

FOREIGN CORPORATIONS
which are
PERSONAL HOLDING COMPANIES
or
FOREIGN PERSONAL HOLDING COMPANIES *

1. INTRODUCTION AND SCOPE

- A. Vocabulary here is terrible, since the discussion concerns foreign corporations, but the Code refers both to personal holding companies (sections 541 et seq.) and to foreign personal holding companies (sections 551 et seq.). To avoid confusion, abbreviations are in order. Thus, this outline will consider the U.S. income tax treatment of foreign corporations which are PHC's or FPHC's.
- B. Although the predecessors to the current Code PHC provi-

sions, sections 541 et seq., were first enacted in 1954, and have apparently always applied to foreign corporations (see II/A, below). There has been very little written about the area. The best long article, Alexander, Foreign Personal Holding Companies and Foreign Corporations that are Personal Holding Companies, 67 YALE L.J. 1173 (1958) (hereinafter cited as Alexander), was written before the very important amendments of 1955. The one article that does deal with the effect of the 1955 changes, Hochberg, The Foreign Investors Tax Act: Its Impact on Personal Holding Companies, 27 J. TAXATION 118 (1967) (hereinafter cited as Hochberg), although excellent, is less than four pages long. [A bibliography is attached to this paper.] Nothing of significance has been written on the topic since 1967, although a few more recent treatises do contain some brief discussion of the subject. A re-examination of the treatment of foreign corporations as PHC's seems timely.

- C. Because the focus is on foreign corporate PHC's, a general discussion of the PHC provisions of the Code is outside the scope of this paper. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ch. 8, part B (4th ed. 1979) (hereinafter cited as B+B), and sources referred to

therein.

- D. Part A of this outline deals with the PHC provisions.
Part B deals with the FPHC provisions.

PART A

II. BACKGROUND

- A. The first PHC-type regime was adopted in the Revenue Act of 1934, section 351. The legislative history contains no indication that Congress was thinking about foreign corporations. It also lacks any language from which to reason to the contrary, i.e., that foreign corporations were intended to be excluded. The statutory language, however, was broad enough to include them. The Revenue Act of 1936, while making many changes to the PHC provisions, carried forward these particular provisions without material change.
- B. The predecessor to the current FPHC regime was adopted in the Revenue Act of 1937. This was specifically aimed at foreign corporations, as the legislative history -- and the speech of F.D.R. requesting the Congress to act -- made clear. Section 352(b), added by section 1 of

the 1937 Act, standing within the PHC provisions (which were again carried forward, but this time subject to significant changes), excepted from PHC treatment "a foreign personal holding company as defined" Compare current Code section 542(c)(5). Since the 1937 legislation -- like the current version -- classified as FPHC's only foreign corporations, it was clear not later than 1937 that foreign corporations could be PHC's. Furthermore, the section 352(b) exception was explicitly made applicable only with respect to taxable years ending after the date of the Revenue Act of 1937. Thus, the implication was almost overwhelming that foreign corporations had always been subject to the PHC rules. The Service squarely so held in C.C.M. 18077, 1937-1 C.B. 123, decl. obs., Rev. Rul. 68-674, 1968-2 C.B. 609. Accord, Rev. Rul. 60-34, 1960-1 C.B. 203, 204. A series of court decisions, without discussing the point, apparently assumed this result, e.g., Blanneim Co. Ltd., 42 B.T.A. 1248 (1940), aff'd, 125 F.2d 906 (4th Cir. 1942); Elston Co. Ltd., 42 B.T.A. 208 (1940); Taylor Securities, Inc., 40 B.T.A. 696 (1939). The first case in which the taxpayer argued for an exclusion, on the ground that foreign corporations could not be PHC's, was Fides, A.G. v. Comm'r, 47 B.T.A. 280 (1942), aff'd, 137

F.2d 791 (4th Cir.), cert. denied, 320 U.S. 797 (1943)

-- and the taxpayer lost. Finally, the regulations have long explicitly included foreign corporations within the PHC class, starting with the regulations adopted to reflect the 1937 Revenue Act (T.D. 4777, 1937-2 C.B. 196).

- C. The PHC provisions were carried forward, without any changes significant here, into the 1954 Internal Revenue Code. The exception for FPHC's was preserved. A second exception was added to the statute: for foreign corporations (1) all of whose stock was owned, during the last half of its taxable year, directly or indirectly through other foreign corporations, by nonresident alien individuals, and (2) less than half of whose gross income "from all sources" was from within the United States. Section 542(c)(10), renumbered as 542(c)(7) by the Revenue Act of 1964. This latter exception had first been added to the regulations, without statutory support, in 1938. T.D. 4791, 1938-1 C.B. 83, 100, amending article 351-1 of Regulations 94. It was carried forward in successive versions of the regulations, and was numbered section 39.500-1(b) just prior to the 1954 Code. (See VI/B, below.)

- D. The April 1964 Fowler Task Force Report suggested that

the PHC definition be amended to exclude foreign corporations wholly owned by nonresident alien individuals. In effect, this amounted to recommending the elimination of the second half of the second exception in II/C, above.

E. The Foreign Investors Tax Act of 1966 contained several significant amendments to the PHC provisions affecting foreign corporations.

1. The Fowler Task Force recommendation was adopted, but with two changes --

a. An exception was added in the Senate, contained in a parenthetical phrase in section 542(c)(7) of the Code, continuing PHC status for foreign corporations, although wholly owned by nonresident aliens, if such corporations have "income to which section 543(a)(7) applies" -- i.e., income from incorporated talents. Sections 543(b)(1)(C) and 545(d) were also added to limit the tax base, in such cases, to the 543(a)(7) income. See V/A/5 and VI/B, below.

b. The ownership by nonresident aliens was allowed to be direct (as before), indirect through foreign corporations (as before), and also indirect through foreign estates, foreign trusts, and foreign partnerships. No reason appears why

indirect ownership through U.S. entities was interdicted, but a more limited suggestion along that line -- i.e., to eliminate the adjective "foreign" before "partnerships" -- was made and not adopted.

2. Normally, foreign corporations (and other foreign persons) cannot claim the benefit of any tax deductions unless they prepare and file a "true and accurate return." Sections 874(a) and 882(c)(2). [The regulations had long contained similar provisions.] The Senate added an exception to this rule for foreign corporations for purposes of the PHC provisions. Section 882(c)(2), second sentence. This exception, and the apparently contradictory provisions of Code section 5689 (which was added at the same time), are discussed at V/A/3 and VIII/A, below.
3. A de minimis rule was adopted, in addition to the wholly-foreign-owned rule (II/E/1, above), reducing the tax base if the foreign PHC has 10 percent or less U.S. ownership. Section 545(a), second sentence, discussed at V/A/4, below.
- F. No subsequent legislation has affected foreign PHC's in any significant way. The regulations, issued in 1958

and amended in various ways since then, do not deal at all with the important 1966 changes (which also are bereft of meaningful legislative history). The regulations proposed in 1968 are noteworthy for the following reasons:

1. They do not deal with, and thus do not address or clarify problems in, the 1966 legislation.
2. They have the dubious distinction of being the longest outstanding proposed regulations not yet adopted or withdrawn.
3. The very few provisions in them which do deal with foreign corporations are hopelessly outdated by the passage of legislation not reflected in them. E.g., Proposed Reg. section 1.541-1(b) is simply wrong. (See IV/B, below.)

III. THE SHAREHOLDER TEST

- A. The statute provides that a corporation may be a PHC only if:

"At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals."
Section 542(a)(2).

These words raise seven issues worth discussing:

1. The relevant time period within which to apply the test is only the last half of the foreign corporation's taxable year. Ownership during the first half of the year is irrelevant. The legislation as it reached the floor of the House had originally referred to the last day of the taxable year. It was amended on the floor to refer to the last half of the taxable year. 78 Cong. Rec. 3003 (1934). All traces of any reasons for this choice have been covered over by the sands of time. (The legislative history is silent.) But note that the comparable shareholder test for FPHC purposes looks to the entire taxable year rather than only the last half of it. Section 552(a)(2).
2. The test is to applied against the "taxable year" of

the corporation. In the case of foreign corporations, it is not always easy to determine what the proper taxable year is. It seems clear, nevertheless, that foreign corporations do have taxable years, whether or not they have ever filed a U.S. tax return, derived U.S. source income, or engaged in trade or business within the U.S. See generally Dale, Tax Accounting for Foreign Persons, 37 TAX L. REV. 275, 276-281 (1982) [hereinafter cited as Dale].

3. The tainted ownership must exceed 50 percent in value. Thus, exactly 50 percent is acceptable, i.e., will not cause a corporation to become a PHC.
4. The test is not determined by vote, but by value. Value is to be "determined in the light of all the circumstances." Reg. section 1.542-3(c).
 - a. This will always cause problems in cases of more than one class of stock. In such situations, the shareholder test may be aimed at a moving target, depending on the daily economic fortunes of the corporation. For example, if X corporation has a net worth of \$1 million, and has outstanding a widely held class of preferred stock so constituted as to have a fair market value of \$600,000, X will not be a PHC even if

all of the common stock is owned by one person. Suppose, however, that X prospers, and that its net worth increases to \$1.8 million. The common stock is presumably then worth \$700,000, and the shareholder test is met. The regulations seem to confirm this result, referring explicitly to the corporation's net worth, and to any appreciation in value of its assets, in describing the valuation determination. Reg. section 1.542-3(c). Cf. Wolf Bergman, 6 T.C.M. 1118 (1947) (section 267).

- b. Other issues of value will also be relevant, including perhaps premiums for control or discounts for blockage or minority status. See, e.g., Robishaw v. U.S., 515 F.2d 507 (Ct. Cl. 1980), and authorities cited therein (section 1239).
- c. Upon invoking the attribution rules, the valuation questions become even more confused, since they then probably must be answered not only at the level of the corporation whose shareholders are being tested, but also at the higher or other levels relevant under section 544. See, e.g., section 544(a)(1), attributing stock to

shareholders "proportionately." (Although the regulations do not clarify the phrase, it probably refers to the value of shares held by shareholders, but there is room for some doubt. Compare sections 267(c)(1) and 318(a)(2)(C).)

- d. Votes are not tested, although of course they may be relevant in determining value. It thus seems that a class of nonvoting stock could have a value in excess of 50 percent of the total stock outstanding. Such stockholders might not be able to force the corporation to make distributions. This consequence, which seems to be at variance with at least part of rationale for the PHC provisions, also exists (and for the same reason) in the FPHC provisions. The latter were modeled on the PHC rules. H. Rep. 1546, 75th Cong., 1st Sess., 1937-2 C.B. 620. At least one court has expressed doubt whether the FPHC shareholder test would be met if nonvoting shareholders, i.e., non-controlling shareholders, could by themselves constitute the more-than-50 percent "control" group. Estate of Nettie S. Miller, 43 T.C. 760 (1965), nonacq. 1966-1 C.B. 4, 1966-2 C.B. 8 (discussed at length

at XI/C, below). The better view, however, would seem to be that value means just that, and that the shareholder test may be applied to nonvoting as well as to voting shares.

e. There is no minimum threshold of ownership here. There is also no minimum threshold for FPHC purposes. Contrast the subpart F rule, which establishes a 10 percent minimum test. Section 951(b).

5. The test applies only to "stock." Labels will certainly not control. Thus, debt/equity issues remain. E.g., Washmont Corp. v. Hendrickson, 137 F.2d 306 (9th Cir. 1943). In addition, other (e.g., "hybrid") securities will have to be examined to see if they should be treated as stock. B+E at 8-55 n. 138. Furthermore, options or "share warrants" may really be stock. Rev. Rul. 82-150, 1982-23 I.R.B. 5; Estate of Nettie S. Miller, supra. However, membership certificates in nonprofit corporations are probably not stock for this purpose. Stevens Brothers Foundation, Inc. v. Comm'r, 324 F.2d 633 (8th Cir. 1963), cert. denied, 375 U.S. 959 (1964); Rev. Rul. 58-556, 1958-2 C.B. 355. cf. LTR 8147002 (January 24, 1979).

6. The relevant group must "own" the stock. However, the statute says that ownership may be direct or indirect, and that shares held by or for the individual may be included. Thus, even before reference is made to the constructive ownership rules of section 544, some notion of beneficial ownership is triggered by the language of section 542(a)(2) itself. The regulations provide no useful guidance on the scope of these notions.
7. The stock must be owned by five or fewer "individuals,"
 - a. There is no limitation to U.S. individuals, as there is in the comparable FPHC provision (section 552(a)(2)). Thus, it is clear that foreign individuals may wholly own a foreign corporation which may nevertheless be a PHC (albeit that, since 1966, such a corporation would have to be generating U.S. source income described in 543(a)(7)).
 - b. The status of trusts and estates as "individuals" for this purpose is unclear. Normally, they are so treated for many purposes of the Code. Sections 641(b), 305(e)(1)(A)(i); Reg. section 1.871-2(a). However, section 542(a)(2) expressly includes certain -- but not all --

trusts as individuals for purposes of the shareholder test. It also includes "an organization described in section 401(a), 501(c)(17), or 509(a)" for these purposes. Does it follow that other trusts, or estates, are not to be treated as individuals here? If they are not, a corporation all of whose stock is owned by a single trust, which however has a large class of equally-vested beneficiaries, would not be a PHC.

