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An Overview of Outbound Foreign Investment

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The purpose of this discussion is primarily to provide a road map for this afternoon's session. Like most road maps, it will not familiarize you with all the pitfalls and detours that come in each and every course of the road, but, hopefully, it will provide a bird's eye view. And also like some road maps, those who are familiar with the terrain might find it a little tedious. But, again, the purpose is to provide an overview so that the others speaking this afternoon can get right into the heart of their topics.

FOREIGN TAX CREDIT

The first area of concern is the jurisdiction of United States taxation. We learned this morning that the United States taxes its citizens and residents on their worldwide income, while, to a large extent, the United States taxes foreigners only on their U.S. source income. This leaves a considerable amount of income untaxed. For instance, a Filipino living in the Philippines who has his money in a Philippine bank account and earns interest certainly cannot expect to be paying U.S. tax on the interest income. Similarly, Volkswagen, producing automobiles in Germany and selling them in Germany, does not expect to pay U.S. tax on the sales income. Although the United States might have sufficient jurisdiction to tax those transactions, it does not. This gives us one of the primary keys to the taxation of foreign investments of U.S. taxpayers; the foreign business activities of U.S. taxpayers that are conducted through *foreign* corporations will often not be subject to U.S. taxation.

A second key to the taxation of foreign activities is the desire of the U.S. to eliminate double taxation. As just pointed out, the United

* This material is the transcript of Mr. McDonnell's presentation at the symposium.

States taxes its citizens and residents—including domestic corporations—on their worldwide income. This creates obvious problems when a foreign country taxes the same income. There is an example in my outline in which the United Kingdom imposes a $60 tax on $100 profit, and the United States imposes a $50 tax on the same profit, so the taxes on a $100 profit are $110 and the taxpayer actually loses money due to double taxation. It is expecting a bit much of U.S. taxpayers to promote their foreign business activities solely to subsidize the respective treasuries of the two countries. Thus, the United States in implementing its system of worldwide taxation included the foreign tax credit. (Prior to utilization by the United States, the foreign tax credit was a relatively seldom-used device. It was used primarily by the British Empire in giving credit for its possessions' taxes.) Under the credit mechanism, the U.S. tax on worldwide income is computed, and then a full dollar-for-dollar credit for the amount of foreign taxes paid is granted to the U.S. taxpayer. The economic impact of foreign taxation on the income of the U.S. taxpayer is effectively eliminated. If you look at the example in the outline, you will see that there is a $100 U.S. tax imposed upon $200 of worldwide income, $100 earned in Mexico and $100 earned in the United States. The $100 U.S. tax is then offset by the $40 tax credit for the tax paid in Mexico, leaving a net U.S. tax of only $60. The entire tax is still $100, but $40 of it was paid to Mexico, leaving only $60 to be paid to the United States. Thus, the overall burden on the U.S. taxpayer is not increased simply because part of the income was earned in Mexico and was subjected to Mexican income tax. If you contrast that result with the second part of the example, you will see that if the United States merely granted a deduction for the foreign tax, then the U.S. would, in effect, be imposing its tax on some of the foreign source income, and the overall tax on the U.S. taxpayer would be $120. The total tax would be increased by $20 simply because the taxpayer earned some of the income in Mexico and was required to pay Mexican income taxes on it. For this reason, the deduction mechanism has never been viewed as full relief from double taxation, and the credit mechanism is used in the United States.

