Taxation of Domestically Controlled Foreign Corporations: A Comparative Study of Subpart F and Section 482

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THE TAX TREATMENT of foreign corporations controlled by United States taxpayers, typically parent domestic corporations, has, from the inception of the income tax, presented Congress with the continuing problem of resolving a basic conflict between disparate policy objectives. On the one hand, there is a recognized need to adjust the domestic tax liability of United States businesses abroad to enable those businesses to compete effectively with their foreign counterparts. On the other hand, corporate taxpayers ordinarily are required to bear that portion of the annual income tax burden which their profits indicate they are capable of bearing, irrespective of the forms they choose to employ in their operations. Congress has consistently resolved the conflict in favor of the competitive needs of the foreign operations of United States businesses. Until 1962 the basic technique for implementing this policy with respect to foreign subsidiaries of domestic corporations was simply to ignore the fact of domestic control of foreign corporations and treat them no differently than foreign corporations as to which the United States could assert no tax jurisdiction at all. Only when a foreign controlled corporation made distributions from earnings or in liquidation was the domestic taxpayer subject to tax. Moreover, the foreign tax credit ensured, as a general rule, that profits attributable to foreign operations, and dividends from foreign subsidiaries, would be taxed at a rate no greater than if the profits and dividends had originated within the United States.

This liberality of policy became the inducement for many United States taxpayers to establish controlled corporations in low-tax foreign countries through which they funnelled goods and services destined for other foreign countries, all for the purpose of taking advantage

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The views expressed in this Article are entirely those of the author and are in no way intended to reflect the official position of any agency of the United States.

1. Foreign corporations are taxed only on their income derived from sources within the United States. Int. Rev. Code 1954, §§ 881, 882 [hereinafter references to the 1954 Code will be by section only].

2. Under section 61, United States taxpayers are taxed on their income from all sources, unless, under section 911, a source is specifically excluded, e.g., income of United States citizens earned while the citizen is abroad.

3. Sections 901-02.
of the above-noted United States tax policy but without bearing the foreign tax burden which was the basis for the favorable congressional treatment.\(^4\)

Moreover, a domestic corporation engaged in transactions with its foreign subsidiaries could take advantage of this liberal policy by setting the intercompany cost of goods, services, and other benefits flowing between the parent and the subsidiary so that the income tax burden would fall where it was most advantageous to the parent to have it fall, typically, but not universally, on the foreign subsidiary.\(^5\) These related devices for tax avoidance are the respective targets of two recent developments in federal tax law: the enactment of sections 951-964 (hereinafter referred to as subpart F) of the Internal Revenue Code as part of the Revenue Act of 1962 and the administrative development of section 482 of the Code as an instrument for allocating income, deductions, and credits among commonly controlled corporations. Subpart F is an enactment of extraordinary detail and complexity; section 482 is, in its basic outline, a remarkably simple provision, but one which has been embellished by regulations, especially directed at international transactions, which match the complexity of subpart F.\(^6\) The purpose of this Article is to examine the essentials of these two taxing devices and to appraise the effectiveness with which each accomplishes its objective, with special attention to their divergent treatment of common factors.

II. Subpart F: An Outline

Subpart F represents a congressional judgment that prior law conferred tax advantages which failed to serve intended policy.\(^7\) The basic technique adopted by Congress to cure the defect is to include in the income of the parent corporation (or other shareholder) that much of the subsidiary's undistributed income which is attributable to transactions that objectively reflect a tax-avoidance character. The new provisions are meticulously constructed to neutralize particular tax-avoidance techniques and thus do not mark a repudiation

\(^6\) The House version of the Revenue Act of 1962 contained amendments to section 482 which were rejected by the Senate. The Conference Report on the Act states that the Treasury Department "should explore the possibility of developing and promulgating regulations under [section 482] . . . which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income." H.R. Rep. No. 2508, 87th Cong., 2d Sess. 19 (1962).
of the fundamental policy of not taxing the income of the foreign subsidiaries of domestic corporations.

No attempt was made by Congress to tax all of the subpart F income of foreign corporations which are controlled by domestic corporations. Rather, United States shareholders of controlled foreign corporations must include in income their prorata share of the subpart F income of the foreign corporation. This approach, rather than a tax on the controlled foreign corporation itself, avoids the difficulty inherent in any attempt to tax directly a foreign corporation partially owned by non-United States taxpayers. By attributing income to the United States shareholders and by prorating the attributable income in accordance with the United States shareholders' percentage of ownership, the interest of foreign taxpayers, if any, in the controlled foreign corporation remains untaxed.

