amount equal to the loan.

In *Gulf Oil Corporation v. Commissioner*,³⁶ the taxpayer maintained a centralized cash management system. Cash receipts and disbursements for transactions between an affiliate and an unrelated party were handled through this system. In transactions among affiliates, the system acted as a clearinghouse by offsetting intercompany receivables and payables.³⁷ The taxpayer owned two CFCs for which the system showed an intercompany payable at year end. The taxpayer contended that this balance did not represent an investment in U.S. property within the meaning of Subpart F, because regulations specifically exempt any debt collected within one year.³⁸ Based on a first-in-first-out (FIFO) debt collection assumption, the payable turns over at least once during the year. The government argued instead that the balance should be viewed as a single, open-account loan, which is not collected in full during the year.³⁹ In upholding the government's contention, the court noted that individual transactions could not be traced through the cash management system and, therefore, a FIFO assumption did not appear proper.⁴⁰ The court also stated that the facts created a situation envisioned as taxable by the statute.⁴¹

In *Ludwig v. Commissioner*,⁴² a U.S. citizen and resident obtained a bank loan to purchase 15% of Union Oil. In addition to the shares of Union Oil, the taxpayer pledged as collateral for the loan the shares of a wholly-owned Panamanian corporation, a CFC. Certain restrictions were placed on the assets and liabilities of the CFC.⁴³ The taxpayer argued that the CFC did not become a guarantor simply because its stock was pledged as collateral for

35. *Id.* §§ 951(a)(1)(B), 956.

36. 87 T.C. 548 (1986).

37. *Id.* at 558.

38. *Id.* at 572.

39. *Id.*

40. *Id.* at 573.

41. *Id.*

42. 68 T.C. 979 (1977).

43. *Id.* at 981-82.

a loan.⁴⁴ The government contended that the effect of pledging the CFC's stock was the same as a guarantee.⁴⁵ It relied on section 956(c), which states that a CFC is considered to hold "an obligation of a United States person if such controlled foreign corporation is a pledgor or guarantor of such obligation."⁴⁶ The Tax Court looked to the normal, everyday meaning of the term "guarantor" since the term was not specifically defined in the Internal Revenue Code or Treasury Department Regulations. To be a guarantor, there had to be (1) an undertaking or promise by the guarantor and (2) an obligation by the guarantor to make payment if the obligor failed to do so. Neither of these elements was present.⁴⁷ The court noted further that the CFC took no action and had no obligation to pay if the taxpayer defaulted on the loan. The purpose of the the loan agreement's negative covenants was to preserve the value of the CFC's stock, not to ensure that sufficient assets were available to satisfy a contingent claim.⁴⁸ Notwithstanding the favorable outcome for the taxpayer, the Internal Revenue Service has issued a regulation that, if upheld, would effectively override the decision in *Ludwig*.⁴⁹

Certain investments in the United States do not result in a constructive dividend. For example, any equity investment in and loans to unrelated parties are not "U.S. property." Similarly, property purchased for U.S. export, transportation property that is to be used outside the United States, U.S. government obligations, and U.S. bank deposits, among others, are safe investments.⁵⁰

B. *Passive Foreign Investment Companies*

For a U.S. multinational that succeeds in avoiding CFC status, the next obstacle to avoid is characterization as a passive foreign investment company (PFIC). Pursuant to the Tax Reform Act of 1986,⁵¹ any foreign corporation that meets either of the following tests is considered a PFIC: (1) at least 75% of the corporation's gross income during the current taxable year is passive income or (2) at least 50% of the average value of assets held during the current taxable year are passive assets.⁵²

Generally, passive income is equivalent to "foreign personal holding company income" as defined in Subpart F, which was previously discussed. However, passive income does not include dividends, interests, rents, and royalties received or accrued from a related party to the extent properly allocable

44. *Id.* at 988.

45. *Id.* at 984.

46. *Id.*

47. *Id.* at 985.

48. *Id.*

49. Treas. Reg. § 1.956-2(c)(2) (1981).

50. I.R.C. § 956(b)(2) (1988).

51. Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

52. I.R.C. § 1296(a) (1988).

to nonpassive income of the related party. Neither is income derived in the active conduct of a banking or insurance business considered passive income.⁵³

Because receipts from the sale of goods must be reduced by the cost of the goods to determine gross income, the 75% test is easier to meet than it might appear at first. Consider an offshore manufacturing company with gross receipts from sales of \$1,000,000, a gross profit ratio of 10%, and passive income of \$300,000. This corporation has gross income of \$400,000 ($(\$1,000,000 \times .10) + \$300,000$) and, therefore, meets the 75% test ($\$300,000/\$400,000 = 75\%$). The fact that the passive income is not reduced by any cost or expenses endows it with additional weight relative to the manufacturing income.

Passive assets are those that are held for the production of passive income or that produce passive income.⁵⁴ An example of the former is raw land held for investment.⁵⁵ Examples of the latter are tax-exempt securities, cash, and current assets readily convertible into cash. Thus, assets that constitute the working capital of an active business are, nonetheless, passive in nature. Nonpassive assets include depreciable property and real property used in a trade or business that produce nonpassive income, trade or service receivables derived in the ordinary course of a trade or business that produce nonpassive income, intangible assets that produce nonpassive income, and stocks and securities held for sale to customers in the ordinary course of business. Goodwill can be more problematic. It must be identified with an income-producing activity and categorized as passive or nonpassive based on the nature of that activity.⁵⁶

For purposes of the 50% test, assets are valued at the end of each quarter. The test is to be applied on a gross basis; liabilities secured by or traceable to assets are not considered. Notwithstanding the emphasis on fair market value, regulations will not necessarily mandate an independent appraisal.⁵⁷ Furthermore, the taxpayer can elect to measure assets by basis rather than value. Once made, however, the election applies to subsequent years and cannot be revoked without consent.⁵⁸ Manufacturers with valuable intangibles, such as patents and licenses, should exercise caution in making the election, particularly if these assets have low bases.

Any stock or option to acquire stock held by a U.S. person, either directly or indirectly, is treated as PFIC stock if the company meets one of the

53. *Id.* § 1296(b)(2).

54. *Id.* § 1296(a)(2).

55. Consider a foreign corporation that accumulates vast holdings of realty over a number of years and later subdivides and sells the land at substantial profits. It is not clear whether the land is converted from passive to nonpassive when subdivided and whether the sale of the subdivided tracts, therefore, generates nonpassive income.

56. I.R.S. Notice 88-22, 1988-1 C.B. 489.

57. *Id.*

58. See I.R.C. § 1296(a) flush language (1988).

tests discussed above at any time during the period the investor held the stock.⁵⁹ In other words, the PFIC stain can persist on the stock long after the foreign corporation has ceased to be a PFIC. Furthermore, and contrary to the CFC provisions, there is no stock ownership test with the PFIC. So, a foreign corporation meeting either the 75% income test or the 50% asset test is a PFIC, even if 99% of the stock is held by foreign investors. The U.S. investor owning the 1% interest is subject to the PFIC provisions. The lack of percentage ownership requirements, coupled with the either/or definition, means that the traditional deferral benefits on the offshore operating profits of many CFCs engaged in manufacturing, service, and trading businesses is seriously jeopardized.

Because Congress never intended for holding companies with active business subsidiaries to be subject to these provisions, a look-through rule was adopted. For purposes of performing the 75% income test or the 50% asset test, income generated and assets held by 25%-owned subsidiaries (considering both direct and indirect ownership) are treated as being held proportionately by the parent holding company.⁶⁰ To illustrate, assume that a Dutch holding corporation owns only two assets—a 40% equity share in a subsidiary valued at \$40,000 and a business asset valued at \$30,000. Absent the look-through rule, the foreign holding corporation meets the 50% asset test and, accordingly, is a PFIC. But because at least 25% of the subsidiary's stock is owned, the foreign holding corporation is treated as owning 40% of each asset owned by its subsidiary. Assume further that the subsidiary owns business assets valued at \$20,000 and passive assets valued at \$80,000. In this case, the foreign holding corporation is considered to own business assets valued at \$8,000 ($\$20,000 \times 40\%$) and passive assets valued at \$32,000 ($\$80,000 \times 40\%$). Note that the equity ownership in the subsidiary is ignored under the look-through rule, as are any dividends received on the stock. When added to the \$30,000 of business assets owned directly, the ratio of passive assets to total assets ($\$32,000/\$70,000$) is less than 50%. If the foreign holding corporation does not meet the 75% income test, it is not a PFIC.

Several exceptions act to prevent certain corporations from intentionally becoming PFICs. For example, start-up companies and corporations selling off a business can avoid PFIC status.⁶¹ Similarly, income from a bona fide banking business licensed to do business in the United States, income from a bona fide insurance business, and rental and royalty income from active businesses are not considered to be passive income.⁶² Further, any foreign investment company that made an election before 1963 to distribute at least 90% of its taxable income each year is exempt from the PFIC provisions.⁶³

59. *Id.* § 1297(a), (b)(1).

60. *Id.* § 1296(c).

