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United States Tax Developments During 1983 That Can Affect International Transactions

Frederick R. Chilton Jr.

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I. INTRODUCTION

A number of important and interesting international tax developments occurred in 1983. This Outline surveys the most significant of these developments including developments in United States tax treaties, legislation creating Foreign Sale Corporations (FSC's) and rules affecting trade receivable factoring. This Outline will also survey recent tax cases, Internal Revenue Service rulings and private letter rulings affecting international taxation.

II. TREATIES

A. Terminations

1. The United States stated on June 30, 1983, that it intended to terminate the extensions of the United Kingdom Treaty and the Belgium Treaty. This move affected treaties with eighteen countries: Anguilla, Barbados, Belize, Burundi, Dominica, Falkland Islands, Gambia, Grenada, Malawi, Montserrat, Rwanda, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines, Seychelles, Sierra Leone, Zambia and Zaire. The terminations were effective on January 1, 1984. The Treasury Department confirmed that the United States-United Kingdom Treaty as applied to Antigua and Barbuda had been terminated by the United Kingdom.

2. The United States terminated its tax treaty with the British Virgin Islands effective January 1, 1983. A new treaty had been negotiated with the British Virgin Islands by the Carter administration. Neither the Reagan administration's Treasury Department nor the Senate was happy with the antitreaty
shopping provision included in the new treaty, however. Because revised language could not be agreed upon, the United States terminated the existing treaty.

3. As of early 1984, the only treaty extension will be the extension of the 1948 Netherlands Treaty with the Netherlands Antilles.

B. Ratifications

1. The U.S. Senate ratified new tax treaties with Australia and New Zealand. Instruments were exchanged and these treaties are now in effect.

2. The Senate also ratified the Mutual Exemption Agreement with the People’s Republic of China, involving taxation of income from shipping and air transportation.

C. Negotiations

1. The United States and the People’s Republic of China completed a second round of negotiations on a comprehensive income tax treaty.

2. Negotiations are continuing on a new United States-Netherlands Antilles Tax Treaty. The parties have met many times and appear to be close to an agreement. Many foreign investors take advantage of the existing treaty to channel investment into the United States. In addition, many U.S. companies rely on this treaty when borrowing funds abroad to avoid incurring U.S. withholding tax on interest payments. Congress has introduced bills which would eliminate the 30 percent withholding tax on interest paid by foreign sources. Under these bills it would not be necessary for U.S. corporations to establish Netherlands Antilles finance subsidiaries to avoid the withholding tax on foreign interest income. The Treasury Department supports the repeal of the withholding tax on foreign interest payments to portfolio investors.

D. United States-Canada Protocol

1. The United States and Canada signed a protocol on June 14, 1983, to the pending 1980 tax treaty. 2 Tax Treaties (CCH) ¶ 9942 (July 1983). The 1980 treaty has not been ratified by the U.S. Senate because of a number of concerns, including provisions dealing with taxation of real property. Moreover, the 1980 treaty had been negotiated before the Foreign Investment in Real Property Tax Act (FIRPTA) was enacted and was inconsistent with FIRPTA in some provisions.
2. The protocol amends the 1980 treaty provisions dealing with taxation of real property. Canadian investors now will be subject to the entire set of FIRPTA provisions. The protocol provides that "in the case of real property situated in the United States, 'real property' means a United States real property interest and real property referred to in Article VI (Income from Real Property) situated in the United States." 2 Tax Treaties (CCH) ¶ 1317P Art. VII(1) (July 1983). Article VI of the Convention provides that "real property" shall be defined as it is under the taxation laws of the contracting state in which the property in question is located and shall include options or similar rights.

3. The protocol provides a transitional rule for Canadian residents who owned U.S. property on September 26, 1980. The appreciation of the property realized between September 26, 1980, and December 31 of the year in which the treaty becomes effective will not be subject to U.S. tax. This exemption does not apply to real property owned on September 26, 1980, which was part of the business property of a permanent establishment in the United States. The provision does apply, however, to real property acquired after September 26, 1980, if the property was acquired in a nonrecognition transaction.

4. Other provisions of the treaty were also amended.
   a. Permanent establishment status was expanded to include installation of drilling rigs or ships used to explore for or exploit natural resources, if used for more than three months in any twelve month period.
   b. The royalty provision was amended to clarify the scope of the copyright royalty exemption. The amendment also applies to gains from the alienation of intangible property rights described in Article XII (4), to the extent that such gains are contingent on the productivity, use or subsequent disposition of such property or rights.

