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Comparative Analysis of Systems of Domestic Taxation of Controlled Foreign Corporations

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NOTES

COMPARATIVE ANALYSIS OF SYSTEMS OF DOMESTIC TAXATION OF CONTROLLED FOREIGN CORPORATIONS

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I. INTRODUCTION

The domestic taxation of the controlled foreign corporation (CFC) has received considerable attention in recent years and has been the subject of extensive legislation in economically developed nations.[1] The United States has long recognized the need for

1. The establishment of foreign corporations or foreign subsidiaries is often necessary to facilitate international operations, because domestic corporations are generally fully taxable on their current worldwide income. In the absence of specialized legislation, such foreign entities are beyond the taxing jurisdiction of the parent corporation's home country, allowing domestic shareholders to defer or avoid taxation on the earnings of the foreign corporation. The general scheme of avoiding tax through the CFC involves the accumulation of substantial profits in the low tax foreign jurisdiction through inter-company pricing arrangements, transfer of patent licensing rights, and shifting of management fees, in order to avoid higher domestic rates.

comprehensive legislation directed against tax avoidance accomplished through the use of domestically-controlled foreign corporations.[2] Until 1962, this type of tax avoidance was attacked primarily through general tax laws, such as income reallocation and personal holding company provisions, and through piecemeal statutory provisions directed at specific avoidance schemes utilizing foreign companies, such as the foreign personal holding company provisions. In 1962, Congress enacted the Subpart F provisions[3] of the Internal Revenue Code (Code) which require attribution of certain types of income earned by a CFC to its United States shareholders, regardless of whether such income is distributed. Since the United States adopted the Subpart F provisions, a number of other economically developed nations have enacted measures directed against CFC's whose only purpose is to avoid domestic taxation.

This Note outlines the existing law and practice of the domestic taxation of CFC's in the United States, United Kingdom, France, West Germany, and Japan, each of which exhibits a high level of economic and industrial advancement. United States developments are important because the statutory provisions of Subpart F have been adopted, with modifications, by other nations, including West Germany and Japan. The United Kingdom and France, on the other hand, have not yet adopted an integrated statutory scheme providing for domestic taxation of CFC's. These countries attack tax evasion schemes utilizing foreign controlled companies primarily through general laws, exchange controls, and the requirement of government consent for certain international transactions.

II. Tax Treatment of Selected Nations

A. *United States*

1. Introduction

Under United States tax laws, a United States shareholder of a foreign corporation is generally not taxable on any portion of the

2. The term "controlled foreign corporation" is used in a general sense to mean any corporation which is (a) controlled by domestic shareholders and (b) located in a foreign jurisdiction which offers a complete exemption from tax, lower corporate tax rates, or other favorable tax status.

3. Subpart F (§§ 951-964) of Part III, Subchapter N of the Internal Revenue Code (1954) (hereinafter cited as "Subpart F").

foreign corporation's profits until they are distributed to the United States shareholder as a dividend. A substantial number of provisions are, however, utilized by the Internal Revenue Service to combat taxpayer abuse of the general rule. The most comprehensive and complex taxing system is contained in Subpart F of the Code. The Subpart F provisions are specifically designed to prevent tax deferral and avoidance by United States shareholders through the use of CFC's. Because of the dominant role played by the Subpart F provisions, they are examined in detail in this Note. In addition to the Subpart F provisions, the United States employs numerous other tax provisions to prevent tax abuse. These provisions deal with foreign personal holding companies, personal holding companies, foreign investment companies, the accumulated earnings tax, reallocation of income, taxable exchanges, and the use of appreciated securities. These provisions will also be examined in order to illustrate the United States anti-avoidance system and provide a basis for comparison with the tax avoidance measures of other countries.

2. Non Subpart F Provisions

a. Foreign Personal Holding Companies[4]

A foreign personal holding company is defined both in terms of the character of its ownership, and the character of its income. A foreign personal holding company is a foreign corporation owned, directly or indirectly, by five or fewer individuals, which derives 60% [initially, thereafter 50%] of its gross income in the form of dividends, interest, royalties, net securities gain, commodities gains, estate or trust income, personal service contract income, and rental income [unless rental income constitutes 50% or more of the company's gross income].[5] If a foreign corporation is characterized as a foreign personal holding company, each of its United States shareholders, regardless of the percentage of stock held, must include in taxable income his pro rata share of the corporation's undistributed income, even if some or all of that income is not itself within the definition of foreign personal holding

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4. The foreign personal holding company provisions are contained in I.R.C. §§ 551-558. For more detailed discussion of the foreign personal holding company provisions, see generally Lerner & Kirschbaum, *Foreign Personal Holding Companies*, TAX MNGM'T PORT. No. 103-2nd (1978).

5. I.R.C. § 552(a).

company income and regardless of whether or not that income is actually paid to the shareholder in dividends.[6]

Two basic methods are available to avoid foreign personal holding company status. Foreign personal holding company status can be avoided by either (1) fractionalizing ownership so that no five or fewer United States citizens or residents together own more than 50% in value of the corporation's stock, or (2) keeping gross income from the tainted sources below 60%.

The foreign personal holding company provisions are generally not of concern to large operating corporations, since concentrated ownership is required. It should be noted, however, that the foreign subsidiary of a domestic corporation may be a foreign personal holding company if the stock of the parent is closely held, since attribution of stock ownership rules are applicable.[7] When a United States shareholder is subject to tax under the foreign personal holding company provisions on income of a CFC,[8] the income so taxed is not required to be included in the taxpayer's gross income under the provisions of Subpart F.[9] In addition, a company subject to the foreign personal holding company provisions will not be subject to the personal holding company provisions.[10]

b. Personal Holding Companies[11]

The personal holding company provisions are applicable to both domestic and foreign corporations serving as personal holding companies. Like foreign personal holding companies, personal holding companies are identified by reference to both the nature of the ownership and the income of the corporation.

A personal holding company is defined as any corporation, either domestic or foreign, in which more than 50% of the equity is owned by five or fewer persons during the last half of the taxable year, and which has "adjusted ordinary gross income," at least

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6. I.R.C. § 551.
7. I.R.C. § 554(a).
8. As defined in I.R.C. § 957.
9. I.R.C. § 951(d).
10. I.R.C. § 542(c)(5).
11. The personal holding company provisions are contained in I.R.C. §§ 541-547. For a more detailed discussion of the personal holding company provisions, see generally Nicholson, *Personal Holding Companies (Domestic) - Taxation and Relief* TAX MNGM'T PORT. No. 114-2nd (1979).

60% of which is composed of dividends, interest, royalties, personal service contract income, estate or trust income, and rental income [unless rental income constitutes 50% or more of the company's adjusted gross income].[12] "Adjusted ordinary gross income" is defined as gross income less gains from the sale or other disposition of capital assets or section 1231(b) assets (property used in the trade or business) minus depreciation, taxes, interest, and rent incurred in connection with certain rental income and mineral royalties.[13] The adjustments for rental income and mineral royalties are designed to determine whether these specially treated activities are significant elements in the corporation's economic function, or merely tax-avoidance operations serving to disguise the importance of the corporation's personal holding company income.[14] If a corporation is determined to be a foreign personal holding company, the company will be subject to a tax equal to 70% of its "undistributed personal holding company income."[15]

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12. I.R.C. § 542 stock attribution rules apply. I.R.C. § 544(a).
13. I.R.C. § 543(b)(2).
14. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 8-45 (4th ed. 1979).
15. I.R.C. § 541. In essence, the calculation of undistributed personal holding company income involves three steps. First, the corporation's taxable income is adjusted in a prescribed manner, designed to transform taxable income into an amount that more closely resembles the corporation's net economic gain for the year. Federal income taxes are deducted, the § 243 deduction of 85% for dividends received is eliminated, the deduction for charitable contributions is increased from 5% of taxable income to the 20-50% limit applicable to individuals, the excess of net long-term capital gain over the excess of net short-term capital loss (less the taxes allocable thereto) is eliminated, the limitation on business expenses and depreciation of § 545(b)(6) is applied, and certain other adjustments are made. Second, a special deduction is available to pre-1964 corporations. Corporations that were not personal holding companies in one of their two taxable years immediately preceding enactment of the Revenue Act of 1964, but that would have been personal holding companies if the 1964 amendments had been applicable to that year, are permitted a deduction in computing undistributed personal holding company income for amounts paid or set aside to amortize certain "qualified indebtedness" (generally, debt incurred before 1964). Finally, from such adjusted taxable income, there is deducted the dividends-paid deduction of I.R.C. § 561. This deduction is the sum of (a) the dividends paid during the taxable year, (b) the consent dividends of the taxable year as provided in I.R.C. § 565, and (c) the dividend carryover of I.R.C. § 564 (which consists of the excess of dividends paid during the two preceding taxable years over the corporation's taxable income, as adjusted under I.R.C. § 545, for those years).

As in the case of the foreign personal holding company provisions, personal holding company status can be avoided by fractionalizing the ownership so that no five individuals together own more than 50% of the corporation's equity, or by keeping income from the prescribed sources below 60% of the company's adjusted ordinary gross income. It should be noted that the gross income of a personal holding company, unlike the gross income of a foreign personal holding company, is limited to United States source income and those items of foreign source income which are deemed effectively connected with the conduct of a trade or business within the United States.[16] Also, unlike foreign personal holding company status, personal holding company status cannot be avoided by having 50% or more of the equity owned by non-United States persons because the personal holding company "control group" includes both United States and non-United States persons.[17] The personal holding company provisions can be avoided, however, by using a two-tier stock structure which allows distributions of the company's earnings and profits in the form of dividends to a foreign parent corporation.[18]

c. Foreign Investment Companies[19]

The foreign investment company provisions apply to foreign corporations which are either (1) registered under the Investment Company Act of 1940, or (2) engaged primarily in the business of investing, reinvesting, or trading in securities at a time when more than 50% of its voting stock is owned, directly or indirectly, by United States persons, irrespective of the number of shareholders or number of shares held by any of them.[20] The provisions were designed to deal specifically with foreign mutual funds, which do not qualify as foreign personal holding companies because of their public share ownership. It is important to note, however, that a corporation which qualifies as a foreign personal

16. I.R.C. § 543(b)(1),(2).

17. I.R.C. § 542(a).

18. Breen & Wolfe, *United States Law and Practice*, in TAX HAVEN ENCYCLOPEADIA 7 (B. Spitz ed. 1979).

19. The foreign investment company provisions are contained in I.R.C. §§ 1246-1247. For a more detailed discussion of I.R.C. § 1247, see generally Lederman, *Foreign Investment Companies - Section 1246*, TAX MNGM'T PORT. No. 405 (1979).

20. I.R.C. § 1246(b).

holding company is not excluded from foreign investment company status as well.

Under the foreign investment company provisions, gain recognized by a United States shareholder upon sale or exchange (including liquidation) of a foreign investment company is denied long-term capital gain treatment to the extent of the shareholder's ratable share of earnings and profits accumulated in years beginning after 1962.[21] A foreign investment company may, however, elect to distribute at least 90% of its taxable income each year to its shareholders, in which event capital gains treatment must be applied.[22] The shareholder must include his pro rata share of the undistributed capital gain of the corporation as taxable long-term capital gain.[23] A United States shareholder of a CFC[24] who is also a qualified shareholder of a foreign investment company is not required to include in gross income any amount under the provisions of Subpart F.[25] A corporation subject to the foreign investment company provisions is not subject to the personal holding company provisions.[26]

d. Accumulated Earnings Tax[27]

Section 531 imposes a penalty tax on the "accumulated taxable income" of corporations formed or used to avoid income tax with respect to its shareholders, or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being distributed.[28] The surtax rates are 27.5% on the first $100,000 of accumulated taxable income, and 38.5% on any amounts exceeding $100,000.[29] A credit provision allows accumulation of earnings and profits necessary to meet the reasonable anticipated needs of the business. The credit provision allows the corporation to accumulate at least $150,000 during its corporate

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21. I.R.C. § 1246(a).
22. I.R.C. § 1247(a).
23. I.R.C. § 1247(d)(2).
24. As defined in I.R.C. § 957.
25. I.R.C. § 951(d).
26. I.R.C. § 542(c).
27. The accumulated earnings tax provisions are contained in I.R.C. §§ 531-537. For a more detailed discussion of the accumulated earnings tax provisions, see generally, Lewis, *Accumulated Earnings Tax,* TAX MNGM'T PORT. No. 35-5th (1979).
28. I.R.C. §§ 531, 532.
29. I.R.C. § 531.

existence,[30] unless barred by other provisions of the Code.[31] The tax does not apply to personal holding companies (as defined in section 542), foreign personal holding companies (as defined in section 552), or corporations exempt from tax under Subpart F.[32]

"Accumulated taxable income" is defined as the corporation's taxable income for the year (with certain adjustments), minus the sum of the dividends-paid deduction of section 561, and the accumulated earnings credit (discussed above).[33] As in the case of personal holding company income, the accumulated taxable income of a foreign corporation includes only its United States source income.[34] Therefore, a two-tier foreign corporation arrangement can be utilized to minimize the impact of the provisions. The foreign corporation could receive United States source income and distribute it as a dividend to a parent foreign corporation for accumulation. The subsidiary corporation thus would not be subject to accumulated earnings tax because it would have distributed its income as a dividend to the parent. And the parent would not be taxable under the accumulated earnings provisions because all of its income would be from a foreign source, i.e., dividend distributions from a foreign subsidiary.[35]

e. Reallocation of Income[36]

If two or more entities are owned or controlled, directly or indirectly, by the same interests, the Internal Revenue Service (Service) may distribute, apportion, or allocate income, deductions, credits, or allowances between them under section 482 if it determines that such reallocation is necessary in order to prevent evasion of taxes or to clearly reflect the income of such trade or business.[37] The regulations under section 482 serve to revise transactions between controlled taxpayers to reflect what would have occurred in arm's length dealings.[38]

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30. I.R.C. §§ 531, 535.
31. *See* I.R.C. §§ 1551, 1561, 269.
32. I.R.C. § 532(b).
33. I.R.C. §§ 535(a)-535(b).
34. *See* Treas. Reg. § 1.535-1(b) (1972).
35. Breen & Wolfe, *supra* note 18, at 8.
36. The reallocation of income provision is contained in I.R.C. § 482. For a more detailed discussion of I.R.C. § 482, see generally Ruffalo & Isaacs, *Foreign Income—Section 482 Allocations*, TAX MNGM'T PORT. No. 115-2nd (1976).
37. I.R.C. § 482.
38. *See* Treas. Reg. § 1.482 (1975).

The regulations specifically address the following five types of transactions which might occur between controlled taxpayers: (1) loans and advances,[39] (2) performance of services for another entity,[40] (3) use of tangible property,[41] (4) transfer or use of intangible property,[42] and (5) sale of tangible property.[43] The regulations provide accounting rules to aid in constructing the arm's-length consequences of such transactions, taking into account the costs, tax consequences, and the potential profitability of the transactions.[44]

Reallocation of income can greatly affect the total tax burden of the entities. In a typical international context, the reallocation of income from a subsidiary in a tax haven country to its United States parent would greatly increase the parent's total tax burden by taxing such income at the higher United States rate. The impact of section 482 is particularly acute in an international setting because the definition of "control" under section 482 is much broader than under the Subpart F provisions. For purposes of section 482, "control" means "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form. . . . A presumption of control arises if income or deductions have been arbitrarily shifted."[45]

f. Taxable Exchanges[46]

Section 367 authorizes the commissioner to disregard the existence of a foreign corporation as a party to any tax-free incorporation or exchange (described in sections 332, 351, 354, 355, 356 or 361) resulting in recognition of gain, unless it can be established that the principal purpose of the exchange is not the avoidance of federal income taxes. The provision requires rulings from the Service on all transfers purporting to be tax free. The taxpayer must file a ruling request within 183 days after the begin-

39. Treas. Reg. § 1.482-2(a) (1975).
40. Treas. Reg. § 1.482-2(b) (1975).
41. Treas. Reg. § 1.482-2(c) (1975).
42. Treas. Reg. § 1.482-2(d) (1975).
43. Treas. Reg. § 1.482-2(e) (1975).
44. Treas. Reg. § 1.482 (1975).
45. Treas. Reg. § 1.482-1(a)(3) (1975).
46. For a more detailed discussion of I.R.C. § 367, see generally BITTKER & EUSTICE, *supra* note 14, at 17-73 to 17-99.

ning of an exchange resulting in the transfer of property out of the United States. No ruling is required for property transferred into the United States.

g. Excise Tax on Transfers of Appreciated Securities[47]

Section 1491 imposes an excise tax on any United States taxpayer who contributes appreciated securities to a foreign corporation as paid-in capital or surplus.[48] The tax is assessed at the rate of 35% on the amount by which the value of the securities exceeds their adjusted tax basis.[49] Section 1491, however, applies only to contributions of paid-in capital or surplus; it does not apply to sales of appreciated securities to a foreign corporation, even if such sales are on an installment basis, or in return for a private annuity.[50] Section 1491 does not apply to any transactions subject to section 367.[51]

h. The "Sham" Transaction

In addition to the statutory provisions outlined above, the Service can attack a transaction involving a foreign corporation as a "sham." Generally, United States tax law treats a corporation as a taxable entity, separate from its shareholders. The Service, however, closely scrutinizes transactions between foreign subsidiaries and their domestic parents. The Service has taken the position that foreign subsidiaries of domestic corporations should not be regarded as separate entities, unless they actively engage in some industrial, commercial, or other business activity.[52] The courts, however, have been less willing to disregard the corporate entity.[53] In general, the courts will examine a number of factors in determining whether to disregard the foreign entity, including whether there is a genuine business purpose for the corporation

47. The tax on transfers to avoid income tax is governed by I.R.C. §§ 1491, 1492, 1494.
48. I.R.C. § 1491.
49. *Id.*
50. Adams, *How to Avoid the Section 1491 Tax, in* U.S. TAXATION OF INTERNATIONAL OPERATIONS, 5301-06 (1977).
51. I.R.C. § 1491.
52. *See* 4 *Hearings on the President's 1961 Tax Recommendations Before the House Committee on Ways and Means* 3546, 87th Cong., 1st Sess. (1961).
53. *Id.*

other than tax avoidance,[54] the corporation's business activities,[55] the extent to which the shareholders have respected the corporation's separate existence in dealing with corporate assets,[56] and the presence of fraud.[57]

3. Subpart F Provisions

a. Introduction

Prior to enactment of the Revenue Act of 1962,[58] United States shareholders of foreign corporations were generally not subject to United States income tax on the foreign corporation's earnings until such earnings were repatriated to the United States in the form of dividends or upon a disposition of the shares by the United States shareholder.[59] Under this statutory framework, many domestic corporations found it advantageous to form subsidiaries in low-tax countries, thereby deferring the payment of United States tax until repatriation could ultimately be accomplished at capital gain rates upon liquidation of the foreign corporation, or sale of its stock.[60] The Service's mechanisms to reach the foreign source income and tax it currently to the United States shareholder were largely unsuccessful. The theory of "constructive dividends" under pre-1962 law, and reallocations under section 482, proved cumbersome in practice and difficult of proof.[61]

The Revenue Act of 1962 was directed against this tax deferral

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54. *See* Aiken Industries, Inc. v. Comm'r, 56 T.C. 925 (1971); Sam Seigel v. Comm'r, 445 T.C. 566 (1966); Columbian Rope Co. v. Comm'r, 42 T.C. 800 (1964).