61. *Id.* § 1297(b)(2)-(3).

62. *Id.* § 1296(b)(2).

63. *Id.* § 1296(d).

When a U.S. investor in a PFIC disposes of any stock investment (e.g., through sale or liquidation), the gain is allocated as ordinary income on a daily basis over the entire period that stock was held.⁶⁴ It does not matter that all of the gain, for example, actually accrued during the most recent taxable year. Furthermore, the statute authorizes the Treasury Department to issue regulations that tax otherwise nontaxable transfers of stock, including gifts and transfers at death.⁶⁵ Pledging the stock as security for a loan is treated as a taxable disposition.⁶⁶ Any gain allocated to prior taxable years is taxed at the maximum tax rate in effect for those years and interest at three percentage points above the Federal short-term rate is charged on these tax deferrals. The interest charge is deductible by a U.S. multinational payor. The sum of the deferred tax and the interest is the "deferred tax amount."⁶⁷ The general effect of the interest charge is to terminate the deferral benefit on corporate earnings, including profits that are not considered Subpart F income.

If the U.S. investor does not dispose of its stock, a so-called "excess distribution" can trigger the same procedure. An excess distribution is the difference between distributions received in the current taxable year and 125% of the average distributions received during the past three taxable years. In determining the average distribution for the prior three years, only the portion of a distribution received that is included in that year's gross income is considered. In other words, any excess distribution allocable to a post-1986 taxable year that precedes the distribution year is ignored when determining the average distribution from the prior three years.⁶⁸ The excess distribution is allocated over the investor's holding period, taxed at the maximum tax rate during prior years, and charged interest on the deferral. However, any portion of the excess distribution allocable to the current year or to periods before the later of January 1, 1987 or the first day of the first year the corporation became a PFIC is included in gross income during the current year. Similarly, that portion of the distribution that is not part of the "excess" is also gross income.⁶⁹ As an aside, no portion of any distribution from a PFIC is eligible for a dividend-received deduction.⁷⁰

To illustrate, suppose that on January 1, 1988, Domco, a U.S. corporation, acquired 100,000 shares of Forco, a PFIC. Both corporations use the calendar year for tax purposes. Forco made cash distributions to Domco as follows: \$10,000 on December 31, 1988, \$11,000 on December 31, 1989, \$12,000 on December 31, 1990, and \$15,750 on December 31, 1991. The excess distribution of \$2,000 ($\$15,750 - (1.25 \times \$11,000)$) in 1991 is allocated

64. *Id.* § 1291(a)(2).

65. *Id.* § 1291(f).

66. *Id.* § 1297(b)(6).

67. *Id.* § 1291(c).

68. *Id.* § 1291(b).

69. *Id.* § 1291(a)(1).

70. *Id.* § 245(a)(2).

over the four-year holding period of the stock. Thus, \$500 is allocated to each year from 1988 through 1991. Assume that the maximum tax rate each year is 34% and that the interest rate on tax underpayments is 10%. The \$1,500 allocated to the prior three years is taxed at 34% regardless of the actual marginal tax rate of Domco during the current or prior years. In 1991, Domco must add \$510 ($\$500 \times 34\% \times 3$) to its tax liability. The \$500 allocated to 1991 simply increases gross income, as does the \$13,750 portion of the distribution that is not considered "excess." In addition, Domco must pay an interest charge of \$102 ($(\$500 \times 34\% \times 10\% \times 3) + (\$500 \times 34\% \times 10\% \times 2) + (\$500 \times 34\% \times 10\% \times 1)$).

Creditable foreign taxes, including section 902 deemed-paid taxes, that are attributable to an excess distribution on PFIC stock (i.e., withholding or deemed-paid) are "excess distribution taxes." They are treated in a manner similar to the excess distribution. Accordingly, the excess distribution taxes are divided on a pro rata basis between the portion of the excess distribution that is included in gross income and the residual portion of the excess distribution that is used to determine the deferred tax amount. Creditable taxes attributable to the former are treated the same as other creditable taxes. To the contrary, creditable taxes attributable to the latter reduce the deferred tax amount.⁷¹

Any amount that is Subpart F income to a U.S. shareholder cannot be included in the gross income of the U.S. shareholder a second time under the PFIC provisions.⁷² Mere status as a CFC, however, does not prevent application of the PFIC provisions. The coordination rule applies only when the U.S. shareholders of a CFC report Subpart F income.⁷³ Thus, the earnings of a CFC with no Subpart F income are subject to the special PFIC provisions described below if the CFC is also a PFIC as a result of the asset or income test. Any Subpart F income of a CFC, however, is not subject to the PFIC provisions since it has already been taxed. Furthermore, the coordination rule does not preclude assets that generate Subpart F income or the Subpart F income itself from consideration when testing for PFIC status; it only protects the U.S. shareholders from double taxation.

For example, a CFC engaged in manufacturing activities abroad that invests its profits in a wholly-owned foreign investment company must consider the passive assets and the passive income of its subsidiary in determining its status as a PFIC. It does not matter that the subsidiary's income is foreign personal holding company income and, therefore, already currently taxable under Subpart F. As a result, the CFC is a PFIC, and the manufacturing profits of the CFC, though they escape Subpart F, are subject to the PFIC provisions.⁷⁴

71. *Id.* § 1291(g).

72. *Id.* § 951(f).

73. *Id.*

74. Rev. Rul. 87-90, 1987-2 C.B. 216.

Three possible strategies exist for avoiding similar predicaments. First, the multinational can reorganize so that the foreign investment company becomes the first-tier subsidiary and the manufacturing CFC becomes the second-tier subsidiary. Under this reconstruction, the assets and income of the foreign investment company are not considered owned or generated by the lower-tier manufacturing company and, therefore, are irrelevant in determining whether the CFC is a PFIC. However, any distribution of manufacturing profits to the first-tier investment company is divested of its deferral benefit. Second, the U.S. parent can infuse operating assets into the CFC. This action decreases the CFC's ratio of passive assets to total assets and, consequently, makes it less susceptible to surpassing the 50% passive asset threshold. Furthermore, the income derived from these operating assets decreases the CFC's ratio of passive income to total income, making it less likely that the 75% passive income limit will be exceeded.⁷⁵ A third possibility is to restructure so that the two foreign corporations become brother-sister related. The look-through rules are based solely on direct and indirect ownership rules.⁷⁶ Without constructive ownership rules, the assets and income of the brother investment company cannot be attributed to the sister manufacturing company.

C. *Foreign Personal Holding Companies*

Avoiding CFC and PFIC status does not necessarily mean that deferral paradise has been attained. The Internal Revenue Service has several other weapons in its arsenal to combat investments in tax haven countries, one of which is characterization as a foreign personal holding company (FPHC).

To be a FPHC, two tests must be met. First, more than 50% of the voting power or stock value of the foreign corporation must be concentrated, directly or indirectly, in the hands of five or fewer U.S. citizens or U.S. residents.⁷⁷ Complex constructive ownership rules operate to make the 50% test difficult to circumvent.⁷⁸ Second, at least 60% of the corporation's gross income must be derived from dividends, interest, royalties, annuities, net gains on stock and security transactions, net gains from commodity transactions, rents, and certain personal service contracts. Once FPHC status is achieved, the 60% gross income threshold drops to 50% in future years.⁷⁹

Special provisions that pertain to a foreign corporation that primarily derives income from rental activities or royalties enable such operations to avoid FPHC status.⁸⁰ But once a company is characterized as a FPHC, all U.S. shareholders are deemed to be in receipt of a taxable dividend equal to any FPHC income that has not been distributed, in much the same manner as

75. Bernardi, *The Stealth Bombing of CFCs by the PFIC Provisions: Tax Strategies after TAMRA*, 67 *TAXES* 365 (1989).

76. I.R.C. § 1296(c) (1988).

77. *Id.* § 552(a)(2).

78. *Id.* § 554.

79. *Id.* § 552(a)(1).

80. *Id.* § 553(a)(7).

are the U.S. shareholders of a CFC.⁸¹ Any amount that is Subpart F income to a U.S. shareholder cannot be included in the gross income of the U.S. shareholder a second time under the FPHC provisions.⁸² Similarly, any amount included in the gross income of a person under the FPHC provisions is not included in the gross income of that person under the PFIC provisions.⁸³

D. Personal Holding Companies

If a foreign corporation can successfully sidestep the CFC, FPHC, and PFIC provisions, there are yet two more obstacles to negotiate—the personal holding company (PHC) tax and the accumulated earnings tax. A PHC is any corporation, whether domestic or foreign, which meets both an income test and an ownership test. The income test is satisfied once PHC income reaches 60% of adjusted ordinary gross income.⁸⁴ The ownership test is met if more than 50% of the value of outstanding stock is owned (directly, indirectly, or constructively) by five or fewer shareholders at any time during the last half of the taxable year.⁸⁵

A 28% penalty tax is imposed on the undistributed personal holding company income of any PHC.⁸⁶ In the case of a foreign corporation, the penalty base includes only U.S. source income. If the corporation does not file a U.S. tax return, the U.S. source income cannot be reduced by deductions.⁸⁷ As is true of most penalties, this tax must be paid in addition to the regular corporate income tax. Fortunately, the penalty can be avoided by making sufficient dividend distributions to shareholders, even long after the taxable year has ended.⁸⁸ In light of the harshness of the penalty and the ability to retroactively avoid its caustic sting, the purpose of the penalty tax is clear: to force phlegmatic corporations to distribute earnings.