5. The protocol also includes a number of miscellaneous and antiavoidance rules, including tougher antitreaty shopping rules in Article XXIX (6).

E. United States-France Protocol
A new protocol to the existing United States-France Treaty was released on October 6, 1983. The protocol includes a partial exemption from French wealth tax for U.S. citizens who live in France and own assets outside of France. Modifications were
made to the treaty interest provisions and antitreaty shopping provisions were added.

F. Case Law Development
The Tax Court in Estate of Burghardt v. Commissioner, 80 T.C. 33 (1983), held that the United States-Italy Estate Tax Treaty included the unified credit. In Burghardt a significant portion of the gross estate of a nonresident alien who died in Italy was in the United States. The estate argued that no U.S. taxes were due because the estate was allowed a unified credit. Under Article IV of the treaty, nonresident aliens of the member countries are allowed a pro rata "specific exemption equal to a proportion of the specific exemption that would have been allowable if the decedent had been domiciled in the taxing country." The term "specific exemption" is not defined in the treaty. The Tax Court held that the term includes a unified credit which was added to the Tax Code in 1976 to replace the $60,000 specific exemption.

G. Private Letter Rulings
In LTR 8320031 and its underlying GCM 38989 (January 14, 1983), the Service issued rulings under the United States-Canadian Treaty relating to FIRPTA. The ruling and GCM dealt with the sales of stock of U.S. subsidiaries by Canadian corporations. The U.S. corporations were U.S. real property holding corporations under I.R.C. § 897. Gain on the stock sales was exempt under treaty Article VIII (which exempts gain on the alienation of capital assets), even though the corporations might be "collapsible" under I.R.C. § 341. The ruling and GCM also concluded the gain on the sale of the stock is derived in the United States (which is necessary under Article VIII), even though the sale may occur in Canada. This conclusion was based on logical analysis and treaty history. Finally, the ruling and GCM stated that the transfer of assets pursuant to a liquidation under I.R.C. § 336 constitutes a sale or exchange to the liquidating corporation. Thus, Article VIII applied to exempt tax from FIRPTA in a § 336 liquidation.

III. INVESTMENT IN THE UNITED STATES

A. FIRPTA
Temporary and proposed regulations under FIRPTA were published on September 21, 1982. They do not cover the rules that apply to corporate distributions (I.R.C. § 897(d)), the nonrecognition and reorganization provisions (I.R.C. § 897(e)) or
the provisions concerning partnerships, trusts and estates (I.R.C. § 897(g)). They do, however, cover definitional aspects, reporting requirements and the I.R.C. § 897(i) election. Revised proposed regulations under I.R.C. § 897 (but not I.R.C. § 6039C) were issued on November 3, 1983. The revised proposed regulations are a substantial improvement over the first set of regulations. They address many of the unclear and burdensome provisions found in the first regulations. Highlights include:

1. An “interest in real property” is defined to include among other things:
   a. unharvested crops, uncut timber, mines, wells and other natural deposits. Minerals and natural deposits cease to be real property when extracted; crops and timber cease to be real property when severed;
   b. fee ownership, co-ownership or leasehold interests in real property, a life estate or any other right to share in appreciation in value of, or in gross or net proceeds or profits from, real property;
   c. the right to installment or other deferred payments from the disposition of a real property interest; and
   d. a direct or indirect right to share in the appreciation in value of a stock interest (such as an interest in phantom stock or in stock appreciation rights) and a right to convert or exchange an interest which would otherwise constitute a permitted interest “solely as a creditor” into a U.S. real property interest.

2. Regulations which establish that a U.S. corporation is not a U.S. real property holding corporation (USRPH) have been substantially amended. Foreign persons are required only to ask the domestic corporation whether it is a USRPH and obtain a written statement of the answer.

3. The I.R.C. § 897(i) Election
   a. The I.R.C. § 897(i) election permits certain foreign corporations to elect to be treated as domestic corporations.
   b. The election cannot be made if any interest in the foreign corporation was disposed of before the election, unless there was a payment of tax.
   c. The election is effective only for I.R.C. §§ 897 and 6039C.