55. *See* Bass v. Comm'r, 50 T.C. 595 (1968); Hay v. Comm'r, 2 T.C. 460 (1943), *aff'd.*, 145 F.2d 1001 (4th Cir. 1944), *cert. denied*, 324 U.S. 863 (1945).

56. *See* Consolidated Premium Iron Ores, Ltd. v. Comm'r, 28 T.C. 127 (1957), *aff'd.*, 265 F.2d 320 (6th Cir. 1959).

57. *See* Factor v. C.I.R., 281 F.2d 100 (9th Cir. 1960), *cert. denied*, 364 U.S. 933 (1961).

58. Pub. L. No. 87-834, 76 Stat. 960 (1962).

59. An exception to the general rule is provided in I.R.C. § 552 for United States shareholders of foreign personal holding companies.

60. Wilcox & Geen, *Controlled Foreign Corporation—Sec. 956*, TAX MNGM'T PORT. No. 232-2d at A-1.

61. BITTKER & EUSTICE, *supra* note 14, at ¶ 17.32. Under § 482, the Commissioner may reallocate income, deductions, credits, or other allowances between or among multiple corporations controlled, directly or indirectly, by the same interests so as to "clearly reflect income."

on certain undistributed earnings of CFC's.[62] Under the Subpart F provisions,[63] certain types of income of CFC's,[64] even if not distributed to United States shareholders,[65] are included in the gross income of the United States shareholders in the year the income is earned by the CFC.[66] Two categories of undistributed income that are taxed to the United States shareholder of a CFC include[67] (1) Subpart F income,[68] and (2) any increase in earnings invested in United States property.[69]

The following brief overview of the operation of Subpart F is provided as an aid for understanding the subsequent, more detailed discussion:

I. *The controlled foreign corporation*—The heart of Subpart F is the "controlled foreign corporation," which is any foreign corporation more than 50% of whose total combined voting power is owned by United States shareholders on any day of the taxable year in question.[70]
A United States person is characterized as a United States stockholder only if he owns directly, indirectly, or constructively, 10% or more of the corporation's combined voting power.[71]

II. *Income attributed to United States shareholders*—Every United States shareholder of a CFC who owns stock in the corporation on the last day of a taxable year during which the corporation was a CFC, is taxable to the extent of his pro rata share of the Subpart F income and the increase in earnings invested in United States property of the foreign corporation, regardless of whether the corporation makes any distributions.[72]

III. *Subpart F income*—Subpart F income includes income de-

62. *See* H.R. REP. No. 1447, 87th Cong., 2d Sess. 57-58 (1962).
63. I.R.C. §§ 951-964.
64. *See* note 79 *infra* and accompanying text.
65. *See* note 81 *infra* and accompanying text.
66. The Subpart F provisions were held constitutional in Whitlock v. Comm'r, 494 F.2d 1297 (10th Cir. 1974), *cert. denied,* 419 U.S. 839 (1974); Garlock, Inc., v. Comm'r, 489 F.2d 197 (2d Cir. 1973), *cert. denied,* 417 U.S. 911 (1974); Albert L. Dougherty v. Comm'r, 60 T.C. 719 (1974).
67. I.R.C. § 951(a)(1).
68. *See* I.R.C. § 952(a).
69. I.R.C. § 951(a)(1)(B).
70. I.R.C. § 957(a).
71. I.R.C. § 951(b).
72. I.R.C. § 951(a)(1).

rived from the insurance of United States risks, foreign base company income, international boycott factor income, and the amount of illegal payments to government officials.[73]

IV. *Investment in United States property*—Generally, United States property includes most tangible and intangible property located in the United States which is owned by a CFC.

V. *Relief provisions*—Several provisions mitigate the effect of Subpart F by allowing deductions for expenses allocable to Subpart F income,[74] disregarding foreign base company income if it amounts to less than 10% of the CFC's income,[75] excluding foreign base company income where tax avoidance motive does not exist,[76] not taxing Subpart F income where the corporation is not a CFC for at least thirty days during the taxable year,[77] and allowing an individual to elect to be taxed at corporate rates.[78]

b. The Controlled Foreign Corporation

For purposes of Subpart F, a "controlled foreign corporation" is any foreign corporation of which more than 50% of the total combined voting power is owned directly, indirectly, or constructively, by United States shareholders on any day during the taxable year of such corporation.[79] Under the provisions of Subpart F, a

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73. I.R.C. § 952(a).
74. I.R.C. § 954(b)(5).
75. I.R.C. § 954(b)(3)(A).
76. I.R.C. § 954(b)(5).
77. I.R.C. § 951(a)(1).
78. I.R.C. § 962.
79. I.R.C. § 957(a). Control ownership of 50% or less of combined voting power by United States shareholders may be sufficient to classify the foreign entity as a controlled foreign corporation in certain cases. For example, in Weiskopf v. Comm'r, 76-1 U.S.T.C. ¶ 9387, 37 A.F.T.R. 2d 76-1427 (2d Cir. 1976), *aff'd.* 64 T.C. 78 (1975), the Second Circuit held that United States shareholders were in effective control of a foreign corporation even though stock representing 50% of the combined voting power was owned by a British corporation. A similar holding was reached by the Seventh Circuit in Koehring v. United States, 78-2 U.S.T.C. ¶ 9621 (7th Cir. 1978), based on the following factors: (a) the taxpayer had a long-standing working relationship with the English corporation to which the purported transfer of control took place, (b) the taxpayer indirectly provided the English corporation with funds to purchase the subsidiary's stock, (c) there was an understanding between the parties that the operational control of the subsidiary would be left in the hands of the United States corporation, and (d) the English corporation failed to exercise independent control over the subsidiary.

"United States shareholder" is a United States person[80] who owns, directly, indirectly, or constructively, 10% or more of the total combined voting power of all classes of stock of such foreign corporation entitled to vote.[81]

The constructive ownership provisions of section 318(a) apply for purposes of determining the status under Subpart F as "United States shareholder" and "controlled foreign corporation," with certain exceptions set out in section 958(b).[82] As modified, the attribution rules regarding members of families are applied as stated in section 318, except that stock owned by a nonresident alien individual (other than a foreign trust or estate) is not considered as owned by a citizen or by a resident alien individual.[83] Under the attribution rules, a partnership, estate, trust, or corporation that owns, directly or indirectly, more than 50% of the total combined voting power of all classes of stock of a corporation entitled to vote, is considered to own all of the stock entitled to vote.[84] The rule of attribution to partnerships, estates, trusts, and corporations is not applied so as to attribute stock owned by a non-United States person to a United States person.[85]

Although the constructive ownership rule governing attribution from entities is not applicable under Subpart F, a special rule governs situations where stock is owned through a foreign entity. Stock held directly or indirectly through a foreign corporation or other entity ordinarily will be deemed to be owned by the United States shareholder.[86] This rule creates a chain of ownership starting with the foreign entity, and stopping with the first United States person.[87]

c. Subpart F Income

Various schemes have been employed by United States taxpayers to take advantage of the United States lack of jurisdiction to

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80. I.R.C. § 7701(a)(30) defines "United States person" to mean a citizen or resident of the United States, a domestic partnership or corporation, or a non-foreign trust or estate.

81. I.R.C. § 951(b).

82. It should be noted that the constructive ownership rules in I.R.C. § 318 turn on the value of shares rather than their voting power.

83. I.R.C. § 958(b)(1).

84. I.R.C. § 958(b)(3).

85. I.R.C. § 958(b)(4).

86. I.R.C. § 958(a)(2).

87. *See* Treas. Reg. § 1.958-1(b) (1966).

tax foreign corporations on income derived outside of the United States. In the past, many United States firms organized foreign enterprises with their management structures and parent-subsidiary transactions arranged in such a manner as to avoid or defer both United States and foreign tax liability.[88]

Subpart F was enacted by Congress in 1962 in part to combat the deferral of United States taxes by means of nonoperating foreign subsidiaries. Subpart F is directed at the United States shareholder of such corporations, since the United States has no jurisdiction to tax such foreign corporations directly.[89] Subpart F taxes the United States shareholders of a CFC currently on their pro rata share of certain items of tainted income, without regard to whether dividend distributions are made.

Subpart F income includes the following four categories of income: (1) income derived from the insurance of United States risks, (2) foreign base company income, (3) an amount equal to income (with certain exceptions) multiplied by an international boycott factor,[90] and (4) illegal payments to foreign government officials.[91]

Income effectively connected with the conduct of a trade or business within the United States, derived from sources within the United States by such foreign corporation, does not constitute Subpart F income, unless such income is exempt from taxation, or subject to a reduced rate of tax, pursuant to a treaty obligation of the United States.[92]

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88. A United States taxpayer would typically establish a nominal corporation in a tax haven country and would employ artificial arrangements between the taxpayer and the foreign corporation regarding inter-company pricing, the transfer of patent licensing rights, the shifting of management fees and similar practices to maximize accumulations in the tax haven. Olsen & Choate, *Foreign Operations-Base Companies*, TAX MNGM'T PORT. No. 23-4th at A-1 to A-13 (1976), *citing* President Kennedy's 1961 Tax Message, S. REP. No. 1881, 87th Cong., 2nd Sess. 88 (1962).

89. *See, e.g.*, I.R.C. § 951(a) which imposes the tax on United States shareholders.

90. The international boycott factor provisions are beyond the scope of this Note and will not be discussed further. For a detailed discussion of the topic, see generally Dinur, *International Boycott Determinations*, TAX MNGM'T PORT. No. 345 (1978).

91. The provisions concerning illegal payments are beyond the scope of this Note.

92. I.R.C. § 952(b). Effectively connected income is not included in Subpart F income because it is already subject to full United States tax. I.R.C. § 864(c).

(1) *Income from Insurance of United States Risks*—A detailed discussion of the income from the insurance of United States risks is beyond the scope of this Note. Basically, however, income of a CFC derived from premiums or other consideration, or reinsurance of, or the issuing of insurance or annuity contracts on, property in, or residents of, the United States is included in Subpart F income, and taxed to United States shareholders on the basis of their pro rata share.[93] Subpart F income also includes income derived from arrangements between a CFC and another corporation, in which the latter holds insurance involving United States risks for the former and the former holds insurance not involving such risks for the latter.[94]

This provision of Subpart F is designed to prevent domestic insurance companies from avoiding United States taxation of underwriting gains by reinsuring their policies abroad, or by placing the initial policy with a foreign insurance subsidiary.[95] A de minimus provision provides for attribution to the United States shareholder only if the CFC receives premiums or other consideration for reinsurance, or for the issuance of insurance or annuity contracts on United States risks, in excess of 5% of their total premiums and other income.[96]

(2) *Foreign Base Company Income*—The most important category of Subpart F income is foreign base company income. There are four types of foreign base company income: (1) foreign personal holding company income, (2) foreign base company sales income, (3) foreign base company services income, and (4) foreign base company shipping income.[97]

(a) *Foreign Personal Holding Company Income*—The provisions of Subpart F incorporate the Code's section 553 definition of foreign personal holding company income, with adjustments intended to broaden its scope. Foreign personal holding company

93. I.R.C. § 953(a).

94. *Id.*

95. The Life Insurance Company Act of 1959 imposed a tax on underwriting gains of insurance companies. Numerous companies sought to avoid the tax by reinsuring their policies abroad. In other cases the initial policy was placed with a foreign insurance company which was controlled by either a domestic insurance company or another United States business. Olsen & Choate, *supra* note 88, at A-16.

96. I.R.C. § 953(a). Details of the provision are explained in Treas. Reg. § 1.953-1 (1964).

97. I.R.C. § 954(a).

income generally includes dividends, interest, rent, royalties, and annuities; gains from futures transactions in any commodity; gains from the sale of an interest in an estate or trust; personal service contracts; and the use of corporate property by a shareholder.[98] The foreign personal holding company provisions exclude rental income if it constitutes 50% or more of the gross income of the foreign corporation.[99] In contrast, rents are included in foreign personal holding company income under Subpart F without regard to the percentage of gross income they constitute.[100] Exclusions are provided under Subpart F, however, for rents and royalties derived from the active conduct of a trade or business, dividends and other securities transactions in the banking or financing business, certain income of insurance companies, and income received from related parties organized in the same country.[101]

(b) *Foreign Base Company Sales Income*—Foreign base company sales income is income derived in connection with the purchase of personal property from a related person and sales of such property to any person; the sale of personal property to any person on behalf of a related person; the purchase of personal property from any person and the sale of such property to a related person; or, the purchase of personal property from any person on behalf of a related person where: (1) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the CFC is created or organized, and (2) the property is sold for use, consumption, or disposition outside such foreign country, or in the case of property purchased for or on behalf of a related person, is purchased for use, consumption, or disposition outside such country.[102]

For purposes of Subpart F, a person is a "related person" with respect to a CFC if such person is (1) an individual, partnership, trust or estate which controls the CFC, (2) a corporation which controls, or is controlled by, the CFC, or (3) a corporation which

98. I.R.C. § 555(a).
99. I.R.C. § 553(a)(7).
100. I.R.C. § 954(c)(2).
101. I.R.C. § 954(c)(3) & (4).
102. I.R.C. § 954(d)(1). See Treas. Reg. § 1.954-3 (1964) for examples and explanation.

is controlled by the same person or persons which control the CFC.[103]

The foreign base company sales income provision is intended to subject income from a selling subsidiary, separated from the manufacturing activities of a related corporation, to United States taxation in order to achieve a lower tax rate for the sales income.[104] Two of the schemes most frequently employed to avoid United States taxation of sales profits were (1) the sale of property manufactured in the United States to a controlled foreign subsidiary located in a low tax rate country, and the subsequent resale by that subsidiary at a higher price to world-wide markets, and (2) the purchase by the foreign subsidiary of raw materials or goods in foreign markets, and the subsequent resale of those materials to the United States parent corporation at an increased price. Prior to the adoption of new regulations under section 482, a reallocation of income and deductions between the foreign subsidiary and the United States parent usually would not be sufficient to completely offset the profit of the sales subsidiary. Some of the income, therefore, escaped current United States taxation.[105]

Where a foreign controlled sales subsidiary also partially manufactures, assembles, or constructs the product to any significant degree, income from product sales does not constitute base company sales income. Under the Regulations, manufacturing or processing will be considered significant if total conversion costs (direct labor plus factory overhead) are at least 20% of the total cost of goods sold. Packaging, repackaging, labeling, or minor assembly operations do not qualify as manufacture, construction, or production.[106]

(c) *Foreign Base Company Services Income*—Foreign base company services is income arising from the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, and similar services, if such services are (1) performed for, or on behalf of, a related person, and (2) per-

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103. I.R.C. § 954(d)(3). As used in this context, "control" means the ownership, directly or indirectly (applying the stock ownership attribution rules prescribed in I.R.C. § 958), of stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote. *Id.*

104. [1980] 6 STAND. FED. TAX REP. (CCH) ¶ 4383 at 51, 076-77.