If you pursue the credit mechanism through the example, you will see that the foreign tax credit has a somewhat beneficial effect for the U.S. Treasury when contrasted with the granting of an exemption from tax for foreign income. If the $100 of Mexican income in the example were exempt from U.S. tax, then the U.S. taxpayer would have only the $100 of income earned in the United States. The U.S. taxpayer would pay a $50 tax on this income. As can be seen in the example, by using a credit mechanism, the United States is collecting a $60 tax. In effect, by using the credit mechanism, the United States is collecting the difference between the U.S. tax rate on the *foreign* source income and the foreign tax rate on the foreign source income. To that extent, the credit mechanism (as opposed to an exemption mechanism) works to the benefit of the government. Looking at the example, however, if the foreign tax were instead $75 and a full credit were granted for the foreign tax, the United States would collect only $25 on the entire worldwide income of the taxpayer. So, when the foreign tax rate is in excess of the U.S. tax rate on the foreign source income, the credit mechanism could work against the U.S. Treasury. To prevent this problem, the United States has imposed a limit on the foreign tax credit under Internal Revenue Code (I.R.C.) section 904. In effect, the foreign tax credit limit is the U.S. tax rate on the foreign source income. If this limit works properly, the taxpayer should never receive a foreign tax credit on foreign source income that is any greater than the U.S. tax that would have been paid on that income. Thus, up to a certain level, the United States is making money on its foreign tax credit mechanism, but when the foreign tax credit gets up to 100% of the U.S. tax, it cuts off. Any amount over 100% is the taxpayer's problem—it must be carried forward or carried back to other taxable years. It is important to recognize the importance of what the United States is trying to do in its method of taxation. Within certain limits, the U.S. seeks to neutralize the effect of foreign income taxes. Limits are important, however, to avoid having the U.S. government subsidize taxpayers doing business in high-tax countries.

The principle issue recently with respect to the foreign tax credit has been what taxes qualify for credit. In general, the foreign tax credit is limited to income taxes, and for a number of years there were questions as to whether or not certain payments that U.S. corporations were making to foreign governments were income taxes or nothing more than a disguised royalty payment for the right to do business in the country. Over the course of the years, beginning in the early 1970's, the Internal Revenue Service (IRS) began to win cases stating that certain foreign income taxes that were income taxes (at least in name) did not qualify for a credit. The first was the *Bank of America* case, holding that an income tax imposed upon gross income as opposed to net income would not qualify for the credit. Later in the 1970's, after much study, the IRS and the Treasury Department issued Revenue Rulings 78-61, 78-62, and 78-63. These revenue rulings are very important, because they signal the establishment of more stringent standards for dealing with the question of whether or not a foreign charge will qualify as a creditable tax in the United States or as simply a deductible expense. For many companies, primarily companies doing business overseas in extracting oil, that difference can result in millions of dollars. In 1979, the IRS issued proposed regulations under I.R.C. § 901 and then revised them in 1980. They are now in effect as temporary regulations accompanying I.R.C. §§ 901 and 903. (Section 903 provides a credit for taxes paid in lieu of income taxes.) The new administration is said to be considering substantial revisions to these regulations. The entire area is currently in a state of flux. It appears that the government's position is being substantially upheld by the courts, and we are looking at an era of restricted availability of a foreign tax credit.

A second major foreign tax credit issue is the indirect or "deemed paid" credit. If a U.S. taxpayer does business overseas, earns money overseas, and pays income taxes on it, he is entitled to a credit. However, if that person owns a controlled foreign corporation which pays the foreign taxes, the foreign corporation (not being a U.S. taxpayer) pays no U.S. income taxes and therefore would not be entitled to any foreign tax credit. To equalize or offset the difference between doing business overseas directly and doing business overseas through a controlled foreign corporation, Congress decided to grant the U.S. shareholders of a foreign corporation a credit for the taxes that they are deemed to have paid because they are paid by a corporation the shareholders own. So when the company pays out a dividend to its shareholders, the shareholders are allowed to claim a credit as if they themselves had paid the foreign income taxes paid by the company. This indirect credit has become a very important part of the international taxation scheme.

U.S. INVESTMENT AND BUSINESS OPERATIONS ABROAD

A U.S. taxpayer investing or doing business abroad directly pays tax on his foreign income and is entitled to a foreign tax credit, limited by I.R.C. § 904. That is a relatively straightforward method of taxing, and it generally results in the United States collecting some tax on the income from a direct foreign investment. For instance, a U.S. taxpayer owning shares in a foreign corporation traded on the Tokyo stock exchange pays U.S. tax on any dividends or capital gains derived from the shares. If he has money in a foreign bank account, he pays U.S. tax on the interest. The taxpayer is entitled to any deductions that are attributable to the foreign income under Treasury Reg. § 1.861-8, and is liable for U.S. tax on the net amount, subject to a credit for foreign taxes imposed on the income. This is a relatively straightforward (and potentially expensive) method of taxation for individuals or corporations which simply invest and earn passive investment income overseas.