4. Reporting Requirements
   a. FIRPTA information returns must be filed no later than
May 15 of the calendar year following the calendar year to which the returns relate.

b. Form 6659 must be filed by domestic corporations and certain nominees. Information concerning the names and addresses of all foreign persons who held an interest in the corporation during the year, the amount and types of interests they held, all dispositions of interests, distributions of U.S. real property interests to foreign persons and other information must be filed. A domestic corporation is only required to supply the information if it is "known" to the corporation.

c. Form 6660 must be filed by foreign corporations and by domestic or foreign partnerships, trusts or estates.
   1) Form 6660 must be filed if, on any applicable determination date during the calendar year, an entity has a substantial investment in U.S. real property and does not have a security agreement with the IRS in effect for the calendar year.
   2) If the entity cannot obtain the required information, it must provide security and enter into a security agreement with the IRS.

d. Form 6661 must be filed by foreign persons holding U.S. real property interests. An exemption is provided to persons who enter into security agreements with the IRS.

e. A security agreement may be entered into in lieu of filing Forms 6659, 6660 and 6661. The IRS has absolute discretion to determine the type and amount of security required. The security must be adequate to secure payment of income taxes which could be imposed on the filer or an owner of an interest in the filer. Types of security include, but are not limited to, liens, escrowed property, letters of credit, surety bonds and evidence of binding voluntary withholding agreements. A written personal guarantee may be accepted if substantial assets are located in the United States.

5. Postponement of Reporting Requirements

a. The original FIRPTA regulations provided that the application for security agreements for July 1982 and later years must be filed by January 30, and that statements to substantial investors must be filed by January 31 for 1982 and later years. In January the IRS delayed these
requirements for 1982 to conform with the dates for the transitional years 1980 and 1981. Thus, applications for security agreements had to be filed before March 21, 1983, and substantial investor statements had to be mailed by February 21, 1983.

b. Due to the lack of detailed guidance as to what information needed to be included on the application for security, as well as the deluge of requests for security agreements, the Service, on March 17, 1983, postponed the requirement of security agreements and allowed people to withdraw applications already filed.

c. Finally, on April 27, 1983, all reporting requirements, applications for security agreements and substantial investor statements for 1980, 1981 and 1982 were postponed until the date established by final regulations. Issuance of final regulations was anticipated before June 15, but as of December 1, 1983, no final regulations had been issued.

B. Oil and Gas Investment

The IRS issued two interesting and helpful private letter rulings (LTR 8234091 and 8316109) concerning foreign investment in U.S. oil and gas interests.

1. The taxpayers sought rulings that a U.S. partnership's activities would constitute engaging in trade or business in the United States, and that their foreign limited partners' distributive shares of partnership income or loss would constitute income or loss effectively connected with the conduct of trade or business in the United States. The tax presumably would be less, and in some cases zero, if the income were effectively connected with a trade or business in the United States because deductions would be available. If the income was not effectively connected with a trade or business in the United States it might constitute "fixed or determinable annual or periodic income" (FDAPI); no deductions would be available and the partnership would be the withholding agent. LTR 8234091 concerned limited partners from a nontreaty country; LTR 8316109 concerned limited partners from the Netherlands. The facts of the rulings are the same.

2. The partnerships planned to acquire portions of working interests in oil and gas properties in the continental United States. They would then enter into joint operating agreements with the owners of other working interests in those properties.
An operator would be responsible for day-to-day direction and control of the oil and gas exploration and exploitation activities. Some of the properties would be farmed out pursuant to an agreement under which the party contracting with the partnership, the farmee, would agree to drill one or more oil and gas wells in exchange for the transfer of a working interest in specific acreage. The partnership, the farmer, would retain a royalty interest in the farmed-out property. The burden of drilling and development would be shifted to the farmee. Funds awaiting use in the business would be invested in fixed-income U.S. obligations.

3. In LTR 8234091 the IRS stated that "[t]he court cases hold that the activity of nonresident alien individuals (or their agents) in connection with owning domestic real estate that is beyond the mere receipt of income from rented property and the payment of expenses incidental to the collection of the rental income, places the owner in a trade or business within the United States provided the activity is considerable, continuous and regular." The ruling then concluded that the partnership in question would be engaged in business in the United States. I.R.C. § 875 attributes a partnership's trade or business status to its foreign partners. Accordingly, the foreign partners in the partnership were also considered to be engaged in business in the United States. In LTR 8316109 the IRS held that the limited partners would have permanent establishment in the United States by reason of the investments.