The focal point of subpart F is the “controlled foreign corporation” as defined in section 957(a). It is, essentially, a foreign corporation more than 50 percent of whose total combined voting power is owned by United States shareholders on any day of the taxable year in question. A United States shareholder is any citizen or resident of the United States or any domestic partnership, corporation, trust, or estate, who owns 10 percent or more of the corporation's combined voting power. Thus, where ownership of a foreign corporation is sufficiently diffuse (e.g., owned in equal shares by 11 or more United States shareholders) its shareholders are not subject to subpart F.

The United States shareholder is taxed on his prorata share of subpart F income, and also on his share of income imputed to the foreign controlled corporation under subpart F by reason of (1) increases in the corporation's investments in United States property and (2) withdrawals of investments in less developed countries which had originally supported exclusions from subpart F income. Subpart F income of the foreign controlled corporation consists essentially of “foreign base company income” as defined in section 954. It is here that the thrust of subpart F is most specifically manifested: it reaches income from the sale of goods which were manufactured or produced outside the country of incorporation of the controlled subsidiary and are sold for use outside of that country, and income from the per-

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8. Subpart F income is defined in section 952 as: "[I]n the case of any controlled foreign corporation, the sum of — (1) the income derived from the insurance of United States risks (as determined under section 953), and (2) the foreign base company income (as determined under section 954)."

9. Section 951(a)(1).
10. Sections 957(d), 7701(a)(30).
11. Section 951(b).
12. Section 951(a)(1).
13. Section 954(d)(1).

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formance of services for related parties outside of the country of the subsidiary's incorporation. Thus, the statute includes income which the parent domestic corporation attempts to "drop off" in foreign countries, other than the country of destination for the pertinent goods or services, by running the amounts paid for those goods or services through a subsidiary in a separate foreign country where part or all of the profit involved is deposited. In addition to sales and services income, foreign base company income includes the standard items of passive income — i.e., dividends, interest, royalties, etc. — included as personal holding company income. Section 954(b)(3) provides, however, that if less than 30 percent or more than 70 percent of gross income is foreign base company income, none or all of gross income, respectively, shall be treated as foreign base company income.

Also taxed to United States shareholders is an increment of income representing the value of the corporation's increase in domestic investments. Thus, under what amounts to a constructive dividend-reinvestment rule, funds invested in, or made available by loan to United States sources, are considered as having been withdrawn from the foreign corporation by its shareholders and are taxed to the extent of the corporation's current or accumulated earnings. This rule applies irrespective of the actual source of funds invested in United States property, so that if in a year when the foreign corporation has no earnings it makes a loan to its domestic parent, the amount of the loan will be taxed as income to the parent to the extent of the foreign corporation's accumulated earnings. Where, however, current income is otherwise taxed to the parent as foreign base company income and there are no accumulated earnings, the amount of increased investment is not also taxed; instead the investment will be triggered into income as soon as there are non-subpart F earnings in a later year.

The domestic parent may avoid taxation on subpart F income by investing in countries classified as "less developed." Its income from such investments is specifically excluded from foreign base company income by section 954(b)(1), but only to the extent that the subsidiary increases its investment in less developed countries. In short, the less developed country exception is available only so long as the

14. Section 954(e).
15. Sections 553, 954(c).
16. Section 956.
19. Section 956(a)(1).
20. Section 955(b). In Exec. Order No. 11,071, 3 C.F.R. § 684 (1963), 26 U.S.C. § 955 (1960), the President designated essentially all the countries of the world as "less developed" except those forbidden that designation in section 955(c)(3). The latter are the countries of Western Europe, Communist countries, and the industrial nations of the Far East.

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excluded subpart F income is actually put back into the less developed countries. Conversely, as the subsidiary reduces its investments in less developed countries, the reduction triggers into the United States shareholder’s subpart F income the amount of the reduction to the extent that the United States shareholder has previously benefited from the subpart F exclusion for investments in less developed countries.\footnote{Section 955(a).} That is, a repatriation rule, once removed, applies to the United States shareholder so that the advantage derived from the foreign subsidiary’s investments in less developed countries is temporary and is terminated by taxation whenever the excluded income is withdrawn by the subsidiary from the favored investment.

III. Section 482 and Foreign Subsidiaries

Section 482 of the Internal Revenue Code of 1954 authorizes the Commissioner, with respect to commonly controlled entities, to “distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.” The regulations under section 482 were recently amended and greatly elaborated on with specific attention given to transactions typical of those entered into between domestic parents and their foreign subsidiaries.\footnote{Treas. Regs. §§ 1.482-1(d), 1.482-2 (1968).} Any discussion of the application of section 482 to foreign subsidiaries against the background of subpart F must begin with the recognition of section 482’s applicability to commonly controlled corporations irrespective of their place of incorporation. Thus, although foreign controlled corporations are not themselves subject to United States taxation, their transactions with their parent corporations are, so that not only the parent’s income but also the foreign subsidiary’s tax attributes can be significantly altered as a result of section 482 adjustments.