PHC income generally includes dividends, interest, manufacturing and marketing royalties, copyright royalties, net mineral royalties, annuities, net rental income, payments for the use of corporate property by 25% shareholders, and income under certain personal service contracts. It does not include gains from the sale or exchange of stock, securities, commodities, and foreign currency.⁸⁹ Adjusted ordinary gross income equals gross income less gains from the sale of assets held for investment or used in the business less expenses allocable to royalty income from mineral rights or rental income.⁹⁰

81. *Id.* § 551(a).

82. *Id.* § 951(d).

83. *Id.* § 551(g).

84. *Id.* § 542(a)(1).

85. *Id.* §§ 542(a)(2), 544.

86. *Id.* § 541.

87. Treas. Reg. § 1.545-1(b) (1968).

88. I.R.C. § 547 (1988).

89. *Id.* § 543(a).

90. *Id.* § 543(b)(2).

Special exemption rules pertain to some classes of income. For example, if the net rental income is at least 50% of adjusted ordinary gross income, and dividends paid exceed the non-rental personal holding company income as reduced by 10% of ordinary gross income, net rental income is not considered to be PHC income.⁹¹ Since surpassing this 50% rental threshold makes it mathematically impossible for the company to be a PHC, corporations primarily engaged in bona fide rental activities are not affected by the PHC tax.

The Internal Revenue Code explicitly states that any corporation subject to the FPHC or PFIC provisions during the taxable year cannot also be a PHC.⁹² The silence of the statute suggests, however, that the PHC tax can be applied to a corporation that is a CFC. Generally, the PHC tax does not apply to a foreign corporation if all of its outstanding stock is owned, directly or indirectly, by nonresident aliens during the last half of the taxable year.⁹³ Nevertheless, any foreign corporation that is obligated to perform services under a personal service contract may be subject to the penalty tax, despite the fact that all shareholders are nonresident aliens. In particular, the tax applies if: (1) at least 25% of the value of corporate stock is owned, directly or indirectly, by an individual who is designated by name or description in the contract or who may be designated by someone other than the corporation as the one to render services on behalf of the corporation or (2) income is derived from the sale of a contract described in (1) above.⁹⁴

E. Accumulated Earnings Tax

The accumulated earnings tax penalty is triggered whenever it becomes evident that a corporation has been formed or used for the purpose of unreasonably accumulating earnings and, thereby, avoids the income tax with respect to its shareholders.⁹⁵ The penalty is equal to 28% of accumulated taxable income.⁹⁶ The accumulated earnings credit allows corporations to accumulate \$250,000 (\$150,000 in the case of some service-oriented businesses) of earnings with no questions asked.⁹⁷

A foreign corporations also may be subject to this penalty if any of its stock is owned, directly or indirectly, by individuals who would be subject to U.S. taxation on a dividend received from the corporation, including nonresident aliens.⁹⁸ If a U.S. return is filed, accumulated taxable income includes the net profits of a foreign corporation that is from U.S. sources, as reduced by dividends paid and the accumulated earnings credit. If no U.S. return is

91. *Id.* § 543(a)(2).

92. *Id.* § 542(c)(5), (10).

93. *Id.* § 542(c)(7).

94. *Id.* §§ 543(a)(7), 545(d).

95. *Id.* § 532(a). Earnings can be accumulated to meet reasonable business needs. *Id.* §§ 535(c)(1), 537.

96. *Id.* § 531.

97. *Id.* § 535(c).

98. Treas. Reg. § 1.532-1(c) (1960).

filed (i.e., there is no effectively connected income), only U.S. source gross income is included in accumulated taxable income. In this latter case, no deduction or credit can be used to reduce the penalty base.⁹⁹ Although the tax cannot be imposed on a corporation subject to the PFIC, FPHC, or PHC provisions,¹⁰⁰ it can be applied to a corporation that is a CFC if, as noted above, the CFC has U.S. source income.¹⁰¹

A corporation may avoid the accumulated earnings tax if it demonstrates that tax avoidance was not the reason for its failure to pay dividends; rather, earnings must be accumulated for the reasonable or reasonably anticipated needs of the business.¹⁰² Reasonable needs may include expansion of business or product lines; replacement or relocation of plant facilities; acquisition of another business; retirement of bona fide indebtedness; stock redemption from estate of deceased shareholder; provision of daily working capital; necessary investments in or loans to major customers or suppliers; maintenance of reserves for reasonably anticipated product liability losses; funding of pension and profit-sharing plans; or self-insurance against loss of key personnel, casualties, litigation, and strikes.¹⁰³ Reasonable needs normally do not include loans to shareholders, family members and friends of shareholders, and related corporations engaged in a different business; the expenditure of corporate funds for the personal enjoyment or benefit of shareholders; investments in properties or securities with no relationship to the business of the corporation; and retention of funds to provide a buffer against unrealistic hazards.¹⁰⁴

IV.

NAVIGATING THE ANTI-HAVEN TAX SHOALS

Navigating around (or in some cases towards) the anti-haven tax shoals requires an integrative strategy. Exhibit 2 provides a simple comparison that may be used to formulate such a strategy. Note that if stock in the U.S. multinational is widely dispersed, its foreign subsidiary is not a FPHC or a PHC. Similarly, except in unusual cases, only closely-held companies need be concerned with the accumulated earnings tax, despite the statutory proclamation that the number of shareholders does not affect its application.¹⁰⁵ Thus, most U.S. multinationals must contend with only two of the five anti-haven tax shoals. Accordingly, this section focuses on integrative strategies to deal with the CFC and PFIC provisions of the Internal Revenue Code.

99. Treas. Reg. § 1.535-1(b) (as amended in 1972).

100. I.R.C. § 532(b) (1988).

101. *Id.*

102. *Id.* § 533(a).

103. *Id.* § 537; Treas. Reg. § 1.537-2(b) (as amended in 1986).

104. Treas. Reg. § 1.537-2(c) (as amended in 1986).

105. I.R.C. § 532(c) (1988).

A. Avoiding CFC Status

U.S. multinationals with foreign subsidiaries in low or zero tax jurisdictions often wish to defer income. If they are willing to reduce their equity ownership and voting power to 50% or less, CFC status is avoided. Although there are exceptions, schemes formulated to circumvent the 50% test without relinquishing actual control, once discovered by the Internal Revenue Service, rarely survive judicial scrutiny. The following court decisions are instructive, both as to what works and what does not.

In *Hans P. Kraus v. Commissioner*,¹⁰⁶ the voting power of a Liechtenstein corporation was split evenly between common shares and preferred shares. All of the common stock was owned by U.S. shareholders, but the preferred stock was owned by amicable third parties, none of whom were U.S. shareholders.¹⁰⁷ Thus, the statutory "more than 50%" criterion was averted. Drawing from Treasury Department Regulations, however, the court noted that the crux of the matter was the reality of voting power. The initial price of the preferred shares was incongruent with the true worth of one-half the business, suggesting that the outward appearance of ownership was only a facade.¹⁰⁸ From the beginning, preferred shareholders assumed a passive role in managing the business. Further, substantial restrictions were placed on the transferability of the preferred shares. A callable feature enabled the common shareholders to redeem preferred shares, if necessary, to secure more than 50% of the voting power and, thereby, favorably resolve any impasse.¹⁰⁹ All in all, the court was convinced that the U.S. shareholders never truly relinquished control of the corporation and held that it was a CFC.¹¹⁰

In a similar situation, the court in *CCA, Inc. v. Commissioner*¹¹¹ held for the taxpayer. All of the common stock of a Swiss corporation, but none of the preferred, was held by a U.S. shareholder. Again, exactly 50% of the voting power was vested in the common shareholder.¹¹² In this case, however, there were no express or implied arrangements or understandings that undermined the independence of the preferred shareholders. They were free to exercise their right to vote as they pleased and were active in corporate affairs, both as shareholders and as board members. No substantial restrictions were imposed on the transferability of the preferred stock that were not also applicable to the common stock.¹¹³ Notwithstanding the favorable outcome for the taxpayer, it should be noted that *CCA, Inc.* was decided before the 50% test was

106. 490 F.2d 898 (2d Cir. 1974).

107. *Id.* at 900.

108. *Id.* at 902.

109. *Id.*

110. *Id.* at 903.

111. 64 T.C. 137, 153 (1975), *nonacq.* 1982-1 C.B. 1.

112. *Id.* at 143.

113. *Id.* at 153.