4. The foreign partners' distributive shares of partnership income or loss derived from U.S. oil and gas properties were held to constitute income or loss effectively connected with a trade or business in the United States. In LTR 8316109 the partnership income would be subject to tax under Article V of the treaty. The Service expressed no opinion with respect to income from farm-outs in LTR 8234091 but held such income to be taxable under Article V of the treaty in LTR 8316109. Both rulings expressed no opinion as to whether interest income from the temporary investment of the limited partners' capital contributions and income from farmed-out oil and gas properties would be effectively connected with the conduct of a trade or business in the United States. Although the rulings were generally favorable, the partnerships were left with the question as to whether they must withhold tax on the foreign
partners' shares of farm-out income and income from the temporary investment of excess funds.

5. LTR 8125067 is the partnership classification ruling issued to the same taxpayer in LTR 8316109. It similarly held that if the income was effectively connected with a trade or business in the United States, and each partner was engaged in business under I.R.C. § 875, then no withholding tax would be due under I.R.C. §§ 1441 and 1442, and each partner would be required to file a U.S. tax return. The Service declined to rule on tax preference (minimum tax) treatment under I.R.C. § 58(h).

IV. LEGISLATION

A. No major legislation affecting international transactions has been enacted in the past twelve months and none will be passed in 1983. A number of important bills, however, may be considered in 1984.

B. In July 1983 Ways and Means Committee Chairman Dan Rostenkowski (D-Ill.) and Congressman Barber Conable, Jr. (R-N.Y.) introduced the Tax Law Simplification and Improvement Act of 1983, H.R. 3475. This bill was included as part of the Tax Reform Bill of 1983, H.R. 4170, reported by the Ways and Means Committee, and contains provisions which would affect international transactions. Because of concerns with other provisions, the bill was not considered by the full House.

1. Residency test

   a. The tax code currently has no definition of a resident or nonresident. Treas. Reg. § 1.871-2 provides a test to determine if a person is a resident. The test is based upon the person's intention as to the length and nature of his or her stay. Residence depends upon whether an alien is a mere "transient or sojourner" in the United States.

   b. The bill would define "resident alien" for U.S. tax purposes. An individual would be a resident for any calendar year in which the individual is (1) a permanent United States resident at any time during the calendar year (the "green card" test); or (2) present in the United States for a substantial period of time—as many as 183 days during a three year period weighted toward the present year—but for at least 31 days during the year (the "substantial presence" test).
c. The bill would also provide rules to determine the beginning and termination of residency.

d. Certain individuals such as foreign government-related individuals, teachers, trainees and students who satisfy the substantial presence test would be considered nonresident aliens unless circumstances indicate that they intend to reside permanently in the United States.

2. Community Property Income of Nonresident Aliens

The bill would provide that a married couple, both of whom are nonresident aliens, would treat the earned income of one spouse as that spouse's income regardless of community property laws. Thus I.R.C. § 879 would extend to such couples.

3. Foreign Personal Holding Company Attribution Rules

a. The foreign personal holding company rules provide that U.S. citizens, U.S. residents and corporate shareholders of a foreign personal holding company are taxed on their pro rata share of the corporation's undistributed foreign personal holding company income. Attribution rules determine whether a foreign corporation is more than 50 percent owned by five or fewer U.S. citizens or residents. Foreign partnerships, trusts and corporations do not include foreign personal holding company income except that a foreign corporation shareholder includes its pro rata share as a dividend to determine whether it is a foreign personal holding company.

b. Under current law, the foreign personal holding company rules can be avoided by interposing a foreign partnership, a foreign corporation other than a foreign personal holding company or an estate or trust between a U.S. taxpayer and a foreign personal holding company. The bill would add a tracing rule to prevent U.S. taxpayers from avoiding the rules by interposing such an entity. The bill would provide that the stock of a foreign personal holding company owned by a partnership, estate or trust that is not a U.S. shareholder, or by a foreign corporation that is not a foreign personal holding company, would be considered for income inclusion purposes as being owned proportionately by the partners, beneficiaries or shareholders. A transitional rule for structures in existence on June 30, 1973, is included.
c. The bill would also change (for purposes of determining whether five or fewer U.S. citizens or residents own more than 50 percent of the stock) the rule that attributes ownership of stock actually owned by nonresident aliens related by blood to the U.S. person whose stock ownership is being tested. This issue is involved in the well-known case of Estate of Nettie S. Miller, 43 T.C. 760 (1965), in which the court strained to reach this result. There would, nonetheless, be attribution of ownership of stock actually owned by a nonresident alien to the alien’s U.S. spouse and partners.