The function of section 482 is to deprive commonly controlled entities of tax advantages that derive exclusively from the fact that they are commonly controlled and therefore amenable to income manipulation by the controlling interest.\footnote{Treas. Reg. §§ 1.482-1(b) (1968).} The purpose of allocations by the Commissioner under section 482 is to place controlled entities on the same plane as other taxpayers who are not commonly controlled.\footnote{Treas. Reg. § 1.482-10 (1968).} The standard applied to the controlled entities is that of the arm’s-
length transaction; that is, where a transaction between controlled entities is different from what it would have been if the parties were not commonly controlled, the Commissioner may adjust the result of the transaction for tax purposes to reflect what the result would have been if the transaction had been between unrelated parties.25

Generally speaking, the expanded section 482 regulations are directed at the same categories of transactions which can give rise to subpart F income, although the reach of section 482 transcends that of subpart F. Sales of property from one controlled entity to another are subject to detailed arm's-length standards, the preferred standard being that of comparable uncontrolled sales,26 with resort to resale prices and hypothesized markups27 or cost-plus computations28 where comparable uncontrolled sales are not available for comparison. The regulations also focus on services by one entity for another and provide that when services are performed "without charge or at a charge which is not equal to an arm's-length charge,"29 appropriate allocations may be made by the Commissioner. Here the determinative standards are (1) what the charge would have been for an unrelated party, if the services are part of the performing party's trade or business and (2) the cost of performing the services where they are not an aspect of the performing party's trade or business.30

The section 482 regulations attack interest-free or low interest loans between controlled entities by imputing interest and taxing it to the lending party where an arm's-length interest rate is not provided.31 And lastly, manipulation of income-producing intangibles, including patents, trademarks, licenses, contracts, and the like, is subject to allocation to reflect an arm's-length charge upon their transfer or sale.32

Bona fide cost sharing arrangements for the development of products between controlled entities are not subject to allocation where the sharing of costs is based on objective factors no different from those used by unrelated parties.33

25. The arm's-length standard has been judicially accepted as an appropriate device for implementing section 482. South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890 (5th Cir. 1966); Oil Base, Inc. v. Commissioner, 362 F.2d 212 (9th Cir. 1966); Ach v. Commissioner, 358 F.2d 342 (6th Cir. 1966).


The section 482 regulations are not in terms addressed to, or limited to, foreign subsidiaries and their domestic parents. The connection between section 482 and subpart F arises from their common underlying objective — the abrogation of tax benefits sought by taxpayers in circumstances where the policy of the tax benefit is being distorted. Thus, section 482 is commonly applied in wholly domestic situations where income of one entity is transferred to another to provide the latter with income to offset otherwise unusable operating loss deductions and carryovers.\textsuperscript{34} The tax benefit to domestic parents from operating through foreign subsidiaries rather than foreign branches is of the same character as the operating loss deduction in that the benefit serves particular policy objectives which are distorted when the benefit is put to particular uses. Subpart F is a particularized response to those attempted uses, while section 482 is addressed generally to income manipulations that include, but are not limited to, the practices that will result in taxation under subpart F. The significant difference in the mechanics of the two devices is that subpart F accepts the critical transactions as they are devised by the parties and taxes them at the shareholder level if they meet the statutory definitions, while under section 482 the transactions are recast and indeed may be disregarded for tax purposes. The new regulations under section 482 were motivated by an intention on the part of the Internal Revenue Service, and a demand on the part of taxpayers, that some predictability be introduced into the revived administration of section 482 so that taxpayers could anticipate its impact.\textsuperscript{35} Nonetheless, subpart F, in contrast to section 482 and its regulations, specifies in detail the interaction of its rules with other provisions and requirements of the Code — \textit{e.g.}, the computation of the foreign tax credit\textsuperscript{36} and the earnings and profits of the affected corporations.\textsuperscript{37} Resolution of these corollary questions under section 482 is less clear, although IRS procedural announcements have provided some specifics for years prior to 1965.\textsuperscript{38} Because the impact of both devices is substantially shaped by the manner in which the corollary questions are resolved, the

\textsuperscript{34}See, \textit{e.g.}, Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967); Ach v. Commissioner, 358 F.2d 342 (6th Cir. 1966); Spicer Theatre, Inc. v. Commissioner, 346 F.2d 704 (6th Cir. 1965); Ballentine Motor Co. v. Commissioner, 321 F.2d 796 (4th Cir. 1963).

\textsuperscript{35}See IRS release, Aug. 2, 1966, 7 CCH 1966 STAND. FED. TAX REP. ¶ 6685. See also Hilinski, \textit{Some Thoughts on Section 482}, in \textit{TAXATION OF FOREIGN INCOME} 147 (1966).

\textsuperscript{36}Section 960.

\textsuperscript{37}Section 959.