EXHIBIT 2
COMPARISON OF FIVE ANTI-HAVEN ENTITIES

<u>Special Designations</u>	<u>Ownership Requirements</u>	<u>Income Requirements</u>	<u>Other Requirements</u>
Controlled Foreign Corporation (§ 957(a))	More than 50% of either voting power or stock value is owned by U.S. persons that own 10% or more of voting power	None	None
Passive Foreign Investment Company (§ 1296(a))	None	At least 75% of gross income is passive income	At least 50% of average value of assets generate passive income
Foreign Personal Holding Company (§ 552(a))	More than 50% of either voting power or stock value is owned by no more than five U.S. individuals	At least 60% of gross income is foreign personal holding company income	None
Personal Holding Company (§ 542(a))	More than 50% of stock value is owned by no more than five individuals	At least 60% of adjusted ordinary gross income is personal holding company income	None
Corporation Subject to Accumulated Earnings Tax (§ a532(a))	None	None	Formed or availed of to shield shareholders from federal income tax by accumulating rather than distributing income

expanded to include value and might have been decided differently under the current statutory construction.

In *Koehring Co. v. United States*,¹¹⁴ only 45% of the voting power in a Panamanian corporation was owned by a U.S. shareholder. The other 55% was owned by Newton Chambers (NC), an English corporation, that had a long-standing licensing agreement with the U.S. shareholder to manufacture and market construction equipment.¹¹⁵ Despite its control of a majority of

114. 583 F.2d 313 (7th Cir. 1978).

115. *Id.* at 315.

votes, NC never took an active role in the affairs of its subsidiary. In fact, the lower court determined its activities on the board of directors to be that of "sham directors."¹¹⁶ Furthermore, NC referred to both its investment in and its control over the Panamanian corporation as "nominal." The arrangements suggested that an implied agreement existed that vested effective control in the U.S. shareholder, despite the shortfall in stated voting power. If NC ever attempted to exercise its legal control over its subsidiary, moreover, the U.S. shareholder could "pull the rug" by canceling certain licensing agreements with NC.¹¹⁷ The court held that the reality of voting power was retained by U.S. shareholders and that the subsidiary was a CFC.¹¹⁸

The primary lesson of these cases is that the courts look beyond a mere mechanical calculation of voting power when there is sufficient evidence that the true voting power of the U.S. shareholder(s) exceeds 50%. Therefore, U.S. multinationals must be willing to effectively relinquish control to avoid CFC status. One way to accomplish this objective is to vest 50% of the voting power *and* value in the U.S. multinational and disperse the other 50% among non-U.S. shareholders (i.e., foreign parties and U.S. persons who own less than 10% of the voting power). Alternatively, the U.S. multinational might enter a joint venture with a foreign party, perhaps a close and trusted business associate. As indicated in the decisions above, neither implied nor expressed restrictions can be placed on the power to vote shares. Non-U.S. shareholders must act in their own interests. Nonetheless, transferability restrictions might pass muster if their only purpose is to prevent any U.S. party from obtaining actual or constructive ownership of 10% or more of the voting power.

B. *Seeking CFC Status*

As a result of the drastic decline in U.S. tax rates during the 1980s, the objective to defer income is not as prevalent as it used to be. The deferral benefit gradually dissipates as the foreign tax rate approaches the U.S. rate. When the foreign tax rate reaches or surpasses the U.S. rate, the deferral of income ceases to provide the traditional present value benefits. At that point, other facets of international tax planning, such as the optimal use of foreign tax credits, supplant the deferral objective. In this case, the U.S. multinational may want to steer towards rather than away from the anti-haven tax shoals. So the initial question that must be addressed, with sincere apologies to Shakespeare, is: "To be or not to be [a CFC]?"

To illustrate, assume that a U.S. multinational is considering a joint venture with a foreign corporation. According to the proposal, the two parties establish a foreign corporation in which each owns 50% of the stock and voting power. Thus, the subsidiary is not a CFC under U.S. law. Annual earnings are projected to be \$2,000 (i.e., \$1,000 for the U.S. multinational).

116. *Id.* at 322.

117. *Id.* at 321.

118. *Id.* at 314-15, 325.

Two countries are under review for possible incorporation. Foreign country A is a tax haven that imposes no foreign income tax. If selected, the deferral of U.S. taxes is a worthy goal solely for its present value benefits. As long as no distributions are made to the U.S. multinational, U.S. taxes on the foreign profits can be deferred indefinitely. Foreign country B, on the other hand, imposes a 55% tax. If U.S. taxes can be deferred, worldwide taxes on the profits attributable to the U.S. multinational consist entirely of foreign taxes, which are \$550. Without deferral, worldwide taxes are demonstrated to be the same. First, the U.S. multinational increases its taxable income by \$1,000, which is its share of after-tax profits (.5 (\$2,000) (1 - .55)) plus the section 78 gross-up for foreign tax paid (i.e., \$550) by the joint venture corporation. Second, the U.S. tax before credits of the U.S. multinational increases by \$340 ($\$1,000 \times .34$). Third, the U.S. multinational is deemed to pay \$550 in foreign taxes per section 902. Finally, the U.S. tax before credits is offset entirely with a \$340 foreign tax credit. Thus, foreign taxes remain at \$550 without any corresponding increase in U.S. taxes. The excess credit of \$210 ($\$550 - \340) is carried over.

If the joint ventures decide to incorporate in foreign country B, which has a 55% tax rate, the analysis above suggests that worldwide taxes are the same regardless of whether the U.S. multinational adopts a deferral or nondeferral strategy. Be that as it may, the foreign subsidiary is a "noncontrolled section 902 corporation."¹¹⁹ As a result, its excess foreign tax credit (i.e., \$210) is quarantined in a separate limitation basket and cannot be used currently or, without a change in tax rates, in the future to reduce U.S. taxes.¹²⁰

The attainment of CFC status, on the other hand, means that any deemed-paid taxes fall into the general foreign tax credit basket. This is a desirable outcome when the U.S. multinational has an overall excess foreign tax credit limitation before considering the foreign taxes paid by the joint venture corporation. For example, suppose that the U.S. multinational owns 100% of another CFC in a tax haven country. Its annual Subpart F income is \$600, none of which is subject to foreign taxation. The U.S. tax imposed on the \$600 is \$204 ($\$600 \times .34$), creating an excess foreign tax credit limitation of \$204. If the \$1,000 foreign profit from the subsidiary in foreign country B can be treated as Subpart F income, the U.S. multinational is entitled to claim a deemed-paid credit.¹²¹ Moreover, the excess limitation of \$204 can almost entirely absorb the excess credit of \$210.

A second foreign tax credit advantage is derived from attaining CFC status. Normally, passive income is subject to a separate limitation formula under section 904. When dividends, interest, rents, and royalties are received

119. I.R.C. § 904(d)(2)(E)(i) (1988).

120. *Id.* § 904(d)(1)(E).

121. *Id.* § 960(a).

from a CFC, however, a special look-through rule applies. Whether the passive income is allocated to a separate basket depends on the composition of the CFC's income.¹²² If, for example, the CFC's income is entirely from the conduct of an active business, then all of the passive income received from the CFC is subject only to the general section 904 limitation formula. The effect of this rule is that any foreign taxes withheld on this passive income are less likely to be limited by the section 904 restrictions.

How can this non-deferral strategy be implemented? Simply repatriating annual profits, though precluding deferral, is not effective in removing the foreign subsidiary in foreign country B from its classification as a "noncontrolled section 902 corporation." Instead, the proper strategy is to convert the foreign subsidiary into a CFC by increasing its voting power or equity ownership, however slight, above 50%. In many cases, an increase in equity ownership is more palatable to the foreign co-owner than an increase in voting power. One word of caution, however, must be given. The U.S. multinational should not depend on administrative law or prior judicial decisions, such as those mentioned previously, to contend that in substance, if not in form, there has been an increase in the reality of voting power. Good tax planning dictates that an actual increase take place.

But suppose that the foreign co-owner is unwilling to disturb the delicate balance in either equity or voting rights. In this case, the U.S. multinational may be able to acquire a nominal equity interest in the co-owner. The acquisition is particularly simple if the stock of the foreign co-owner is publicly traded in an established securities market. Indirect ownership rules can be used affirmatively to attribute a proportional interest to the U.S. multinational through the foreign co-owner.¹²³ For example, if the U.S. multinational acquires 2% of its co-owner's outstanding stock, it is treated as owning 51% of the foreign subsidiary (i.e., 50% directly plus 1% (.02 × .50) indirectly). As this one example suggests, there are numerous other means of attaining CFC status through the indirect and constructive ownership rules.

C. Investing in U.S. Property Assertively

U.S. multinationals with an excess foreign tax credit limitation may find some advantage in assertively investing their earnings in U.S. property. Suppose that a domestic parent with an excess limitation owns a CFC in a high-tax country. The CFC has substantial foreign earnings on which it has paid foreign taxes. The parent would like the use of the after-tax foreign earnings as well as credit for the foreign taxes paid. A direct distribution of the earnings will obtain a deemed-paid foreign tax credit for the U.S. parent.¹²⁴ A direct dividend, however, can trigger a foreign withholding tax, which may not be desirable. A better solution might be to indirectly repatriate the foreign

122. *Id.* § 904(d)(3).