[Note that the section 544 rules do not contain a beneficiary-to-trust attribution rule.] The regulations, although hazy here, may be read to support the negative implication. Reg. section 1.542-3(a). [This discussion assumes that the trust in question is not a grantor trust.]

c. The status of partnerships as "individuals" for this purpose is unclear, but the issue is mooted by the constructive ownership rule which attributes stock among partners. Section 544(a)(2).

2. There are five groups of relevant attribution or constructive ownership rules:

1. Those specifically so labelled and contained in section 544.
2. Those specifically so labelled and contained in

section 958(a), incorporated by reference in section 545(a).

3. Those specifically so labelled and contained in section 318(a), incorporated by reference in section 545(c)(3)(B).

4. The "directly or indirectly" and "by or for" language of section 542(a)(2).

5. The "directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations" language of section 542(c)(7).

C. A general discussion of these rules is outside the scope of this paper. One issue is of importance in planning: to what extent may stock actually owned by a foreign person be treated as owned by a U.S. person? Since this question is of much greater importance in dealing with the FPHC provisions, it will be analysed in connection with that portion of the outline, at XI/C, below. [This issue also may be of interest in various other contexts, not discussed here, e.g., filing of information returns under sections 6038 and 6048. Various portions of the discussion at XI/C, below, may be relevant, even if not conclusive, in those other contexts.] Even though the issue is much less significant here (see III/A/7/a, above) than it is for FPHC purposes, where the very

applicability of the penalty provisions hinges on finding U.S. owners, there are still situations in which the issue matters for PHC purposes. For example:

1. The de minimis rule of 545(a) only applies if U.S. ownership does not exceed 10 percent in value.
 2. A U.S. person may be the attributee of stock of another U.S. person, as well as possibly the stock of a foreign person, where there is no attribution between the two attributors.
 3. Other?
- D. The language in sections 544(a)(1) and 544(a)(2) is identical to the "directly or indirectly" and "by or for" language of section 542(a)(2), discussed at III/B/4 above. However, a foreign person's stock may be attributed to U.S. persons under section 544(a)(1), without regard to the possible contrary argument under section 544(a)(2) resulting from the Estate of Nettie S. Miller case. See III/E/3, below.
- E. The section 958(a) rules, incorporated by reference in section 545(a), apply for purposes of the de minimis exception (discussed below at V/A/4).
1. Section 958(a)(2) contains the same "directly or indirectly" and "by or for" language discussed above.

2. Section 958(a) does not contain any provisions cutting off attribution from foreign persons to U.S. persons. Section 958(b) does --
 - a. Section 958(b)(1) cuts off family attribution from nonresident alien individuals to U.S. citizens or residents. See Reg. sections 1.958-2(b)(3) and 1.958-2(g) Example (5).
 - b. Section 958(b)(4) cuts off attribution from a foreign person to a U.S. entity. See Reg. sections 1.958-2(d)(2) and 1.958-2(g) Example (4). [There remains some question about the scope of this provision, not clarified by the regulations.]
3. Should one then conclude, by negative implication, that foreign-to-U.S. attribution is to be permitted, under section 958(a), for purposes of section 545(a)? Although reasoning by negative implication in the Code is very risky, here that result is clearly correct. There can be no question that stock owned by a foreign entity will be attributed to its U.S. beneficial owners under 958(a). See, e.g., Reg. section 1.958-1(b). (Indeed, the same result is quite clear under the "directly or indirectly" language of section 544(a)(1). The language

is exactly identical to that in section 554(a)(1), and the regulations properly provide for attribution through foreign corporations. Prop. Reg. section 1.554-2 Example; Reg. section 1.555-2(b) Example (1).) Even Estate of Nettie S. Miller casts no doubt upon this rule, because it involves only the section 554(a)(2) family attribution rules.

F. It follows a fortiori that foreign-to-U.S. attribution will be permissible for purposes of section 545(c)(3)(B), incorporating by reference section 312(a). The point is of little practical importance, however, since the substantive exception relates only to a very narrow group of taxpayers.

IV. INCOME TEST.

A. Section 542(a)(1) provides that a PHC must meet the following income test:

"At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a))"

Three points should be made about this language.

1. The threshold is exactly 60 percent, not more than

that,

2. Once again, the taxable year in question is that of the foreign corporation. See the discussion at III/A/2, above.
 3. Both the "adjusted ordinary gross income" and the "personal holding company income" phrases are terms of art. A third term of art -- "ordinary gross income" -- is defined in section 543(b)(1) and is important here. A fourth term of art -- "undistributed personal holding company income" -- is defined in section 545(a), and will be discussed below at V/A. These various terms will be referred to, respectively, as AOGI, PHCI, OGI, and UPHCI.
- B. The source rules here reign supreme. The devious trail to that result follows.
1. Section 882(b) defines "gross income" of a foreign corporation to include only (a) income which is "effectively connected with the conduct of a trade or business within the U.S." (hereinafter referred to as ECI), and (b) U.S. source income which is not ECI.
 2. Section 864(c)(1)(B) makes clear that if a foreign person is not engaged in trade or business within the United States, it cannot have any ECI. (Exceptions are provided for foreign persons either (a)

electing to be treated as engaged in trade or business within the U.S. with respect to real estate, or (b) conducting certain banking activities in U.S. possessions.)

3. Thus, in general, a foreign corporation which is not doing business here only has gross income from U.S. sources, i.e., its foreign source income is not "gross income." See Dale at 291-95.
4. Nevertheless, because ECI can include foreign source income (section 864(c)(4)), it is possible that a foreign corporation may have gross income from sources without the United States, if it is doing business here (or electing to be so treated) and has foreign source ECI. See Reg. section 1.882-3(a)(1)(ii). To the extent that earlier-adopted regulations do not reflect this possibility, they are simply wrong. See 1V/3/8/p, below.
5. AOGI is OGI reduced by certain subtractions. Section 543(b)(2). Thus, its scope must be less than that of OGI.
6. PHCI is a "portion of the [AOGI]," and thus its scope cannot exceed AOGI. Section 543(a).
7. OGI is gross income reduced by certain exclusions. Section 543(b)(1). Thus, OGI's scope must be less

than that of "gross income."

8. In conclusion, in almost every case, AOCI will be limited to income from sources within the United States.

- a. Such income will count in the calculation of AOCI (and also OCI, PHCI, and UPHCI) whether or not taxed by the United States. There is no limitation here to "fixed or determinable annual or periodical" items of the sort described in section 881(a). Reg. section 1.541-1(b).
- b. Despite the correctness of the conclusion as a general matter, because of the possible inclusion within "gross income" of foreign source ECI, it is not correct to state that only U.S. source income will ever count for PHC purposes. The regulations to the contrary were adopted prior to the 1966 Foreign Investors Tax Act which, in turn, created the ECI concept. Thus, Reg. section 1.541-1(b) is incorrect to the extent that it appears to limit the tax base to U.S. source income. [Query: to what extent will this regulation still protect taxpayers relying on it?] Proposed Reg. section 1.541-1(b) contains the same error. Several commentators have

uncritically accepted this old language in the regulations. E.g., POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION 216 (1980).

C. The impact of this usual source rule limitation can be helpful or hurtful.

1. The good news is that a foreign corporation which derives only foreign source income cannot be a PHC (so long as none of the income is ECI). This, in connection with the dividend source rule of section 861(a)(2)(B), gives rise to the so-called two-tier gambit to avoid PHC consequences. See VII/3, below. (No one is concerned that, if AOCI and PHCI are both zero, the mathematics of section 542(a)(1) do not work properly. No one should be.)
2. The bad news is the corollary: only U.S. source items will generally count in the computation of OGI, AOCI, and PHCI. Thus, a foreign corporation which conducts an active business and generates substantial active business income may nevertheless be a PHC if its U.S. source income -- no matter how minor in comparison to its worldwide activities -- is largely PHCI. Indeed, even if its overall business produces a net loss, the PHC tax may apply to its U.S. source income. Porto Rico Coal Co. v.

Comm'r, 44 B.T.A. 221 (1941), aff'd, 126 F.2d 212 (2d Cir. 1942); Berwindmoor Steamship Co., 9 T.C.M. 193 (1944); ROBERTS & WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS (1971) [hereinafter cited as ROBERTS & WARREN] at X-33.

D. Even if U.S. source income must be generated, there are several possible escape routes to avoid PHC status for foreign corporations:

1. Invest only in tax exempt municipal bonds. The interest is excluded from "gross income" by virtue of section 103, and will not produce any amount for the numerator of the section 542(a)(1) fraction. Cf. Rev. Rul. 72-527, 1972-2 C.B. 456.
2. Treaty protection may perhaps be available. A discussion is beyond the scope of this paper. See generally ROBERTS & WARREN para. X/6; Alexander at 1192-96; Rev. Rul. 60-34, 1960-1 C.B. 203.
3. Any other generally available method of avoiding the tax will also be available to a foreign corporation, subject always to the source rule considerations discussed above, at IV/B and IV/C. See VII/A/2, below.

E. Section 543(b)(1)(C), defining UOI, starts with "gross

income" and then excludes from it:

"[i]n the case of a foreign corporation all of the outstanding stock of which during the last half of the taxable year is owned by nonresident alien individuals (whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations), all items of income which would, but for this subparagraph, constitute personal holding company income under any paragraph of subsection (a) other than paragraph (7) thereof."

Many of the observations at III/A, above, apply here. The purpose of the provision is plain -- given section 542(c)(7)'s outright exception from PHC status for foreign corporations wholly owned by foreign individuals (if such corporations do not derive any "incorporated talent" income, per section 543(a)(7)), it would seem harsh to subject foreign corporations to the rigors and pains of all of the PHC rules simply because they generate some section 543(a)(7) income in addition to other sorts of PHCI which otherwise would have been free from taint. Therefore, the OGI amount, and thus the AOGI amount, are to be determined by including only the section 543(a)(7) income, plus any other U.S. source income which would not constitute PHCI. The PHCI amount is to

include only section 543(a)(7) income. A similar limitation is elsewhere created for the calculation of UPHCI, i.e., for the tax base itself. See V/A/5, below.

V. CALCULATION OF THE PHC TAX

A. The PHC tax is in addition to any other income tax imposed on the corporation. The tax rate is now 50 percent. See V/B, below. The tax base is UPHCI as defined in section 545. Section 541.

1. Here too source rules control. (Compare IV/B, above.) The trail to this conclusion starts with UPHCI (section 545(a)). That, in turn, is derived from "taxable income." Although here some of the required adjustments, en route from taxable income to UPHCI, are additions, most are still subtractions, and it is not believed that any of the additions could so function as to create UPHCI if taxable income was zero in the first instance. (The adjustments in section 545(b) are similar to those permitted by section 558(b) in computing UFPHC. The latter are discussed at XIV/B/2, below. The section 545(b) adjustments will not be further discussed here. See generally BITTKER & EUSTICE at 8-57 - 8-59.) "Taxable income" is defined, in sec-

tion 58, to be "gross income" less deductions.

Since "gross income," in turn, is limited -- in the case of foreign corporations -- to U.S. source income (except in the unusual case of foreign source ECI), a foreign corporation which derives no income from sources within the U.S. will not have any PHC tax to pay. It is possible for a foreign corporation to be a PHC without having any UPHCI, since the latter concept does not derive from OGI, AOGI, or PHCI. (A simple example would be a foreign corporation with a net operating loss from the prior year. See section 545(b)(4).) In such a case, a tax return may nevertheless be due from the corporation. See VIII, below. It is equally possible for the UPHCI to exceed PHCI.

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2. A corporation is permitted a deduction for dividends paid in calculating UPHCI. Section 545(a), referring to section 561. Several aspects of that deserve comment:

- a. The entire amount of the dividends paid which qualify under section 561 operates to reduce UPHCI, even if the corporation has other income for the taxable year which does not enter into the UPHCI amount. There is no need to apportion

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the deduction, Rev. Rul. 68-127, 1968-1 C.B. 287. The ruling involved a closely-held foreign corporation which had worldwide income from services and dividends from wholly-owned service subsidiaries. It was a PHC because one of the subsidiaries was U.S., and dividends from that subsidiary constituted 60 percent of its* (U.S. source) OGI. It made distributions during the taxable year which exceeded its U.S. source income, but which were less than its worldwide income. The ruling concludes that the full amount of the distributions (all of which were dividends, because of adequate earnings and profits) qualified as dividends paid and could be deducted against UPHCI. "There is no reason for requiring, and the Code does not require that an allocation between income from domestic and foreign sources be made in computing the deduction for dividends paid." Id. Commentators writing before the publication of this ruling had expressed doubts about the issue. Alexander at 1177-79; Hoenberg at 119 n. 15. See also ROBERTS & WARREN para. X/5D.

b. The dividends paid deduction is available even

though the dividends are paid to foreign shareholders and are not taxable in their hands. Section 562(a) and Reg. section 1.562-1(a) only require that the distribution be a dividend "described in section 316." Nor was the issue of taxation of dividends to foreign persons overlooked -- because section 563(a), relating to consent dividends, requires withholding of tax if an actual dividend paid would have required that. The amount of withholding required is limited to what would have been required if a cash dividend had been paid. Reg. section 1.563-5. Accord, ROBERTS & WARREN para. X/58; Hochberg at 119.