\textsuperscript{38}Rev. Proc. 65-17, 1965-1 CUM. BULL. 833; Rev. Proc. 64-54, 1964-2 CUM. BULL. 1008.
following comparative analysis of subpart F and section 482 centers on those questions.

IV. SUBPART F AND SECTION 482: A COMPARISON

A. Coverage

The transcendent reach of section 482 in comparison to subpart F is apparent from the definition of "controlled" set forth in Treas. Reg. § 1.482–1(a) (3) (1968). That definition, which describes the inter-entity relationship which brings the entities within section 482, covers "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." The regulation further provides: "It is the reality of the control which is decisive, not its form or the mode of its exercise." This is in sharp contrast to the precise rules of percent of ownership which define a controlled foreign corporation subject to subpart F as one 50 percent of whose voting stock is held by United States shareholders;\(^{39}\) in turn the term "United States shareholders" does not include those whose holdings are less than 10 percent of the voting stock in the corporation, as we have noted previously.\(^{40}\) Thus, participation in a foreign venture by a domestic corporation with other domestic or foreign interests may be shaped by the domestic corporation to avoid the "controlled foreign corporation" rules, especially if it holds less than 50 percent of the voting power. Section 482, however, looks to the practicalities of control, and where it exists de facto without regard to the distribution of voting stock, section 482 may apply.\(^{41}\) Thus, practical control which partially derives from informal arrangements with other shareholders, or by reason of creditor rights, can bring a transaction within section 482 but poses no threat of subpart F treatment.

All corporations, foreign and domestic, and irrespective of their business activities, are subject to section 482.\(^{42}\) Subpart F, as we have noted, reaches only the income from specific transactions and those involve essentially sales, service, and investment activities that are multinational from the perspective of the foreign subsidiary. In contrast, every subsidiary of a domestic parent is in a section 482 relationship to that parent, including those which manufacture products for

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39. Section 957(a).
40. Section 951(b).
41. See, e.g., Ach v. Commissioner, 358 F.2d 342 (6th Cir. 1966), in which a taxpayer who transferred business assets to a corporation wholly owned by her son was held to have controlled the corporation for purposes of section 482 although she owned no stock in it.
42. Section 482 in terms applies to "two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated)" (emphasis added).
sale in the foreign country of manufacture or whose services are performed in the foreign country of incorporation. Thus, it is useful in considering the combined impact of subpart F and section 482 on a particular foreign subsidiary to isolate that much of the subsidiary's income ascribable to controlled transactions with the parent from the rest of the subsidiary's income and then consider the extent to which that component of income was derived from arrangements which did not meet arm's-length standards. That amount constitutes excess income which section 482 allocates to the parent. Once the excess income is isolated, subpart F applies more mechanically to actual income and taxes the subpart F component to the parent. Thus, section 482 operates to alter income, while subpart F takes the income as it finds it and taxes it to the shareholder-parent.

B. The Foreign Tax Credit

The foreign tax credit is designed to ensure that the total tax paid by a United States taxpayer on income from sources outside the United States is no greater than what the tax would have been if the source of income had been domestic. Thus, section 901 of the Code allows a domestic corporation a credit for any income or excess profits taxes which it paid to a foreign country, and section 902 allows the domestic corporation a credit for the taxes paid or deemed paid on income distributed to the domestic corporation.43 That credit, however, is limited to what the United States tax would have been on the foreign income if it had been derived from United States sources.44 Thus, if the foreign tax rate is the same as the United States tax rate, the United States taxpayer pays no United States tax on income derived from foreign sources.

Subpart F and section 482 present new problems which overlay the policy of the foreign tax credit and which require adjustments in their implementation if the foreign tax credit is to be maintained as a relief measure in aid of foreign investment.45 The interplay between

43. When section 902 credit is used, the taxpayer must increase its U.S. tax base by including in it the amount of foreign income paid in taxes which is attributable to the dividends distributed. Sections 78, 902.

44. Sections 904(a), (b).

45. It is suggested by some that tax advantages in behalf of foreign investment by U.S. corporations actually enhances the U.S. balance of payments by generating sales of U.S. products abroad. The converse of this argument is that the investment itself has a negative impact on the balance of payments and the latter is immediately felt while the former is conjectural. Moreover, the sale of U.S. products by foreign subsidiaries who do not repatriate the funds but instead plow them back into the foreign operation is not the kind of foreign trade which will alleviate the balance of payments problem.
subpart F and the foreign tax credit is prescribed by statute, but the relationship between the credit and section 482 is not so clear and requires more sophisticated planning on the part of the taxpayer to achieve the credit's ultimate advantage.