123. *Id.* § 958(a)(2).

124. *Id.* § 902(a).

earnings through a loan or equity investment in the U.S. parent. This alternative can secure the deemed-paid credit without subjecting the remittance to withholding.¹²⁵ The loan is treated as a dividend payment for purposes of determining the deemed-paid credit, but only under the U.S. tax system. The foreign tax law in most cases will treat the transfer in keeping with its outward appearance. Accordingly, foreign withholding tax is normally avoided. In addition, a constructive dividend from an investment of earnings in U.S. property can avoid other host country restrictions such as exchange controls.

A direct loan to or equity investment in the U.S. parent from a second or lower-tier CFC organized in a low-tax jurisdiction can be used to bypass a first-tier CFC that is located in a high-tax jurisdiction. The loan is treated as a direct distribution from the second or lower-tier subsidiary directly to the U.S. parent.¹²⁶ In this way, foreign earnings can be brought onshore at the effective tax rate that will allow optimal use of foreign tax credits. This technique can be particularly appealing when foreign tax credits are about to expire.

Finally, consider a first-tier CFC with an accumulated deficit. A distribution from a second-tier CFC to the first-tier CFC followed by a distribution from the latter to the U.S. parent is not effective in obtaining a deemed-paid credit for foreign taxes paid by the second-tier CFC. This is because the first-tier subsidiary's denominator for the deemed-paid calculation (i.e., post-1986 undistributed earnings) is negative.¹²⁷ An investment by the second-tier CFC of its earnings in U.S. property, however, is treated as a constructive dividend that passes directly from the second-tier subsidiary to the U.S. parent. It bypasses the first-tier CFC and, therefore, preserves significant foreign tax credits.

D. Avoiding PFIC Status

If deferral of offshore profits is desirable and Subpart F can be circumvented, the next line of defense must be to avoid becoming a PFIC. Close monitoring of both assets and income are absolute necessities. A foreign corporation that ventures too close to the edge can be swept into the PFIC net, for example, by an unexpected decline in sales volume or an unexpected upsurge in the stock market. Similarly, service businesses with few assets (e.g., architectural, engineering, or construction firms) are particularly susceptible to PFIC status.

As a practical matter, the asset and income tests mean that indefinite deferral eventually must end for most foreign corporations that continue to operate as going concerns. That is, passive assets and income of a profitable

125. *Id.* § 960(a)(1).

126. *Id.* § 960(a)(1)(B), (C).

127. *Id.* § 902(a)(2).

foreign corporation eventually swell and trigger the PFIC provisions. Nonetheless, five strategies can prolong the deferral and, with some good fortune, perhaps avoid PFIC status altogether.

First, PFIC status can be avoided as long as foreign earnings are reinvested back into the business. This strategy might be appropriate for a foreign corporation that finds that its market for the goods or services it provides is continuing to grow. If expansion makes sense from a purely business perspective, it too can provide substantial deferral benefits. Alternatively, foreign earnings can be used to acquire a 25% equity interest in other corporations, whether domestic or foreign, engaged in active businesses. Ownership interests in subsidiaries that are presently just below the 25% threshold can be increased while those just above the 25% threshold can be maintained. As noted earlier, this level of investment triggers the look-through rule and can be utilized to avoid PFIC status. One caveat regarding this strategy is in order. Without a controlling interest, the investor is subject to the managerial whims of the majority owner. If the latter decides to sell all assets and invest the proceeds in marketable securities, for example, the look-through rule is neutralized.

Second, the foreign corporation can periodically distribute sufficient passive assets to avoid the two PFIC threshold tests. While this action terminates the deferral benefit on the earnings distributed, it preserves the deferral benefit from prior years, if any, on the earnings distributed. In addition, it continues the deferral benefit on earnings not yet distributed. Aphoristically, a bird in the hand is worth two in the bush.

Third, PFIC status can be avoided by selling stocks, securities, commodities, and other investment assets following significant tumbles in market values. The resulting losses can be used to reduce net gains from these assets, which is one source of passive income. Similar assets can be repurchased in the market almost immediately, but at a lower basis. If the investor has elected to measure assets by their bases, the lower cost basis means that the 50% asset test is less likely to be passed. Also, since the income test is an annual determination, passive assets with potential gains (i.e., passive income) can be sold during taxable years when the PFIC is not near the 75% threshold.

Fourth, retained earnings can be invested in non-income-producing assets to avoid satisfying the PFIC 75% asset test. Possible investments include raw land, gold or other precious metals, and growth stocks that do not pay dividends. True, these assets are still considered passive assets. But when the foreign corporation is not in danger of passing the 50% asset test (e.g., because of heavy investment in plant and equipment), this strategy can forestall the possibility of meeting the 75% income test. When these assets are sold later, of course, any gain will be passive income. Therefore, the timing of a later disposition should be considered carefully.

Fifth, manufacturing concerns and other businesses with substantial investments in depreciable assets might avoid PFIC status by replacing their plant and equipment a little sooner than might otherwise be warranted. This strategy increases the fair market value as well as basis of nonpassive assets. Any increased productivity that results from the replacements may lead to an increase in nonpassive income. In addition, cash financing of the replacements reduces passive assets and passive income.

E. Living with PFIC Status

A U.S. multinational that suddenly finds itself to be a PFIC can make an election to cleanse itself and start anew. Essentially, the taxpayer must recognize gain (but not loss) as if its entire PFIC stock were sold on the last day of the taxable year. A new basis and holding period accompanies the deemed-sale election.¹²⁸ In conjunction with this election, the astute investor should liquidate all passive investments and distribute the proceeds. In this way, the multinational obtains a fresh start and can stave off another action of this type for a longer period of time. This maneuver, however, does not avoid the payment of a deferred tax amount on the gain.

Apparently, a gift of PFIC stock does not remove the taint in most cases since the Internal Revenue Code provides that:

[s]tock 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.¹²⁹

The holding period of the donee includes the holding period of the donor only if the stock is later sold at a gain or if the stock's fair market value exceeded its adjusted basis at the time of the gift but the stock is nonetheless sold at a loss later.¹³⁰ Unless the PFIC stock's fair market value was less than its adjusted basis on the date of gift and the stock is later disposed of at a loss, the PFIC taint remains even though the foreign corporation has not satisfied either the asset or the income test since the time of the donation. It is unclear how intervening distributions of earnings to the donee must be treated when the status of the stock is not known until some future disposition. Presumably, inherited stock in a prior PFIC does not lose its PFIC taint since the holding period carries over to the beneficiary.¹³¹

128. Temp. Treas. Reg. § 1.1297-3T(a), (b)(3) (1988).

129. I.R.C. § 1297(b)(1) (1988) (emphasis added).

130. *Id.* §§ 1015(a), 1223(2).

131. Section 1291(e) applies the rules of § 1246(c)-(f) to the disposition of PFIC stock. *Id.* §§ 1291(e), 1246(c)-(f). According to the modification introduced by § 1291(e)(1), the beneficiary of a decedent's PFIC stock takes a basis equal to that held by the decedent just prior to death. Under § 1246(c), this basis is treated as a carryover basis. Accordingly, § 1297(b)(1) causes the PFIC taint to carry over. Presumably, the carryover basis rule is inapplicable to PFICs that have made a QEF election based on a literal reading of § 1291(d)(1). *Id.* § 1291(d)(1); see *infra* text accompanying notes 133-50.

Even when PFIC status cannot be avoided, there may remain some advantages over current taxation of profits. First, the deferral might be viewed as a low-interest loan by the U.S. Government. When cash is tight, the loan is particularly beneficial. Second, if tax rates increase, for example to 42%, allocation to prior years where the maximum rate is only 34% may prove beneficial, even after the interest charge. Some foreign corporations, in fact, could actively seek to qualify as a PFIC after a substantial tax rate increase to minimize the cost of its liquidation. Finally, consider whether a corporation that is already subject to the alternative minimum tax would feel any pain from the PFIC bite.¹³²

F. *Becoming a Qualified Electing Fund*

In some ways, the deferred tax rule seems to go well beyond the expressed purpose of the legislation, which was to achieve parity between direct passive investors and passive investors that utilize a foreign corporation.¹³³ For example, the excess distribution calculations ignore the fact that current earnings and profits may be negative. No consideration is given to earnings and profits in prior years either. A PFIC may have experienced a loss during each of its prior years that correspond with the investor's holding period; nevertheless, the maximum corporate rates are applied.¹³⁴ If the PFIC's profit is low in early years and high in later years, the allocation procedure apportions too much profit to earlier years, bloating the interest charge. At the shareholder level, the deferred tax amount becomes a liability even if the shareholder has an overall loss for the year and capital gain treatment is denied on excess distributions. Furthermore, any actual or deemed distributions received from a CFC/PFIC are denied look-through treatment for purposes of the foreign tax credit limitation. Accordingly, such distributions are poured into the passive income basket.