- c. The combination of (a) and (b) above reinforces the utility of the two-tier gambit, discussed at VII/B, below, as a method of avoiding PHC taxation.
- d. The consent dividends procedure clearly applies for this purpose, notwithstanding that the corporation is foreign, and whether or not its shareholders are foreign. (There are, however, some confusions about consent dividends here, and also for FPHC purposes. See XIV/B/2/g/2,

below.) The very recent nonruling position announced for consent dividends indicates some concern with the scope of section 365, but it casts no doubt on it for purposes of the PHC provisions. Rev. Proc. 82-55, 1982-40 I.R.B. 14, effective on and after October 4, 1982. See LTR 8244070 (July 30, 1982).

- a. Note the special rule of section 315(b)(2), making earnings and profits less significant here.
3. As a general matter, foreign corporations are not allowed to claim any deductions unless they file "a true and accurate return." Section 282(c)(2). This rule, long contained in the legislation and regulations, could have produced harsh consequences for a foreign corporation, particularly if it did indeed distribute its UPHCI via dividends, the dividends were not subject to tax in the hands of the shareholders, and the corporation inadvertently failed to file a return. See Rev. Rul. 60-94, 1960-1 C.B. 203. Commentators pointed this out, e.g., Alexander at 1199-1201, and the New York State Bar Association recommended that the result be changed to permit the dividends-paid deduction for PHC purposes. Report

of Subcommittee on Income Tax Problems of Nonresident Aliens With Respect to H.R. 11297, New York State Bar Ass'n Tax Section, reprinted in The Foreign Investors Tax Act of 1965, 89th Cong., 1st Sess. 196-97 (Comm. Print 1966). The Senate adopted such a provision during its consideration of The Foreign Investors Tax Act of 1966, and -- as enacted -- it adds the following language to section 882(c)(2): "The preceding sentence shall not apply for purposes of the tax imposed by section 541 (relating to personal holding company tax)" Thus, it is clear that the dividends paid deduction -- and, it would seem, all other allowable deductions for computing UPHCI -- are available to a foreign corporate PHC even though it does not file "a true and accurate return."

- a. This provision does not eliminate the need to file a return. Section 6683 was added by the same legislation, and specifically requires a foreign corporation to file a PHC return. See VIII/A, below.
- b. The existing regulations, which deny any deductions to foreign corporate PHC's unless returns are filed, are out of date, and should not be

read to contradict the 1966 legislative changes,
Reg. section 1.545-1(b).

4. UPHCI is reduced under the de minimis rule of section 545(a). The statute provides:

"In the case of a personal holding company which is a foreign corporation, not more than 10 percent in value of the outstanding stock of which is owned (within the meaning of section 958(a)) during the last half of the taxable year by United States persons, the term 'undistributed personal holding company income' means the amount determined by multiplying the undistributed personal holding company income (determined without regard to this sentence) by the percentage in value of its outstanding stock which is the greatest percentage in value of its outstanding stock so owned by United States persons on any one day during such period."

- a. The regulations have not been amended since 1966 so as to reflect this addition.
- b. This rule collides with the exception to the total exclusion from PHC treatment for wholly-owned foreign corporations. Such corporations are generally exempt from PHC taxation, unless they derive "incorporated talent" income under section 548(a)(7). See VI/B, below. If they do

derive such income, their tax base is intended to be limited to the section 543(a)(7) income (see V/A/5, below), and their status as PHC's is to be tested solely against the section 543(a)(7) income (see IV/E, above). If applied literally, the de minimis rule quoted above would eliminate the tax base altogether. This would be manifestly inconsistent with section 545(d) (see V/A/5, below). Furthermore, if the quoted language were interpreted to operate only if there existed at least some small stock ownership in U.S. persons, the result would be even more strange -- for the tax would then be less in the case of a foreign PHC partially owned by U.S. persons than in the case of one wholly owned by foreign persons.

- c. The statutory language is clearly deficient, and should be fixed by legislation. While the Treasury might attempt to correct the drafting errors by regulation, the language does not easily admit of such correction, despite its obvious subversion of Congressional purpose. Accord, Hochberg at 119-20.

5. Among the special rules for wholly-foreign-owned

foreign corporate PHC's is one which limits UPHCI to section 543(a)(7) (i.e., incorporated talent) income for such corporations. Section 545(d) provides:

"In the case of a foreign corporation all of the outstanding stock of which during the last half of the taxable year is owned by nonresident alien individuals (whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations), the taxable income for purposes of subsection (a) shall be the income which constitutes personal holding company income under section 543(a)(7) reduced by the deductions attributable to such income, and adjusted, with respect to such income, in the manner provided in subsection (b)."

The introductory portion of this language is virtually identical to that used in section 542(c)(7) and 543(b)(1)(C). The final portion of the language deserves two comments.

- a. The deduction for dividends paid should not have to be allocated for this purpose, any more than it does in general. See V/A/2/a, above.
- b. This leads to a loophole. Suppose a foreign individual wishes to work in this country. Non-

mailly, that will constitute engaging in trade or business under section 864(b) -- at least if no treaty applies and if the time spent or money earned is more than trivial. As a result, income tax will be due at progressive rates on the net amounts earned. Suppose instead that the foreign individual forms a wholly-owned foreign corporation, hires himself out to it, and thus generates section 543(a)(7) income. The individual also contributes sufficient cash, stock, and securities to the corporation to make sure that it generates at least half of its overall income other than from U.S. source 543(a)(7) services. The corporation can then pay a foreign-source dividend of the net section 543(a)(7) income, free of further U.S. tax, under the section 861(a)(2)(B) source rule. The entire amount of that dividend will reduce UPHCI, under the principles discussed at V/A/2/a and V/A/5/a, above. Thus, the entire tax will be levied only at corporate rates, rather than the progressive rates applicable to individuals.

c. This example may not work because of risks of assignment of income, principal/agent questions,

or the like. (The tax risks here are quite similar to those present in the loan-out area. See Rev. Rul. 74-390, 1974-2 C.B. 278, and Rev. Rul. 74-331, 1974-2 C.B. 282. See Ardi, Tax Planning for Foreign Entertainers Who Perform Within the United States, 32 TAX LAWYER 349 (1979).) Furthermore, new section 269A may apply, at least if the choice of corporate rather than individual rates constitutes an "allowance" for that purpose.

- d. The abuse potential is much reduced when individual and corporate top rates are -- as now -- quite similar. See Hochberg at p.119.
- B. The tax imposed on UPHCI is at the rate of 50 percent. It was reduced by section 101(d)(2) of the Economic Recovery Tax Act of 1981, P.L. 97-34, 95 Stat. 172, for years beginning after 1981. It had previously been imposed at the rate of 70 percent, since the end of 1969, per section 225(a) of the Revenue Act of 1964, P.L. 88-272, 78 Stat. 19.

VI. EXCEPTIONS TO PHC TREATMENT

- A. There are five sets of penalty tax provisions which may affect foreign corporations or their shareholders. The

PHC rules constitute one such set. Four others may apply: the accumulated earnings tax provisions (section 531 et seq.), the FPHC provisions, the provisions of subpart F (including section 1248) dealing with controlled foreign corporations (section 951 et seq., plus section 1248), and the foreign investment company rules (sections 1246 and 1247). Several coordination or overlap sections create minimal ordering among these tentacles of the "pentapus" --

1. The PHC rules prevail over the accumulated earnings tax rules. Section 532(b)(1). Thus, a foreign corporation will not be subject to both.
2. The FPHC rules prevail over the PHC rules. Section 542(c)(5). Thus, it is possible to "escape" from the PHC provisions into the FPHC provisions in some instances. A foreign corporation will not be subject to both.
3. There are no known overlap or coordination rules -- in the statute, regulations, rulings, cases, or elsewhere -- to mediate between the PHC rules and the subpart F provisions or between the PHC rules and the foreign investment company provisions. It would seem that any one or more of these three tentacles could grasp the same foreign corporation at

the same time.

B. Section 542(c)(7) excepts from the definition of a PHC:

"a foreign corporation (other than a corporation which has income to which section 543(a)(7) applies for the taxable year), if all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations."

Many of the comments at II/E/1, III/A/1, III/A/2, and III/A/5 are relevant here. In addition --

1. Note the apparent distinction being drawn between nonresident alien individuals and foreign trusts and estates. Compare III/A/7/b, above.
2. The smallest amount of stock ownership by U.S. persons, directly or indirectly (through the foreign entities mentioned), will eliminate this exception. Of course, the de minimis rule of section 543(a) may then apply. See V/A/4, above.
3. The smallest amount of section 543(a)(7) income will also eliminate this exception.
 - a. Although section 543(a)(7) does not itself contain any source-limiting language, the quoted cross reference must be taken to include the

flush language at the start of section 543(a), limiting all types of PHC1 to "a portion of" AOCI. Thus, only U.S. source income of the sort specified in section 543(a)(7) will destroy the exception. See IV/B, above.

b. Even if the corporation does lose the benefit of this total exception from PHC treatment, the tax base will nevertheless be limited to the section 543(a)(7) income only, assuming that the stock is entirely owned by nonresident alien individuals. See IV/E, above.

c. There is patent inconsistency here between the obvious intention of section 542(c)(7) and the operation of the de minimis rule of section 545(a). See V/A/4/b, above.

C. Several of the other exceptions enumerated in section 542(c) will also apply to foreign corporations, but -- inexplicably -- some will not. Thus, for example, section 542(c)(1) excepts tax exempt corporations, which may include foreign corporations. Section 542(c)(2), however, excepts only domestic building and loan associations, and banks "as defined in section 581" -- which requires them to be domestically incorporated. See ROBERTS & WARREN para. X/3B(2).

VII. AVOIDING PHC TAXATION

A. All of the usual routes to avoid PHC status, or to eliminate UPHCI, will apply to foreign corporations, although sometimes subject to special "twists." Thus --

1. The shareholder test can be avoided:

a. By making sure that no group of five individuals directly or indirectly (or after attribution) owns the necessary greater-than-half of the stock (in value). It appears that stock held by a not-for-profit corporation will count as outstanding for this purpose, even though it does not count for the numerator of the section 542(a)(2) fraction. See III/A/5, above. Foreign corporations may be formed as nonprofit, under the laws of many foreign jurisdictions. [Caveat: beware of the questionable and possibly abusive practices in this area, and the effect that later-decided cases may have, via stare decisis, if particularly egregious examples are brought to trial.] See generally Fuller, Foreign Charitable Organizations, in Langer & Povall, ed., FOREIGN TAX PLANNING 1981 (P.L.I.).

b. By having all of the stock directly and indi-

rectly owned by nonresident alien individuals, if no section 543(a)(7) income is being generated. See VI/B, above.

2. The income test can be avoided (in addition to the methods mentioned at IV/D, above):
 - a. By "stuffing" the corporation with U.S. source income which is not PHCI. (What attacks may the Service mount against this effort? What is the likelihood of such attacks succeeding?)
 - b. By controlling the source of income which, if from sources within the U.S., would be PHCI.
3. The tax base (UPHCI) can be eroded:
 - a. By paying dividends.
 - b. By consenting to treat dividends as having been paid, under section 565.
 - c. By the deficiency dividend procedure of section 547.
 - d. By making distributions in liquidation, as described in sections 562(b)(2) and 316(b)(2)(B), and Reg. sections 1.562-1(b)(2) and 1.316-1(b).
 - e. By making charitable contributions, subject to the rules of section 545(b)(2).

For the reasons discussed at V/A/2/a, above, none of

these deductions should have to be allocated. The entire amount should be available to reduce UPHCI, regardless of the amount of the foreign corporation's foreign income.

- B. The tax base perhaps may be eliminated altogether via the "two-tier gambit." Suppose that N, a nonresident alien individual, and D, an unrelated U.S. individual, each own half of the one class of stock of F1, a foreign corporation, which derives only U.S. source passive income. Without more, F1 will be a PHC. [Note that it will not be a CFC or a FPHC.] Suppose that F1 contributes its assets to a newly-formed foreign corporation, F2, in exchange for all of its stock, so that the U.S. source passive income is now received by F2, and F1 has no income (at this stage). [Section 367 will not apply to this incorporation transaction, since F1 is not a U.S. person.] Prior to the end of F2's taxable year, it pays a dividend to F1 of at least 5/6ths of its anticipated total UPHCI for that year. Within the first two and one-half months after the end of that year, F2 pays a further dividend to F1 of the balance of the UPHCI. Under section 563(b), the sum of both distributions counts for the dividends paid deduction, and thus will eliminate UPHCI for the year. F2 has never been "en-

gaged in trade or business within the United States," because of section 864(b)(2)(A)(ii). It thus has no income which is "effectively connected" with the conduct of such a trade or business. Section 864(c)(1)(B). As a result, the numerator of its section 861(a)(2)(B) fraction will always be zero, and the entire amount of any dividends paid will be treated as foreign source. Thus, F1 is not subject to any tax upon the distribution under section 881(a), and F2 is not required to withhold any such tax under section 1442(a). Furthermore, since the dividend received by F1 is from sources without the United States, it does not constitute OGI, AOGI, PHCI, or UPHCI to F1. See IV/B and IV/C/1, above. Thus, F1 is not a PHC.