105. Olsen & Choate, *supra* note 88, at A-17.

106. Treas. Reg. § 1.954-3(a) (1964).

formed outside the country under whose laws the CFC is organized. Services directly related to the sale or exchange of (or an offer to sell or exchange) property manufactured, processed, grown, or extracted by the foreign corporation itself are not included as foreign base company services income.[107] The primary purpose of the services provision is to prevent the separation of services income from other income in a low tax rate country.[108] The amount of foreign base company services income is determined by the physical location of the persons performing the service.[109] Difficult problems of allocation arise where services are performed both in and out of the country of incorporation. Where services are performed partially within and partially out of the country of incorporation under the same contract or arrangement, the Regulations require an allocation of the service income according to the employee time spent in each country.[110] Such allocation must be weighed against the value of the services performed by the various employees.

(d) *Foreign Base Company Shipping Income*—In 1975, Congress created a new category of Subpart F income encompassing income derived from, or in connection with, the use of an aircraft or vessel in foreign commerce.[111] Income from the hiring and leasing of such vessels also constitutes shipping income.[112] Prior to this amendment, all such income had been excluded from the definition of foreign base company income. Foreign base company shipping income includes (1) dividends, interest, and gains from the sale, exchange or other disposition of stock in a foreign corporation, to the extent such income is attributable to foreign base company shipping income, and (2) that portion of the distributive share of partnership income so attributable.[113]

There are no de minimus exceptions to the specific categories, so exceptions which might otherwise apply will not prevent indirectly realized shipping income. Unlike the other categories of foreign base company income, there is no exclusion for income derived from the active conduct of a business.

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107. I.R.C. § 954(e). See Treas. Reg. § 1.954-4 (1964) for explanation.
108. *See generally* S. REP. No. 1881, 87th Cong., 2d Sess. 88 (1962).
109. Treas. Reg. § 1.954(c) (1964).
110. *Id.*
111. I.R.C. §§ 954(a)(4), 954(f).
112. *See* proposed Reg. § 1.954-6 at [1980] 6 STAND. FED. TAX REP. (CCH) ¶ 4383 EA.
113. I.R.C. §§ 954(f)(1), 954(f)(2).

d. Increase in Earnings Invested in United States Property

United States shareholders of CFC's are taxed on their pro rata share of the CFC's increase in earnings invested in United States property on the theory that such returned earnings are "substantially the equivalent of a dividend."[114] The tax on the increase in earnings of a CFC invested in United States property has been termed "one of the harshest provisions of the Subpart F rules,"[115] because the effects are often quite unexpected. The multivariable computation of the increase makes possible the generation of a constructive dividend in a taxable year without either an increase in the amount of investment in United States property, or an increase in CFC's earnings and profits for such taxable year.[116] In addition, the "relief provisions" applicable to Subpart F income are not available with regard to earnings invested in United States property.[117] Unlike Subpart F income, which is taxed to the United States shareholder only where a minimum percentage of the income of the CFC is of a tax haven nature, the tax imposed on the increase in earnings invested in United States property is generally applicable to all CFC's, whether or not the CFC has Subpart F income, and even when it is clear that tax avoidance is not motivating conduction for business operations in the foreign locale.

The tax consequences of investment in United States property by a CFC can be briefly summarized as follows. First, the inclusion of the pro rata share of a CFC's increase in earnings invested in United States property is gross income of the United States shareholder.[118] Second, the allowance of foreign tax credit for foreign taxes paid by the CFC on the earnings constitutes an increase in investment in United States property.[119] Third, an increase in the basis of a United States shareholder's stock to the extent of the amounts required to be included in a United States shareholder's income is an increase in earnings invested in United

114. S. REP. No. 1881, 87th Cong., 2d Sess. 88 (1962).

115. RUSSO, *Constructive Dividends and the Long Arm of Section 956*, 1 INT'L TAX J. 31, 31 (1974).

116. *See* note 159 *infra* and accompanying text.

117. *See* notes 189-97 *infra* and accompanying text. *See generally* BITTKER & EUSTICE, *supra* note 14, at 17.33.

118. I.R.C. § 951(a)(1)(B).

119. I.R.C. § 960.

States property.[120] Last, the subsequent distributions by the CFC are received tax-free to the extent of amounts previously included in income by the United States shareholder as an increase in earnings invested in United States property.[121]

(1) *United States Property*—Under the provision of section 956, United States shareholders are required to include in income their pro rata share of the CFC's increase in earnings invested in United States property for the taxable year. "United States property" is defined as:

> any property acquired after December 31, 1962, which is: (1) tangible property located in the United States, (2) stock of a domestic corporation, (3) an obligation of a United States person, or (4) any right to the use in the United States of (a) a patent or copyright, (b) an invention, model, or design (whether or not patented), (c) a secret formula or process, or (d) any other similar property right, which is acquired or developed by the [CFC] for use in the United States.[122]

Thus, most tangible and intangible property located in the United States which is owned by a CFC constitutes United States property.

In order to prevent an easy circumvention of the tax on increase in earnings invested in United States property, a United States shareholder will also be taxed on any investments in United States property held on behalf of the CFC by a trustee, nominee, or any other foreign corporation controlled by the CFC which is created or availed of by the CFC principally for the purpose of holding United States property.[123]

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120. I.R.C. § 961(a). A corresponding decrease in basis results when amounts previously included in income are actually distributed. I.R.C. § 961(b)(1).

121. I.R.C. § 959; *see* note 158 *infra* and accompanying text. *See also* Rev. Rul. 76-538, 1976-2 C.B. 230.

122. I.R.C. § 956(b)(1). The United States property is taken into account at its adjusted basis, reduced by a liability to which the property is specifically subject. I.R.C. § 956(a)(3).

123. Treas. Reg. § 1.956-1(b)(3) (1964); *see* Rev. Rul. 76-192, 1976-1 C.B. 205 (CFC deemed to hold United States investments made by wholly-owned subsidiary of common domestic parent, in an amount equal to sub's loan parent, where sub borrowed from same financial institution an amount equal to the CFC's deposit, then reloaned proceeds of loan to domestic parent on similar terms); Rev. Rul. 74-41, 1974-1 C.B. 190 (CFC not deemed to hold United States investments made by trustee of pension trust unless CFC's contributions result in overfunding of trust, or corpus or trust income are diverted to the CFC).

(a) *Tangible Property*—Tangible property includes both real and personal property located in the United States.[124] This provision has been interpreted, however, to require more than mere physical presence in the United States. Tangible property only temporarily present in the United States in the course of international transit does not constitute United States property.[125]

(b) *Domestic Stock*—Prior to 1976, stock of any corporation created or organized in the United States, or any state or territory, constituted United States property.[126] The Tax Reform Act of 1976 narrowed the definition of United States property to permit the investment of a CFC's accumulated profits in United States portfolio securities.[127] Under the 1976 amendment, securities of unrelated domestic corporations are excluded from the definition of United States property. Unrelated domestic corporations are defined as United States corporations which are not shareholders of the CFC nor substantially owned by United States shareholders of the CFC.[128]

(c) *Obligations*—Obligation is defined to include virtually any indebtedness of a United States person,[129] whether on open account or evidenced by written instrument, and whether or not bearing interest.[130] Limited exceptions from the definition of United States property are provided for indebtedness arising out

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124. The term "United States," as used in § 956, includes only the 50 states and the District of Columbia, not Puerto Rico or United States territories or possessions. *See* I.R.C. § 7701(a)(9).

125. Rev. Rul. 67-130, 1967-1 C.B. 191. *But cf.* Rev. Rul. 73-195, 1973-1 C.B. 349 (leasehold improvements made on vesels leased by CFC and used exclusively in shipping operations between the United States and its possessions constitute United States property).

126. I.R.C. § 7701(a)(4).

127. The exclusion is, however, strictly limited to unrelated domestic corporations. The legislative history of the amendment clearly indicates that if the CFC "facilitates" a loan to its United States shareholder, the obligation will be treated as United States property. S. REP. No. 938, 94th Cong., 2d Sess. (1976).

128. I.R.C. § 956(b)(2)(F). The constructive ownership rules of § 958(b) apply in determining whether the domestic corporation is related to the CFC. Under those rules, the domestic corporations cannot be a shareholder of the CFC, nor more than 25% owned by United States shareholders of the CFC.

129. *See* note 80 *supra* and accompanying text.

130. Treas. Reg. § 1.956-2(d)(2) (1964). The term "obligation" includes "any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest . . . ." *Id.*

of the involuntary conversion of non-United States property,[131] and for short-term obligations maturing and collected within one year or less.[132] Under the collection exception, indebtedness which (1) is collected within one year from the date incurred, or (2) matures within one year but is not collected solely due to the inability or unwillingness of the debtor to make payment, is excluded from the definition of United States property. To qualify for the exception, however, the creditor must clearly establish that it has made reasonable efforts to collect the indebtedness within the one-year period.[133]

A CFC is also deemed to hold United States property if the CFC becomes a pledgor or guarantor of any obligation of an United States person.[134] The Regulations, however, do not define the terms pledge or guaranty. The Service has ruled that stock pledge transactions in which the sole shareholder pledges the stock of its CFC to secure the shareholder's personal loan will constitute a guarantee of the shareholder's obligation by the CFC, and thus an investment in United States property by the CFC.[135] On April 20, 1979, the Service issued proposed regulations under section 956(c) clarifying and extending the circumstances under which a CFC will be considered to have made a pledge or guarantee with respect to an obligation of a United States person. The proposed regulations generally provide that indirect pledges or guarantees may be included as a CFC's investment in United States property.[136] Specifically, a CFC will be considered a pledgor or guarantor of an obligation of a United States person if the

131. For example, a claim against a United States insurer on account of loss or damage to foreign property owned by the CFC would constitute an exception. Wilcox & Geen, *supra* note 60, at A-3.

132. Indebtedness arising in connection with the sale or processing of property is excepted from this provision, such indebtedness being subject to the provisions of Treas. Reg. § 1.956-2(b)(1)(v) (1964).

133. Treas. Reg. § 1.956-2(a)(2) (1964); *see* Dougherty v. Comm'r, 60 T.C. 917 (1973) (Creditor had made reasonable efforts to collect an indebtedness, even though no demand for repayment was made at maturity, where advances were made to finance oil production and loans could not be repaid without first selling the leaseholds).

134. I.R.C. § 956(c).

135. *See* Rev. Rul. 76-125, 1976-1 C.B. 204. *But see* Ludwig v. Comm'r, 68 T.C. 979 (1977) (Tax Court rejected Rev. Rul. 76-125, holding that pledge of CFC's stock by sole shareholder was not within purview of § 956(c)).

The Service has announced that it will not follow *Ludwig*. *See* 1978-1 C.B. 2.

136. Proposed Treas. Reg. § 1.956-2(c)(2).

CFC facilitates a loan to, or borrowing by, such United States person.[137]

Conduit financing arrangements using a United States financing vehicle are generally excluded from the definition of obligation. Thus, a pledge or guarantee by a CFC of the obligation of a United States person will not be treated as an investment in United States property if the United States person is a mere conduit in a financing arrangement.[138] The Regulations do not establish guidelines for this exception, and the determination of whether the United States person is a mere conduit depends upon all the facts and circumstances in each particular transaction.[139] The only specific transaction identified in the Regulations as a conduit financing arrangement is the case in which a CFC pledges stock of its subsidiary, another CFC, to secure the obligation of a United States person, provided that: (1) the United States person is a domestic corporation not engaged in the active conduct of a trade or business and has no substantial assets other than those arising out of its blending of the funds borrowed by it on such obligation to the CFC whose stock is pledged, and (2) the assets of the United States person are at all times substantially offset by its obligation to the lender.[140]

(d) *Patents, Copyrights, and Other Similar Property Rights*—This category of United States property generally includes patents, copyrights, and other similar property rights acquired or developed by the CFC for use in the United States.[141] In the absence of affirmative evidence that such property right was not acquired or developed for use in the United States, property rights actually used principally in the United States are considered United States property.[142]

(2) *Excluded Property*—Certain property interests normally acquired in routine commercial transactions do not generally constitute United States property.[143] Specifically, the term "United States property" does not include the following: (1) obligations of

137. Proposed Treas. Reg. § 1.956-2(c)(3). Example (3) recites the *Ludwig* fact situation and concludes that the CFC would be considered a pledgor or guarantor of the obligation of the United States person.

138. Treas. Reg. § 1.956-2(c)(2) (1964).

139. *Id.*

140. *Id.*

141. *See* note 122 *supra* and accompanying text.

142. Treas. Reg. § 1.956-2(a)(1)(iv) (1964).

143. I.R.C. § 956(b)(2).

the United States, money, or deposits with persons carrying on the banking business,[144] (2) property located and purchased in the United States for export to, or use in, foreign countries,[145] (3) any obligation of a United States person arising in connection with the sale or processing of property, if the amount of the obligation does not exceed an amount ordinary and necessary to carry on the trade or business of both parties to the transaction, had the transaction been made between unrelated persons,[146] (4) equipment for the transportation of persons or property used predominantly outside the United States,[147] (5) certain insurance company reserves related to the insurance of foreign risks,[148] (6) stock or obligations of an unrelated domestic corporation,[149] (7) movable equipment used for the exploration, removal, or transportation of resources from the United States continental shelf,[150]

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144. I.R.C. § 956(b)(2)(A). "Banking business" is defined as in § 361(c)(1). Although the Service had previously ruled that mutual savings banks and savings and loan associations would qualify as a banking business in some circumstances, the Service has ruled that for purposes of this section, financial institutions will not be considered a banking business unless they qualify as "banks" under § 581, or would so qualify if they were United States companies. Rev. Rul. 70-385, 1970-2 C.B. 156.

The obligations of states and municipalities, state housing authorities, and United States possessions are also excluded from the definition of United States property. *See* Rev. Rul. 72-454, 1972-2 C.B. 457; Rev. Rul. 71-14, 1971-1 C.B. 218. *See also* Letter Ruling Nos. 7911122; 7829132.

145. I.R.C. § 956(b)(2)(B). Equipment used primarily in international transport and export trade assets under section 971(c) are excluded from the definition of United States property.

146. I.R.C. § 956(b)(2)(C). This provision is designed to exclude intercompany trade receivables arising in the ordinary course of business from the definition of United States property.

147. I.R.C. § 956(b)(2)(D). The determination of use predominately outside the United States is made on the basis of all relevant facts and circumstances. Generally, transportation equipment will be deemed to be used predominantly outside the United States if 70% or more of the miles travelled during the taxable year are outside the United States, or if the equipment is located outside the United States 70% of the time during the taxable year. Treas. Reg. § 1.956-2(b)(1)(iv) (1964).

148. I.R.C. § 956(b)(2)(E). This provision is designed to permit foreign insurance companies to invest premium reserves in the United States, except for those reserves attributable to insurance of United States risks which would be currently taxable under § 953. *See* note 95 *supra* and accompanying text.

149. I.R.C. § 956(b)(2)(F). This exclusion is applicable only to taxable years beginning after Dec. 31, 1975. *See* notes 127-28 *supra* and accompanying text.

150. I.R.C. § 956(b)(2)(G). This exclusion was added in order to encourage

and, (8) assets of a CFC equal to earnings and profits accumulated after December 31, 1962, and excluded from Subpart F income because such assets are attributable to income from sources within the United States which is effectively connected with the conduct of a trade or business within the United States.[151]

(3) *Calculation of Amount Included in Gross Income*—A United States shareholder's pro rata share[152] of a CFC's increase in earnings invested in United States property is determined, for any taxable year, by comparing the amount of United States property held at the end of the current year that would have constituted a dividend if distributed with the dividend amount at the end of the prior taxable year.[153] Application of the dividend limitation requires computation of the earnings and profits of the CFC accumulated after February 28, 1913, not just from the effective date of the Subpart F provisions.[154] To prevent double taxation, two major adjustments are provided for purposes of applying the dividend limitation. The calculation of earnings and profits excludes (1) distributions in the taxable year of amounts previously included in the income of a United States shareholder in respect of an increase in earnings invested in United States property, and (2) amounts that are or have been included in income as foreign personal holding company income under section 551(b), or which would have been so included if they had not been distributed.[155] Thus, while the actual distribution may be received tax-free, the reduction in the dividend amount makes

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exploration and development of oil and other valuable natural resources, and applies only to taxable years beginning after Dec. 31, 1975.

151. I.R.C. § 956(b)(2)(H). This exclusion insures that income of the CFC which has been subject to full United States taxation, by virtue of its character as effectively connected income, will not be subjected to United States taxation a second time due to investment in United States property. The exclusion is not available for income exempt from United States tax or subject to a reduced rate of tax pursuant to a tax treaty. I.R.C. § 952(b).

152. The determination is made on the basis of stock owned by such United States shareholder on the last day during the taxable year on which the foreign corporation is a CFC. I.R.C. § 956(a)(2); Treas. Reg. § 1.956-1(d) (1964).

A United States shareholder's increase is limited proportionally to that part of the taxable year in which the CFC qualified as a CFC. I.R.C. § 951(a)(4).