One solution to these objections is to make an election to treat the PFIC stock as stock in a qualified electing fund (QEF).¹³⁵ This election is made by the investor, not the PFIC. Nonetheless, the election must be ratified by the PFIC and, depending on yet-to-be-issued regulations, obligates the PFIC to disclose certain ownership and financial data. Many foreign corporations with U.S. minority shareholders are not eager to reveal such information and, accordingly, can be expected to withhold ratification.¹³⁶

132. A literal reading of § 1291(a)(1)(C) suggests that the deferred tax amount is imposed in addition to any alternative minimum tax liability. *Id.* § 1291(a)(1)(C).

133. H.R. REP. NO. 426, 99th Cong., 1st Sess., pt. 5, at 408 (1985).

134. For a discussion of the constitutionality of taxing a distribution in the absence of earnings and profit, see Rubinfeld & Rubin, *Passive Foreign Investment Companies: The Pentapus Becomes the Sextapus, Or Does It?* 36 TAX NOTES 199, 206 n.58 (1987). The authors contend that such a distribution is a return of capital, not income.

135. I.R.C. § 1295(a)(1) (1988).

136. *Id.*; I.R.S. Notice 88-125, 1988-2 C.B. 535.

Once made, the election applies to all subsequent taxable years unless revoked with consent.¹³⁷ An election made under the erroneous assumption that the foreign corporation is a PFIC, however, is null and void.¹³⁸ The election requires a U.S. person to report a proportionate share of the PFIC's current ordinary earnings and net capital gain as income each year.¹³⁹ A special rule permits the U.S. multinational to look through the PFIC to its underlying income for purposes of the separate foreign tax credit baskets.¹⁴⁰ Without this rule, income reported as a result of the QEF election would be assigned to the passive income basket.

Contrary to the treatment of current earnings, a current loss or earnings deficit is not permitted to flow through. Foreign corporations with sizeable losses should consider restructuring, perhaps in partnership form, to obtain the deduction benefits. Moreover, current earnings are not reported until distributed if the QEF is a CFC, the investor is a 10% U.S. shareholder, and the current earnings are subject to a foreign effective tax rate greater than 90% of the top U.S. statutory rate (i.e., 30.6%). Similarly, U.S. shareholders of CFCs that have elected to be QEFs are not required to currently report U.S. source income that is effectively connected with a U.S. trade or business unless it is exempt or subject to a reduced tax rate pursuant to a U.S. treaty.¹⁴¹

Although most deferral benefits are forfeited, this procedure does avoid the allocation of excess distributions and gains from sale over the investor's holding period. Avoiding deferred tax is particularly appealing when rates have decreased during the holding period or when the investor was not subject to the maximum tax rate specified in the statute during his entire holding period. In addition, interest charges and deferred tax payments are eliminated.¹⁴² Moreover, capital gains are preserved, which can be particularly valuable when the investor is carrying forward a large capital loss or when lower capital gains rates are restored.¹⁴³ Stock in a QEF is increased for any amount reported as income and decreased by any amount distributed that was previously taxed.¹⁴⁴

Consider the foreign corporation that generates little or no recognized income each year. Perhaps the corporation holds raw land for investment purposes, maybe with standing timber or valuable mineral deposits. A QEF election actually safeguards the deferral benefit in this case. Since there is no current income, the QEF makes no constructive distribution. When the land is exploited or sold, the full gain is recognized currently without deferred tax and interest charges. Moreover, the capital or section 1231 nature of any gain

137. I.R.C. § 1295(b)(1) (1988).

138. I.R.S. Notice 88-22, 1988-1 C.B. 489.

139. I.R.C. § 1293(a) (1988).

140. *Id.* § 904(d)(3)(I).

141. *Id.* § 1293(g)(1).

142. *Id.* § 1291(d)(1).

143. *Id.* § 1293(a)(1)(B).

144. *Id.* § 1293(d).

is preserved. To be effective, however, the QEF election may need to be accompanied by a mark-to-market election, which will be discussed later.

U.S. persons that buy into a PFIC and opt to make the QEF election should ascertain whether the prior owner of the stock also had a QEF election in effect. If so, the present owner should request a prior history of income inclusions to avoid paying tax on amounts previously taxed but undistributed.¹⁴⁵ Unless earnings are reportable under Subpart F or under the FPHC provisions, QEF investors that are unable to pay the tax liability on amounts not yet received can elect annually to defer payment until earnings are distributed. Loans to a QEF investor and pledges or guarantees by the QEF of loans by third parties to the investor are treated for this purpose as distributions of earnings. This election is considered an extension of time to pay tax. Accordingly, the investor is charged interest and may be required to post a bond for payment.¹⁴⁶

Finally, a QEF can make a mark-to-market election to stop the running of interest.¹⁴⁷ The election is unnecessary when the QEF election has been in effect for the investor's entire holding period of the PFIC stock. However, when the stock has been held for a period of time before the QEF election is made, the prior years' earnings are still subject to the normal PFIC rules. When distributed or when the PFIC stock is sold, any excess distribution carries deferred tax and interest charges.¹⁴⁸ The mark-to-market election, on the other hand, permits the taxpayer to determine the fair market value of the stock at the time of the QEF election. The PFIC stock is treated as though sold at this fair market value and receives a stepped-up basis and a new holding period.¹⁴⁹ However, no loss can be recognized if the basis of the PFIC stock exceeds its fair market value.¹⁵⁰

V.

OFFSHORE COMPANIES—WHO'S AFLOAT AND WHO'S NOT

Always ravenous for revenue, Congress seems to have a suspicion against big business in general and offshore operations in particular. As a result, tax deferrals on the unrepatriated earnings of U.S. multinationals, though not yet totally extinct, are on the endangered species list. A comparative analysis between the United States and other developed nations suggests that our global competitiveness may suffer as a result.

[T]he United States has reached farther and farther into the foreign operations of its multinationals, imposing increasing tax burdens and administrative complexities. This continuing effort to bring more foreign revenues into the net of current taxation . . . represents an overreaching policy and implementation of

145. *Id.* § 1293(c).

146. *Id.* § 1294; Temp. Treas. Reg. § 1.1294-1T (1988).

147. I.R.C. § 1291(d)(2)(A) (1988); Temp. Treas. Reg. § 1.1291-10T(a) (1988).

148. I.R.C. § 1291(a)(1)-(2) (1988).

149. *Id.* § 1291(d)(2)(A), (C); Temp. Treas. Reg. § 1.1291-10T(e) (1988).

150. I.R.C. § 1291(d)(2)(A) (1988); Temp. Treas. Reg. § 1.1291-10T(b)(1) (1988).

global tax jurisdiction. As a result, the United States subjects the foreign operations of its multinationals to the severest tax constraints and the heaviest tax burden of any of the four countries studied United States multinationals are disadvantaged by home country tax costs to a far greater degree than are any of their competitors in the other three countries. The Netherlands has no Subpart F type taxation. In Germany and Japan it is far less broad in scope and complexity than the United States provisions and contains many exceptions. Overall, the application is far less onerous than in the United States.¹⁵¹

Notwithstanding this continual drift toward Subpart F restrictions (not to mention the PFIC legislation), the coveted but recently illusive tax deferral can be procured by U.S. multinationals willing to ply the mine-strewn harbors according to the strict prescripts of the tax law. Below, specific obstacles and opportunities for companies involved in offshore manufacturing, trading, service, banking, and holding activities are discussed. Some of these companies are still afloat, despite the recent rash of anti-haven legislation. Other businesses, notably banking, were struck broadside and, if not completely submerged, are taking on water fast.

A. Offshore Manufacturing Companies

Offshore manufacturing subsidiaries established in low-tax countries can obtain substantial deferral benefits by avoiding PFIC status and, if not avoiding CFC status, minimizing Subpart F income. Because the gross income from manufacturing activities is determined by subtracting the cost of goods manufactured from net sales, the typical manufacturing company is more susceptible to the 75% gross income test than would be, for example, a service company in which gross income would be synonymous with gross receipts. Notwithstanding this observation, manufacturing activities often require a significant investment in plant and equipment, which can delay failure of the 50% asset test for some time. In short, a reasonable dose of precaution and advanced planning can forestall the PFIC specter for several years. Accordingly, the avoidance of Subpart F income (more particularly, foreign base company sales income) is the initial concern of offshore manufacturing companies with a deferral objective.

There are at least two ways for a CFC to generate profits that are not foreign base company sales income. First, the manufacturer can sell to a party who plans to use, consume, or dispose of the product within the country where the CFC is organized. Note that title passage is irrelevant. Whether a product is consumed, used, or disposed of within a country cannot always be known with certainty by the seller. Therefore, a destination rule controls. Sales shipped to some point within the company's base country are presumed to be consumed, used, or disposed of within the country. This presumption is negated when the seller knows or should know that, contrary to its destination, the product is not consumed, used, or disposed of within the country.