1. The same result can be achieved, even if the foreign corporation derives some U.S. source "effectively connected" income, by making sure that F2 never allows such income to constitute more than 50 percent of its worldwide income. This may require careful planning, and the initial contribution of sufficient funds to F1 to allow F2, when later receiving those funds, to invest them to produce sufficient income to maintain the fraction at the proper level.

2. The crucial element in the two-tier gambit is the conversion of source upon distribution from F2. It was well understood, at the time of amending section 861(a)(2)(B) to its current form, that changing the numerator of the relevant fraction from U.S. source gross income (as it was prior to 1966) to "effectively connected" income (as it now is) would make foreign corporations into source converters if they were not doing business within the U.S. H. Rep. 1450, 89th Cong., 2d Sess. 10-11 (1966); S. Rep. 1707, 89th Cong., 2d Sess. 13-15 (1966). Coupling that result with the source-sensitive definition of UPHCI, and the non-allocation rule of Rev. Rul. 68-127 (see V/A/2/a, above), makes the two-tier gambit appear to be an easy route to complete and cost-free avoidance of the PHC tax for foreign corporations.
3. Although the Service has various weapons in its arsenal which may be brought to bear on the two-tier gambit, it is believed that none of them, separately or in combination, pose a fatal threat to the device. Among various attacks that may be considered are:
 - a. Disregard of the separate existence of F2, F1,

or both.

- b. Disregard of the transfer of F1's assets to F2 under the "sham transaction" doctrine.
- c. Characterization of F2 as the mere "agent" or "nominee" of F1, or of F1 as the mere "agent" or "nominee" of D and N.
- d. Characterization of F2, F1, or both as mere "conduits."
- e. Utilization of section 269.
- f. Utilization of section 482.
- g. Gregory, Knetsch, Goldstein, etc.
- h. Other?

A detailed analysis of each of these would require an extended discussion of case law and other precedents. It is believed, however, that strong arguments may be made for the taxpayers -- assuming, of course, that proper corporate formalities are rigorously observed -- and that the Service has the weaker case here.

- C. A foreign corporation which may be subject to PHC problems may escape them by qualifying for any one of the exceptions to PHC status. See VI, above. Particularly intriguing here is the possibility, if the PHC is more than 50 percent U.S. owned, of escaping from PHC into FPHC status. In limited cases, when the FPHC teeth may

be pulled, this may be an attractive route. Full discussion is deferred to part B of this outline -- but consider that FPHCI is only attributed through intermediate foreign corporations, and not through other forms of foreign entities, under sections 535(b) and (c). Perhaps the use of foreign partnerships, foreign trusts (if not within section 679), or foreign estates can be useful here. See XIV/B/4, below. Note that if the foreign corporation is a FPHC, it will escape most, if not all, of the subpart F rules. Section 951(d); Estate of Lovett, 621 F.2d 1130 (Ct. Cl. 1980); Estate of Whitlock, 494 F.2d 1297 (10th Cir.), cert. denied, 419 U.S. 339, reh'g denied, 419 U.S. 1041 (1974).

- D. Treaties may perhaps eliminate PHC treatment for foreign corporations entitled to their benefits. A discussion of treaties, however, is outside the scope of this outline. See ROBERTS & WARREN para. X/6; Alexander at 1192-96. Note, however, that Reg. section 1.394-1(a) provides that treaty exemptions will not normally apply for purposes of determining UPHCI. [Query: will they apply in determining PHCI?]

VIII. INFORMATION AND TAX RETURNS

- A. Although the 1966 legislation softened the requirement that foreign corporate PHC's file a return if claimed deductions were to be allowed (see V/A/3, above), it is wrong to conclude that such corporations were excused from filing returns. Indeed, in the same legislation, Congress added section 6689, which reads as follows:

"Any foreign corporation which (1) is a personal holding company for any taxable year, and (2) fails to file or cause to be filed with the Secretary a true and accurate return of the tax imposed by section 541, shall, in addition to other penalties provided by law, pay a penalty equal to 10 percent of the taxes imposed by chapter 1 (including the tax imposed by section 541) on such foreign corporation for such taxable year."

Since the penalty is not based solely on the amount of the PHC tax, but also includes any other chapter 1 tax (e.g., the 30 percent tax imposed by section 881(a)), it will normally be necessary for foreign corporate PHC's to prepare and file Schedule PH, attached to its 1120-F, as required by Reg. sections 1.6012-2(b). Failure to do this may also prevent the corporation from making use of the deficiency dividend procedure of section 547. See Reg. section 1.547-5. See generally 1 RHOADES & LANCER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS 4-91 -

4-93 (1982).

B. Other returns may be called for, to be filed by the foreign corporation or by its shareholders, under certain circumstances. A partial list of possible returns would include:

1. Form 959 (Section 6046).
2. Form 1120-F (Reg. section 1.6012-1(g)).
3. Form 926 (Sections 1491, 1494).
4. Forms 6659, 6660, or 6661 (Section 6039C).
5. Section 6038A (the so-called reverse Form 2952).

The listing is not intended to be exclusive. It does not include any returns required under the provisions of any laws other than the Internal Revenue Code of 1954, as amended. It does not reflect the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, 97 Stat. , sections 338-41, adding or amending Code sections 6035, 6038, 6038A, 6046, 6048, and 6679. It is expected that a new Form 5471 will be promulgated which will supersede and consolidate several of the currently used forms.

IX. CONCLUSION

A. There has been little activity in the PHC area with

respect to foreign corporations in the last fifteen years. Many questions, whether arising before or caused by the 1966 legislation, remain unanswered. The long-proposed regulations should be withdrawn. It would be helpful to have some guidance on some of the open questions via freshly proposed regulations. It may be that some of the problems can only be cured by further legislation.

- B. In view of the complexity of the subject matter, and its obvious lack of revenue potential, it may be that total repeal of the PHC provisions with respect to foreign corporations -- however owned -- would be in order.

PART B FOREIGN PERSONAL HOLDING COMPANIES

X. BACKGROUND

- A. On May 29, 1937, Secretary of the Treasury Henry Morgenthau, Jr., wrote to President Roosevelt enclosing a preliminary report about tax evasion and tax avoidance

schemes. Among 11 areas discussed by him, the first was captioned, "The device of evading taxes by setting up foreign personal holding corporations in the Bahamas, Panama, Newfoundland, and other places where taxes are low and corporation laws lax." The Secretary cited statistics indicating a growing surge of U.S. taxpayer use of such entities.

- B. The President sent a message to Congress on June 1, 1937, enclosing the May 29 letter, and adding that it "reveals efforts at avoidance and evasion of tax liability, so widespread and so amazing both in their boldness and their ingenuity, that further action without delay seems imperative." The message characterized the tax avoidance plans, variously, as "unethical," "unpatriotic," "evil," "tax dodging," and as involving "the decency of American morals."
- C. Congress created a Joint Committee on Tax Evasion and Avoidance, which held hearings from June 17 to July 28, 1937.
- D. The Revenue Act of 1937, P.L. 75-377, 50 Stat. 813, was passed unanimously by both houses of the Congress, and was signed by the President on August 26, 1937. It added sections 331-41 to the Revenue Act of 1926, containing the predecessors to current Code sections 551

through 557. Indeed, these first statutory provisions have been little changed since 1937.

- E. The provisions were carried forward into the Internal Revenue Code of 1939, and then into sections 551 et seq. of the Internal Revenue Code of 1954. Although Congress occasionally tinkered with the language of these sections, there have been no significant amendments -- from 1937 to the present date.
- F. Prior to 1964, foreign personal holding company income [hereinafter FPHCI] and the stock ownership rules of section 554 and its predecessors were defined by cross reference to the corresponding provisions of the PHC sections. The 1964 legislation worked substantial changes in the PHC rules. Congress did not intend these to apply to the FPHC portions of the Code. Thus, section 225(e) of the Revenue Act of 1964, P.L. 88-272, 78 Stat. 19, restated the pre-existing definitions of FPHCI (i.e., the PHCI definitions prior to the 1964 changes) into section 553(a), and the attribution rules into section 554. It was intended that this would not involve any substantive change in the FPHC law. H.R. Rep. No. 88-749 (Part 4), 88th Cong., 2d Sess. 103-04 (1963), reprinted at 1964-1 C.B. (Part 2) 352. The Act, section 225(j)(1), also modified the inherited-basis rule of

section 1014(b)(5) (discussed below at XV11/A), but this last modification -- codified for a time as Code section 1022 -- was, in turn, repealed by section 1901(a)(126)(A) of the Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520.

- C. The FPHC provisions were the first to tax shareholders on the income of a corporation, even if it was not distributed to them. This was done because Congress felt it lacked jurisdiction to impose tax directly upon foreign corporations (at least if not doing business within the United States.) [It is interesting to note that this concern did not cause Congress to repeal the PHC provisions vis-a-vis foreign corporations. See II/B and II/C, above.] The legislative history of the 1937 Act stated that it was believed that this approach was constitutional. When the legislation later was challenged on constitutional grounds, the courts held the taxing pattern to be acceptable. Eder v. Comm'r, 138 F.2d 27 (2d Cir. 1943). The taxpayer's argument, of course, was that taxing him on corporate income which had not been -- and, on the facts of the case, because of foreign exchange control restrictions could not be -- distributed, violated his constitutional rights. The Court, in an opinion by Judge Frank, with Judges Augustus and

Learned Hand concurring, disposed of the point in a single sentence:

"Interpreting the statute to bring about such a consequence does not render the statute unconstitutional; the Congressional purpose was valid and the method of taxation was a reasonable means to achieve the desired ends."

138 F.2d at 28 (footnote citations omitted). See also Alvord v. Comm'r, 277 F.2d 713 (4th Cir. 1960), reversing 92 T.C. 1 (1959); and Rodney, Inc. v. Hoey, 53 F. Supp. 604 (S.D.N.Y. 1944).

X1. THE SHAREHOLDER TEST

A. The statute provides that a corporation may be a FPHC only if it is "foreign" and only if:

"At any time during the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, hereinafter called "United States group," Section 552(a)(2).

These words deserve five comments:

1. They are identical to the language of section 542(a)(2), for PHC's, with only the three exceptions

referred to in the following paragraphs (XI/A/2 through XI/A/4). Thus, the points discussed at III/A, above, are generally relevant.

2. The relevant time period for ascertaining ownership is the entire taxable year of the foreign corporation. The PHC test, by contrast, refers only to the last half of the taxable year. See III/A/1, above.
3. Only foreign corporations may be FPHC's. (PHC's may be either domestic or foreign.) Thus, the definition of "foreign corporation" becomes material.

Sections 7701(a)(4) and (5) define foreign corporation to mean any corporation other than one "created or organized in the United States or under the law of the United States or any State." Two separate questions are posed --

- a. Is the entity properly classified as a corporation for U.S. tax purposes? See generally Committee on Foreign Activities of United States Taxpayers, New York State Bar Association Tax Section, Report on Foreign Entity Characterization for Federal Income Tax Purposes, 35 TAX L. REV. 167 (1980) (hereinafter cited as Foreign Entity Characterization Report).
- b. Where has it been "created or organized." This

is normally quite easy to determine, by inspecting the appropriate seal at the bottom of the certificate of incorporation or like local document.

4. Only individuals who are U.S. citizens or residents count for purposes of the FPHC shareholder test. (By contrast, the PHC test looks to any five or fewer individuals.) Although it is not always easy to determine whether an individual is a citizen or a resident, those issues are outside the scope of this outline.

5. The relevant five or fewer individuals, once ascertained, are labelled the "United States group." This definition, in turn, becomes relevant in taxing "United States shareholders" of the FPHC on the UFPHCI of the foreign corporation. The determination of the "United States group" is not always easy. For example, that "group" may comprise more than five individuals! These complexities, and others relevant to the meaning of "United States shareholders," are considered further at XIV/A, below.

- B. There are two sorts of attribution or constructive ownership provisions:

1. The language of 552(a)(2) itself (quoted above) states that the United States group may own the relevant stock "directly or indirectly." Similar language appears in sections 553(a)(5), 553(a)(6), 554(a)(1), and 554(a)(2).

2. Section 554 contains other constructive ownership rules, made applicable for purposes (only) of the first three sections referred to in XI/B/1, above.

A general discussion of these rules is beyond the scope of this outline. See generally Coven, The Affinity Provisions of the Internal Revenue Code: A Case Study in Nonsimplification, 45 TENN. L. REV. 557 (1978) (a 148 page article). The only issue which will be discussed involves the attribution to a U.S. person of stock owned by a foreign person. (See also III/C, III/D, III/E, and III/F, above.)

C. The language in XI/B/1, above, also appears in sections 542(a)(2), 543(a)(6)(A), 544(a)(1), and 544(a)(2). Furthermore, the section 544 attribution rules are virtually identical to those in section 554. There are, however, no regulations, cases, or rulings in the PHC context which shed any light on the question whether the language would permit foreign-to-U.S. attribution. The leading -- albeit confusing -- precedent arises in the

FPHC area: Estate of Nettie S. Miller, 43 T.C. 760 (1965), nonacq. 1966-1 C.B. 4, 1966-2 C.B. 9.