153. I.R.C. § 956(a)(2).

154. Dougherty v. Comm'r, 60 T.C. 917 (1973). The computation of other Subpart F income is based on earnings and profits accumulated after Dec. 31, 1962, the effective date of the Subpart F provisions.

155. I.R.C. § 959(d); Treas. Reg. § 1.956-1(b)(2) (1964).

possible an increase in the amount of earnings invested in United States property in a subsequent year.[156] Also, in computing the amount includable in income as an increase in earnings invested in United States property, the amount of previously taxed Subpart F income[157] is subtracted from the amount of increase in earnings invested in United States property, thereby reducing the amount includable in income as an increase in earnings invested in United States property.[158]

As can be seen, the calculation of increase in earnings invested in United States property does *not* represent either an increase in the amount invested in United States property or an increase in earnings of the CFC, but a combination of the two. This multivariable calculation often leads to an unexpected increase in earnings invested in United States property, with multiple taxation of the same investment in subsequent years; a result clearly in violation of statutory intent. The structure of the increase in earnings calculation produces three types of unexpected results. If the CFC begins with no earnings and thereafter maintains a constant level of earnings which it invests entirely in United States property, the annual earnings generated by such investment are attributed to the United States shareholder in the year of investment and then only every other year thereafter, although the investment in United States property is increased each year. Thus, the United States shareholder escapes taxation of its increased investment in United States property every other year. Every other year inclusion also results when the CFC maintains a constant level of investment in United States property but experiences fluctuations in its annual level of earnings, or when the CFC maintains a constant level of annual earnings, but liquidates its investment in United States property every other year. However, the result in these latter cases is multiple taxation of the same initial investment.[159]

e. Income Attributed to United States Shareholders

Under the provisions of Subpart F, every United States share-

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156. *See* Wilcox & Geen, *supra* note 60, at A-17.

157. The amount of previously taxed Subpart F income deducted includes Subpart F income of the current year and for prior years. *See* Rev. Rul. 76-538, 1976-2 C.B. 230.

158. I.R.C. § 959(a); Treas. Reg. § 1.959-1(c) (1965).

159. *See* Wilcox & Geen, *supra* note 60, at A-15, A-16.

holder of a corporation qualifying as a CFC for at least thirty days during the taxable year, owning stock in the corporation on the last day of a taxable year during which the corporation is a CFC, is taxed on the following four items of income: (1) his pro rata share of the corporation's increase in earnings invested in United States property, (2) his pro rata share of the corporation's Subpart F income, (3) his pro rata share of previously excluded Subpart F income which has been drawn from investment in less developed countries, and (4) his pro rata share of the corporation's previously excluded Subpart F income withdrawn from investment in foreign base company shipping operations.[160]

The pro rata share of Subpart F income is the amount which would have been distributed with respect to the stock that the shareholder owns if the corporation had distributed its earnings and profits earned during the period of the year for which it was a CFC.[161] It is immaterial whether the stock is owned directly or by application of the attribution rules. Thus, a shareholder may be subjected to taxation even though he has no direct interest in the corporation. The amount of the deemed distribution is reduced by actual distributions received by any other person during the taxable year as a dividend.[162]

The Subpart F income of the United States shareholder may not exceed the earnings and profits of the foreign corporation for the year.[163] If the shareholder has been required to include an amount in his income because it is Subpart F income, he will not be required to include such income again when it is actually distributed to him.[164] The exclusion applies even if he sells the stock before the distribution takes place.[165] For this purpose, distributions are deemed to be drawn first from amounts already included in gross income and then from amounts not already included.[166]

There is an exclusion for amounts invested in qualified foreign base company shipping operations. The exclusion only applies, however, when the investment increases. When there is a decrease in investment, the United States shareholder must include his pro

160. I.R.C. § 951(a)(1).
161. I.R.C. § 951(a)(2).
162. I.R.C. § 951(a)(2)(B).
163. I.R.C. § 952(c).
164. I.R.C. § 959(a).
165. *Id.*
166. I.R.C. § 959(c).

rata share of the reduction in income as additional Subpart F income.[167]

Prior to 1975, a CFC could exclude from its Subpart F income certain income derived from investment in a less developed country (LDC). This exclusion was terminated by Pub. L. No. 94-12,[168] but amounts previously excluded must now be included in income if they have been withdrawn from investment in LDC's.[169]

As discussed earlier, a United States shareholder will be taxed on his pro rata share of the earnings of the CFC invested in United States property to the extent that the investment constitutes an increase for the year.[170] If the corporation is a CFC for its entire taxable year, the shareholder's pro rata share to be included in gross income is that amount which would have been distributed with respect to the shareholder's ownership interest if the corporation had distributed the total amount of the above items. If the corporation is a CFC for only a part of its taxable year, the United States shareholder will have to include the above items in gross income only with respect to the period during the year the corporation was controlled.[171]

f. Special Provisions

(1) *Foreign Tax Credit*—Subpart F contains a special provision granting United States shareholders who are taxed on Subpart F income or on the increase in earnings invested in United States property a foreign tax credit for foreign income, war profits, and excess profits taxes paid or deemed to have been paid by the foreign corporation, if the shareholder is a person to whom such a foreign credit would be allowed in the case of an actual distribution.[172] The provision was necessary because amounts taxed under Subpart F to a United States shareholder are not dividends and would not be covered by the foreign tax credit provisions of section 902.[173]

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167. I.R.C. § 951(a)(A)(iii).

168. Title VI-Taxation of Foreign Oil & Gas and Other Foreign Income, Pub. L. No. 94-12, 89 Stat. 54 (1975).

169. I.R.C. § 951(a).

170. I.R.C. § 951(a)(1)(B), 956(a); *see* notes 114-21 *supra* and accompanying text.

171. I.R.C. § 951(a)(2).

172. I.R.C. § 960.

173. For a detailed description of the availability of foreign tax credits, see

The foreign tax credit will be allowed when the shareholder is a domestic corporation holding the stock of a foreign corporation and has at least a 10% voting stock interest (i.e. a "first-tier foreign corporation").[174] When a first-tier foreign corporation has at least a 10% voting interest in a "second-tier foreign corporation,"[175] a foreign tax credit will be allowed the United States shareholder with respect to the earnings of the subsidiary when the undistributed earnings of the subsidiary are taxed to the United States corporate shareholder.[176] Under the Tax Reform Act of 1976, a domestic corporate shareholder of a foreign corporation is also entitled to a foreign tax credit for foreign taxes paid by the subsidiary of the subsidiary (i.e., "third-tier foreign corportions") with respect to the third-tier corporation's earnings and profits required to be included in the domestic shareholder's gross income.[177] For the foreign tax credit to be available for foreign taxes paid by the lower-tier companies, the domestic corporation must have at least a net 5% ownership in the voting stock of each such corporation of the lower tiers.[178] This is determined by multiplying the applicable percentages of voting stock held by each of the preceding tiers.[179] Where a tax is allowed as a credit, it will not again be allowed as a credit when distributions are actually made.[180]

(2) *Adjustments To Basis*—Amounts required to be included in the income of a United States shareholder because of Subpart F income or an increase in earnings invested in United States property are added to the basis of the stock owned by the United States shareholder.[181] A United States individual shareholder, however, who elects to be taxed at corporate rates under section 962, is required to write up his basis only to the extent of the United States tax paid on the amounts included in his gross in-

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Geen & Schreyer, *Foreign Tax Credit-Qualification and Computation*, TAX MNGM'T PORT. No. 5-4th (1979).

174. I.R.C. § 960(a)(1)(A).

175. I.R.C. § 960(a)(1)(B).

176. *Id.*

177. I.R.C. § 960(a)(1)(C).

178. I.R.C. § 960(a)(1), incorporating by reference I.R.C. §§ 902(b)(3)(A), 902(b)(3)(B).

179. I.R.C. §§ 902(b)(3)(A), 902(b)(3)(B).

180. I.R.C. § 960(a)(2).

181. I.R.C. § 961(a).

come.[182] The upward adjustment must be made at the end of the corporation's taxable year or the date on which it ceased to be a CFC.[183]

A decrease in the basis of the shareholder's stock is required when he receives a distribution which is excluded from his gross income as having been previously taxed.[184] Shareholders who have elected to be taxed at corporate rates are limited to an exclusion equal to the tax that was paid on the amounts previously included in gross income.[185] The amount of the decrease in basis is equal to the exclusion for previously taxed earnings and profits plus any income, war profits, or excess profits taxes imposed on the excluded distribution.[186] To the extent that the excluded amount exceeds the adjusted basis of the stock to which it is distributed, it is treated as a gain from the sale or exchange of property.[187]

(3) *Calculation of Earnings and Profits*—Special rules are provided for the calculation of earnings and profits of the CFC. The Regulations call for the following five-step procedure to adjust the books of the foreign corporation. First, prepare a profit and loss statement from the regular books of account kept by the corporation for the purpose of accounting to its shareholders. Second, make adjustments necessary to conform the statement to accounting principles used in the United States. Third, make any further adjustment necessary to conform the statement to tax accounting standards used in the United States. Fourth, translate the amount shown into United States dollars. Last, adjust the profit or loss to reflect any exchange gain or loss.[188]

g. Exceptions and Exclusions

Subpart F contains a number of exceptions and exclusions designed to provide taxpayer relief when a tax avoidance motive is not present, and, in some cases, to effectuate policy determinations of Congress that are not directly related to tax avoidance.

In keeping with the United States policy of encouraging devel-

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182. *Id.*
183. Treas. Reg. § 1.961-1(a), T.D. 6850 (1965).
184. I.R.C. § 961(b)(1).
185. *Id.*
186. Treas. Reg. § 1.961-2(a), T.D. 6850 (1965).
187. I.R.C. § 961(b)(2).
188. Treas. Reg. § 1.964-1(a), T.D. 7322 (1974).

opment in United States possessions, section 957 provides that foreign corporations created or organized in the Commonwealth of Puerto Rico, or in a possession of the United States, which have 80% or more of their income for the three-year period immediately preceding the close of the taxable year from sources within Puerto Rico or a possession of the United States,[189] and derive 50% or more of their gross income from the active conduct of a trade or business within Puerto Rico or a possession,[190] will not be considered a CFC for Subpart F purposes. Section 957 contains further provisions which exclude from the definition of United States person, for purposes of Subpart F, bona fide resident individuals of Puerto Rico,[191] the Virgin Islands,[192] and other possessions[193] if certain tests are met.[194]

Subpart F also contains a broad subjective exception that is available when the foreign corporation is not used to reduce taxes. The subjective test is satisfied when the taxpayer establishes to the satisfaction of the Secretary or his delegate that neither the creation or organization of the controlled corporation, nor the effecting of the transaction giving rise to income, had as one of its significant purposes a substantial reduction of income, war profits, excess profits, or similar taxes.[195] Reliance on this exception may be dangerous because of its subjective nature.

If foreign base company income comprises less than 10% of the CFC's total gross income, none of the gross income is treated as foreign base company income. Conversely, if foreign base company income (with certain exclusions) exceeds 70% of the total gross income of the CFC, all gross income for the taxable year (with certain exceptions) is treated as foreign base company in-

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189. I.R.C. § 957(c)(1).

190. I.R.C. § 957(c)(2).

191. *See* I.R.C. § 957(d)(1).

192. *See* I.R.C. § 957(d)(2).

193. *See* I.R.C. § 57(d)(3).

194. I.R.C. § 931(a).

195. I.R.C. § 954(b)(4). Objective tests were employed until the Tax Reform Act of 1969. In the case of foreign personal holding company income, the exclusion applied only if no minimum distribution would have been required (i.e., when the foreign tax rate was at least 90% of the United States corporate rate). More complex rules were applied for sales and service income. One of the reasons for the change was to provide relief where foreign investments are sold in countries which have little or no capital gains tax. *See*, *S. Rep. No.* 91-552, 91st Cong., 1st Sess. 290 (1969).

come.[196] Foreign base company income of a CFC is reduced to take into account expenses, taxes, and other deductions properly allocable to the income.

Until December 13, 1975, section 954(b)(1) excluded from the definition of personal holding company income, any foreign base company dividends and interests received during the taxable year from investments in less developed countries. Gains from the sale or exchange of investments which qualified as investments in a LDC at the time of the sale or exchange were not treated as Subpart F income. Taxpayers who have previously excluded amounts of income under the prior law may continue to do so but must include those amounts into income when their LDC investments decrease.[197]

Subpart F also originally excluded income derived from, or in connection with, the use, hiring, or leasing for use, of any aircraft or vessel in foreign commerce. This exclusion was repealed in 1975 and shipping income was made into a separate category of Subpart F income. An exclusion is still available to the extent the income is invested in shipping operations. Also terminated in 1975 were provisions relating to minimum distributions. Under prior law, relief was available if distributions were made which, when taxed by the United States, resulted in an overall tax rate equal to 90% of the United States rate.

Congress recognized the serious consequences of income deemed distributed under Subpart F to an individual and provided relief for such individuals. And United States shareholders may now elect to be taxed as a corporation for Subpart F purposes under section 962. If an individual takes the election, the tax on the attributed income is equal to the corporate tax on such amounts if they had been received by a domestic corporation, with a corresponding limitation on the foreign tax credit available.

B. *West Germany*

1. Jurisdiction

The primary jurisdictional basis for taxation in West Germany is residency. Residents are subject to tax on their total income, from foreign as well as domestic sources. In German terminology

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196. I.R.C. § 954(b)(3).
197. I.R.C. § 951(a)(A)(ii).

residents are said to be liable to "unlimited tax liability." The nationality of the taxpayer is disregarded in the determination of unlimited tax liability.

For individual taxpayers, residence is established either by domicile or customary place of abode. "Domicile" of an individual is defined as the place where he occupies a residence under circumstances indicating an intent to remain and not merely to use it temporarily.[198] An individual may have more than one domicile, and if he has a domicile within, as well as outside of West Germany, he is considered to be a resident for West German income tax purposes. Intent is established by objective facts and not by declared or undeclared intention. One of the important factors in the determination of domicile is whether a person who moves to West Germany brings his family with him. "Customary place of abode" connotes mere physical presence for an extended period of time under circumstances which indicate that the stay will not be temporary. Once the individual's stay exceeds six months, he will be irrefutably presumed to maintain a customary place of abode in West Germany.[199]

A corporation is a resident taxpayer if it maintains its statutory seat or its principal place of business in West Germany. A corporation has its seat at the place designated in its charter. If there is no such designation, the corporation's seat is the place where the management is located, or where administration of the corporation takes place. "Place of management" is defined as "the center of management control."[200] Place of management is generally located at the main office where the fiscal decisions on major questions affecting the corporation's business are made. Corporations organized under West German law are required to specify in their charter a statutory seat in West Germany. Consequently, all such corporations are resident taxpayers. Corporations organized under the laws of a foreign jurisdiction may be treated as residents if they transfer their principal place of business to West Germany. The opening of a German branch operation by such a foreign corporation will not expose its worldwide income to West

198. General Tax Act (Abgabenordnung, or AO) § 8.

199. Killius, *Business Operations in West Germany*, TAX MNGM'T PORT. No. 174-4th, at A-33 (1978).

200. Keining, *Anti-Avoidance Measures in Germany*, in TAX HAVENS AND MEASURES AGAINST TAX EVASION AND AVOIDANCE IN THE EEC, 29 (A. Jones ed. 1974).

German corporate income taxation provided its home office remains outside of West Germany. Nonresident individuals are subject to "limited tax liability" (beschraenkte steverpflicht) which covers only certain items of income derived from German sources.[201] Nonresident corporations are similarly subject to West German corporate income taxes only with respect to certain income derived from West German sources. In contrast to resident corporations which can only generate business profits, the income of a nonresident corporation is not automatically considered to constitute business profits. Rather, it must be determined whether the corporation derives items of income from West German sources which would qualify under another category of income, such as dividends, interest rentals, and royalties, or income from independent services if they had been realized by an individual and if an individual could have performed such services outside of a business activity.[202]

2. Tax Abuse Measures

a. Introduction

Abuse of the tax laws through utilization of CFC's has been attacked by West German authorities on four grounds. The first three are based on general provisions of the West German tax law. The first provision empowers the tax authorities to disregard a transaction if concepts or institutions of civil law are abused with the intention of evading taxes.[203] The second provision em-

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201. The following types of income are taxable to a nonresident individual: (a) commercial or industrial profits derived either through a permanent establishment situated in West Germany or through a permanent representative located in West Germany; (b) profits from the sale or exchange of shares in a domestic corporation if the nonresident individual holds an interest of at least 25% in such domestic corporation; (c) income from independent personal services performed or used in West Germany; (d) compensation from employment if the services are performed or used in West Germany; (e) dividends paid by resident corporations; (f) interest paid with respect to straight bonds, convertible bonds, or income bonds, if the debtor maintains a statutory seat, or principal place of management in West Germany, or interest paid with respect to receivables secured by West German real estate; (g) rental income from domestic real estate, unless held for a period of at least two years; and (h) rental income for the use of personal property or of intangible property within West Germany. Income Tax Act (Einkommesteurgesetz) § 49.