If individuals, sole proprietors or U.S. corporations are interested in expanding their overseas business operations and setting up business in a foreign country, then for tax purposes they are deciding to become engaged in a trade or business in a foreign country or to set up a permanent establishment. They are not going to question whether they are or are not engaged in business in a foreign country; they are going to admit it and get out there and set up a factory or other branch operation. Once that branch operation is set up, it is considered by most foreign countries to be a local taxpayer. It has local income, it has local deductions, and it pays local taxes. From the U.S. perspective, however, that foreign branch operation, although set up as an accounting entry or a separate internal bookkeeping portion, is still part of a United States taxpayer, whether it is a sole proprietorship or a corporation. It is still a U.S. taxpayer, and all income is subject to U.S. tax. The principal question will be how much of the foreign taxes paid can be claimed as a foreign tax credit. How much can be claimed is primarily a function of how much *net* foreign source income is earned, and in that regard some rather tricky adjustments come in to play.

Remember, this is a foreign branch operation: for instance, a factory in London. For U.S. accounting purposes and for just good business sense, that operation will be tracked as a separate bookkeeping entry. Its local expenses and its local income will be recorded so that management can know how much of a profit is being made on this operation. For instance, salaries of the branch employees, any interest expense attributable to the operation, depreciation of the operation's assets and so on will all be tracked locally by the corporation. Naturally, the foreign branch operation will have to pay foreign taxes. This means applying local tax rules to determine how much income was earned in the London branch, what deductions are allowed, and what the tax is on the difference. Under U.S. principles, however, you cannot take the income from those foreign books or the foreign tax return, bring it home, and say that is what will be reported in the United States. The foreign income must be determined under U.S. principles, because this is a U.S. taxpayer. Possibly some of the income that the corporation thought was earned in London, under U.S. tax principles was not earned there at all; it could be U.S. source income. For instance, if that London factory sells something to a U.S. individual on credit, the interest income paid by a U.S. person is considered U.S. source. And the fact that the interest goes running to London before it comes to the United States does not change the source of the income. On the other hand, considering the deduction side, quite often there will be certain expenses of the corporation which have to be apportioned into and out of the foreign branch. One example that has caused difficulty in the last couple of years has been the interest expense, because there is a special rule for determining how much of the interest expense of a U.S. taxpayer is attributable to foreign source income. The rule does not follow general bookkeeping principles, but goes on the basis of apportionment of assets. Thus, some of the interest expense that shows up on the books of the foreign branch may not be deductible against the income of the foreign branch. On the flip side of the coin, because the U.S. applies its own rules, some of the general overhead expenses that might have been paid at the head office in the United States show up as deductible expenses for the branch.

It becomes a somewhat complicated endeavor to figure out exactly how much income, how much deduction, and how much foreign taxes the U.S. company can credit from the foreign operation. And again, these are all determined under U.S. principles. The only exception to the general rule that a foreign branch operation is treated as currently taxable in the U.S. is a special rule that if all of the foreign branch income is restricted and cannot be remitted to the U.S. (it is called blocked foreign income), then the branch is allowed to defer the income, the deductions, and the credits from that branch until the blockage ceases and the company can bring the money home.

Another principal concern for U.S. persons beginning to engage in foreign business operations is the entity that they choose to do this. Often, in starting a new venture, there might be a joint venture among three or four U.S. companies or U.S. individuals, set up in a manner to obtain the maximum tax benefits. Because a U.S. taxpayer would be allowed to deduct start-up losses in the U.S., if they are expecting to incur a lot of start-up expenses, they will want to remain U.S. taxpayers and do business as a partnership to get U.S. tax benefits from the losses. On the other hand, if it is a fairly well-established venture, and they think that they are going to start up and have net income immediately, they may want to do business as a foreign corporation, because, as a general matter, the business income of the foreign corporation is not currently subject to U.S. tax. That is a very important decision, and they will set up the entity that they feel is most advantageous. The only problem is that they have to choose an entity that is qualified to do business in a foreign country, yet the foreign countries might have multitudes of different types of legal entities that these U.S. taxpayers can choose to use as their business operation. Depending upon U.S. tax principles or the U.S. tax characterization of the foreign entity, something that the taxpayers think is a corporation may turn out to be a partnership currently subject to U.S. tax. Or the opposite may be true: something that they thought was a partnership may be a corporation, and all of those losses end up staying offshore. The expectations of the taxpayers can be frustrated by an imprudent choice of entity. Interestingly, the published rulings of the IRS indicate that a particular form of doing business, such as *limitadas* in Brazil, and GmbHs in Germany, can shift characterization depending upon the nuances of how they are set up: they may be a corporation or they may be a partnership. So, you have something that has the same name but may be a different taxable entity for different U.S. taxpayers. A great amount of money can hinge on some rather subtle nuances in how you set up one of these foreign business operations.