The essential rule of section 960 is that a domestic parent shall be deemed to have paid the foreign tax on the subpart F income which is taxable to it and its foreign tax credit under section 902 is thereby increased, much as if the subpart F income had been distributed to the parent as a dividend. Thus, subpart F has no practical effect where the tax rate of the country of incorporation of the controlled foreign corporation is the same as the United States tax rate. But this is merely consistent with the premise of subpart F that the international transactions it reaches are motivated by the low tax rate of the country of incorporation of the subsidiary whose income is attributed to the parent. Where the premise is belied by the actualities, subpart F has no impact by reason of the section 960 adjustment to the foreign tax credit.

Section 959 allows tax-free distributions from a foreign subsidiary to a domestic parent to the extent that income of the subsidiary has already been taxed to the parent by operation of subpart F. Since the parent has already enjoyed the benefit of the foreign tax credit arising from the foreign taxes deemed paid on the subpart F income, it may not take the credit again when the tax-free distribution is made. But if there is an additional foreign tax paid at the time of the distribution with respect to the amount distributed a credit is allowed for that tax and the overall limitation is adjusted accordingly in the year of distribution to allow for it.

Subpart F treats separate taxpayers as if they were a single taxpayer by imputing the income of one to the other. Since the foreign tax credit is not designed to combat the kind of double taxation that results when different tax jurisdictions tax the same income to different taxpayers, subpart F, as we have noted, had to make the appropriate adjustments in the foreign tax credit to account for its treatment of separate taxpayers as if they were the same. The problem under section 482 is that it operates just as subpart F does in this respect, but does not carry with it its own foreign tax credit adjustments. If the United States allocates income to a domestic parent from a foreign

46. Section 960.
47. The tax credit allowed by section 960 is available only to corporations, as is the case with the credit under section 902 itself.
48. Section 960(a)(2).
49. Section 960(a)(3).
50. Section 960(b).
subsidiary and characterizes the income as having derived from sources within the United States, a tax is paid by the parent on that income and a foreign tax will also be paid on the same income by the foreign subsidiary. This sharply distinguishes a multinational section 482 allocation from one involving a domestic subsidiary; in the latter instance, a corresponding adjustment of the income of the subsidiary avoids double taxation of that increment of income. The ultimate tax effect of a section 482 allocation, however, is determined by the potential adjustments in the foreign tax credit in light of the reduction in the subsidiary’s earnings and profits by reason of the allocation. The correlative adjustment that is actually made in the case of a domestic subsidiary is, in the case of a foreign subsidiary, “deemed to have been made . . . for the purposes of determining the U.S. income tax liability of any person for any taxable year.”

A correlative adjustment which reduces the earnings of a foreign subsidiary for purposes of determining the tax due from the United States parent will operate to increase the foreign tax credit allowable to the parent on any dividends actually paid to the parent by the subsidiary. This is because the tax credit for taxes deemed to have been paid by the parent is measured by a fraction applied to the foreign subsidiary’s tax, the numerator of which is the dividends paid to the parent and the denominator of which is the accumulated profits of the subsidiary. Thus, a section 482 allocation which for United States tax purposes will be deemed to have reduced the earnings of the subsidiary will therefore reduce the denominator of the fraction applied to the subsidiary’s foreign tax, the effect being to increase the tax credit allowed on the dividends. Whether this offsets the increased tax resulting from the allocation of income to the parent depends on the tax rate of the foreign country and the portion of the foreign subsidiary’s earnings which are distributed to the parent. If, for example, the foreign tax rate is the same as the U.S. rate and all of the subsidiary’s earnings not otherwise allocated to the parent are distributed as a dividend, the tax on the allocated income will be more than offset by the amount of tax credit allowed on the dividend. Thus, if we assume that the foreign subsidiary’s income is $100, its tax is $50, it pays dividends of $25 to its domestic parent, and $25 is allocated to the parent under section 482, we have the following.

53. Section 902(a)(1).
### Taxation of Foreign Corporations

**Subsidiary**

<table>
<thead>
<tr>
<th>100</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>-50</td>
<td>Tax</td>
</tr>
</tbody>
</table>

| 50   | Earnings & Profit |

**Parent**

<table>
<thead>
<tr>
<th>25</th>
<th>Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>+25</td>
<td>Section 482 allocation</td>
</tr>
</tbody>
</table>

| 50   | Income |

| 25   | Tax (at a 50 percent rate) |

**Tax Credit without the allocation:**

\[
\begin{align*}
25 & \quad \text{(Dividend)} \\
50 & \quad \text{(Earnings & Profit)} \\
\times & \quad 50 & \quad \text{(Foreign tax)} = 25
\end{align*}
\]

**Tax Credit with the allocation taken into account:**

\[
\begin{align*}
25 & \quad \text{(Dividend)} \\
25 & \quad \text{(Earnings & Profit } \text{ reduced by amount allocated)} \\
\times & \quad 50 & \quad \text{(Foreign tax)} = 50^{54}
\end{align*}
\]

Where the tax rate of the foreign subsidiary is substantially lower than the United States tax rate, the foreign tax credit cannot overcome the tax effect of a section 482 allocation, as may be seen from the following.