151. ARTHUR YOUNG & COMPANY, *THE COMPETITIVE BURDEN: TAX TREATMENT OF U.S. MULTINATIONALS* 2-3, 11 (1987).

For sales to related parties, the presumption takes an about-face. Unless there is sufficient evidence to the contrary, products sold to related parties are presumed to be consumed, used, or disposed of outside the base country.¹⁵²

The second means of minimizing foreign base company sales income is to manufacture, produce, grow, or extract ("manufacture") the product within the base country. Suppose that a U.S. multinational wants to establish manufacturing operations abroad and sell in three countries. Establishing operations in any one country means that sales to customers in the other two generate foreign base company sales income. As an alternative, the multinational can consider establishing manufacturing plants in each of the three countries. In this way, none of the sales produce Subpart F income. The feasibility of this alternative course, among other things, hinges on a comparison between (1) the tax savings and reduced distribution cost and (2) the increased costs of constructing and maintaining three small operations rather than one large plant.

Substantially transforming a product so that raw materials are sufficiently distinguishable from the finished goods (i.e., the appearance test) constitutes manufacturing activities. For example, the transformation of steel rods into screws and bolts is manufacturing. A safe haven rule considers products to be manufactured if the conversion costs (i.e., direct labor and overhead) are at least 20% of the total cost of the goods when sold. Finally, any operations on a component part that are substantial in nature and are generally considered to be manufacturing are conceded to be manufacturing. Component parts that require only minor assembly are not considered manufactured. Neither are mere packaging, repackaging, or labeling considered to be manufacturing activities.¹⁵³

*Dave Fischbein Manufacturing Co. v. Commissioner*¹⁵⁴ is particularly instructive in showing how to demonstrate that manufacturing has occurred. The taxpayer was a domestic corporation engaged in the manufacture of bag-closing equipment. It sold component parts of this equipment to its wholly-owned Belgian subsidiary.¹⁵⁵ The component parts (283 parts in total) were assembled in Belgium. Each finished unit required six hours of labor and fifty-eight separate steps. There were two business reasons for buying component parts rather than the finished product. First, tariffs and quotas of the European Common Market could be avoided if a certificate of Belgian origin could be obtained. Second, labor and overhead costs were cheaper in Belgium. Upon assembly, the subsidiary sold the finished bag-closing equipment to distributors throughout Europe and Africa.¹⁵⁶ As noted above, foreign base company sales income does not include income from the sale of a product

152. I.R.C. § 954(d)(1)(B) (1988); Treas. Reg. § 1.954-3(a)(3) (as amended in 1983).

153. I.R.C. § 954(d)(1)(A) (1988); Treas. Reg. § 1.954-3(a)(4) (as amended in 1983).

154. 59 T.C. 338 (1972).

155. *Id.* at 339.

156. *Id.* at 349.

manufactured or produced within the country of incorporation, here Belgium. The taxpayer insisted that a substantial transformation or, at the least, major assembly had occurred.¹⁵⁷ The Tax Court agreed.¹⁵⁸ Though the component parts were not sufficiently different from the finished bag-closing equipment to constitute a substantial transformation, the time-consuming, fifty-eight step operation was substantial and generally considered to be manufacturing. The operation was neither minor nor insignificant. The transformation required trained personnel, proper equipment, and proper testing of the finished product.¹⁵⁹

In addition to the possibilities noted above, agricultural commodities that are not grown within the United States in quantities that are commercially marketable do not produce foreign base company sales income. These commodities include bananas, black pepper, cocoa, coconut, coffee, crude rubber, and tea. Thus, a tax haven corporation that raises or purchases these crops can sell them at a profit that does not result in Subpart F income, even if the sale is outside the haven country and the crops are raised outside the haven country.¹⁶⁰ A CFC that sells rubber to a tire manufacturer in the Far East, for example, would not derive Subpart F income from this activity. Similarly, a CFC that purchases coffee beans from Brazil on behalf of its domestic parent for processing in the United States does not have foreign base company sales income.

Recall that the U.S. Government seeks to tax the CFC's earnings only when no significant business reason appears to exist for basing operations in the particular foreign country. When neither sales nor manufacturing takes place in the base country, it is presumed that the real reason for selecting the country is to avoid taxes, and, therefore, Subpart F applies. Sales within the base country and sales of goods manufactured within the base country circumvent Subpart F and, with careful PFIC planning, can generate substantial tax deferred profits.

157. *Id.* at 355.

158. *Id.* at 360.

159. *Id.* In a similar case, the process of harvesting timber, trimming limbs, cutting to desired lengths, and shipping was held to be substantial in nature and generally considered to be production. Though considered in the context of the DISC regulations, the definition of manufacturing is the same for DISCs as it is under Subpart F. *Webb Export Corp. v. Commissioner*, 91 T.C. 131, 148 (1988). A DISC is a domestic corporation that meets the following requirements during the taxable year: (a) at least 95% of its gross receipts are from qualified export transactions; (2) the adjusted basis of its assets used in qualified export activities constitute at least 95% of the adjusted basis of its total assets at year end; (3) it has only one class of stock authorized; (4) the par or stated value of its outstanding shares is \$2,500 or more on each day; (5) a timely election has been made to be a DISC; and (6) the corporation is not a member of a controlled group that includes a foreign sales corporation. I.R.C. § 992(a)(1) (1988).

160. I.R.C. § 954(d)(1) (1988); Treas. Reg. § 1.954-3(a)(1) (as amended in 1983).

B. Offshore Trade Companies

Unlike manufacturing operations, offshore trade companies do not produce anything. A trade company is essentially an international intermediary that sells goods produced by some other party, either related or unrelated. A trade company can be used when sales are made to several different countries with different tax systems. With no permanent establishments in these countries, the complexity and administrative inconvenience of complying with foreign tax laws can be avoided.

Since most trade companies have fewer assets than the typical offshore manufacturing activity, the 50% asset test for PFIC status is a more serious threat to deferral for the former. Subpart F, however, may be a less serious concern since transactions involving unrelated parties do not trigger a constructive dividend. Therefore, when the purchase of raw materials or components is not from a related entity (e.g., an unrelated licensee) and the sale of the finished product is not to a related entity, the CFC can retain its earnings with no Subpart F implications.¹⁶¹ But in many cases the dividend is not so easily avoided by offshore trading companies since the U.S. parent corporation is likely to be the major supplier of goods for sale. Under these arrangements, the U.S. parent might consider dispersing ownership to avoid CFC status.

C. Offshore Service Companies

As long as no substantial assistance is furnished by a related party, CFCs do not generate Subpart F income when they perform services for or on behalf of an unrelated party.¹⁶² To illustrate, consider D, a domestic corporation, and its wholly-owned foreign subsidiary, F corporation. F contracts with a foreign party to construct a dam and D acts as guarantor on the contract. The necessary equipment and materials to complete this task are partially bought and partially leased from D at arm's length. The technical and supervisory services are performed by full-time employees of F. The clerical and accounting services are performed by full-time employees of D. F pays D for these services at arm's length. Since the services rendered by F are not performed for or on behalf of D, and the services rendered by D do not directly assist F in its task, the income received by F for constructing the dam is not foreign base company services income.¹⁶³

Even when services are performed for or on behalf of a related party, however, no Subpart F income results if the services are rendered within the CFC's country of incorporation. Services are considered performed wherever the individuals rendering the services are physically located at the time.¹⁶⁴

161. I.R.C. § 954(d)(1), (3) (1988); Treas. Reg. § 1.954-1(e)(1) (as amended in 1983).

162. I.R.C. § 954(e)(1)(A) (1988); Treas. Reg. § 1.954-4(b)(1)(iv), (2) (as amended in 1983).

163. Treas. Reg. § 1.954-4(b)(3) examples (3)-(4) (as amended in 1983).

164. Treas. Reg. § 1.954-4(c) (as amended in 1983).

When products are mailed to the CFC for repair or refurbishment, for example, income from this activity is not foreign base company services income. Similarly, income from professional services that are rendered partly within and partly without the CFC's country is partially exempt from Subpart F.

Notwithstanding the ability to circumvent Subpart F, the paramount obstacle for offshore service companies with a deferral objective is to avoid the 50% asset test for PFIC status. As noted earlier, this test presents a Solomonic challenge for businesses with few business assets. Absent the possibility of depositing profits in a 25%-owned subsidiary that is actively engaged in a business, many service companies quickly become PFICs.

D. Offshore Holding Companies

Since many tax haven countries have lax or no exchange controls, an offshore holding company can be incorporated in one of these locales to coordinate and streamline the treasury function of overseas operations. Taking profits out of countries with strict exchange controls or monetary instability reduces risk and increases flexibility. In addition, holding companies can sometimes be used to secure treaty benefits not otherwise available. For this reason, U.S. multinationals doing business in Europe often establish offshore holding companies in the Netherlands.

Among other things, treaties can be used to reduce the withholding tax on various remittances. Today, however, many countries are busy amending or renegotiating treaties to prevent their use by non treaty parties. But even without a specific anti-abuse article, the use of a holding company solely for its tax benefits should be approached very carefully, as the following case illustrates.