FOREIGN PERSONAL HOLDING COMPANIES

Some U.S. persons investing overseas are simply going to put their money at risk in foreign markets and earn foreign source income from owning property or stocks overseas, or earn interest in a foreign bank account, which is passive investment income. These individuals are subject to U.S. tax on this foreign income. Since a lot of United States people do not like to pay tax, they decided to use a foreign corporation as a foreign personal holding company, or what became known as an "incorporated pocketbook." Under this wonderful scheme, a U.S. person could simply put his portfolio investments into a foreign corporation located in a tax haven where they would accumulate income endlessly, and the U.S. person would never pay tax on it. The worst thing that happens in this case is that the U.S. person liquidates the foreign corporation and pays a capital gains tax on several years' worth of accumulated income. Better than that, if this person has the foresight to die, then his heirs receive the stock in the corporation, pay an estate tax, receive an increased basis in the stock, and can liquidate the corporation without even paying the capital gains tax.

For a number of years, the foreign personal holding company was a classic tax shelter, but that disappeared a long time ago. Congress caught on before World War II and enacted the foreign personal holding company provisions. These established a classification called Foreign Personal Holding Company Income, which generally is passive investment income such as rents, interest, dividends, royalties, and gains from the sales of stock and securities. That type of income became tainted, and if the foreign personal holding company earned foreign personal holding company income (*e.g.*, an individual owned a Bahamas corporation that earned only interest and dividends), then that income would be taxed to the shareholder as if distributed as a dividend at the end of the year. The foreign corporation itself was not taxed, but the U.S. shareholder was taxed as if there had been a dividend of all of this tainted income at the end of the year. That is how these incorporated pocketbooks were dealt with.

A company is only a foreign personal holding company, however, if it meets both the stock ownership requirement and the gross income requirement. The first test is met if five or fewer shareholders own fifty percent of the corporation. This means that if you have eleven people owning 9.9% of the corporation, then you can avoid meeting the stock ownership requirement. The second is that sixty percent or more of the income of the foreign corporation must be foreign personal holding company income. By having this two-prong test, foreign corporations that were conducting legitimate overseas business operations are not forced to report current income in the United States simply because they have some passive income, such as accounts receivable from selling property overseas. These provisions attempt to attack incorporated pocketbooks but leave plenty of room for legitimate business operations.

CONTROLLED FOREIGN CORPORATIONS

The other main provision that deals with foreign corporations owned by U.S. shareholders is the controlled foreign corporation provision, or what is also referred to as Subpart F. To a large extent, we are leaving behind individual investments overseas at this point. The foreign personal holding company provisions largely eliminated the incorporated pocketbook device. However, if you can get enough U.S. shareholders together who can agree on their investment philosophy and are willing to spread their investments into this somewhat more widely held foreign corporation, you can get benefits despite the foreign personal holding company provisions. Because the foreign personal holding company provisions were meant to attack only the *personal* holding companies, they never apply to widely held corporations. In determining whether a foreign corporation is personal or who owns it, keep looking through corporate owners until you find some real live human beings who own indirectly the shares of stock. A large company like Exxon could own all the stock of a foreign corporation, but that would not be a personal holding company because the stock of that foreign corporation would be considered owned by all the shareholders of Exxon. So Exxon, realizing that it is nice to earn money and not pay U.S. taxes on it, was perfectly free to set up its own incorporated pocketbook offshore and put its investment income in the foreign company. Needless to say, Congress could not think of a good policy reason for letting large corporations set up tax-free portfolios offshore, and therefore wanted to stop that practice for large corporations also.