202. Income Tax Act § 49(2).

203. General Tax Law § 42.

powers the tax authorities to disregard sham transactions.[204] The third provision requires that items of income or assets received or held by a trustee (Treuhander) are to be attributed directly to the person who granted the trust (Treugeber).[205] Under this latter provision, the West German government has contended that when residents organize a foreign corporation which invests in securities, the foreign corporation can be treated as a dummy or nominee and its income attributed to resident shareholders.

Until 1972, the above provisions were the predominant bases for attacks against the use of CFC's to avoid or evade taxes. The provisions, however, were insufficient to effectively combat abuse. Consequently, in September 1972, a statute was enacted which was aimed at curbing tax abuse through foreign corporations. This statute, entitled "Act to Ensure Quality of Tax Treatment in International Relationships and to Improve the Competitive Situation Regarding the Taxation of Foreign Investments,"[206] is generally referred to as "Foreign Tax Law" (Aussensteuergestez). It operates in a manner analogous to Subpart F in the United States Internal Revenue Code by attributing to resident shareholders of a CFC income of such corporation (under certain circumstances) whether or not the income is actually distributed.

b. General Measures

(1) *Tax Evasion*—Section 8 of the General Tax Act (Abgabenordnungor A.O.) empowers the tax agent to disregard a transaction if concepts or institutions of civil law are abused with the intention to evade taxes. Under the decisions of West Germany's highest tax court, the Bundesfinanznof (BFHE), the provision is not an effective weapon for combating tax abuse. The BFHE has repeatedly held that the taxpayer is free to cast his transactions in a form which will result in the least possible tax burden.[207] The BFHE has further held that the provision can only be used to disregard the transaction if the intent to evade tax can be clearly

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204. *Id.* § 41.

205. *Id.* § 39(2)(1).

206. For a bilingual English-German text, see BILLSTEDT, INTERNATIONAL TRANSACTIONS TAX ACT (1972).

207. Killius, *A New German Statute Regulating International Tax Aspects—Its Implications For Multinational Companies*, TAX. MNGMT. INT'L J., Dec., 1973, at 3.

established.[208] In this respect, two criteria must be satisfied; first, the concept of civil law used has to be unusual for the economic purposes the transaction seeks to achieve, and second, there must not be any economic or other significant reasons which justify the use of such a concept of civil law.[209] The latter requirement limits the effectiveness of the provision because the taxpayer can almost always assert an acceptable alternative motivation. For example, a taxpayer could successfully argue that he organized a base company in Switzerland because of the availability of its developed capital market or because of its stable currency situation.[210]

(2) *Sham Transaction*—Section 41 of the General Tax Act empowers the tax agent to disregard sham transactions, such as the organization of a base company for the sole purpose of transfering assets to it.[211] This provision is largely ineffectual, however, since in most instances the taxpayer is able to establish that the organization of the foreign corporation and the transfer of assets to it were seriously intended and consummated. A further limitation of the provision is that it presumes that the transaction constitutes a sham and is void under civil law as well.[212]

(3) *Attribution of Trust Income*—Section 39(2)(1) of the General Tax Act requires that the income or assets received or held by a trustee (Treuhander) be attributed directly to the person who granted the trust (Treugeber). Under this provision the BFHE, in a case in which German residents had organized a Swiss corporation to invest in securities, treated the Swiss corporation as a nominee or dummy and attributed ownership of the securities to its resident shareholders.[213] The decision was based on the fact that the Swiss corporation merely served the personal interest of its West German principals. The impact of the decision was restricted, however, by a subsequent case which held that the mere fact that a base company serves the interests of its shareholders and is controlled by them does not justify the assumption of an express or implied trust relationship between

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208. BFHE decision of Mar. 2, 1966, BStBl. 1966 III 509; BFHE decision of Oct. 20, 1965, BStBl. 1965 III 697.

209. BFHE decision of July 17, 1968, BStBl. 1968 II 695; RAUPACH, OER DURCHGRIFF IN STEUERRECHT 64 (1968).

210. Killius, *supra* note 207, at 3.

211. BFHE decision of July 17, 1968, BStBl. 1968 II 695.

212. Killius, *German Law and Practice*, in TAX HAVEN ENCYCLOPAEDIA 11 (B. Spitz ed. 1979).

213. BFHE decision of May 21, 1971, BStBl. 1971 II 721.

them, and that as a rule the base company cannot hold its stated capital in trust for its shareholders.[214]

c. Foreign Tax Law

(1) *Introduction*—Three aspects of West Germany's tax structure were largely responsible for the creation of the Foreign Tax Law: West Germany's reliance on the taxpayer's residence as the jurisdictional basis for imposing its income tax; the exemption method traditionally employed by West Germany in its tax treaties;[215] and West German corporate law's recognition of the corporate entity as a separate and distinct taxpayer in relation to its shareholders.[216] As a consequence of the above, West German taxpayers were able to effectively defer payment of taxes by using subsidiaries in tax haven countries.

The Foreign Tax Law was enacted in September 1972 to combat the use of CFC's to avoid or evade taxation. Among the provisions of the statute are measures providing for reallocation of profits between related enterprises[217] and for special treatment of foreign base companies.[218] The reallocation provisions are roughly analogous to section 482 of the United States Internal Revenue Code and the provisions relating to foreign base companies are analogous to Subpart F in the United States Internal Revenue Code.

(2) *Reallocation of Income*—Section 1 of the Foreign Tax Law provides that, notwithstanding other statutory provisions, a taxpayer's income may be adjusted upward to reflect what should

214. BFHE decision of Jan. 29, 1975, BStBl. 1975 II 553.

215. Traditionally, German tax treaties allocated the items of income to either the country of source or the country in which the taxpayer was domiciled and exempted such income from taxation in the respective other contracting state. Beginning with the United States West Germany Treaty of 1954, German tax treaties have increasingly adopted the tax credit method as well. Thus, certain items of foreign source income are exempt from the corporate income tax by operation of a tax treaty, while a foreign tax credit may be granted with respect to other foreign source income. The Swiss Treaty of 1971 revealed a definite shift to the tax credit method, as the application of the exemption method there was confined to certain foreign items of income derived from an active business (such as the income of a Swiss manufacturing branch) or dividends distributed by a Swiss manufacturing subsidiary. Killius, *supra* note 199, at A-27.

216. Killius, *supra* note 207, at 3.

217. Foreign Tax Law (Aussensteuergesetz) § 1.

218. *Id.* §§ 7-14.

have been an arms-length compensation if the taxpayer's income was reduced as a result.

Several aspects of this provision should be noted. First, it applies only to international transactions. Second, it applies only to transactions between two or more taxpayers.[219] Third, the statute does not apply in instances where the controlled transactions resulted in an increase of income rather than a decrease in income. Last, the provision only applies to transactions between related persons as defined by the statute. A taxpayer will be considered related to a person if the following conditions are met:

(1) the person holds directly or indirectly an interest of at least 25% in the taxpayer or if the person is in a position to exercise directly or indirectly a dominating influence over the taxpayer, or conversely, if the taxpayer holds an interest of at least 25% in the person or is in a position to exercise directly or indirectly a controlling influence upon such person; or

(2) a third person holds an interest of at least 25% in such person as well as in the taxpayer or if such third person is in a position to exercise directly or indirectly a controlling influence upon both of them; or

(3) the person or the taxpayer is in a position when negotiating the conditions of a business transaction to exercise on the taxpayer or such person an influence which is based on factors outside of such business relationship, or if one of them has an interest of his own in seeing the other party generate such income.[220]

(3) *Attribution of Foreign Base Company Income*—The Foreign Tax Law contains detailed provisions under which items of base company income realized by foreign controlled corporations are includable in the taxable income of their West German shareholders. The provisions are designed to eliminate from West German taxation the deferment of certain income realized by a foreign corporation but not distributed to the West German shareholder and not subject to comparable taxation abroad. Like Subpart F in the United States, the provisions do not attempt to

219. Consequently, it applies neither to transactions between a domestic company and its foreign establishment nor to transactions between a foreign company and its West German establishment. Conversely, it does apply to transactions between domestic businesses of taxpayers (whether resident or nonresident) and their foreign establishments. *Id.* at 7.

220. Foreign Tax Law § 1(2).

extend the jurisdiction of West Germany to tax foreign controlled corporations directly. Rather, the provisions are concerned with the tax status of the resident shareholders of the corporation. In essence, under certain circumstances resident shareholders of a foreign corporation will be taxed on their pro rata share of the corporation's earnings regardless of whether or not the income is distributed.

(a) *Controlled Foreign Corporation*—As in Subpart F, the heart of the West German foreign base company provisions is the "controlled foreign corporation." Controlled foreign corporation is defined as a foreign corporation in which more than 50% of its shares or the total voting power of all of its shares are owned or considered to be owned, directly or indirectly, on the last day of the corporation's financial year, by resident taxpayers alone or together with persons who are subject to extended limited tax liability under section 2 AS&G.[221] If the corporation does not have a stated capital and does not grant voting rights, then the participation in the corporation's assets will be controlling.[222]

Like Subpart F, constructive ownership rules apply. Shares held by a trustee on behalf of a resident taxpayer are considered owned by the resident taxpayer.[223] Shares or voting rights owned by a person who is not a trustee but who, nevertheless, has to follow the instructions of a resident taxpayer or who, in fact, abides by such instructions without having any discretionary rights are equally attributed to the resident taxpayer.[224] Shares or voting rights held by an intermediary corporation are attributed to the resident shareholders of such intermediary corporation in the proportion which their share holdings in the intermediary corporation bear to all of the shares in the foreign corporation held by the intermediary corporation. The same rules apply if more than one corporation should be interposed between the foreign entity and the resident taxpayer.[225] Shares in a foreign corporation held by a domestic or foreign partnership are considered as owned by resident partners in proportion to their interests in

221. Foreign Tax Law § 2 covers German residents who move to a low tax country and retain significant economic ties with Germany.

222. Killius, *supra* note 207, at 9.

223. Fiscal Code (German name) § 39(2)(1).

224. Foreign Tax Law § 7(4).

225. *Id.* § 7(2).

such partnerships.[226]

(b) *Domestic Shareholder*—A domestic shareholder under the attribution provisions is a domestic corporation or resident individual who holds an interest in a foreign controlled corporation. Unlike the definition of United States shareholder in Subpart F,[227] there is no minimum holding requirement. Consequently, resident shareholders owning only a few shares in a foreign corporation may be subject to taxation of undistributed income, if the resident shareholders together hold more than 50% of the corporation's shares.

(c) *Base Company Income*—The attribution provisions contain a conclusive list of items which are considered active income. All other items are considered base company income and may be attributable to domestic shareholders if the foreign entity qualifies as a foreign controlled corporation. AS&G section 8 contains the following list of active items: (1) income from agriculture or forestry, (2) manufacturing activities including the manufacture, processing, transformation, or assembly of tangible personal property, the production of energy, as well as the exploration for and extraction of natural resources, (3) income from the operation of a bank or insurance business which maintains office facilities to transact its business, (4) sales income,[228] (5) service income,[229] (6) rental and royalty income,[230] (7) the borrowing

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226. *Id.* § 7(4).

227. *See* note 79 *supra* and accompanying text.

228. Income from sales between the controlling domestic taxpayer or an affiliated person and a third party, however, will be considered tainted unless the taxpayer can establish that the foreign corporation maintains office facilities equipped to transact such sales activities in preparation, execution, and follow-up of the sales without the assistance of a controlling domestic taxpayer or of an affiliated person.

229. Service income is tainted if the services are performed by the foreign controlled corporation with the assistance of either a resident controlling shareholder or a person who is considered affiliated with such taxpayer, or if the services are rendered to a resident taxpayer who is considered a controlling shareholder or to an affiliated person, unless the taxpayer can establish that the foreign controlled corporation maintains fully equipped office facilities required for the performance of the services concerned and engages in the active conduct of its business with third parties; furthermore, the activities forming part of its service must be performed without the assistance of the controlling taxpayer or of an affiliated person.

230. The rental and royalty exception is subject to stringent limitations which are spelled out in Foreign Tax Law § 8(1)(6).

and lending of money if the taxpayer establishes that the funds are borrowed exclusively at foreign capital markets and are contributed on a permanent basis to businesses or business establishments located otside of Germany which derive their earnings exclusively or almost exclusively from the activities listed above, and (8) dividends income, if the foreign corporation holds at least 25% of the stated capital of the distributing foreign corporation from the beginning of the financial year, and if it can be established that the distributing corporation maintains either its statutory seat or principal place of management in the same state as the foreign controlled corporation and that it derives its gross receipts exclusively or almost exclusively from the activities listed above under (1)-(7), or if the interest in such distributing foreign corporation is held in the context of the particular activities of the foreign controlled corporation under (1)-(7) above, and if the distributing corporation derives its gross receipts exclusively or almost exclusively from such activities.

(d) *Attribution of Income*—The tainted income of a CFC will be attributed to its German controlling shareholders if such tainted income is subject to income taxes at a rate below 30% in the state in which the principal seat of management or its statutory seat is located.[231]

The attributable tainted income is deemed to have been received by the resident controlling shareholder immediately after the close of the financial year of the foreign controlled corporation. It is includable in the German controlling taxpayer's taxable income as income from capital unless, as is commonly the case, the interest in the foreign controlled corporation forms part of the business assets of the controlling German taxpayer. In the latter situation, the attributable income is includable in taxable net profits of the business for the financial year which ends after the close of the financial year of the foreign controlled corporation.

The net income which forms the basis of the attributable income must be computed in accordance with German tax law provisions. Generally, such net income has to be determined on the accrual basis. If all the German controlling taxpayers concerned agree, however, the cash method may be used.[232] In determining the attributable tainted income, only such expenditures may be deducted as expenses which are economically connected with the

231. Foreign Tax Law § 8(3).
232. Income Tax Act § 4(3).

attributable items of income. Income and net worth taxes which have been levied against the foreign controlled corporation may be deducted from the attributable income. The amount of the tainted income is reduced by the amount of actual dividend distributions.

C. *Japan*

1. Introduction

In general, Japanese corporations are subject to tax on their worldwide income, including income earned by branch offices established in foreign countries, even though such income is not repatriated to Japan. Prior to 1978, however, income earned by foreign subsidiaries was not attributed to and included in income of the Japanese parent until such profits were repatriated in the form of dividends, liquidation proceeds, or proceeds from the sale of shares. Under comprehensive legislation effective April 1, 1978, certain Japanese shareholders are taxed currently on the taxable undistributed profits of designated tax haven subsidiaries.[233]

2. Jurisdiction

Generally, all private business entities established in Japan, including corporations (*kabushiki kaisha*), limited companies (*yugen kaisha*), and commercial partnership companies (*gomei kaisha* and *goshi kaisha*), are subject to Japanese corporate tax on their worldwide income.[234] Income earned by foreign subsidiaries generally is not taxed to the Japanese parent company until remitted to the parent, unless such undistributed profits are realized by a "designated tax haven subsidiary." In this latter situation the profits must be reported by Japanese shareholders having at least a 10% equity share in such subsidiary.

Japanese domestic tax law defines a domestic corporation as one having its "head office or principal place of business" in Japan.[235] It has been suggested, however, that a foreign corporation

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233. Special Tax Measures Law (sozei tokubetsu sochiho), arts. 66-69 (1978) [hereinafter cited as STML].

234. Corporate Tax Law (hojizeho), arts. 4(1), (5) [hereinafter cited as CTL]; Local Tax Law (chihozeho), arts. 23(1)(iii), 23(1)(iv), 292(1)(iii), 292(1)(iv) [hereinafter cited as LTL].

235. Income Tax Law (shotukuzeiho), arts. 2(1)(vi), 2(1)(vii) [hereinafter cited as ITL], *see* Minpa (Civil Code) art. 50 (company has its domicile or per-

established in a foreign country, which conducts its sole business activity in Japan may be subject to tax as a Japanese domestic company.[236]

3. Taxation of Designated Tax Haven Subsidiaries

a. Introduction

Provisions similar to the Subpart F provisions of the United States were first enacted in Japan in 1978. Under these provisions, the taxable undistributed profits of designated tax haven subsidiaries are imputed to their Japanese shareholders as earned, regardless of whether such profits were actually distributed. Unlike the United States Subpart F provisions, which specify the types of tainted income which must be currently reported by the United States shareholder of a controlled foreign corporation, the Japanese provisions focus on the identification of designated tax haven subsidiaries. If a foreign subsidiary falls within the definition, all of its income is included in the calculation of taxable undistributed profits which must be currently reported by the Japanese shareholder, even if some of the foreign subsidiary's income is active business income which would not constitute Subpart F income under United States laws.[237]

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sonal residence at the place of its principal office); Shoho (Commercial Code) art. 54(2) (company has its permanent abode where its head office is located).

236. Way, Brockman & Otsuka, *Business Operations in Japan*, TAX MNGM'T PORT. No. 51-6th, at C&A-7, *citing* Komatsu, Hojineiho ni okeru Kokusai Kazei no sokumen ni tsuite (On Facets of International Taxation in the Corporation Tax Law) in GENDAI KIGYO KAZEIRON (Discussion of the Taxation of Modern Industry) 167-70 (1977).