**Subsidiary**

<table>
<thead>
<tr>
<th>100</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>-20</td>
<td>Tax</td>
</tr>
</tbody>
</table>

| 80   | Earnings & Profit |

**Parent**

<table>
<thead>
<tr>
<th>40</th>
<th>Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>+40</td>
<td>Section 482 allocation</td>
</tr>
</tbody>
</table>

| 80   | Income |

| 40   | Tax (at a 50 percent rate) |

**Tax Credit without the allocation:**

\[
\begin{align*}
40 & \quad \text{(Dividend)} \\
80 & \quad \text{(Earnings & Profit)} \\
\times & \quad 20 & \quad \text{(Foreign tax)} = 10
\end{align*}
\]

**Tax Credit with the allocation:**

\[
\begin{align*}
40 & \quad \text{(Dividend)} \\
40 & \quad \text{(Earnings & Profit } \text{ reduced by amount allocated)} \\
\times & \quad 20 & \quad \text{(Foreign tax)} = 20
\end{align*}
\]

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54. These computations are without regard to the "gross-up" rule or the overall limitation. See sections 78, 904. It may be seen that with respect to an allocation from a high tax rate subsidiary, the allocation may create a credit to be used against income from other foreign subsidiaries if the overall limitation is not exceeded.
Since the allocation increases the parent's tax by $20 and the resulting increase in credit is only $10, the allocation does result in the same income being taxed twice. It is also to be noted that in both of the examples above, the tax credit is increased indirectly by reason of the allocation only if dividends are distributed from the subsidiary to the parent; otherwise the numerator of the ratio applied to the foreign tax is zero and there is no credit at all. Thus, where the payment of dividends cannot provide an increased tax credit sufficient to offset the tax on the allocated income, the subsidiary's dividend policy should be adjusted accordingly. Since intercompany transactions giving rise to section 482 allocations are more likely to arise where the foreign tax rate is less than the United States tax rate,\(^5\) it will most frequently be the case that the adjustment in the foreign tax credit arising from dividends paid will not offset the tax on the allocated income.

C. Relief Provisions

Both section 482 and subpart F, as noted, presuppose a tax advantage to the controlling interest in the shifting of income to, or its accumulation in, a foreign subsidiary. Where the subsidiary makes substantial dividend distributions to the parent, however, that premise is belied and invocation of subpart F or section 482 becomes superfluous. This conclusion is reflected in the minimum distribution rules applicable to controlled foreign corporations set forth in section 963 of the Code. Under section 963(a) a corporate shareholder of a controlled foreign corporation may exclude from income its share of the foreign corporation's subpart F income if the shareholder has received a distribution from the corporation at least in the minimum amount prescribed in section 963(b). The minimum distribution schedule is keyed to the effective foreign tax rate applicable to the controlled foreign corporation and operates so that the lower the foreign tax rate, the greater the required distribution. In general, the schedule is designed so that if the combined foreign tax on the earnings and the United States tax on the distribution is equal to at least 90 percent of what the United States tax would have been if the earnings were from sources within the United States, subpart F income will not also be taxed. Even if the shareholder qualifies under the minimum distribution test, income attributable to increased investments in United States property will still be taxed to it; section 963(a) prescribes the exclusion only to reach income described in section 951(a)(1)(A)(i), or subpart F income, which correctly perceived is a separate category

\(^{55}\) See Surrey, supra note 26, at 79.
of income from that ascribable to increased investment in United States property. It is not clear from the legislative history why the minimum distribution under section 963 does not abrogate the tax on increased investment in United States property. With respect to the latter, the Senate Finance Committee stated that "earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them." Since the treatment of increased investment in United States property is no different from that of other subpart F income in that the taxpayer is not again taxed on earnings actually distributed to him once earnings are taxed under subpart F, there is no apparent reason not to extend the exclusion to the increased investment increment of taxable income. If earnings are substantially distributed within the minimum distribution standard, then it should make no difference whether an amount equal to the remainder of the foreign corporation's earnings are retained in the corporation or are reinvested in United States property. The untaxed reinvestment would not alter the earnings account of the corporation and would not reduce the potential of taxation on further distributions or reinvestments in United States property in later years.