1. Taxpayers were Nettie S. Miller (deceased by trial date) and Elsie I. Sweeney. (Although the case does not so indicate, they were sisters, and their family -- which controlled Cummins Engine -- knew Cyrus Eaton.) In 1946 and 1947, they each owned 2.72 percent of the stock of Investors Trust Ltd., a Canadian corporation. More than 60 percent of its income was FPHCI. Two nonresident alien sisters of Cyrus Eaton (a U.S. individual) each owned 28.95 percent of the stock of Investors Trust. Cyrus Eaton owned none of the stock. The IRS said that Investors Trust was a FPHC, via attribution of stock from his nonresident alien sisters to Cyrus Eaton. The result was to impose a tax liability on Nettie Miller and Elsie Sweeney, but not to impose any on Cyrus Eaton (who owned no stock in Investors Trust directly). Absent attribution from the two sisters to Cyrus Eaton, Investors Trust would not have met the shareholder test for FPHC status. (Discussion is omitted of the portion of the opinion finding that the "bearer warrants" held by Cyrus Eaton's sisters really constituted "stock." 43 T.C. at 764.) The

Tax Court, in a reviewed decision, issued five different opinions.

2. The "prevailing" opinion, by Judge Mulroney, discussed the purpose of the 1937 legislation, concluding that it was aimed "at foreign corporations that were actually controlled by U.S. individuals." 43 T.C. at 766. Thus, that opinion held that the family attribution rules should only operate to concentrate stock ownership among U.S. individuals who actually own some stock in the corporation. Any other interpretation, said the Judge, "leads to absurd results." 43 T.C. at 768. As one example of such an absurd result, the Judge suggested that otherwise a foreign corporation might be a FPHC even if no U.S. person owned any stock directly and thus even if no one was subject to any tax by reason of the FPHC's status. 43 T.C. at 768. [Compare Rev. Rul. 79-116, discussed at XI/C/8, below.] Said the Judge, "It is unreasonable and absurd to try to force corporate action without being able to bring pressure on those who control the corporation's actions." 43 T.C. at 768. This opinion would thus appear to cut off any attribution from foreign individuals to U.S. individuals via the family attribution rules. It is im-

possible to discover how many judges joined in the opinion, but the maximum number -- apart from Judge Mulroney -- is five.

3. Judge Fay concurred, with Judges Dawson and Hoyt joining in his opinion. He agreed that the family attribution rules would only attribute stock to someone within the U.S. who actually owned at least some stock. He would have permitted attribution, however, even from foreign relatives of the U.S. attributee.
4. Judge Hoyt separately concurred, in an opinion in which Judges Fay, Bruce, and Train joined. Judge Hoyt's position seems to be precisely the same as that taken by Judge Fay in his own concurrence (X1/C/3, above). It is not clear why Dawson did not join in Judge Hoyt's opinion, or why Judges Bruce and Train did not join in Judge Fay's.
5. Judge Withey dissented, in an opinion in which no other Judge joined. Unlike the prior opinions, his would allow attribution even if the attributee did not actually own any stock. He felt, however, that this interpretation would have to give rise only to a rebuttable presumption of control; else "it would be in some instances in violation of the due process

- clause of the United States Constitution." 43 T.C. at 771. Since the burden of proof would be on the taxpayer, Judge Withey would have found for the IRS, since there was no evidence introduced to rebut to presumption of Cyrus Eaton's control of Investors Trust. This opinion would have permitted foreign to U.S. attribution, even if the attributee owned no shares, subject to cut off upon proof that the attributee did not actually control the corporation.
6. Judge Scott dissented, in an opinion in which Judge Atkins joined. The Judge would have applied the attribution language literally, without any opportunity to rebut any presumption of control. The result would not be "absurd." 43 T.C. at 773.
 7. The opinions create no clear rule of law. Because the votes in a reviewed case are not all able to be determined, it is not perfectly clear how many judges agreed with the first opinion (by Judge Mulhoney). Eight judges would have permitted attribution from foreign to U.S. individuals, at least if the attributee owned some stock directly. There appear to have been only 14 sitting Tax Court Judges at the date of the decision. It seems completely inaccurate, then, to cite the case for the proposi-

tion that no attribution can occur from nonresident alien individuals to U.S. individuals.

9. The IRS nonacquiesced in the case (twice). 1966-1 C.B. 4; 1966-2 C.B. 8. It has continued to apply the attribution rules literally. In Rev. Rul. 79-116, 1979-1 C.B. 213, the Service found a foreign corporation to be a FPHC via family attribution from a nonresident alien husband (who owned all of its stock) to his U.S. citizen spouse (who owned none). The ruling is fascinating:

- a. It does not even cite Estate of Nettie S. Miller, thus maintaining the case's perfect record of never having been cited anywhere (except in secondary source materials).
- b. It appears to reach a result quite favorable to the taxpayer (involving, it is believed, the dividends received deduction under section 243), by a grotesquely literal reading of section 264(b)(2)(A)(ii). (The section 243 result is not mentioned in the ruling.)
- c. It is based upon a prior private letter ruling, LTR 7724022 (March 17, 1977), supplemented by LTR 7749052 (September 12, 1977), which contained further facts -- including that the non-

resident alien spouse had not one but two wives. Despite that, the attribution rules were applied to treat all of the stock as being owned by the U.S. wife, thus settling the burning question of how to apply the rules in cases of polygamy.

- d. It holds that a Leichtenstein "anstalt" is a grantor trust, without any discussion and without citing any authority for the proposition.

D. Some commentators, writing both before and after the decision in Estate of Nettie S. Miller, concluded without discussion that the family attribution rules would permit stock owned by nonresident aliens to be treated as owned by U.S. persons. Alexander at 1185-86 (discussing the FPHC provisions and giving, as an example, exactly the case which Judge Mulroney described as "absurd" -- see X1/C/2 above); ROBERTS & WARREN para. X/3A(4) (discussing the PHC provisions) and para. X/4B(2) (discussing the case and the FPHC rules). See generally Note, Constructive Ownership of Stock Held by Nonresident Aliens in Foreign Personal Holding Companies, 57 VA. L. REV. 657 (1971); Popkin, The Taxation of Foreign Incorporated Pocketbooks with Nonresident Alien Shareholders, 20 RUTGERS L. REV. 268, 290-99 (1966); Sitnick, Tax Court Reads New Exception into Stock Attri-

bution Rules for Foreign PHCs, 22 U. TAXATION 301
(1965).

XII. THE INCOME TEST

A. Section 552(a)(1) provides, in part, that an FPHC must meet the following income test:

"At least 60 percent of its gross income (as defined in section 555(a)) for the taxable year is foreign personal holding company income as defined in section 553"

The concept of "foreign personal holding company income" [hereinafter FPHCI] will be discussed below at XIII.

Three other observations may be made:

1. The initial threshold is exactly 60 percent, as in the PHC provisions. See IV/A/1, above. However, in the case of FPHC's, unlike PHC's, the threshold is variable. See XII/C, below.
2. The taxable year here -- just as for PHC's -- is that of the foreign corporation. See III/A/2, above.
3. As we have seen (IV/B, above), for PHC purposes, the source rules govern the concept of gross income and its derivatives, UCI, AOCI, PHCI, and UPHCI. A different result obtains for purposes of the FPHC

provisions. See XII/8, immediately below.

- B. In order to deal effectively with the perceived tax avoidance evil described in President Roosevelt's June 1, 1937, message (see X/B, above), Congress decided to foreclose the income deferral opportunities available to U.S. persons forming FPHC's. Even the most casual attention to the problem makes one realize that such foreign corporate vehicles may as easily invest to derive foreign source income as to derive U.S. source income. Thus, if the fisc was to be protected, deferral had to be ended on foreign as well as on U.S. source income of FPHC's. It would not do, then, to have the tax's application or scope be limited by the source rules. Thus, the definition here of "gross income" is different than for PHC's. By explicit cross reference to section 555(a), the concept of "gross income" is freed from source constraints for these purposes. That section provides:

"For purposes of this part, the term 'gross income' means, with respect to a foreign corporation, gross income computed (without regard to the provisions of subchapter N (sec. 861 and following)) as if the foreign corporation were a domestic corporation which is a personal holding company."

The language is clearly intended to slay the source rules here, and it clearly accomplishes that purpose. However, the language is not perfect.

1. The parenthetical clause effectively does the trick, all by itself. The source rule limitations on the scope of the "gross income" concept are contained in section 882(b) (see IV/B/1, above), which is in subchapter N. By forcing disregard of that section, and indeed the source rules themselves (sections 861 through 863 are also in subchapter N), section 555(a) clearly makes the broader definition contained in Code section 61 applicable -- see Rev. Rul. 56-514, 1956-2 C.B. 499 -- and section 61 is not circumscribed by source notions.
2. The next nine words in section 555(a) require the gross income of an FPHC to be determined "as if the foreign corporation were a domestic corporation." These, too, are sufficient for the purpose, since the source limitations on the "gross income" notion only apply to foreign corporations.
3. The final six words are mysterious. They add that the "as if" domestic corporation should also be an "as if" personal holding company. It is not clear what, if anything, this adds -- except, of course,

confusion. The legislative history is casts no light on the choice of these words.

4. Thus, although section 555(a) aims at the source rule limitations, and successfully slaughters them, it seems to use too many arrows for the purpose and perhaps also shoots wide of the target in part.
5. The regulations confirm the death of source, saying that "the gross income of a foreign personal holding company thus includes income from all sources, whether within or without the United States, which is not specifically excluded from gross income under any other provisions of the Code." Reg. section 1.555-1.
6. In other contexts, it has also proved necessary to eliminate the source rule limits on "gross income" or similar concepts. The language chosen has varied widely. Section 555(a) contains perhaps the best draftsmanship, notwithstanding the criticism in XII/8/4, above. Compare, e.g., sections 643(a)(5)(A), and 961(a)(1)(B); and Reg. section 1.952-2(a)(1). See generally Dale at 291-95.
7. There are seven exceptions to the broad section 61 definition of gross income:
 - a. Only net gains from sales of stock or securities

- are included. Section 553(b)(1).
- b. If sales of stock or securities produce a net loss, the loss may not be used to reduce gross income. Prop. Reg. section 1.553-2(a).
 - c. Only net gains from commodity transactions are included. Section 553(b)(2).
 - d. If commodity transactions produce a net loss, the loss may not be used to reduce gross income. Prop. Reg. section 1.553-2(a).
 - e. Capital loss carryovers are to be disregarded.
Id.
 - f. The regulations add an interesting, but esoteric, exception coordinating the FPHC provisions with those of subpart F (dealing with controlled foreign corporations). Reg. section 1.555-1, last sentence.
 - g. Certain income of other foreign corporations may be included in the gross income of an FPHC, under the "toothpaste tube" principles of section 555(b), discussed at XIV/B/5, below.
- C. The 60 percent threshold of section 552(a)(1) only applies for the first year in which a foreign corporation is characterized as an FPHC. For succeeding years, the threshold is reduced to 50 percent. It remains at

that lower level -- thus making it more likely that the shareholders will be subject to the FPHC provisions -- until either:

1. For an entire taxable year of the corporation, the stock ownership test of section 552(a)(2) is not met, or
2. For three consecutive taxable years of the corporation, the reduced 50 percent threshold of section 552(a)(1) is not met.

If either of these occurs, the higher 60 percent threshold is restored, and the cycle begins again. See Reg. section 1.552-2(a)(2).

XIII. FPHCI

- A. The income test requires the comparison of a foreign corporation's gross income with its FPHCI, to see whether the latter equals at least 60 percent (or sometimes 50 percent, see XII/C, above) of the former. FPHCI is defined in section 553(a) to comprise seven types of income. A detailed discussion of these categories is beyond the scope of this outline. They are quite similar to the categories which constitute PHCI (see X/F, above), but there are important differences

too. Each will be mentioned briefly.

1. Dividends, interest, royalties, and annuities constitute FPHCI. Section 553(a)(1). This category is very similar to section 543(a)(1), with three differences:

- a. PHCI has been broken down into more subdivisions than FPHCI, including (i) mineral, oil, or gas royalties (section 543(a)(3)), and (ii) copyright royalties (section 543(a)(4)). To preserve this pattern, the PHCI definition of "royalties" explicitly excludes these two latter varieties. Section 543(a)(1). See Reg. section 1.553-1(b).
- b. The PHCI rules exclude from the definition of interest both (i) interest which is treated as rent (see sections 543(a)(1)(A) and 543(b)(3)), and (ii) interest on certain reserve funds set aside pursuant to specific provisions of the Merchant Marine Act of 1936 (section 543(a)(1)(B)). See Reg. section 1.553-1(a).
- c. Dividends for PHCI purposes do not include amounts paid in partial liquidation. Section 543(a)(1)(C).

2. FPHCI includes gains from the sale or exchange of

stock or securities. Section 553(a)(2).

- a. An exception is provided for "regular dealers." See United States v. Ross, 251 F. Supp. 175 (S.D.N.Y.), aff'd, 368 F.2d 455 (2d Cir. 1966) (U.S. shareholder failed to prove foreign corporation was "regular dealer").
- b. The amount of such income to be included is only the net excess of gains over losses. Section 553(b)(1); Prop. Reg. section 1.553-2. (If the net amount is a loss, it is to be disregarded, i.e., it may not be used to reduce FPHCI. Reg. section 1.553-2(a).)
- c. PHCI does not include such income. Indeed, not only the numerator but also the denominator of the section 542(a)(1) fraction -- UCI -- excludes such gains. Section 543(b)(1)(A). The contrast is dramatic: for FPHC purposes, such gains are treated as FPHCI, and, in addition, they are included within UPHCI (see XIV/B, below, and contrast section 545(b)(5), eliminating them from UPHCI). The result is: (i) such gains may cause the corporation to become an FPHC, and (ii) the gains, although long term and capital in nature, may be taxed to the United

States shareholders at ordinary income rates!