The suggestion stems from a 1954 case arising under Shoho (Commerical Code), art. 482. Judgment of June 4, 1954, Hanrei Taimusu No. 40, at 73 (Tokyo Dist. Ct., Showa 28 (MO) 16308). The court found that a Delaware corporation whose sole business was in Japan should have complied with the formal corporate procedures for incorporation under the Japanese Commercial Code. Although not a tax case, the theory of the case indicates that the corporation would be treated as a domestic company.

237. The effect of the Japanese focus on the nature of the foreign subsidiary rather than the type of income it produces is to allow a foreign subsidiary not falling within the definition of "designated tax haven subsidiary" to realize substantial amounts of passive income that would be classified in the United States as Subpart F income, without causing current attribution to its Japanese parent.

b. Japanese Shareholders

Japanese corporations which (1) hold, directly or indirectly, 10% or more of the outstanding shares of a designated tax haven subsidiary, or (2) are part of an affiliated group of shareholders (including residents and nonresidents) which holds in the aggregate 10% or more of such shares, are required to include in income their pro rata share of the taxable undistributed profits of the designated tax haven subsidiary.[238] Only the first tier of Japanese corporations are subject to the current reporting requirement.

c. Designated Tax Haven Subsidiary

"Designated tax haven subsidiary" is defined as a joint stock corporation or other corporate entity, incorporated or having its head office in a tax haven country (designated by the Ministry of Finance), which is more than 50% controlled, directly or indirectly, by Japanese shareholders.[239]

(1) *Tax Havens*—The Ministry of Finance has designated thirty-three jurisdictions as "tax havens."[240] The designated tax havens are divided into three groups: jurisdictions in which all corporate income is tax exempt or taxed at a low rate;[241] jurisdictions in which the foreign source income of a domestic corporation is tax exempt or taxed at a low rate;[242] and, jurisdictions in which corporate income from certain operations is tax exempt or taxed at a low value.[243]

(2) *Control*—The current reporting requirement applies only to designated tax haven subsidiaries more than 50% controlled,

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238. STML, arts. 66-6(1)(i), 66-6(1)(ii). Shares held by affiliated non-Japanese corporations are considered only for purposes of determining indirect ownerships by Japanese shareholders. STML, art. 66-6(2)(iii).

239. STML, art. 66-6.

240. Ministry of Finance Notification No. 38 (1978). The Ministry of Finance is authorized to amend this list as conditions warrant.

241. Included in this group are Andorra, Bahamas, Bahrain, Bermuda, British Channel Island, British Virgin Islands, Cayman Islands, Djibouti, Hong Kong, Isle of Man, Lichtenstein, Macao, Nauru, New Hebrides, Turks and Caisos Islands, Anguilla, and New Caledonia.

242. Included in this group are Panama, Costa Rica, St. Helena, Uruguay, and Venezuela.

243. Included in this group are Antigua, Barbados, Grenada, Gibraltar, Jamaica, Liberia, Luxembourg, Montserrat, Netherlands Antilles, St. Vincent, and Switzerland.

directly or indirectly, by Japanese shareholders. The shares held by all unrelated Japanese shareholders are counted in the control calculation, regardless of the shareholder's percentage ownership.[244] There are no limitations on the number of tiers of foreign subsidiaries which will be deemed to be owned by Japanese shareholders through the usual indirect ownership principles, even if intervening subsidiaries are not themselves controlled by Japanese shareholders.[245]

d. Exception

The purpose of the new provisions is to require current reporting by Japanese shareholders of undistributed profits of a foreign subsidiary if those profits are being shielded from Japanese tax through diversion of income to lower tax jurisdictions. Therefore, an exception is provided for foreign subsidiaries engaged in active business, even if the subsidiary is located in a designated tax haven. The following five requirements must be met in order to avoid imputation of undistributed profits from a tax haven subsidiary to its Japanese shareholders:[246] (1) the foreign subsidiary must have a fixed place of business in the tax haven, (2) the foreign subsidiary's business operations in the tax haven must be independently managed and controlled by a local staff, (3) the foreign subsidiary's principal business must not consist of holding securities, licensing industrial property rights, know-how, or copyrights; or, leasing shipping vessels or aircraft, (4) dividends received from designated tax haven subsidiaries must not exceed 5% of the foreign subsidiary's total current revenues, and (5) the majority of the foreign subsidiary's business must be conducted in the tax haven; or, in the case of banks and sales, trust, securities, insurance, shipping, and air freight companies, more than 50% of the volume in the foreign subsidiary's principal line of

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244. Unlike the United States Subpart F provisions, there is no minimum holding requirement for each shareholder included in the determination of control. *See* note 81 *supra* and accompanying text.

Members of a group of affiliated Japanese shareholders are deemed to be one shareholder for purposes of determining control and the current reporting requirement. STML, arts. 66-6(2)(i), 66-6(2)(iv).

245. STML, art. 66-6(2)(i).

246. STML, art. 66-6(2). It is anticipated that the Ministry of Finance will establish an informal procedure to advise Japanese companies as to whether their tax haven subsidiaries fall within the exception in a particular case.

business during the fiscal year must be transacted with unrelated parties.[247]

e. Taxable Undistributed Profits

Japanese shareholders must report currently their pro rata share of the taxable undistributed profits of the designated tax haven subsidiary. The amount which must be currently reported is equal to the income of the designated tax haven subsidiary less certain deductions for carried-over losses, corporate income tax paid to the tax haven country, and dividends declared by the tax haven subsidiary.[248]

(1) *Subsidiary Income*—The income of a designated tax haven subsidiary may, at the election of the Japanese taxpayer, be calculated pursuant to either Japanese domestic corporate income tax law or the laws of the tax haven where the subsidiary is located.[249] If the Japanese taxpayer elects to calculate the subsidiary's income in accordance with Japanese tax law, all of the deductions allowed domestic corporations may be taken, except that the amount of dividends received by the designated tax haven subsidiary must be fully included in income.

If the subsidiary's income is calculated under the law of the tax haven, certain income must be included in order to approximate the result that would be obtained under Japanese law. This includes the following types of income: (1) corporate income exempt from tax in the tax haven, (2) bonuses, compensation, retirement benefits, and other similar payments to corporate officers, if such payments would be deemed excessive, and therefore nondeductible, under Japanese law, (3) depreciation, corporate donations, and entertainment expenses in excess of the maximum amount deductible under Japanese law, and (4) any carried-over losses,

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247. Related parties include the following: (a) Japanese shareholders subject to the current reporting requirement and their affiliates or specially related persons, (b) a company holding 50% or more of the shares of such a Japanese shareholder and its affiliates or specially related persons, and (c) intervening foreign corporations through which Japanese shareholders hold an interest in the subsidiary. STML, art. 66-6(2).

248. Way, Brockman & Otsuka, *supra* note 236, at C&A-8, *citing* Saito Susumu, *Takkusu Heibun Zeisei no Kozo* (Structure of the Tax Haven System), 21 Zeiri (No. 8) 100, 101-04 (July 1978).

249. Once the election has been made, it may be changed only with the prior authorization of the Japanese tax office having jurisdiction over the Japanese taxpayer's head office.

corporate income taxes paid, and dividends declared by the tax haven subsidiary, which have been deducted under tax haven rules.

(2) *Deductions*—The following are the three major deductions from the subsidiary's pre-tax income which are permitted in order to determine the amount of taxable undistributed profits: (1) corporate income tax refunds received, if such refunds were included in income under tax haven rules, (2) losses incurred by the subsidiary during the immediately preceding five years,[250] and (3) corporate income and withholding taxes paid to the local tax haven, and dividends declared currently by the tax haven subsidiary.

f. Foreign Tax Credit

In order to prevent double taxation, a deemed paid credit in respect to undistributed taxable profits of a designated tax haven subsidiary is available to any Japanese corporate shareholder subject to the current income reporting requirements.[251] The credit is limited to the amount of corporate income tax paid by the designated tax haven subsidiary which is attributable to taxable undistributed profits. The foreign tax credit is calculated in the following manner. First, taxable undistributed profits are grossed up by the amount of foreign tax attributable thereto. Second, the grossed up profits are included currently in income of the Japanese corporate shareholder. Last, a credit for the foreign tax deemed paid is allowed the Japanese shareholder.[252]

g. Subsequent Distribution of Taxable Undistributed Profits

(1) *Dividends*—When previously taxed undistributed profits are distributed to the Japanese shareholder in a subsequent fiscal period in the form of dividends, the Japanese shareholder is permitted a deduction from its current income equalling the amount

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250. No losses may be carried over from fiscal periods prior to the classification of the subsidiary as a designated tax haven subsidiary, or from fiscal period beginning prior to Apr. 1, 1978.

251. STML, art. 66-7(3); CTL, art. 69(4). The Japanese deemed paid credit in respect to dividends is normally available only to Japanese corporate shareholders holding 25% or more of the foreign subsidiary's shares. For foreign subsidiaries other than designated tax haven subsidiaries, the 25% ownership rule still applies.

252. STML, art. 66-7.

of previously taxed undistributed profits in respect to the subsidiary which the Japanese shareholder had taken into income during the immediately preceding five years.[253] The amount taken by the shareholder as a deemed paid credit in those years must be taken back into income in the current year.[254] Thus, in order to prevent the subsidiary's previously taxed profits from being taxed again, the dividends received by the Japanese shareholder are added to taxable income, the grossed up amount of previously taxed undistributed profits is deducted, and the deemed paid credit previously taken is added back into income.

(2) *Sale of Shares*—Under Japanese corporate tax law, gains from the sale of shares are fully included in income and taxable at ordinary rates. In the case of tax haven subsidiaries, however, a portion of the gain will already have been taxed to the Japanese shareholder as taxable undistributed profits. No regulations have been issued as to the treatment of the sale of shares so as to avoid double taxation. It has been suggested that there are two alternatives. Either reduce the amount of gain realized on the sale by the amount of any previously reported taxable undistributed profits through an upward adjustment of basis, or include all gain from the sale of shares in current income, and then deduct the amount of taxable undistributed profits reported and taxed within the preceding five years. In addition, any deemed paid credits previously taken in respect to the taxable undistributed profits should be taken back into current income.

(3) *Liquidation*—Liquidation proceeds distributed to the Japanese shareholder in excess of its acquisition are deemed constructive dividends and are included in income. In order to avoid double taxation, a deduction of previously taxed undistributed profits taken into income during the immediately preceding five years is afforded the Japanese shareholder of a tax haven subsidiary.[255] Any deemed paid credits previously taken in respect to the taxable undistributed profits should be taken back into current income.

253. STML, art. 66-8.

254. STML, arts. 66-7(2), 66-8(1).

255. *Id.* Upon liquidation of foreign subsidiaries which are not tax haven subsidiaries, constructive dividends are fully included in income and taxed at the normal rates.

h. Filing and Reporting Requirements

The Japanese shareholder must report its pro rata share of taxable undistributed profits in respect to its fiscal year, which includes the last day of the second month following the end of the tax haven subsidiary's fiscal year. The Japanese shareholder must attach to its return information concerning the designated tax haven subsidiary, including a balance sheet and profit and loss statement.[256] A Japanese shareholder which has a subsidiary in an identified tax haven which meets the requirement for exclusion must attach to its tax return a statement to that effect and must retain relevant documentation and other information to substantiate the exclusion.[257]

D. *France*

1. Introduction

The use of tax havens is not expressly prohibited under French law. French law, however, provides a number of measures intended to control tax avoidance accomplished through the use of tax haven corporations. The French General Tax Code[258] contains provisions directed against non-arm's length transactions in the form of intracompany transfers of income by multinational enterprises,[259] and the diversion of profits through the use of base companies or service companies located in tax haven countries.[260] These statutory provisions are supplemented by regulations governing foreign investment, including exchange controls, and by regulations which require the consent of the Tax Department of the French Finance Ministry in order to claim the benefit of favorable tax provisions for certain international corporate transactions.[261] In addition to the specific statutory anti-avoidance provisions, the French tax authorities may challenge any arrangement, operation, or transaction lacking sound business substance (in which the sole purpose is to avoid French tax) on the general

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256. STML, art. 66-6(4).
257. STML, art. 66-6(5).
258. A new codification has recently been published, CODE GÉNÉRAL DES IMPÔTS, IMPRIMERIE NATIONALE (1979) [hereinafter cited as CGI].
259. CGI, art. 57.
260. CGI, arts. 155, 238-8.
261. *See* notes 286-89 *infra* and accompanying text.

concept of abuse of right (*abus de droit*).[262]

The proposed Financial Law for 1980, presented to the *Assemblée Nationale* on September 5, 1979, contained specific measures designed to strengthen the government's ability to combat tax evasion accomplished through CFC's and foreign personal service companies.[263] The proposed amendments would tax to French shareholders the earnings of CFC's and foreign service companies.

2. Jurisdiction

The French rule for the taxation of legal entities is that of absolute territoriality, under which only profits arising from French sources are subject to taxation in France.[264] Legal entities (*sociétés*) are classified as either companies[265] or partnerships,[266] and are taxed accordingly.

Under the general rule of territoriality, only French source profits are taxable in France. Likewise, only losses attributable to business activities in France are deductible for tax purposes. There are, however, two exceptions to the rule of territoriality. These are the allowance of temporary deduction of certain expenses incurred abroad, and the election to be taxed on worldwide income.

All corporate taxpayers, resident and nonresident, may deduct expenses attributable to establishments abroad,[267] provided such amounts are approved by the Ministry of Finance and ultimately

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262. *See* note 290 *infra* and accompanying text.

263. *Projet de loi* No. 1290.

264. CGI, art. 39, octies A, III.

265. Included as companies are corporations (*sociétés anonymes*), limited liability companies (*sociétés a responsabilité limiteé*), and limited partnerships with shares (*sociétés en commandite par actions*).

Companies are taxed on their net corporate profits at the rate of 50% on net profits and short term capital gains, and at the rate of 15% on long term capital gains, if such gains are placed in a special reserve account of the company. CGI, arts. 38 & 205-223.

266. Included as partnerships are general partnerships (*sociétés en nom collectif*), limited partnerships without shares (*sociétés en commandite simple*), civil companies (*sociétés civiles*), and undisclosed partnerships (*sociétés en participation*).

Partnerships may elect to be taxed as companies. The election is irrevocable and must be made within the first three months of any fiscal year. CGI, Annexe IV, art. 22.

267. The foreign establishment may be in the form of a branch, or a subsidiary at least 50% owned by the French taxpayer.

restored to taxable profits.[268] The expenses incurred by commercial[269] and industrial[270] establishments located abroad are deductible. The amount of deductible commercial establishment expenses is limited to the lower of the losses incurred during the first five years of operation, or the amount of capital invested in the foreign establishment during the first five years of operation. The amount of deductible industrial establishment expenses is equal to a fraction of the amounts invested in capital during the first five years, such fraction not to exceed one-third.

The election to be taxed on worldwide income is available only to French resident corporations, and requires the approval of the Ministry of Finance.[271] Two options for taxing worldwide income are available. Under the worldwide income plan,[272] the net income of all French and foreign branches and activities of the corporation is subject to French corporate tax. Under the consolidated income plan,[273] the net consolidated income of the corporation and its domestic and foreign subsidiaries[274] is subject to French corporate tax. Under both plans, the tax is determined pursuant to French domestic corporate tax rules. A foreign tax credit is allowed for income taxes paid to foreign countries.

Profits and losses are attributed to foreign sources when they arise from the operations of a foreign establishment of the company,[275] or activities of agents of the company without independent status, or from foreign operations forming a complete commercial cycle of purchases and sales abroad. If the foreign

268. Expenses deducted during the first five years of operation abroad must be restored to taxable profits in equal amounts over the following five years.

269. Commercial establishments include sales offices, offices for market studies, information offices, and other commercial activities that contribute to the promotion of exports of French products. CGI, art. 39, octies A, I.

270. Industrial establishments include manufacturing and conditioning facilities using substantial equipment. To qualify for the deduction, the industrial establishment must be located in a country designated by the Ministry of Finance. CGI, art. 39, octies A, II.

271. The election is irrevocable, unless French corporate tax rates are increased or decreased by more than five points. CGI, Annexe II, art. 133. The Finance Ministry generally refuses election to French resident corporations owned or controlled by foreign interests.

272. CGI, Annexe II, arts. 104-112.

273. CGI, Annexe II, arts. 113-123.

274. To qualify, a subsidiary must be at least 50% owned by its French parent, unless such ownership is prevented by local law.

275. *See, e.g.*, C.E. 12 Nov. 1969; BO4 A-2-70.

business is operated in a country which has signed a tax treaty with France, only the income attributable to a permanent establishment, as defined in such treaty, is exempt from French tax.

3. Taxation of Tax Haven Income

Although the use of tax havens is not expressly prohibited under French law, excessive use of tax havens for the purpose of avoiding French tax is controlled by various general provisions of the French Tax Code and government regulations governing international corporate activities.

Currently, the French government employs the following three types of restrictions to minimize tax avoidance operating through tax havens: (1) general statutory provisions of the French Tax Code, (2) regulations requiring authorization by the Finance Ministry for certain international corporate transactions, and (3) the concept of abuse of rights (*abus de droit*).

a. Statutory Provisions

The French General Tax Code contains three basic provisions serving to restrict the use of tax haven companies for tax avoidance purposes.