A substantial boon to those who seek to qualify under the minimum distribution rule is the provision that for purposes of the rule foreign branches of the domestic shareholder — i.e., the parent corporation — may be treated as subsidiaries, with the result that 100 percent of the earnings of the branches is deemed a part of the distributions to the shareholder from its controlled foreign corporations. Again, the legislative history is uninformative as to the rationale for this provision. It seems patently inconsistent with the entire thrust of subpart F. Branches are in general going to be used by a domestic corporation in those countries where the foreign tax rate is high because as to such operations there is no advantage in avoiding United States taxation, assuming further that incorporation in a country other than the country in which the branch operates is not feasible. Therefore, branch operations are not within the ambit of the congressional

56. Section 951(a)(1)(A), (B).
57. S. REP. No. 1881, supra note 7, at 88.
58. Section 963(c)(4)(B).
59. The minimum distribution provisions were added to the House version of the 1962 Act by the Senate Finance Committee. S. REP. No. 1881, supra note 7, at 88. No policy explanation appears in the Senate report for the branch rule. Id. at 89, 267-68.
motivation for adopting subpart F in the first place. Thus it makes little sense to consider the "distributions" — i.e., the earnings — from branches as meeting an alternative requirement which saves the domestic corporation from taxation on activities and entities which are of a much different character than straightforward branch operations in high-tax foreign countries. The larger the corporation, the more likely it is that the branch rule may operate to leave its tax shelter foreign arrangements substantially untouched by subpart F because, wholly apart from tax advantage machinations, such corporations will have extensive branch operations throughout the world.

The minimum distribution rule is further honeycombed with a series of elections which render an estimate of its ultimate impact on a domestic corporation and its foreign subsidiaries immensely difficult.\(^{61}\) The options available, which in detail are beyond the scope of this Article, permit a taxpayer to compute the minimum distribution separately for each controlled foreign corporation,\(^{62}\) separately for each chain of controlled foreign corporations,\(^{63}\) and for all controlled foreign corporations with or without less developed corporations included.\(^{64}\)

An assessment of the impact of the minimum distribution rule cannot be made without reference to the particular situation of a given corporate taxpayer. It seems clear, however, that the minimum distribution rule was shaped and adopted by Congress in the later stages of development of the Revenue Act of 1962 with neither an understanding of its relationship to the rest of subpart F, nor with a realistic regard for its inordinate complexities. Section 963, and to a lesser extent subpart F itself, is indicative of the current approaches to the drafting of tax legislation, an approach epitomized in the Code sections dealing with corporate mergers and acquisitions,\(^{65}\) collapsible corporations,\(^{66}\) and the income of trusts and estates.\(^{67}\) This type of legislation attempts to treat in detail every conceivable set of circumstances to which the statute applies in order to imbue the statute with a high degree of objectivity calling for little or no administrative or judicial tinkering. This statutory process, however, breeds judicial timidity with respect to the legislated subjects, sometimes in the Commissioner's favor and sometimes in the taxpayer's favor, which in turn induces

\(^{61}\) Id. at 955.
\(^{62}\) Treas. Reg. § 1.963-1(d) (1964).
\(^{63}\) Section 963(c) (2) ; Treas. Reg. § 1.963-1(e) (1964).
\(^{64}\) Sections 963(c) (3), (4) (A).
\(^{65}\) Sections 354, 355, 368, 381, 382.
\(^{66}\) Section 341.
\(^{67}\) Sections 641–91.
further legislation of the same character. Where, in the quest for predictable tax consequences, legislation becomes so abstruse and convoluted that its precise impact cannot be determined without resort to the most sophisticated analytical techniques, including the use of computers, the stated objective itself has been sacrificed and an appraisal of the legislation is not even possible by persons other than experienced experts in the field, a political consequence that should be avoided.

The regulations under section 482 set forth certain built-in measures which in essence reflect a philosophy of balancing not unlike that contained in the subpart F protection against double taxation and in the minimum distribution rule. We have referred previously to the "correlative adjustment" rule under section 482 where for purposes of the United States tax a correlative adjustment conversely to the principal allocation will be deemed made with respect to the foreign subsidiary of a domestic corporation to which foreign income is allocated. The effect, of course, is to reduce the earnings and profits of the subsidiary and to that extent permit a tax-free distribution from the subsidiary to the parent; the advantage is of limited usefulness, however, in that it requires a distribution of all current and accumulated earnings before it may be realized. A more useful relief measure permits the parties subject to a section 482 allocation to offset income-distorting transactions against one another to arrive at a net 482 adjustment. For example, if the parent performs services for the subsidiary at a non-arm's-length discount and the subsidiary sells products to the parent at a non-arm's-length discount, the transactions may be netted for purposes of the section 482 allocation. Also, a non-arm's-length transaction in a given taxable year will not be the basis of an allocation if the parties have made an arrangement for arm's-length compensation in later years, so long as the arrangement is shown to have been made in the taxable year of the transaction. Here the length of time for payment appears critical; the example in the regulations permits the performance of services without charge in the taxable year if payment is to be a percentage of sales over a 5-year period including the year in question.