A more subtle type of tax avoidance, and one about which to this day there are policy debates regarding its propriety, is the use of the so-called "foreign base company." The basic feature of this device was the establishment of an intermediary company in a tax haven, such as the Bahamas. The U.S. company sells the proverbial widget to the Bahamas for $5. The Bahamas would turn around and sell it to another related corporation in England for $10, and the corporation in England would sell it in England for $12. A small amount of this profit would come into the United States where it would be taxed at roughly fifty percent, and a little bit of it would be taxed in England at approximately fifty percent, but maybe half the profit would end up in the Bahamas. Obviously, the Bahamas had nothing whatsoever to do with this transaction. The widget was manufactured in the U.S. and sold in the United Kingdom. The transaction was simply channeled through the base company in the Bahamas to drop off some of the profits there tax-free.

There are a number of provisions that apply to foreign base companies today, but the primary one is Subpart F. Under personal holding company provisions, foreign base company income as well as foreign Subpart F income may be included in the income of the United States shareholder of the controlled foreign corporation. Essentially, Subpart F is a broad attack on large corporations taking advantage of certain multinational situations to generate a large amount of tax-free profits offshore. Subpart F attacks this problem with the same "constructive dividend" device that is used in the foreign personal holding company provisions. To the extent that the controlled foreign corporation earns foreign personal holding company income (*i.e.*, the tainted passive investment income), foreign base company income, or any other type of Subpart F income, the shareholders must report this Subpart F income as a dividend distributed on the last day of the year.

Thus, the benefits of generating this income tax-free offshore disappear, because the U.S. shareholder must pay current U.S. tax on it.

While Subpart F is a broad attack on the potential abuses of doing business offshore, the Subpart F provisions (like the foreign personal holding company provisions) recognize that there is a world of legitimate business transactions taking place offshore. To a large extent, Congress does not want to interfere with overseas business operations, which of course means that there are loopholes in Subpart F; limits meant to encourage legitimate operations. If we look at what a controlled foreign corporation is, we see that there is a definitional limit. It is only a corporation that is owned fifty percent or more by U.S. shareholders. There are opportunities there for a U.S. shareholder to establish a foreign corporation in agreement with one or more unrelated, but cooperative, investors who will own fifty-one percent. To a certain extent, however, these foreign corporations have been found to be controlled even though the foreign shareholder owns more than fifty percent of the stock. Generally, a controlled foreign corporation exists only when a U.S. shareholder or shareholders own fifty percent or more. Now, at this point the phrase "U.S. shareholders" becomes a term of art. Normally, you would think that "U.S. shareholder" means a shareholder who is a U.S. person, but this is not quite true. In the case of Subpart F, it is limited to only U.S. persons who own ten percent or more of the company. Again, if you spread the ownership of the company wide enough, you could have eleven shareholders each owning less than ten percent of the corporation. And although the corporation is one-hundred percent owned by U.S. persons, it would not be considered to be a controlled foreign corporation because there are no "U.S. shareholders," because no one person owns ten percent or more. As you can see, there are little wrinkles here and there in the definition of a controlled foreign corporation. It is important to note, however, that certain constructive ownership rules apply, and that when you decide who owns a share you cannot give half of your shares to your spouse and then say "Now there are two shareholders." Similarly, you could not set up a partnership with your children, give half of your shares to this partnership, and treat the partnership as an additional shareholder. If you have truly unrelated shareholders, however, then you can establish a foreign corporation that would not be a controlled corporation.

We have already covered the two principal types of income that would be tainted under Subpart F: the foreign base company income, and the foreign personal holding company income (which is technically a subcategory of foreign base company income). There are also a few less prevalent types of Subpart F income, such as the foreign corporation's income from insuring U.S. risks, and some punitive measures in the categories of Subpart F income to discourage foreign bribes and kickbacks. Also, if the foreign corporation participates in the Arab boycott of Israel, then it can have "boycott income," which is also Subpart F income. A number of people feel strongly that a number of these provisions do not belong in the Internal Revenue Code because the rules have nothing whatsoever to do with taxation. And, having had enough bad experiences dealing with the insufferable boycott provisions, I would be just as happy if I could shift that burden to some other lawyer who would worry about it as a securities problem or a criminal problem rather than a tax problem.