The problem of intra-company transfers of income by multinational corporations is dealt with in article 57.[276] Under this provision, and complementing tax treaty provisions,[277] profits transferred to foreign enterprises as a result of non-arms-length transactions or transactions between related companies are reallocated to the French company and subjected to French corporate tax.

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276. CGI, art. 57 provides:

> In assessing income tax due by undertakings which are controlled by or which control enterprises established outside France, the income which is indirectly transferred to the latter, either by increasing or decreasing purchase or sales prices, or by any other means, shall be restored to the trading results shown in accounts. The same procedure is followed with respect to undertakings which are controlled by an enterprise or a group of enterprises also controlling undertakings located outside France.
>
> Should specific data not be available for making the adjustments provided for in the preceding paragraph, the taxable profits are determinable by ways of comparison with the profits of similar undertakings normally managed.

277. *See, e.g.*, Convention on Taxation, July 28, 1967, France-United States, art. 8, 19 U.S.T. 5280, T.I.A.S. No. 6518.

Administrative instructions[278] implementing this provision suggest that this provision will be increasingly applied to international transactions. The instructions also indicate that the requisite interdependence of the two entities involved in an income-shifting transaction may be established as a legal,[279] or factual,[280] inter-relationship. Under the regulations, non-arms-length transactions include the payment of excessive royalties or fees, the making of loans without interest, waivers of claims, overpayment for services rendered, and excessive expense contributions. The burden of proving both control and the shifting of profits is ostensibly on the tax authorities. Once the tax authorities have established the existence of "abnormal benefits" conferred by one of the parties on the other, however, a rebuttable presumption of an indirect transfer of income between related companies arises,[281] and the burden shifts to the taxpayer to prove that such benefits were legitimate under the circumstances.[282]

The problem of excessive payments by French taxpayers to entities located in low tax jurisdictions is attacked under article 238A.[283] Under this provision, expenses for interest, claims, royal-

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278. Instruction of 18 May 1972; Instruction of 4 May 1973.

279. The interdependence of the two entities is legal where one of the companies is the parent of the other. No minimum interest is specified, but the Instruction refers to a controlling interest (*par preponderante*) consisting of voting power or the exercise of management functions in the other company.

280. The interdependence of the two entities is factual where control is evidenced by all the facts and circumstances.

281. This presumption is recognized by the highest administrative court of appeals, the *Conseil d'Etat*. Instruction of 4 May 1973.

282. *Cf.* I.R.C. § 482; Treas. Reg. § 1.482, T.D. 6952 (1968). *See* note 36 *supra* and accompanying text.

283. CGI, art 238A provides:

> Interest, arrears or other proceeds of debenture claims, deposits and guarantees . . . royalties against assignments or granting of exploitation licenses, of patents, trade-marks, manufacturing processes or formulae and other similar rights, or compensation for services, paid or due by an individual or entity domiciled or established in France to individuals or entities that are domiciled or established in a foreign state or a territory outside France and are there subject to a privileged tax status, are not admitted as deductible expenses in assessing tax unless the debtor establishes that such expenses correspond to actual transactions and are not abnormal or exaggerated.
>
> For the purposes of the preceding paragraph the persons or entities are deemed to be subject to a privileged tax status in the other territory involved if they are made subject to taxes on profits or income substantially

ties, or compensation for services paid by French taxpayers to entities located in a tax haven country are deductible only if the taxpayer affirmatively proves that such expenses correspond to an actual transaction and are reasonable in amount.

The problem of diversion of personal service income is directly addressed by article 155A.[284] Under this provision, the Tax Administration may reallocate income, received through a foreign service company located in a tax haven jurisdiction for services performed in France, directly to the French taxpayer performing such services. This diversion technique had been utilized by top sports figures and entertainers.

b. Requirement of Government Consent

Indirect control of the use of tax havens is accomplished by regulations requiring prior government authorization for certain international transactions and operations. Any direct investments abroad, including the acquisition or increase of a controlling interest in a foreign company by a French resident, requires the consent of French authorities, if such investment exceeds three million francs for the taxable year.[285]

Government consent is often required in order to obtain the benefit of favorable tax status including the following: (1) use of international consolidated returns,[286] (2) exemption from with-

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lower than in France.

284. CGI, art. 155A provides:

> Notwithstanding any contrary provision, any amounts received by a company or other corporate entity or its corporate office outside France against services rendered by one or several persons domiciled in France are taxable in the name of those persons:
>
> (1) when those persons, directly or indirectly, control those companies or entities; or
>
> (2) when those persons do not prove that those companies or entities have industrial or commercial activities other than rendering services; or
>
> (3) in any event, when those companies or entities have their corporate office in a country which is not bound to France by a general tax convention regarding income tax.

285. Decrees of 21 January and 24 November 1968, *as amended by* the Decree of 5 May 1972.

Direct investment of less than three million francs per year does not require prior governmental authorization, provided such investment does not relate to portfolio, finance or investment companies, foreign real property companies, or the purchase of real property. Decree of 24 November 1968, as amended.

286. CGI, art. 209 *quiquies* and Annexe II, arts. 103-34.

holding tax for debentures issued abroad,[287] (3) deduction by the French parent company of losses incurred by foreign sales or promotional branches of subsidiaries during the first five years of operation,[288] and (4) partial deduction by the French parent company of capital expenditures incurred during the first five years by opening and operating industrial branches or subsidiaries in certain designated countries.[289]

c. Rule Against Abuse of Rights

Under the general concept of abuse of rights,[290] French tax authorities can attack any corporate transaction motivated by tax evasion or avoidance. An elaborate review procedure, consisting of consultation of a special committee (Comite consultatif pour la repression de valus des droits) made up of a member of the *Conseil d'Etat*, a member of the *Cour de Cassation*, a professor of laws, and the general manager of the Tax Department of the Ministry of Finance, is provided by statute.[291] Normally, the burden of proof is on the tax authorities in such proceedings, but once the government has established tax evasion or avoidance by the taxpayer, the burden of proof shifts to the taxpayer to establish that the transaction was not abusive.

In practice, the concept of abuse of rights is of limited value in

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287. CGI, art. 131 *ter*. 1.

288. CGI, art. 39 *octies*.

289. *See* note 14 *supra* and accompanying text.

The proposed Financial Law of 1980 would extend the foreign investment provision, subject to prior authorization, to banks and credit institutions that participate in the capital of the foreign company along with the French company. *See* Exposé des Motifs to Article 71, Projêt de loi No. 1290, Sept. 5, 1979, n.5 at 809, *reprinted in* Feuillet Rapide Frances Lefebvre, Sept. 20, 1979.

290. CGI, art. 1649 *quiquies* B provides:

> The deeds which dissimulate the true nature of contract or of an agreement under the appearance of provisions giving rise to lower registration duties . . . or disguising either the generating or the transfer of profits or income or permitting the evasion, either wholly or partly, of the payment of turnover taxes relating the transactions carried out pursuant to that contract or agreement is not valid against the tax authorities on which lies the onus of proving the true nature of those deeds before the tax judge if, in order to reinstate the true nature of the transaction challenged, they have refrained from taking the advice of the consultative committee the composition of which is referred to in article 1653 C or if they have assessed a taxation not corresponding to that committee's advice.

291. CGI, art. 1653 C.

controlling international tax avoidance schemes because of the more precise remedies afforded under the statutory and treaty provisions regulating transactions between related companies and regulations requiring prior governmental authorization.

d. Proposed Amendments

Because the statutory measures outlined above proved ineffective in controlling the use of tax havens, amendments designed to strengthen the government's ability to stem tax evasion operating through controlled foreign companies and foreign personal service companies were introduced near the close of the 1979 legislative session.[292]

The proposed controlled foreign company amendment would attribute to certain French corporate taxpayers their pro rata share of the earnings of foreign companies controlled, directly or indirectly, by such French taxpayers. "Controlled foreign company" is defined as a foreign company located in a country with a "preferable tax system" as defined in the Tax Code,[293] which is controlled, directly or indirectly, by French corporate taxpayers. An exception from the definition of "controlled foreign company" is provided for foreign companies engaged in commercial or industrial functions which do not conduct the bulk of their business activities with related companies. A French entity that holds, directly or indirectly, 25% of the stock of such a foreign company is subject to the reporting requirements and is taxed at the normal French corporate tax rate of 50% on its pro rata share of the foreign company's earnings, computed according to French domestic tax laws.[294] The French shareholder is allowed a tax credit for any tax paid in the foreign tax haven.

The proposed foreign service company amendment would strengthen the present personal service income provision contained in article 155A[295] by imposing more stringent requirements of independent commercial or industrial functions on the part of

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292. Projèt de loi No. 1290.

293. All the classic tax havens are listed. The administrative interpretation suggests, as a general rule, a total tax burden of one third less than the French corporate tax qualifies as a tax haven. Instruction of 26 June 1975.

294. The foreign company's income is deemed acquired by the French shareholder at the end of the month following the end of the foreign company's fiscal year.

295. *See* note 27 *supra* and accompanying text.

foreign service companies. Proponents of the amendment contend that it would eliminate abuse of the permanent establishment provisions of tax treaties to avoid taxation on personal service "loanouts" by making the person receiving the services jointly liable with the performer of such services for payment of the tax.

E. *United Kingdom*

1. Introduction

Residence is the predominant basis of jurisdiction to tax in the United Kingdom. Under the laws of the United Kingdom, nationality is seldom directly relevant. In general, an individual or company resident in the United Kingdom is taxed on worldwide income regardless of its source. Nonresidents of the United Kingdom are taxed on all income arising within the United Kingdom subject to provisions of various international tax treaties.

An individual is a resident of the United Kingdom if he meets one of the following three tests. First, is he physically present in the United Kingdom for a period aggregating six months in any year of assessment? Second, does he regularly visit the United Kingdom (on a sufficiently frequent and substantial basis as to form part of his normal way of life) even though his aggregate presence in a tax year does not exceed six months and he does not have a fixed abode in the United Kingdom?[296] Last, does he maintain a place of abode in the United Kingdom?[297]

A corporation is regarded as a resident of the country where its "central management and control" is located.[298] The place of incorporation is not determinative. "Control" for this purpose is director control rather than stock ownership.

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296. It is usual practice to treat visits averaging more than 91 days per year as habitual, but someone with no previous residence history would normally be taxed as a resident only for the fifth year of maintaining such an average. Someone departing from the United Kingdom to take up residence abroad would be subject to far more stringent tests. Chown, *United Kingdom Law and Practice*, in TAX HAVEN ENCYCLOPAEDIA 2 (B. Spitz. ed. 1979).

297. Under this test it is relevant whether the individual actually owns the premises. *Id.* at 1. An exception is made if the individual works full time in a trade, profession, or vocation no part of which is carried on in the United Kingdom, or in an office or employment all the duties of which are performed outside the United Kingdom in which case residence will be decided without regard to a place of abode maintained for use in the United Kingdom. Peel, 13 Tax Cas. 443 (1927).

298. Debeers Consolidated Mines v. Howe, 5 Tax Cas. 198 (K.B. 1906).

2. Tax Avoidance Measures

The United Kingdom does not yet have an integrated system of legislation dealing with tax abuse through the use of CFC's. Nevertheless, evasion of taxes through the use of such corporations is attacked on several bases. One provision of the United Kingdom tax laws makes it a criminal offense to carry out certain transactions without Treasury consent.[299] Another statute subjects United Kingdom residents, under certain circumstances, to tax on income arising for his benefit in another jurisdiction.[300] Under general provisions of United Kingdom tax law, the Inland Revenue can, under certain conditions, construe a foreign corporation to be a resident and subject it to tax on its worldwide income. Similarly, under general principles, the Inland Revenue can reallocate income where a foreign corporation has a branch or agent in the United Kingdom.[301] Finally, the United Kingdom has exchange control laws which prohibit transactions between residents of the United Kingdom and nonresidents without Treasury consent.[302]

a. Prohibition of Tax Avoidance Transactions

Certain transactions which are indicative of tax avoidance schemes are prohibited unless approved by the Treasury under section 482 of the Taxes Act of 1970. Section 482 was originally introduced in the Finance Act of 1951 as a "temporary" measure dealing with international tax abuse.[303] Unlike the approach employed in a number of other countries, the section does not combat tax avoidance through the imposition of tax, but rather, prohibits certain transactions under criminal penalties, unless the consent of the Treasury is first obtained. The following transactions are considered to be criminal offenses unless carried out with Treasury consent: (1) a resident corporation ceases to be a resident, (2) a resident corporation transfers any part of the trade or business to a nonresident corporation,[304] (3) a resident corpora-

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299. Taxes Act § 482 (1970).
300. Taxes Act § 478 (1970).
301. Taxes Act § 485 (1970).
302. Exchange Control Act 1947, 10 & 11 Geo. 6, c. 14.
303. Chown, *supra* note 296, at 8.
304. Under the provision, the mere transfer of assets not resulting in a substantial change in the character or extent of the trade or business is not within section 482.

tion causes or permits a nonresident corporation over which it has control to create or issue any shares or debentures,[305] and (4) a resident corporation transfers or causes to be transferred to any person any shares or debentures (which it owns or in which it has an interest) of a nonresident corporation over which it has control except to enable qualification of directors.

The prohibition against resident corporations transferring portions of their businesses to nonresident corporations is the most significant prohibition.[306] Prior to 1951, United Kingdom companies could set up foreign operations as a branch and claim loss relief during the start up phase. When the company became profitable, it could be reorganized as a subsidiary with considerable advantages in the form of tax deferral. This prohibition will normally preclude the splitting off of a part of a United Kingdom company to a tax haven subsidiary or associate.[307]

b. Transfers of Income to Persons Abroad

Section 478 of the Taxes Act contains a very broad provision imposing a tax on a United Kingdom individual resident who has power to enjoy income of a "person" outside the United Kingdom. The term "person" encompasses corporations and trusts. Under this section, an individual is deemed to have a power to enjoy income of a person resident or domiciled outside of the United Kingdom if: (1) the income is in fact so dealt with by any person as to be calculated, at some point of time, and whether in the form of income or not, to inure to the benefit of the individual, or (2) the receipt or accrual of the income operates to increase the value to the individual of any assets held by him or for his benefit, or (3) the individual receives or is entitled to receive,

305. Transfers of securities by a nonresident corporation to a bank in the ordinary course of business or to an insurance company in the ordinary course of investment are excluded under this provision. A Treasury circular has given a general consent to certain situations. In other cases, application for consent may be made to the Treasury. Chown, *supra* note 296, at 14.

306. Two consents are available on the "transfer of business" test. The first refers to a United Kingdom company incorporated after the passing of the Act to carry on a new business where at all times more than 50% of the issued capital is in the beneficial ownership of persons not ordinarily resident in the United Kingdom. The second relates to an arm's-length sale to a nonresident with whom the seller is unconnected for a full consideration paid in cash for a sum not exceeding $50,000.

307. Chown, *supra* note 296, at 9.

at any time, any benefit provided or to be provided out of that income or out of monies which are or will be available for the purpose by reason of the effect or successive effects of the associated operations on that income and on any assets which directly or indirectly represent that income, or (4) the individual has power, by means of the exercise of any power of appointment or power of revocation or otherwise, to obtain for himself, whether with or without the consent of any other person, the beneficial enjoyment of the income, or more, in the event of the exercise of any power vested in any other person, becomes entitled to the beneficial enjoyment of the income, or (5) the individual is able in any manner whatsoever, and whether directly or indirectly, to control the application of the income.[308]

It should be noted that section 478 applies only to individuals and cannot be invoked against United Kingdom corporations. Nothing in the provision expressly prevents a tax from being imposed on a shareholder of a United Kingdom corporation on the undistributed profits of an overseas subsidiary of that company. It is unlikely, however, that such a tax would be imposed, unless the taxpayer is a controlling shareholder of a close company.[309]

"Commercial purpose" can be a good defense to this section, even though such defense is rarely applied to trading companies organized to carry on legitimate business. If, however, the overseas corporate structure is made more complicated than commercially necessary for tax avoidance reasons, the value of the defense would be substantially reduced.[310]

Section 478 does not apply to capital gains. Other provisions, however, provide that when a nonresident company (which would qualify as a close corporation[311] if it were a United Kingdom resi-

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308. Taxes Act § 478(5) (1970).

309. Chown, *supra* note 296, at 12.

310. *Id.*

311. Generally, a corporation is treated as a close corporation if five or fewer "participators" can control the company. The term "participators" includes certain categories of "associates" as a single participator. A company is not able to be considered as close if its shares are quoted in the official list of a recognized stock exchange, provided that there have been actual dealings on such an exchange within the preceding 12 months, and provided that shares, carrying not less than 35% of the voting power, are actually held by "the public," as defined. The corporation cannot be treated as close if it is under the control of one or more corporations, which are not themselves close or which would not be close if they were resident. *Id.*

dent) realizes a capital gain, any person, who is a resident or is ordinarily resident and who is domiciled in the United Kingdom, shall be subject to tax on his attributable portion of the gain, provided that the amount so attributable is at least 5% of the total gain.[312] The liability can be traced through any number of foreign corporations, provided that each company in the chain would, if it were a United Kingdom resident, be treated as a close corporation.[313] Unlike section 478, this provision applies without regard to the intentions of those setting up the company.[314] Also, it should be noted that the provision can apply to United Kingdom corporations, although a subsidiary of a non-closely held company would not itself come within the scope of the section.[315] The provision does not apply to a United Kingdom resident of foreign domicile.[316] Finally, the provision provides relief for losses realized, but only to the extent they offset gains realized by the same corporation.[317]

c. General Measures

One of the most common goals in the use of foreign controlled subsidiaries is the diversion of profits out of the high tax jurisdiction through methods such as manipulation of intercompany pricing. In the United Kingdom, such tactics are frequently attacked under two theories.