See XIV/A, below.

3. Gain from commodity futures transactions are included within FPHCI, if "on or subject to the rules of a board of trade or commodity exchange." Section 553(a)(3).
 - a. The section provides an exception for "bona fide hedging transactions" entered into by "a producer, processor, merchant, or handler of the commodity" in question.
 - b. Only net gains from such transactions constitutes FPHCI. Section 553(b)(1). Net losses are to be disregarded in computing FPHCI. Prop. Reg. section 1.553-2(a).
 - c. Query how the provisions of sections 1092 and 1256 apply here?
4. Any amount includible in the corporation's income by virtue of items distributed or required to be distributed from an estate or trust constitutes FPHCI. (This rule is identical to the PHC provision in section 543(a)(8).) Gains from the sale or disposition of any interest in an estate or trust are also FPHCI. Section 553(a)(4). (This rule is unique to the FPHC area; the PHC rule does not taint such

gains.) These FPHCI rules do not track the usual subchapter J conduit principle, under which the character of income at the beneficiary level normally depends upon the character of the income at the trust or estate level. Instead, this sort of income is automatically tainted, even if it would have been free from FPHCI taint if received directly by the corporation.

5. Income from the performance of personal services by the corporation will be FPHCI if a third person may designate who is to perform the services and the person designated is an individual owning 25 percent or more of the corporation's stock. Section 553(a)(5).

- a. The language of section 553(a)(5) is identical to that in section 543(a)(7). Thus, precedents relevant to interpreting the latter should also illuminate the former. The long-proposed regulations under section 553 confirm this: Prop. Reg. section 1.553-1(b)(8)(iii) refers over to the regulations under section 543 for guidance. See generally BITTKER & EUSTICE at 2-51 et seq.
- b. The section 554 attribution rules apply for purposes of testing for the ownership of 25

percent or more of the corporation's stock.

Section 554(a).

- c. This rule intersects with the conflagration raging over taxation of personal service corporations, other loan-out entities, and their shareholders. It must be considered in that larger context.

5. FPHCI includes amounts received by the corporation for use of its property by a 25 percent or greater shareholder. Section 553(a)(6).

- a. Here again the section 554 attribution rules apply in determining ownership of 25 percent or more of the corporate stock.
- b. The language is markedly similar to that in section 544(a)(6), but subject to several differences, including:
 - 1. FPHCI may include such income from the use of intangible as well as tangible property. PHCI does not include such income from the use of intangibles.
 - 2. The PHCI definition contains detailed provisions for computing the exception to section 543(a)(6) -- see section 543(a)(6)(2) and (C). The FPHCI exception to section

553(a)(6), discussed immediately below, is unelaborated in the statute.

- c. Such income is not FPHCI unless the corporation has other FPHCI, after excluding such income and also rents (see XIII/A/7, below), amounting to more than 10 percent of its gross income. See Prop. Reg. section 1.553-1(b)(9)(ii). Thus, incorporated yachts or other properties are fine, provided that the corporate owner does nothing, or very little, other than rent them to its shareholders.
7. Rents are FPHCI unless constituting one-half or more of the gross income of the corporation. Section 553(a)(7).
- a. The 50 percent threshold is similar to the one used for PHCI purposes in section 543(a)(2), except:
 - 1. The PHC rule refers to "adjusted income from rents," which is defined in section 543(b)(3), and which is quite different from "rents."
 - 2. The denominator of the PHC 50 percent exception is AOCI, not gross income.
 - 3. The PHC rule has a further mandatory divi-

dend rule, forcing disgorgement of income, in order for the exception to apply. Section 548(a)(2)(B). The FPHC rule has no similar provision.

- b. Since the threshold is calculated by reference to gross income, both as to numerator (rents) and denominator, it seems that amounts received under leases are included in full for both purposes, even if the net profit from the lease is low, zero, or negative. Consider, then, the impact of signing net net net leases on, for example, Paris! Contrast the modified tainting rules for rents for purposes of subpart F: the 50 percent threshold is rejected (section 954(c)(2)), and a true active business test is substituted for it (section 954(c)(3)(A); Reg. sections 1.954-2(d)(1) and 1.954-2(d)(1)(ii)(c) Example (4)).
- c. Rents here do not include items included under section 553(a)(6), discussed at XIII/A/5, above.
- d. The proposed regulations except active rents from the definition of "rents." This would cover rents involving the performance of "significant services." Prop. Reg. section 1.553-

1(b)(10)(ii). Given the 50 percent threshold exception to taint (XIII/A/7/a, above), there are circumstances in which this may be hurtful rather than helpful.

- B. There are several possible exceptions or modifications to the categories of FPHCI discussed in XIII/A, above.
1. Some of the types of FPHCI have "internal" exceptions, e.g., the more-than-50-percent exception to rents in section 553(a)(7) (see XIII/A/7, above). Each of these has been discussed in place, above.
 2. Normal accounting notions apply in determining when the relevant income is includible by the foreign corporation. Thus, the taxable year, accounting methods, and accounting elections of that corporation are determinative both as to timing and amount of income which may be FPHCI. See generally Dale at 275-91. For example, a foreign corporation may properly report gains from the sale of stock or securities on the installment method, thus deferring the inclusion of FPHCI. This may make possible reduction of the annual amount of FPHCI below the 80 percent or 50 percent threshold of section 552(a)(1). Rev. Rul. 76-44, 1976-1 C.B. 127. [Note that an affirmative installment reporting election

will likely still be required, in the case of a foreign corporation, despite the adoption of the reverse rule, for most taxpayers, in the Installment Sales Revision Act of 1980. See Dale at 291.1

3. Only recognized gains and income count here, as in the domestic context. Realized gains and income are not to be counted if nonrecognition rules apply. Rev. Rul. 73-277, 1973-1 C.B. 296 (section 337 liquidation of foreign corporation).
4. Code exceptions to gross income continue to apply. Thus, a foreign corporation may receive interest on tax exempt municipal bonds without generating FPHCI. Rev. Rul. 75-527, 1972-2 C.B. 456.
5. Treaty exceptions may also apply. A general discussion is outside the scope of this outline. Note, however, that section 894(a), providing that treaties may create exclusions from gross income, has been interpreted by the regulations not to apply -- in the absence of specific treaty language to the contrary -- for purposes of reducing UPHCI. Reg. section 1.894-1(a). There is no similar language in that regulation referring to FPHC's or UPPHCI. See VII/D. above.

XIV. THE TAXING PATTERN

A. The 1937 legislation was innovative -- it placed the liability for tax, not upon the foreign corporation which is an FPHC, but upon its shareholders. Section 551(a) requires the corporation's UFPHC to be included in the gross income of

"the citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts (other than estates or trusts the income of which under this subtitle includes only income from sources within the United States), who are shareholders in such foreign personal holding company (hereinafter called "United States shareholders") in the manner and to the extent set forth in this part."

This is a startling notion to those not accustomed to the baroque intricacies of the Internal Revenue Code. Imposing a tax upon shareholders of a corporation with respect to undistributed income of the corporation appears grossly unfair and perhaps unconstitutional to most newcomers whose eyes are not glazed over as a result of too much exposure to the income tax laws. Congress chose this route because of concern about jurisdiction to impose a tax upon the foreign corporation

itself. See X/G, above. It thus imposed the tax upon the United States persons who own the stock of the FPHC.

1. The definition of "United States shareholders" is quite different from the definition of "United States group." The latter is used in the shareholder test of section 552(a)(2), and refers to the individuals who directly or indirectly own more than 50 percent in value of the corporation's stock. See XI/A/5, above. By contrast, "United States shareholders" may be entities as well as individuals, and comprise only direct (not indirect) owners of the stock of the foreign corporation. It follows that the taxing burden may fall on persons other than those whose existence causes the corporation to be classified as an FPHC. Reg. section 1.551-2(a). The "United States group" may cause the trigger to be pulled, but the taxing bullet strikes the "United States shareholders."

2. The definition of "United States shareholders" here includes any United States person. Indeed, the definition of "United States person" in section 7701(a)(30) seems to be exactly co-extensive. Thus, there are five possible types of persons who may be United States shareholders:

- a. Natural individuals who are either citizens of the United States or residents of the United States.
- b. Domestic corporations, i.e., corporations created or organized in the United States. See section 7701(a)(4), and XI/A/3, above.
- c. Domestic partnerships, i.e., partnerships created or organized in the United States. Section 7701(a)(4) is again relevant, but here there is occasional difficulty in testing where the partnership has been "created."
- d. Estates which are not foreign estates. The language in the first parenthetical clause of section 551(a), quoted in XIV/A, above, is obscure, but it is the Code's way of saying "foreign estate" or "foreign trust." (The parenthetical clause was not amended in 1966, when the Foreign Investors Tax Act of 1966 was enacted. Thus it does not track the current, correct language of Section 7701(a)(31)). Testing whether an estate is foreign (and thus not capable of being a United States shareholder) requires two steps (after, of course, initially characterizing the entity properly as an es-

tate): first, the estate must be an "alien" estate; second, it must be a "nonresident" estate. This reflects the fact that estates are not grouped as domestic versus foreign in the same manner as partnerships and corporations. Instead, they are treated much like natural individuals and are divided into nonresident aliens versus others. In determining these issues, the two most important factors are the last domicile of the decedent and the jurisdiction under whose laws the estate is being administered. Rev. Rul. 81-112, 1981-1 C.B. 592; Rev. Rul. 69-108, 1969-1 C.B. 192; Rev. Rul. 65-311, 1965-2 C.B. 322; Rev. Rul. 64-307, 1964-2 C.B. 163; Rev. Rul. 62-154, 1962-2 C.B. 148.

- e. Trusts which are not foreign trusts. The discussion immediately above, at XIV/A/2/d, is directly relevant since the determination of whether a trust is a foreign trust is to be made in the same manner as for an estate. Rev. Rul. 62-154, 1962-2 C.B. 148. See also Foreign Entity Characterization Report at 197 n. 116.

- 3. The term "United States shareholder" is also used in

subpart F, for purposes of testing whether a foreign corporation is a controlled foreign corporation, Section 951(b). In that context, it has a quite different definition.

- B. The tax is levied on the United States shareholder's portion of the UFPHCI of the foreign corporation. Section 551(b). Although the notion is fairly straightforward, the precise language of that section is not. Furthermore, the definition of UFPHCI, itself, is complex. In addition, it may be necessary to examine the income not only of the foreign corporation whose stock is owned by the United States shareholder, but also the income of other foreign corporations which are, in turn, directly or indirectly owned by the first foreign corporation. Finally, the character of the income to be included must be determined. These points are considered below.

1. UFPHCI is defined in section 556. It begins with the foreign corporation's "taxable income," which is then adjusted, and reduced by the dividends paid deduction.

- a. "Taxable income" of an FPHC is not source bound. Although the statute explicitly eliminates source considerations only in determining "gross income" (see XII/B, above), the regulations

confirm that "taxable income" is also to be "computed without regard to subchapter N, chapter 1 of the Code" Reg. section 1.556-1. (Note that here no overkill is employed in slaying the source dragon. Contrast section 555(a), and see XII/B/1 through XII/B/4, above.)

- b. Deductions from gross income are here allowed without the necessity of filing a return, since the contrary rule which normally applies for foreign corporations is in section 882(c)(2), in subchapter N, which is made inapplicable. Contrast the situation for PHC's, discussed at V/A/3, above.
- c. Since UFPHCI begins with taxable income, not with FPHCI, there is no necessary relationship between the two. If a corporation generates enough tainted income to become an FPHC, all of its taxable income -- not merely that portion which is tainted -- becomes eligible for taxation. Contrast the pattern of subpart F, where only the net subpart F income is generally subject to tax in the hands of the shareholders (unless that amount exceeds 70 percent of the

~~cap gains~~

income of the controlled foreign corporation).

2. There are six adjustments to taxable income mandated by section 556(b), and, in addition, a deduction is permitted for dividends paid:

a. A deduction is allowed for certain U.S. and foreign income taxes, excess profits taxes, and war profits taxes.

1. Although a deduction is generally allowed for U.S. income taxes, no deduction is allowed for taxes imposed on unreasonably accumulated earnings under section 531, or for personal holding company taxes under section 541. The Code states, and the regulations confirm, that this deduction must be taken on the accrual basis, regardless of the actual accounting method of the foreign corporation. Reg. section 1.556-2(a)(1)(i). Since a corporation which is an FPHC for a given taxable year is automatically exempt from section 531 and 541 taxes for that year, per sections 532(b)(2) and 542(c)(5), the deduction-limiting rule must refer only to (i) section 531 or 541 taxes imposed with respect to a given taxable year, but contes-

ted, which contest is then resolved during an FPHC-status year, or (ii) to foreign corporations which had been taking cashbasis deductions for taxes under the FPHC-predecessor rules of the 1989 Code, and never elected to use the accrual method for this purpose. See section 556(b)(1), last two sentences, and Reg. sections 1.556-2(a)(1)(ii) and 1.556-2(a)(2).