There are some special rules under Subpart F to prevent interference with legitimate business operations. Generally, if Subpart F income is less than ten percent of the foreign company's income, it will be disregarded for Subpart F purposes. This allows foreign corporations that are conducting legitimate operations to earn up to ten percent of their income from passive investments. Also, it is very important to note that under the Subpart F rules, the so-called constructive dividend that the shareholders must report at the end of the year cannot exceed the earnings and profits of the foreign corporation. Thus, if the foreign corporation could not have made an actual distribution of profits, then there will be no constructive dividend under Subpart F, regardless of the amount of tainted income. If a foreign corporation has large start-up losses or a large carry-forward of net operating losses that has depleted its earnings and profits, then this corporation could earn a substantial amount of Subpart F income before the shareholders encounter the problem of current taxation in the United States.

Finally, it is not just the first-tier corporation that is subject to Subpart F. If a U.S. corporation owns one-hundred percent of a foreign corporation which in turn owns one-hundred percent of another corporation, and so forth down three or four tiers, all of those are controlled foreign corporations. If the corporation on the bottom earns sufficient Subpart F income, then the U.S. shareholder is currently taxed on that income. Once a fourth-tier corporation starts making distributions, that income could be included again in the U.S. shareholders' income, and they would have to pay income tax on it twice: once when they constructively received it under Subpart F, and the second time when they actually received it as a dividend. Under section 959 there is a mechanism to supposedly keep that from happening. It is very convoluted and a lot of fun to work with if you are stuck in that situation. And those are the restrictive provisions on the so-called tainted activities overseas.

INTERNATIONAL REORGANIZATIONS

Despite Subpart F and other rules that appear to discourage overseas investments, there are obviously plenty of business reasons and considerable tax advantages to using a foreign corporation for doing business overseas. The question is, once you have decided to do that, how do you get things overseas? You have all of your assets in the United States, and you want to set up a factory, say in London. The simple way is to organize a new subsidiary in England and transfer the assets to the subsidiary in a section 351 transaction. No gain or loss is recognized. Again, historically, Congress looked at that situation and realized that not everybody using section 351 was going to be doing business in London. The Bahamas were a lot closer. People could set up a foreign corporation in the Bahamas and transfer their General Motors stock to that corporation in a tax-free transaction. The stock could then be sold tax-free offshore, and the foreign corporation could be liquidated. If the U.S. shareholder happened to be a corporation, it would be able to engage in a tax-free liquidation. In that case, the income would be tax-free going out and tax-free coming back, and in the interim a large amount of assets that should have been taxed by the U.S. got lost. The assets fell out of the net of U.S. taxation.

This concern with assets being transferred offshore in tax-free transactions led Congress to enact section 367, which deals with organization, liquidation, and reorganization of foreign corporations. It is a somewhat complicated provision that has recently gone through some fundamental changes. Formerly, for all tax-free transfers involving foreign corporations, it was necessary to obtain a ruling that the transfer was not part of a tax-avoidance plan, or else the transaction was not entitled to tax-free treatment. Getting the ruling often caused some problems because the Internal Revenue Service was not generous in issuing rulings. Needless to say, they usually tried to take care of the U.S. Treasury and quite often issued unfavorable rulings. The Service had guidelines for when they would issue favorable and unfavorable rulings, which guidelines were set forth in Rev. Proc. 68-23. Although section 367 was changed in 1976 so that a ruling is now needed only for outbound asset transfers, these 1968 guidelines still tend to be used for the outbound rulings. After 1976, however, if the IRS does not give a favorable ruling, you can go to the Tax Court and ask them to overrule the IRS. Frankly, when it was enacted a lot of people did not think much of the procedure because they did not think the Tax Court would overrule the IRS. But lo and behold, the Tax Court has shown that it will overrule the IRS if it does not think the Service has set up a reasonable standard for issuing an unfavorable ruling. Right now the whole area is in a state of flux because if the Tax Court disagrees with the IRS in interpreting the facts, the court will say that a favorable outbound ruling should have been given on the facts. In addition, the Second Circuit recently threw another monkey wrench into the IRS's ruling machinery. In some cases, the IRS would issue a favorable outbound ruling only if the taxpayer paid a "toll charge." This usually involved reporting a dividend equal to the earnings of the foreign corporation. One corporation obtained a favorable ruling by agreeing to pay this toll charge, but then changed its mind and never reported the dividend income. The IRS found themselves in something of a quandary; nobody had ever done that before. The Service found that they could not collect the toll charge, so they tried to revoke the tax-free ruling and found the court would not back them up. Consequently, we have now the entire ruling system of the IRS being held up in the courts. The Government's well-established procedure appears to be falling like a house of cards. In the next three or four years, however, we are likely to see the IRS restore the credibility of their rulings procedure with new regulations. In any event, it is important to keep in mind that if the IRS will not issue a favorable outbound ruling, you can get a second opinion from the courts.