In *Aiken Industries, Inc. v. Commissioner*,¹⁶⁵ *Compania de Cervezas Nacionales (CCN)*, an Ecuadoran corporation, made a loan to *Mechanical Products, Inc. (MPI)*, a U.S. corporation, and took back a promissory note. CCN (the obligee) and MPI (the obligor) were brother-sister corporations.¹⁶⁶ Because the United States did not have a treaty with Ecuador, CCN established *Industrias Hondurenas S.A. de C.V. ("Industrias")*, a Honduran corporation, and transferred MPI's note to *Industrias* in return for promissory notes in the same principal amount, with the same maturity date, and with the same annual interest rate. The taxpayer contended that the interest payments from MPI to *Industrias* were exempt from the statutory 30% withholding requirement because the U.S.-Honduras income tax treaty exempts the interest.¹⁶⁷ The government argued that the existence of *Industrias* should be ignored and that the true owner of the interest was CCN.¹⁶⁸ In holding for the government, the Tax Court noted that the interest payments were not "received

165. 56 T.C. 925 (1971).

166. *Id.* at 926.

167. *Id.* at 931.

168. *Id.*

by” an entity in Honduras as required by the treaty.¹⁶⁹ In using this phrase, the treaty envisioned more than mere temporary, physical possession. Receipt of interest implies that the recipient has complete control and dominion over the disposition of the funds. Moreover, the indebtedness in this case lacked a bona fide, non tax business purpose.¹⁷⁰

Indirect ownership rules insure that the use of an offshore holding company does not shield the tainted income or “excess distributions” of second and subsequent-tier foreign subsidiaries from the Subpart F¹⁷¹ or PFIC provisions.¹⁷² Moreover, dividends and interest from lower-tier subsidiaries to an offshore holding company are considered to be foreign personal holding company income to the latter.¹⁷³ An exception applies, however, when dividends and interest are received from a lower-tier subsidiary that is organized in the same country as the holding company when a substantial portion of the lower-tier subsidiary’s assets (e.g., 80%) is used in a trade or business operating in the same country. Such remittances are not foreign personal holding company income.¹⁷⁴ The narrowness of this exception means that dividends and interest received by offshore holding companies from related parties are generally Subpart F income.

Most offshore holding companies meet the 50% asset test, the 75% income test, or both and, accordingly, are PFICs. Since the application of Subpart F to the remittances precludes application of the PFIC provisions,¹⁷⁵ however, the latter are often of little consequence to an offshore holding company. But when the remittances are received from a lower-tier subsidiary organized and doing business in the same foreign country, the PFIC provisions would operate to extinguish the deferral benefit.

E. Offshore Banking Companies

There are several legitimate reasons why a U.S. multinational might establish an offshore bank. Banking regulations in several tax haven countries have lower reserve requirements than permitted in the United States. In addition, an offshore bank can provide access to foreign currencies with little or no exchange controls, which facilitates the transfer of funds across national borders and the conduct of international commerce. Third, an offshore bank or finance subsidiary can be used to finance deals with a U.S. multinational’s foreign customers or distributors. Although most offshore banks are in the Bahamas and the Cayman Islands, Bahrain, Bermuda, Hong Kong, Panama, and Singapore also have their share.

169. *Id.* at 933.

170. *Id.* at 934. For similar holdings, see Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383.

171. I.R.C. § 951(a)(1) (1988).

172. *Id.* § 1297(a), (b)(5).

173. *Id.* § 954(c)(1)(A).

174. *Id.* § 954(c)(3)(A)(i); Treas. Reg. § 1.954-2(e)(1) (as amended in 1983).

175. I.R.C. § 951(f) (1988).

Unfortunately, offshore financial institutions are sometimes used for illegitimate reasons such as laundering money from narcotic trafficking, shrouding the identity of security traders using inside information, and hiding untaxed profits from the Internal Revenue Service. These illegal uses often depend on bank and commercial secrecy laws for their success. Recently, in an effort to penetrate these secrecy laws, the U.S. Treasury Department has vigorously negotiated information exchange agreements. The Caribbean Basin Initiative is one example of its efforts.¹⁷⁶ Caribbean countries willing to provide information on illegal activities of U.S. parties become eligible sites for tax-deductible foreign conventions.¹⁷⁷ In addition, island nations that agree to exchange information are qualified locales for foreign sales corporations¹⁷⁸ and acceptable investment receptacles for the profits of possession corporations.¹⁷⁹

Most profits of offshore banking companies are not eligible for U.S. deferral benefits. Generally, interest income is considered to be foreign personal holding company income under Subpart F. Exceptions are made for export financing interest derived in the conduct of a banking business and, as noted earlier, interest income from related parties organized and operating in the same country as the offshore bank.¹⁸⁰ In addition to these restrictions on deferral, any foreign taxes paid on the income derived from an offshore banking or financing business, other than certain export financing interest, is allocable to a separate limitation basket.¹⁸¹

VI.

CONCLUSION

An examination of foreign tax laws is essential to a U.S. multinational doing business abroad. Substantial tax dollars can often be saved by establishing offshore entities in low-tax jurisdictions, sometimes referred to as tax havens. International tax objectives, however, cannot be based solely on foreign laws. To minimize the aggregate of worldwide taxes, the U.S. implications of any tax strategy must be carefully considered. Particular attention must be paid to those provisions of the Internal Revenue Code that are intended to prevent or discourage tax deferrals.

In the right circumstances and with careful advance planning, substantial deferral benefits still can be procured by some U.S. multinationals, even after the Tax Reform Act of 1986. Generally, any tax deferral strategy demands that the subsidiary be established abroad in a low-tax jurisdiction. Congress has created five major obstacles, however, that act to thwart many

176. Caribbean Basin Economic Recovery Act of 1983, 19 U.S.C. §§ 2701-2706 (West Supp. 1991).

177. I.R.C. § 274(h)(6) (1988).

178. *See id.* § 927(e)(3).

179. *Id.* § 936(d)(4).

180. *Id.* § 954(c)(2)(B), (3)(A)(i).

181. *Id.* § 904(d)(1)(C), (2)(C)(iii).

attempts to defer income through the use of tax havens. Avoidance of these impediments requires an integrative strategy; since the Internal Revenue Service can use any one of the five to deny deferral benefits, they must all be considered. Practically speaking, however, the two major obstacles to avoid are classification as a CFC and classification as a PFIC.

A CFC is a corporation organized outside the United States that has more than 50% of either its voting power or value held by U.S. shareholders. The Subpart F income of a CFC is treated as a constructive dividend to U.S. shareholders. Further, any indirect repatriation of foreign earnings such as a loan to or investment in U.S. shareholders is treated as a constructive dividend to them. U.S. shareholders, for this purpose, include all U.S. individuals and entities that own at least 10% of the foreign corporation's voting power.

Avoiding CFC status usually means that the U.S. shareholders must disperse ownership. Devices and strategies that seek to avoid CFC status without relinquishing bona fide control seldom survive judicial review. But classification as a CFC per se does not necessarily mean that the deferral of overseas profits is lost, as long as the earnings are not considered Subpart F income. Subpart F income is derived from many diverse types of business and investment activities, but generally includes income that has little connection with the country where the CFC is organized.

Instead of pursuing a deferral objective, the international strategic plans of some multinationals today emphasize other goals such as the optimal utilization of excess foreign tax credits. Ironically, traditional thinking that called for avoiding CFC status must sometimes be discarded if this is the primary goal. Actively pursuing and achieving CFC status can often release foreign tax credits that would otherwise expire. When successful, the impact on the bottom line is immediate and often substantial. For example, increasing voting power or ownership of stock value above the 50% threshold removes a foreign subsidiary from its classification for foreign tax credit purposes as a "noncontrolled section 902 corporation." This action also can decrease the amount of income derived from the foreign subsidiary that must be placed in the passive income limitation basket. Similarly, a CFC can enjoy substantial deemed-paid foreign tax credits by purposely increasing the amount of its earnings invested in U.S. property (e.g., by loaning funds to its domestic parent).

The second major obstacle to any deferral strategy is the PFIC provisions of the Internal Revenue Code. A foreign corporation is a PFIC if 75% or more of its gross income is from passive sources or if 50% or more of its assets are passive in nature. U.S. investors that dispose of PFIC stock or that receive so-called "excess distributions" from a PFIC are subject to deferred tax and interest charges. The effect of these payments is to retroactively deny the benefits of U.S. tax deferrals.

Careful monitoring of income and assets coupled with actions that forestall attainment of the 75% and 50% thresholds can postpone PFIC status

and thereby prolong the deferral benefits for several years. Nevertheless, classification as a PFIC is not something to be shunned in all cases. A dramatic increase in U.S. tax rates, for instance, might encourage some multinationals to actively seek PFIC status for their foreign subsidiaries that they plan to terminate. This action could actually reduce the tax cost of liquidation. Finally, the QEF election can be used to avoid some of the potential inequities that result from PFIC status.

The plentiful and virulent anti-deferral weapons of the Internal Revenue Service spell the end to significant deferral benefits for most offshore companies involved in service, trade, holding, or banking activities. U.S. multinationals engaged in these business pursuits abroad, at least with respect to deferral strategies, have already run up the white flag. Even offshore manufacturers must respect the impressive promenade of anti-deferral weapons; only by careful navigation can they avoid running aground.