2. The adjustment for foreign taxes is a bit strange. Section 164(a)(3) allows such taxes to be deducted en route to taxable income. UFPHCI starts with taxable income, and then is to be adjusted further under section 556(b). Are such foreign taxes then to be deducted twice? Although the language of the Code would suggest an affirmative answer, the regulations strong arm the issue, and deny the second deduction. Reg. section 1.556-2(a)(3). Query: suppose the foreign corporation is on the cash basis, properly could accrue foreign taxes for year 1 (in which it is an FPHC), but only pays them in year 2, in which latter year it is

not an FPHC and cannot otherwise claim the deduction. May it adjust its UFPHC1 for the foreign taxes?

- b. Charitable contributions are allowed as a deduction, but the deduction is subject to rules which are crafted for this particular purpose. An elaboration of them is beyond the scope of this outline. See section 556(b)(2) and Reg. section 1.556-2(b)(2). The regulations do not here attempt to avoid double deductions, even though the charitable contribution deduction would seem to be available en route to taxable income, subject however to different rules than those stated in section 556(b)(2).
- c. The special corporate deductions of sections 241 through 250, except for section 248, are disallowed. Section 556(b)(3); Reg. section 1.556-2(c).
- d. Net operating losses are generally disallowed, but an NOL from the preceeding taxable year is allowed. Section 556(b)(4).
 - 1. In computing the prior year's NOL for this purpose, the special deductions of sections 241 through 250, except for section 248, are

again disallowed. Id.

2. A doubling up of deductions is here permitted! Suppose the FPHC incurs an NOL for year 4, which it carries back to years 1, 2, and 3 under normal section 172 principles. The NOL is completely used up in those carrybacks. [This may be relevant either because the foreign corporation was doing business within the United States in those early years and thus was paying tax here, or because of the impact of the NOL carryback on indirect foreign tax credits claimed by U.S. shareholders.] May the same year 4 NOL be used in adjusting taxable income for UFPHCI purposes in year 5, if in that fifth year the corporation is an FPHC? The Service, surprisingly, has ruled in the affirmative! Rev. Rul. 79-59, 1979-1 C.B. 209 (PHC ruling, involving the identical language of section 545(b)(4)).
- e. Business and depreciation deductions are limited to the amount of income from the corporation's property, unless the taxpayer can establish to the contrary under a three-part test designed to

prevent tax avoidance. Section 556(b)(5). The burden of proof is on the taxpayer here, of course. Reg. section 1.556-2(e)(2). The taxpayer attempting to justify such excess deductions must attach a statement to his tax return containing detailed relevant information. Id.

f. Deductions are disallowed for taxes of a shareholder paid by the corporation (section 164(e)) and for contributions to pension trusts (section 404). Section 556(b)(6).

g. A deduction is allowed for "dividends paid" as defined in section 561. For this purpose, the dividends paid deduction includes both dividends paid during the taxable year, and consent dividends for the taxable year.

1. Unlike the normal subchapter C rule, which allows a dividend paying corporation to reduce its earnings and profits upon payment of dividends (regardless of receipt by the shareholder), here the regulations permit UFPHCI to be reduced only upon shareholder receipt of dividends. Compare Rev. Rul. 62-131, 1962-2 C.B. 94, and BITTKER & EUSTICE at 7-25 n. 58, with Reg. section

*Correlation with
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must still pay
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portion*

1.561-2(a). For FPHC purposes -- unlike the PHC rule of section 563(b) -- the 2-1/2 month look-back window of section 563 does not apply.

2. The consent dividend procedure of section 565 clearly applies. The regulations, however, are confusing and, in part, unworkable here. For example, they provide for the necessary consent, on Form 972, to be filed "at any time not later than the due date of the corporation's income tax return for the taxable year for which the dividends paid deduction is claimed." Reg. section 1.565-1(b)(3). An FPHC may well have no obligation to file an income tax return. Elsewhere, the regulations state that the shareholder "will be entitled to . . . the exclusion under section 115, or to the dividends received deduction under section 243, with respect to such consent dividend." Reg. section 1.565-3(a). Neither is likely to be correct in the case of a dividend from an FPHC. Finally, the regulations state that the amount of the consent dividend will be

treated as a dividend for all Code purposes, if it is not preferential within the meaning of section 562(c) and if it would be supported by earnings and profits under section 316. Reg. section 1.565-3. That is inconsistent with precedents treating distributions as not dividends when incident to and forming part of the consideration for a sale of the stock in question. See Waterman Steamship Corp. v. Comm'r, 430 F.2d 1185 (9th Cir. 1970), cert. denied, 401 U.S. 939 (1971); Rev. Rul. 75-493, 1975-2 C.B. 108; and BITTKER & EUSTICE at 7-47 - 7-48. The fault here is not with the applicability of the consent dividend procedure, but with the implementation of it in the regulations. There is a pending regulations project relating to section 565; hearings were held in May of 1982; it is hoped that appropriate corrections and clarifications may be made in the regulations, without however reducing the scope of the consent dividend procedures generally.

3. Each United States shareholder of an FPHC must in-

clude in his gross income his share of the UFPHC1. The language of section 551(b) is quite dense, however:

"Each United States shareholder, who was a shareholder on the day in the taxable year of the company which was the last day on which a United States group (as defined in section 552(a)(2)) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend . . . if on such last day there had been distributed by the company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year."

These words raise a number of issues, discussed below.

- a. Tax liability is imposed only on U.S. persons who are shareholders on the last day of the foreign corporation's taxable year on which a United States group existed. Reg. section 1.551-2(a). Thus, if a U.S. person sells his stock during the foreign corporation's taxable

year, and such disposition does not itself terminate the existence of a United States group (e.g., if the transferee is also a U.S. person), the seller is free of FPHC consequences for that year. (A similar rule, but using slightly different language, applies for subpart F purposes. Section 951(a)(2)(A); Rev. Rul. 75-341, 1975-2 C.B. 308.)

- b. Tax liability is imposed for the taxable year of the shareholder in which or with which the foreign corporation's taxable year ends. Reg. section 1.551-2(d). This is a quite typical rule for coordinating tax consequences for pass-through entities which may have different taxable years than their beneficial owners.
- c. The amount to be included requires the computation of the total amount of UFPHCI for the foreign corporation's taxable year (see XIV/8, above). It also requires the computation of a fraction, the numerator of which is the number of days during the corporation's taxable year that a United States group existed, and the denominator of which is the total number of days in the corporation's taxable year (normally 365

on 366, except in the case of a 52-53 week year foreign corporation, per section 441(f)). (Although it is of no practical significance, the regulations give an example in which the fraction is stated to be nine-twelfths, when a calendar year foreign corporation's United States group ceased to exist on September 30. This is not strictly in accordance with the Code language, which appears to require daily, rather than monthly, pro rating. Reg. section 1.551-2(b).) The UFPHCI is then multiplied by the fraction to determine the total amount of UFPHCI which is to be deemed distributed as a dividend. Finally, the United States shareholders each take into income that portion of that amount which would have been received by him if a dividend had been paid on such last day. Reg. sections 1.551-2(b) and (c). If more than a single type of stock is outstanding, the relative rights of the different classes, as well as the number of shares, must be taken into account. Reg. section 1.551-2(c).

- d. The language only contemplates motion in one direction, and is thus defective. It deals

accurately with cases in which the FPHC has a United States group in existence at the outset, but ceases to have one later in the year. It does not deal at all with the reverse case, i.e., when there is no United States group in existence at the beginning of the corporation's taxable year, but one comes into existence later. This created difficulties when foreign individuals, owning stock of foreign corporations (which in turn met the income test of section 552(a)(1)), changed from nonresident aliens to resident aliens during the corporation's taxable year. Read literally, the language of section 551(b) would have taxed the entire year's income to the incoming resident alien. The Tax Court, when first confronted with this, reached exactly that result. Mary A. Marsman, 18 T.C. 1 (1952). The Service acquiesced. On appeal, however, the Fourth Circuit reversed on that issue. Marsman v. Comm'r, 205 F.2d 335 (4th Cir.), rehearing denied, 205 F.2d 335 (4th Cir. 1953). Although agreeing that the Code, read strictly, supported the Tax Court's holding, the Circuit Court of Appeals said that

it could not "attribute to the Congress of the United States the intent to accomplish such an extraordinary result," 205 F.2d at 941. The next time the issue arose, the Tax Court abandoned its literal (and technically proper) reading of the Code, and agreed with the Fourth Circuit's view -- thus taxing the incoming alien only on a portion of the foreign corporation's UFPHCI. Silvio Gutierrez, 53 T.C. 394 (1969), aff'd per curiam, 72-1 U.S.T.C. para. 9121 (D.C. Cir. 1971). The subpart F provisions are more careful here, and would require pro rating even for the case of a foreign corporation starting out as not a controlled foreign corporation, but becoming one during the taxable year. Section 951(a)(2)(A)(ii). [The Gutierrez case is also significant because the subpart F language was considered by it. Instead of reasoning by negative implication -- which would have led the Court to reaffirm its earlier Marsman holding, contrary to the view of the Fourth Circuit -- the Court held that the later statutory enactment of section 951(a)(2)(A)(ii) should be viewed as clarifying the earlier language of the

FPHC provisions!]. See generally Dale at pp. 309-22.

- a. Section 551(b) also provides that the amount of the deemed dividend is to be "determined as if any distribution in liquidation actually made in such taxable year had not been made." (This language, appearing in the Code, was designated by ellipses in the quote at XIV/B/3, above.) This parenthetical language was added in 1964. The same legislation amended Code section 562(b), which permits liquidating distributions, under certain circumstances, to qualify as dividends for purposes of the section 591 and 541 taxes, thus reducing the tax base for those provisions. The parenthetical clause makes clear that a contrary result applies for purposes of the FPHC provisions.

4. The amount to be included in gross income of a United States shareholder is to be included "as a dividend." It appears that it is a dividend for virtually all purposes of the Code, but -- surprisingly -- there is one exception.

- a. The Service has ruled that a deemed section 551(b) dividend is not a dividend for purposes

of section 902. Rev. Rul. 74-59, 1974-1 C.B. 183. Thus, to pass through deemed paid foreign tax credits to a proper corporate United States shareholder of an FPHC, either an actual dividend or a consent dividend must be used.

- b. Subpart F contains explicit rules permitting a deemed paid foreign tax credit for amounts to be included in the income of U.S. shareholders (Section 960), despite the fact that the subpart F deemed inclusion of income is not characterized as a dividend. Compare also the operation of section 1248, which gives rise to a "dividend" (section 1248(a)) -- the regulations provide for a deemed paid foreign tax credit in appropriate cases. Reg. section 1.1248-1(d)(1). (Caveat: some of the provisions of that regulation are out of date.)

5. The FPHC taxing pattern described thus far is subject to a fatal defect. It taxes only United States shareholders who directly own stock in the FPHC. Suppose P, a U.S. citizen, owns all the stock of F1, a foreign corporation, which in turn owns all the stock of F2, also a foreign corporation. All of the income for a given taxable year is generated by F2.

Applying the income and shareholder tests of section 552(a), it is clear that F2 is an FPHC. As a result, its UFPHCI is to be taxed to its United States shareholders. However, it has none -- its sole shareholder is F1, which, being a foreign entity, does not come within the definition of section 551(a). Furthermore, F1 has no gross income whatsoever, at least if F2 declares and pays no actual dividends to it (as any well-advised P would insure). Thus, F1 is not an FPHC. To prevent this two-tier tax avoidance, section 555(b) requires the UFPHCI of F2 to be included in the income of F1, for purposes in turn of taxing P.

- a. Section 555(b), together with section 555(c)(1), operates like a toothpaste tube: it "squeezes" the tainted income up a chain of foreign corporations, no matter how long. At each level, the characterization of the corporation as an FPHC depends upon the deemed dividend of lower tier UFPHCI. Section 555(c). See Reg. section 1.555-2. The squeeze out is only effective, however, if the result is to classify the upper tier company as an FPHC. Reg. section 1.555-2(b) Example (1), paragraph (3).

- b. The toothpaste tube effect is limited to foreign corporations within a chain. The Code contains no rule which would squeeze income through other intermediate entities (trusts, estates, or perhaps even partnerships). Thus, one may perhaps employ other foreign entity "catch basins" in the chain to cut off FPHC consequences. See ROBERTS & WARREN para. X/4D(3). [Although a full discussion is outside the scope of the current outline, consider (i) in the case of foreign trusts, the provisions of section 679; and (ii) in the case of foreign partnerships, the possibility that for this purpose they will be deemed aggregations of partners, rather than entities.]
- c. Contrast the much more effective provisions of subpart F, which create a "leap frog" effect in such circumstances, taxing the income directly from the lower tier entity to the United States shareholder. Section 951(a)(1). There is good news and bad news about this approach. The good news is that it works, and prevents avoidance of the tax by simple interposition of "catch basin" entities. The bad news is that it necessitates an extremely complex set of corollary rules to

deal with earnings and profits, basis, and other income tax effects of later actual distributions up a chain.