First, when there is a United Kingdom source of income or any United Kingdom connection with the corporation, the Inland Revenue will attempt to establish that the corporation is "controlled and managed" in the United Kingdom and is thus taxable as a resident.

The second theory is applicable if the foreign corporation is doing business within the United Kingdom. Under United Kingdom law, a nonresident is assessable with respect to profits or gains arising from any trade exercised within the United Kingdom. A nonresident company is subject to corporation tax only if it

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312. Simon's Taxes C 6.156.
313. Chown, *supra* note 296, at 13.
314. *Id.*
315. *Id.*
316. *Id.*
317. *Id.* at 14. Finance Act § 42(1) (1965) contains somewhat similar provisions regarding chargeable gains accruing to the trustees of a nonresident settlement. *Id.*

trades in the United Kingdom through a branch or agency. The foreign corporation would be subject to tax if the foreign corporation has a "permanent establishment" in the United Kingdom under an applicable tax treaty or under the provisions of general law, if there is no applicable double taxation provision. The foreign corporation would also be taxable if it has an agent (a term which could include a corporation) within the United Kingdom who accepts orders or routinely makes contracts on behalf of his foreign principal.[318]

Where goods are sold between a resident and a nonresident, and the buyer and seller are under common control, the fixed price may be ignored, and the Inland Revenue may substitute the price that would have been negotiated if "the parties to the transaction had been independent persons dealing at arms' length."[319] The governing section also covers leasing of property, grants and transfers of rights, interest, and royalties, and the giving of business facilities of whatever kind. It does not apply to transactions in depreciable assets, but there is a corresponding provision covering these.[320]

These provisions differ from section 482 of the United States Internal Revenue Code in two respects. First, they apply only if the parties are under common voting control, i.e., if the buyer is a subsidiary of the seller, or the seller is a subsidiary of the buyer, or both are directly or indirectly controlled by one or more third parties. Second, under the United Kingdom law any adjustments must in principle be made by varying the price applied to transactions. Under section 482 of the Internal Revenue Code, the

318. There are two major exceptions to this rule. First, a nonresident is not assessable on this basis merely because he carries out business through, or in the name of, a broker or commission agent bona fide carrying on business as such in the United Kingdom, provided that the remuneration of the latter is at a rate not less than is customary in such business.

The second exception is a matter of administration. A foreign nonresident corporation may set up a management services company in the United Kingdom to provide information and serve as a liaison with various markets. Such a corporation could be remunerated by a service fee representing its expenses plus a percentage markup. The markup would be subject to United Kingdom taxation. Provided that the other tests of control are carefully watched, the Inland Revenue would not normally seek to tax the foreign company merely because it had a connection with such a management service company. Chown, *supra* note 296, at 16.

319. Taxes Act § 485 (1970); Simon's Taxes B 1.120, B 1.927.

320. Capital Allowance Act § 78 (1968); Simon's Taxes, B 2.911.

overall profit made worldwide is examined and then apportioned between the parties on a reasonable commercial basis. Unlike section 482, the United Kingdom law specifies no criteria for determining what is an arm's length price.

d. Exchange Control

The United Kingdom's final basis of combating tax abuse through international transactions is its exchange control laws.[321] Transactions between residents and nonresidents are prohibited without Treasury consent.[322] Residence, under the exchange control laws, is a matter of designation, and differs somewhat from residence for tax purposes. It is possible for individuals and companies subject to United Kingdom tax constraints on international operations to be subject to exchange control restrictions.

The exchange control laws can be used in a number of ways to prevent tax abuse. For example, specific consent of the Bank of England is required in order to set up or buy an interest in a private company, or to acquire an interest exceeding 20% of the voting power in a publicly quoted company. Permission will likely be withheld if the transaction has tax avoidance motives. Also, the Treasury has power to direct a United Kingdom resident controlling the shareholders of a foreign company to exercise their vote so as to ensure that the foreign company pays a dividend, is wound up, or otherwise repatriates its assets to the United Kingdom.[323]

III. Comparative Analysis

A. *General Provisions*

The United Kingdom and France have not adopted comprehensive tax systems aimed at controlling the misuse of CFC's. Instead, both the United Kingdom and France rely primarily on reallocation, exchange control, and consent provisions. The excessive amount of government involvement required to regulate multinational transactions, however, has been sharply criticized.

321. Exchange Control Act § 78 (1947).

322. The Channel Islands and the Isle of Man are considered part of the United Kingdom for exchange control purposes. There are no current restrictions on transfers to and from the Republic of Ireland and Gibraltar. Chown, *supra* note 296, at 19.

323. Exchange Control Act § 30 (1947).

In the United Kingdom, government approval must be obtained prior to (1) a change of residence by a resident corporation, (2) a transfer by a resident corporation of any part of its trade or business to a nonresident corporation, and (3) a transfer by a resident corporation to any person any shares or debentures of a nonresident corporation over which it has control (other than to qualify directors).[324] In France, governmental approval is required for any direct investment abroad, including the acquisition or increase of a controlling interest in a foreign company by a French resident, if such investment exceeds three million francs for the taxable year.[325] Prior governmental authorization is also required in order to obtain the benefit of certain favorable tax status provisions.[326] In addition to the consent provisions, both the United Kingdom and France regulate multinational transactions through exchange control laws.[327]

The United Kingdom and France also rely on reallocation of income provisions similar to section 482 of the United States Internal Revenue Code. The French reallocation provisions are very broad, but unlike section 482, the French provisions are directed specifically at multinational transactions. Under both section 482 and the French allocation provisions, transactions between related parties are adjusted to reflect what would have resulted from arms-length bargaining. Under the French provisions, nonarms-length transactions include the payment of excessive royalties or fees, the making of loans without interest, overpayment for services rendered, and excessive expense contributions.[328] The United Kingdom reallocation provisions differ from section 482 in three respects. First, unlike section 482, the United Kingdom provisions apply only if the parties are under common voting control.[329] Second, reallocation under the United Kingdom provisions is accomplished by varying the price applied to the transaction. Under section 482, the overall worldwide profit is apportioned between the parties on a reasonable commercial basis.[330] Last, the United Kingdom provisions specify no criteria for determining

324. *See* notes 304-08 *supra* and accompanying text.
325. *See* note 285 *supra* and accompanying text.
326. *See* note 286-89 *supra* and accompanying text.
327. *See* notes 322-23 *supra* and accompanying text.
328. *See* notes 276-84 *supra* and accompanying text.
329. *See* note 321 *supra* and accompanying text.
330. *Id.*

arms-length price as does section 482.[331]

The "temporary" measures enacted by the United Kingdom in 1951 and renewed annually thereafter have been criticized as an inappropriate method of handling the CFC problem. The fragmented French system also has met with strong criticism. Recently, the need for specialized laws dealing with this type of tax abuse was recognized in France with the introduction of a comprehensive tax system similar to those adopted in the United States, West Germany, and Japan.

B. *Comprehensive Legislation*

The utilization of more general restrictions (including reallocation and exchange control provisions) on the use of foreign corporations in tax avoidance schemes by the United States, Germany, Japan, and France, proved largely ineffective. Accordingly, each of these countries has proposed or enacted comprehensive statutory schemes specifically directed against the use of CFC's strategically located in low- or no-tax jurisdictions. The United States Subpart F provisions, enacted in 1972, represent the most comprehensive plan of taxation of domestically controlled foreign corporations. The influence of the Subpart F provisions is readily illustrated by the adoption of similar legislation by West Germany in 1972, Japan in 1978, and, most recently, the proposal of such legislation in France in late 1979. Although provisions similar to those of Subpart F have been adopted by West Germany and Japan, and have been proposed in France, there are significant differences among the systems adopted or proposed in these countries. The most important differences among the systems concern the reporting requirements, the definition of CFC, the definition of tainted income, and the relief provisions.

1. Reporting Requirement

Under each of the systems analyzed, certain domestic shareholders of foreign corporations are required to report and include in income their pro rata share of certain earnings of the foreign corporation. The respective provisions of the United States[332] and Japan[333] generally provide that domestic shareholders with a 10%

331. *Id.*
332. *See* note 81 *supra* and accompanying text.
333. *See* note 238 *supra* and accompanying text.

or more interest in the foreign corporation are subject to the reporting requirements. The proposed French system would subject domestic shareholders holding 25% or more of the outstanding stock of the foreign corporation to the reporting requirement.[334] In contrast, the German provisions specify no minimum holding requirement, so that all domestic shareholders of the foreign corporation are subject to the reporting requirement, regardless of their percentage ownership.[335] As attribution rules are operative under each system, the reporting requirement is applicable to more than just the record holders of the requisite percentage of stock.

2. Controlled Foreign Corporation

Each of the systems analyzed provides its own definition of the type of foreign corporation whose earnings will be attributed to a domestic shareholder, whether or not such earnings are actually distributed. Generally, the United States[336] and Germany[337] define as CFC's, any nonresident corporation in which more than 50% of the total combined voting power is owned by domestic shareholders. In addition to the control requirement, the Japanese provisions[338] and the proposed French system[339] require that the foreign corporation be located or organized in specified tax haven countries. Under the German system, no attribution results unless the foreign jurisdiction's tax is less than 30% of the German corporate tax burden.[340]

3. Tainted Income

The definitions provided under each system for the tainted income of the foreign corporation that will be attributed to the domestic shareholders vary widely, and illustrate the most significant difference among the anti-avoidance systems.

The Japanese[341] and proposed French[342] systems require attri-

334. *See* note 294 *supra* and accompanying text.
335. *See* note 222 *supra* and accompanying text.
336. *See* note 79 *supra* and accompanying text.
337. *See* note 221 *supra* and accompanying text.
338. *See* note 239 *supra* and accompanying text.
339. *See* notes 293 & 295 *supra* and accompanying text.
340. *See* note 231 *supra* and accompanying text.
341. *See* notes 237 & 248 *et seq. supra* and accompanying text.
342. *See* note 294 *supra* and accompanying text.

bution of all earnings of the foreign corporation to the domestic shareholder. The focus of these systems is on the nature of the foreign corporation, including its location in a specified tax haven country, rather than the particular type of income it produces. If a foreign corporation is deemed to be a "designated tax haven subsidiary" under Japanese law, or a "controlled foreign company" under the proposed French plan, all earnings of that foreign corporation (less allowable deductions) will be attributed to the domestic shareholders and subjected to domestic taxation, regardless of whether such income was subject to tax in the foreign jurisdiction.

Under the United States and German systems, only certain specified types of income of the foreign corporation are attributed to domestic shareholders. These systems define tainted income as passive types of income that have been diverted to the foreign corporation to avoid higher domestic tax rates. The United States Subpart F provisions contain the most inclusive list of tainted income of any of the systems analyzed.[343] Five major categories of income are included in the definition of tainted "Subpart F income." The most important of these in terms of amount, are foreign base company sales and service income, and increase in earnings invested in United States property. While the German system generally includes as tainted income any nonactive sales and service income of a foreign corporation, only the United States system attempts to subject to domestic taxation a CFC's increase in earnings invested in United States property.[344] Under the German system, a conclusive list of allowable income is provided. All other income of the CFC is tainted base company income attributable to domestic shareholders.[345]

4. Relief Provisions

All of the systems analyzed provide relief to the domestic shareholder by allowing the deduction of expenses allocable to production of the tainted income and by provisions for a tax credit or deduction for taxes paid in the foreign country. The systems also guard against double taxation with provisions for reduction of the amount of attributable tainted income by the

343. *See* note 91 *supra* and accompanying text.
344. *See* note 122 *supra* and accompanying text.
345. *See* note 228 *supra* and accompanying text.

amount of actual dividend distributions to the domestic shareholder.

In addition, the United States system contains de minimus provisions which avoid attribution of tainted income if that income constitutes less than 10% of the CFC's gross income.[346] It is important to note, however, that the de minimus provision is not applicable to income from increase in earnings invested in United States property.[347]

Although each of the systems provides exceptions for the conduct of active business operations in foreign countries, the United States is the only system which offers a "pure motive" exception.[348] Under this exception, if the CFC is not formed or operated for tax avoidance purposes, no attribution of income to domestic shareholders will result. Obviously, the test is hard to meet in light of substantial tax savings achieved through operation in a foreign locale.

C. *Summary of Taxation of Controlled Foreign Corporations*

The systems of taxation of CFC's developed by the four major industrial and commercial nations analyzed in this Note may be summarized, in tabular form, as follows:

346. *See* note 196 *supra* and accompanying text.
347. *See* note 117 *supra* and accompanying text.
348. *See* note 195 *supra* and accompanying text.

Country	Reporting Requirement	Controlled Foreign Corporation	Tainted Income	Relief Provisions
United States	*U.S. shareholder:* U.S. person owning, directly or indirectly, 10% or more of the CFC's combined voting power	*Controlled Foreign Corporation (CFC):* any foreign corporation more than 50% of whose total combined voting power is owned by U.S. shareholders on any day of the taxable year	*Subpart F income:* (1) insurance of U.S. risks (2) foreign base company income (a) foreign personal holding company income (b) foreign base company sales income (c) foreign base company service income (d) foreign base company shipping income (3) international boycott factor income (4) illegal payments to government officials (5) increase in savings involved in U.S. property	(1) *de minimus* provision: disregard foreign base company income if it constitutes less than 10% of CFC's gross income (2) pure motive exception (3) no attribution if foreign corporation is a CFC for less than 30 days during the taxable year (4) individual may elect to be taxed as a corporation (5) foreign tax credit
West Germany	*No* minimum holding requirement	*Controlled Foreign Corporation (CFC):* any foreign corporation more than 50% of whose shares *or* total voting power is owned by resident taxpayers on the last day of the corporation's financial year	*Conclusive list of allowable income:* (1) income from agriculture or forestry (2) manufacturing income (3) bank or insurance business income (4) active sale income (5) active service income (6) rental and royalty income (7) income from borrowing and lending of money (8) certain dividend income All other income is tainted base company income.	(1) no attribution unless the foreign jurisdiction's tax is less than 30% of the German corporate tax burden (2) foreign tax credit
Japan	*Japanese shareholders:* Japanese corporation (a) holding directly or indirectly, 10% or more of the shares of a DTHS, or (b) as part of a group, including residents and nonresidents, which holds in the aggregate 10% or more of such shares	*Designated Tax Haven Subsidiary (DTHS):* any corporate entity (a) incorporated or having its head office in a designated tax haven, and (b) which is more than 50% controlled by Japanese shareholders	*Taxable Undistributed Profits:* equal to the total income of the DTHS less deductions for certain carried over losses, income tax paid, and dividends declared	(1) active business exception: 5 requirements insuring the active and independent conduct of business in the tax haven (2) foreign tax credit
France (proposed)	French entity holding, directly or indirectly, 25% of the stock of a CFC	*Controlled Foreign Company (CFC):* any foreign company (a) located in country with a "preferable tax system" and (b) which is controlled by French corporate taxpayers	*All* earnings of the CFC	(1) active business exception (2) foreign tax credit

IV. CONCLUSION

The increased use of domestically-controlled foreign corporations to shelter income from higher tax rates imposed by economically developed nations over the past decade has prompted the development of comprehensive legislation directed specifically against the use of such tax haven corporations. Piecemeal statutory provisions have proved ineffective against most of the worst avoidance schemes, especially those in which income is diverted to corporations located in low- or no-tax jurisdictions.

The law and practice relating to domestic taxation of CFC's in the United States, West Germany, Japan, and France varies in part because of the differences among these nations. The United States was the first nation to adopt an integrated scheme of taxation of CFC's and its system remains the most comprehensive, serving as a model for the development of systems by other nations. The provisions of Subpart F have been adopted, with modifications, by West Germany and Japan. The principle modification incorporated in the German and Japanese systems is a shift in focus from "tainted income," which is paramount under the United States system, to a focus on the nature of the foreign corporation, including its location in a tax haven jurisdiction.

The United Kingdom and France have not adopted integrated systems designed to tax domestically-controlled income diverted to lower tax jurisdictions. Instead, these nations employ general reallocation and exchange control provisions in an effort to control the use of tax haven corporations. The most effective mechanism employed to combat tax avoidance operating through domestically-controlled foreign corporations is the pervasive regulatory framework established in both the United Kingdom and France which requires prior governmental authorization for certain international transactions. Perhaps in recognition of the inefficiency of the present system of strict governmental review of international transactions, however, comprehensive legislation of the type already implemented in the United States, West Germany, and Japan has been introduced in France. It seems that only the sheer magnitude of the task of modifying a long-standing system of taxation prevents the United Kingdom from adopting and implementing its own comprehensive system of domestic taxation of domestically-controlled foreign corporations.

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