Perhaps the most significant relief factor under section 482 is the administrative practice of the Commissioner. Simultaneously with the issuance of the proposed regulations under section 482, the Service

68. See Davant v. Commissioner, 366 F.2d 874, 887 (5th Cir. 1966).
70. Treas. Reg. § 1.482-1(d) (3) (1968).
71. Id.
72. Id. example 1.
stated that it "is following a policy of allocating income between related corporations, for tax purposes, only in 'significant' cases, not in instances where 'minimal amounts are involved.'" While "significant" and "minimal" are not self-defining terms, it seems clear that taxpayers need not expect a section 482 allocation unless their transaction is plainly tax motivated. If one may generalize from reported cases, it would appear that the Commissioner does not attack intercompany allocations except where substantially all of the allocated amount would go untaxed permanently, typically because of an otherwise unusable loss carryover. The application of section 482 to foreign subsidiaries, however, threatens well established patterns of dealings between parent and subsidiary over many years in which it may have been assumed that there would be no IRS scrutiny of non-arm's-length transactions which nonetheless served legitimate non-tax business purposes. Cognizant of this factor, the Service announced relief procedures applicable only to tax years beginning prior to 1965. The most significant among these is the allowance of a foreign tax credit for the amount of tax the foreign subsidiary would not have paid if the parties had treated the transaction consistently with the section 482 allocation. The credit, or offset, as it is called, is the difference between the foreign tax "as actually determined" and "the amount which would have been determined" had the transaction been conducted as presumed under section 482. The choice of the Service thus far not to extend the foreign tax offset to tax years after 1965 departs from the section 482 scheme proposed by the House as part of the Revenue Act of 1962 but which was not enacted into law. Presumably the Service has concluded that the foreign tax paid on income allocated to the domestic parent is properly considered another expense of the foreign operation where the parties set up a non-arm's-length transaction


76. Rev. Proc. 64-54, supra note 75, ¶ 4.01-1.

77. H.R. Rep. No. 1447, supra note 4. For a detailed argument in support of allowance of the offset in years subsequent to 1965, see Miller, Proposals for Amelioration of Section 482 Allocations Affecting U.S. Taxpayers with Foreign Affiliates, 44 Taxes 209, 221-30 (1966).
despite notice of the new section 482 rules. Thus, the foreign tax will reduce the subsidiary’s earnings but will not prevent another tax by the United States on the same income.

Lastly, a minimum distribution rule applies to pre-1965 years, so that if the foreign subsidiary paid out 90 percent or more of its earnings for the year and the earnings were included in the income of the controlling United States shareholder, no allocation will be made.

V. Conclusion

The regulations under section 482 constitute a more imposing barrier to tax avoidance than does subpart F. Their impact is not softened by foreign tax credits for the taxes paid on the allocated income. The objective of section 482 is to abort attempted avoidance of United States taxation, while subpart F is designed merely to increase United States taxes to counter attempted avoidance of foreign taxes through the use of tax-haven subsidiaries in low-tax countries other than the country of ultimate business activity. The 30–70 rule ensures that only those subsidiaries most obviously organized to accomplish foreign tax avoidance will have to confront the provisions of subpart F. The legislative history of subpart F offers little insight into the magnitude of the tax avoidance activity at which it is aimed, and it is a fair guess that the principal effect of the discouragement of the use of tax-haven foreign corporations may have been to increase foreign tax revenues; one doubts that very much income will be reported under subpart F. As is the case with other provisions of the Code aimed at tax avoidance, such as the accumulated earnings, personal holding company, and collapsible corporation provisions, taxpayers are not likely to concede the applicability of the provisions. Rather, their impact will be reflected in changes in organization and in the planning of transactions, changes which need not result in appreciably greater United States tax liabilities. In contrast, changes in the structure of transactions in response to the newly active policy under section 482 will necessarily produce increased United States revenues. Also, the dividend policy of foreign subsidiaries will be substantially affected by the operation of section 1248 of the Code (also adopted as part of the Revenue Act of 1962), which taxes as ordinary income.

78. See Surrey, supra note 26, at 79.
79. Rev. Proc. 64–54, supra note 75, § 3.02.
80. Sections 531–37.
81. Sections 541–47.
82. Section 341.
gain on the disposition of stock in a controlled foreign corporation to the extent of the corporation's post-1962 undistributed earnings.

One must note the severe administrative problems presented under section 482. The arm's-length standard is simple enough in theory, but in practice, especially with respect to international transactions between a parent and subsidiary which have no easy analogies, it portends great difficulties for taxpayers and the Service, as both are aware.\textsuperscript{83} It may well develop that the potential impact of section 482 will be reduced, to the advantage of taxpayers, by practical impediments inherent in any attempt to oversee the myriad transactions that occur daily in circumstances which might give rise to section 482 questions.

\textsuperscript{83} See, e.g., Aidinoff, supra note 5, at 439 (taxpayers); Bacon, \textit{Compliance Problems in Taxation of International Operations} in \textit{TAXATION OF FOREIGN INCOME} 160 (1966).