- d. The UFPHCI squeezed out of lower tier corporations by section 555(b)'s toothpaste tube rule should be treated as having been distributed for all relevant purposes. Thus, lower tier earnings and profits should be reduced, higher tier earnings and profits should be increased, the amounts should be deemed recontributed to the capital of the lower tier companies, and the stock basis of the higher tier companies should be accordingly increased. Cf. XIV/C, below. Surprisingly, there is no known authority confirming any of these consequences.

- C. Whenever income is taxed to a person who does not actually receive it, collateral consequences need to be considered. These typically include: characterization of the income, effect on stock basis of the recipient, and effect on tax attributes (such as earnings and profits) of the deemed payor. The FPHC regime does deal with each of these. The first has already been mentioned (see XIV/B/4, above).

1. The earnings and profits of the FPHC are reduced

whenever UFPHCI is required to be included in the income of a United States shareholder. Interestingly, the reduction is not limited to the amounts so included. Rather, section 551(d) provides for a reduction of "the accumulated earnings and profits as of the close of the taxable year" of the FPHC by the entire amount of UFPHCI. (If the FPHC only had a United States group in existence for the first part of the year, the E&P reduction is pro rated, using a ratio which is identical to that created for purposes of computing the income inclusion for United States shareholders -- see XIV/B/3/c and XIV/B/3/d, above.) Thus, in the typical case in which the corporation is an FPHC for an entire year, the entire amount of UFPHCI is purged from E&P so long as the relevant UFPHCI, "or any portion thereof, is required to be included . . . directly or indirectly, in the gross income of United States shareholders." Section 551(d) (emphasis supplied). The regulations illustrate this with an example (Reg. section 1.551-5(b) Example (1)), but add no exegesis other than an unusual statement of purpose: "[This is] designed to prevent double taxation with respect to the undistributed foreign personal hold-

ing company income." Reg. section 1.551-3(a).

2. The FPHC's capital account is increased in the same amount as its E&P is reduced. The Code says that such amount "shall, for the purpose of determining the effect of distributions in subsequent taxable years by the corporation, be considered as paid-in surplus or as a contribution to capital"

Section 551(d).

- a. It is not normally necessary to refer to a corporation's capital account in order to determine the effect of distributions made by it. However, reference to corporate capital account is necessary, for example, if E&P is reduced as a result of a stock redemption which, as to the redeemed shareholder, is treated as an exchange pursuant to sections 302(a) or 303. See section 312(e); Helvering v. Jarvis, 123 F.2d 742 (4th Cir. 1941); Rev. Rul. 79-376, 1979-2 C.B. 133; and BITTKER & EUSTICE para. 9.65. Are there other cases in which capital account matters?

- b. The deemed contribution to the FPHC by a United States shareholder should be viewed as if made in cash, thus avoiding any consequences under sections 1491 or 367 (see sections 367(c)(2) and

1492(3)).

- c. Not only first tier FPHC's but also lower tier FPHC's may be affected by this rule. Section 551(d) refers to an amount included "directly or indirectly" in the income of a United States shareholder. If the toothpaste tube effect operates (see XIV/B/5, above), the E&P reduction and the deemed contribution to capital will both also operate on the lower tier FPHC's too. In such a case, the deemed contribution should be treated as having been made by the intermediate tier FPHC to the next lowest tier FPHC (from which the relevant lower tier UFPHC1 was squeezed).

- 3. Stock basis is increased in the amount of any inclusion in income by a United States shareholder. Section 551(e). This is simply a further logical consequence of deeming the income to have been received and then contributed back to the FPHC.

- a. If the United States shareholder fails to include any portion of the deemed dividend in income, and the statute of limitations runs on the taxable year in question, then his basis to that extent is not increased. Section 551(e);

Reg. section 1.5551-5(b) Example (2). The language of section 551(d), by contrast, suggests that the E&P reduction and the capital account increase for the FPHC take place so long as the income "is required to be included as a dividend," i.e., without regard to whether it is in fact properly reported by the United States shareholder.

- b. Inexplicably, the stock basis of foreign shareholders of the FPHC does not seem to be increased, even though their share of the E&P has been purged. Accord, ROBERTS & WARREN at X-74. Perhaps that is because there is also no mechanism for including their share of the UFPHC1 in their income (albeit that such inclusion would typically be free of U.S. income tax consequences.)
- c. Equally strange, the stock basis of intermediate FPHC's does not appear to be increased by the amounts squeezed out to them from lower tier FPHC's by the toothpaste tube effect. Here, the result -- if correct -- is harder to explain than that in XIV/C/3/b, immediately above, because here the Code does provide for including

amounts in the income of such intermediate FPHC's, per section 555(b). An argument can thus be made that basis should be increased pro tanto, notwithstanding the absence of any express Code provision to that effect.

XV. EXCEPTIONS TO FPHC TREATMENT

- A. There are no overlap provisions providing for the FPHC rules to give way to other tentacles of the pentapus. Compare VI/A, above. Thus, whenever they apply, the FPHC provisions will either displace or coexist with other Code provisions. The FPHC provisions displace the PHC rules (see VI/A/2, above), the section 531 provisions (section 532(b)(2)), and -- at least to some extent -- the provisions of subpart F (section 951(d); Reg. section 1.951-3; and compare Estate of Whitlock v. Comm'r, 494 F.2d 1297 (10th Cir.), cert. denied, 419 U.S. 839 (1974), with Estate of Lovett v. Comm'r, 621 F.2d 1130 (Ct. Cl. 1980)). The FPHC provisions appear to coexist with those affect foreign investment companies, sections 1246-47.
- B. Section 552(b)(2) excepts from FPHC treatment "a corporation organized and doing business under the banking and credit laws of a foreign country" Qualification

for this exception must be established annually, "to the satisfaction of the Secretary," by showing that "such corporation is not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed upon its shareholders." The regulations explain how to apply for the necessary certification. Reg. sections 1.552-4 and 1.552-5. It is believed that very few foreign corporations apply for the exception. See generally Dale, U.S. Tax Aspects of Foreign Banks or Finance Companies, in FOREIGN TAX HAVENS (Langer & Powell, ed. 1973), pp. 95-113.

- C. Tax exempt organizations are excepted from the FPHC provisions. Section 552(b)(1).

XVI. AVOIDING FPHC TAXATION

- A. Since the FPHC shareholder and income tests are similar -- although obviously not identical -- to those used for PHC status, many of the routes available for avoiding PHC status may also be used, mutatis mutandis, for avoiding FPHC status. See VII/A, above. In addition, the following routes may be considered:
1. Have at least 50 percent of the value of the stock of the foreign corporation owned, directly and indi-

rectly, by foreign individuals. (Beware the risk of attribution from such individuals to U.S. individuals, however. See XI/C, above.) While the detailed anti-avoidance regulations of subpart F (Reg. section 1.957-1(b)) do not directly apply, care should be taken not to attempt to construct a decontrol pattern which smacks of too much tax avoidance and too little substance. Thus, e.g., beware use of a high-dividend rate, non-participating, callable, cumulative, non-voting, putable preferred stock "secured" by liquid assets set aside for the purpose of the put or call.

2. Interpose an appropriate foreign entity, other than a corporation, to act as a "catch basin." See XIV/B/5/b, above. Beware the use of foreign trusts created by U.S. persons, because these may well be grantor trusts, subject to sections 671 et seq., by virtue of section 679. It may follow that their separate existence will be ignored, and the stock held by them will be treated as owned instead by the appropriate U.S. individual. This is a high-stakes planning area: some of the plans which have been used here are both extremely aggressive and not carefully documented or executed; some of these plans

are or will be in litigation; and uncertain and unforeseeable stare decisis effects may impinge on other transactions utilizing the foreign trust format, even if more conservatively and more carefully executed.

3. Other?

- B. The two-tier gambit described in VII/B, above, will not work for FPHC avoidance. The FPHC provisions eliminate the source limitation on gross income and taxable income (see XII/B and XIV/B/1/a, above), and the toothpaste tube effect squeezes lower tier income up to higher tier corporations (see XIV/B/5, above). The two-tier gambit may still be useful, however, to avoid PHC consequences if FPHC consequences have been avoided in some manner which will not also avoid PHC status, e.g., by decontrol (see XVI/A/1, above). Combining the decontrol and the two-tier gambit may avoid both FPHC and PHC consequences (and, for that matter, section 531 consequences too).
- C. The impact of treaties on FPHC's is beyond the scope of this outline. See the authorities cited at VII/D, above.
- D. It may not be desirable to avoid FPHC status. Indeed, there are situations in which FPHC status may be sought after. For example, if the Lovett decision is correct

(see XV/A, above), becoming an FPHC may make possible avoidance of the subpart F tax rules dealing with increased investments in United States property (section 956). FPHC's may, but CFC's may not, reduce their earnings and profits for payments to foreign officials which violate the Foreign Corrupt Practices Act. Section 964(a); Rev. Rul. 77-442, 1977-2 C.B. 264. The tax impact of becoming an FPHC may be quite limited, and it does serve to eliminate PHC (and section 531) tax. Consider, for example, foreign corporation X owned by two individuals, A (a U.S. citizen) and B (an unrelated nonresident alien individual). If they are equal owners of the stock of X, X cannot be an FPHC, since the stock ownership test is failed. But if A directly owns one share of X, and the balance of the X stock is owned by a foreign partnership of which A and B are equal partners, X will clearly be an FPHC (assuming, of course, that the income test is met). As a result, X will be subject to neither PHC nor section 531 taxation. Of course, A will be subject to tax, but perhaps only on the portion of UFPHCI attributable to the one share of X stock which he owns directly, since there is not FPHC mechanism for squeezing UFPHCI up through foreign entities other than corporations, i.e., through foreign partnerships. See

XIV/B/5/b, above. Furthermore, even though A is taxed only on a small portion of the UFPHCI, all of it is purged from E&P of X, thus making later actual distributions either nontaxable returns of capital or perhaps sales or exchanges (section 301(c)(2) and (3)). These results are subject to doubt and risks -- for example, the A-B partnership may here be treated as an aggregate rather than an entity; X may be a foreign investment company; the common law of anti-tax avoidance rules may be applied; etc. The facts of this example could be manipulated to avoid some or all of these risks. But the message should be clear: one should not assume that FPHC status is to be avoided; indeed, it seems clear that it is sometimes quite desirable.

XVII. MISCELLANEOUS

- A. Normally, assets owned at death take a fair market basis in the hands of the estate and the beneficiaries. Section 1014. This rule does not apply, however, to stock in an FPHC. Section 1014(b)(3) provides that, with respect to a foreign corporation which was an FPHC for its taxable year next preceding the date of death, "the basis shall be the fair market value of such property (i.e., stock or securities of the foreign corporation) at

the date of the decedent's death or the basis in the hands of the decedent, whichever is lower."

1. This special basis rule applies not only to stock of an FPHC but also to its "securities."
 2. Despite the special basis rule, the stock and securities of an FPHC constitute part of the gross estate, and will be subject to Federal estate taxes. Even this does not increase their basis in the hands of the estate or its beneficiaries. Congress amended the Code in 1964 to mitigate this last result, allowing the basis to be increased by a portion of the estate taxes paid. The amendment was codified as section 1022. That modest relief provision, in turn, was repealed as dead wood (1) in 1976. See X/F, above. Reg. section 1.1014-2(c)(1).
 3. Contrast the death basis rules for DISC's and foreign investment companies. These take a date of death value, reduced however by the ordinary income with which the stock was pregnant. Sections 1014(d), 1246(e).
 4. There are no special death basis rules for PHC's, CFC's, or corporations subject to section 581.
- B. FPHC's are not required to file an income tax return, and may take deductions notwithstanding this. See

XIV/B/1/b, above. Of course, FPHC's may be required to file a return on the same basis as any other foreign corporation if, for example, they are engaged in trade or business within the United States, or derive U.S. source income as to which the tax liability is not satisfied by withholding of tax at the source. See Reg. section 1.6012-2(g). In addition, information reporting requirements may be imposed on the shareholders of an FPHC, under certain circumstances, by sections 551(c), 6035, 6038, and 6046. This list is not intended to be exclusive.

XVIII. CONCLUSION

- A. It has already been suggested that the PHC rules might be repealed altogether with respect to foreign corporations. See IX/B, above.
- B. This might well be coupled with a repeal of the foreign investment company provisions, which appear to suffer from disuse at least as great as that which affects foreign PHC's.
- C. The section 551 tax could also be eliminated with respect to foreign corporations -- it raises no revenue and is trivially easy to avoid.

D. The FPHC provisions could also be repealed, if the sub-part F provisions were amended to cover the same or approximately the same ground. This would require:

1. Making the control test for CFC purposes apply, in the disjunctive, to votes (as now) or value (as in the FPHC shareholder test) of foreign corporate stock, and
2. Making the threshold of relevant ownership -- now 10 percent, per section 951(b) -- significantly lower, e.g., one percent, or even less.

The result would be concentration of all relevant provisions within a single set of Code sections, and the elimination of much complexity and overlap. It would make subsequent modifications of the U.S. taxing pattern easier, if modifications were felt necessary for any purpose, including for the purpose of dealing with newly perceived abuses. It would result in the amputation of four tentacles of the pentapus. The ensuing simplicity would perhaps even make up for the loss of the word, "pentapus" -- but then again we might learn to live with and love the "unipus"!

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