The so-called inbound transactions under section 367 are the liquidation of a foreign corporation or the reorganization of several foreign corporations. One of the major changes of the 1976 Act was the elimination of the ruling requirement for these transactions. Instead, the treatment of the various inbound transactions is governed by regulations. Obviously, these regulations are even more complex than the outbound ruling procedures. Basically, the IRS remains concerned that U.S. persons owning a foreign corporation not be able to transfer it offshore in a reorganization so that it will never again be subject to U.S. tax as a third-tier subsidiary of a foreign holding company. The IRS wants to make sure that it collects the appropriate tax either now or later. Thus, certain transactions have immediate tax consequences, in that they are either taxable or made subject to the outbound ruling requirement. For other transactions, the tax consequences are deferred, and the tax attributes of the transferred foreign corporation are preserved for later taxation through a set of attribution rules and a set of basis adjustments. When foreign corporations are reorganized, in effect, the stock that the U.S. shareholder receives in the new foreign corporation has the earnings and profits of the old foreign corporation attached to it. If the U.S. shareholder ever receives a distribution in excess of the earnings and profits of the new corporation, then the attached amount becomes a dividend instead of a return of capital under section 301. If the U.S. shareholder ever sells that stock, then the attached amount is triggered as a dividend instead of capital gain. Thus, whether the U.S. shareholder receives a dividend or sells the stock, an appropriate U.S. tax would be due on the income previously generated by the controlled foreign corporation.

INTERCOMPANY ALLOCATIONS

The final major area that I want to deal with is section 482. If you are concerned about the complexity of statutes, section 482 is great because it is only one sentence. This sentence says that if two or more corporations are controlled by the same interests, the Secretary of the Treasury can make whatever allocations he deems necessary to clearly reflect the income of the controlled corporations. By its terms, of course, the section applies to every controlled corporation, but in recent years its greatest impact has been in the context of international corporations.

The concern in this area is that the transfer prices for products or the charges for interest, royalties, or services would be artificially manipulated to shift profits from the U.S. corporation to the foreign corporation. To avoid this problem, the general rule is that controlled corporations must charge each other an arm's length price, *i.e.*, the same price they would charge an unrelated party. Unfortunately, a true arm's length price is just not available most of the time, because the product or service may not be sold to unrelated parties. In that case, a number of different economic theories are used to reconstruct what should have been an arm's length price. At this time there are no positive guidelines on reconstructing the arm's length price, and different economists have different theories that may result in substantially different prices. Consequently, there is a tremendous amount of activity in this area, and a section 482 adjustment can mean a tremendous amount of money when it involves a retroactive adjustment of prices that have been charged for a number of years.

The section 482 adjustment is generally only an allocation of taxable profits into the U.S. The Internal Revenue Service has no authority to tell a foreign government, such as the Bahamas or Canada, that the foreign country cannot tax the profits because of the artificial pricing arrangement. Thus, you can have a situation in which the corporate group is paying tax in the U.S. on increased profits while paying tax in Canada on the same profits because no deduction is allowed in Canada. One of the developing methods of dealing with this type of double taxation is the so-called Competent Authority procedure under the various international tax treaties. Under this procedure, the Internal Revenue Service actually represents the U.S. taxpayer and attempts to negotiate an offsetting deduction with the tax authorities in the foreign country. These negotiations are secretive and often time-consuming, but they generally result in some agreement that will avoid double taxation. The only problem with the procedure is that there is no guarantee that an agreement will be reached, so the U.S. taxpayer must keep the litigation option open to avoid the section 482 allocation in the U.S.

That concludes the overview. I hope that it proves an effective road map for this afternoon's presentations.