4. Ordinary Income Treatment on Disposition of Stock of Certain Foreign Corporations
   a. When a U.S. citizen sells or exchanges stock of a controlled foreign corporation, some of the gain may be taxed as ordinary income rather than as capital gain. I.R.C. § 1248. The purpose of this rule is to deny capital gain treatment to income accumulated by foreign corporations that has not been taxed by the United States. The gain is treated as ordinary income only to the extent of post-1962 earnings and profits accumulated while the shareholder held the shares which were not previously taxed by the United States. In Rev. Rul. 71-388, 1971-2 C.B. 314, the IRS stated that even though the seller of stock had dividend treatment based on the earnings and profits of the controlled foreign corporation, its earnings and profits were not reduced by the amount of the dividend. Thus the earnings and profits remained subject to tax if actually distributed in the future. If the earnings and profits had borne foreign tax, the foreign tax credits could possibly be used again when the dividend was taxed a second time. This point, however, was not settled.
   b. The bill provides that to the extent accumulated earnings and profits have been characterized as ordinary income, the same earnings and profits would not again be characterized as ordinary income. Subpart F “previously taxed income” accounts would be established to effect this result. If an election is made, the effective date is October 9, 1975.

5. Coordination of Subpart F with Foreign Personal Holding Company Provisions
   a. Foreign personal holding company (FPHC) rules and
Subpart F both provide for U.S. shareholder taxation on certain passive income, thus creating an overlap in some situations. Where an overlap occurs the foreign personal holding company rules usually take priority. I.R.C. § 951(a). Some taxpayers have contended that if they are subject to the foreign personal holding company rules they are not also subject to the Subpart F rules for that year. Compare *Whitlock v. Commissioner*, 494 F.2d 1297 (10th Cir. 1974) (taxpayer liable for Subpart F tax even though the foreign personal holding company provisions apply) with *Lovett v. United States*, 621 F.2d 1130 (Ct. Cl. 1980) (no Subpart F tax due where the foreign personal holding company provisions apply). The issue becomes significant if a small amount of FPHC income can prevent a large loan to the U.S. shareholder from being taxed to the shareholder under I.R.C. § 956 (2)(H).

b. The bill would repeal the rule that taxation under foreign personal holding company rules precludes taxation under Subpart F by substituting a new mechanism for avoidance of double taxation. A controlled foreign corporation's Subpart F income would be taxed under Subpart F, but not under the foreign personal holding company rules, to the extent that it would be taxable under both provisions.

6. Stapled Stock

a. To avoid controlled foreign corporation status, some U.S. corporations have stapled foreign stock to domestic stock so that the stock cannot be sold separately. If the U.S. corporation is widely held, the foreign corporation will not be a controlled foreign corporation and thus not subject to Subpart F. U.S. corporate tax on the foreign earnings can also be avoided.

b. The bill would provide that where stapling occurs, the foreign corporation is treated as a domestic corporation. Entities currently stapled can elect to treat the foreign corporation as a subsidiary. The bill defines “stapled entities” to mean any group of two or more entities in which more than 50 percent in value of the beneficial ownership in each entity consists of stapled interests. Two or more interests would be stapled if, by reason of form of ownership, restrictions on transfer or other terms and conditions, the transfer of one of the interests also requires
the transfer of the other interest. This provision would be effective on the date of enactment with the exception that as to interests stapled on or before June 30, 1983, the amendment would not apply until January 1, 1985.

C. International Factoring

1. H.R. 3810 and S. 1804, the Foreign Sales Corporation Act of 1983, would add a new category of Subpart F income:

   "Income from trade receivables of related persons. Income from an account receivable or evidence of indebtedness arising out of the disposition of property described in § 1221(1), or the performance of services, by a related person (within the meaning of § 954(d)(3))."

2. The proposed legislation would also amend § 956(b) by adding the following new paragraph:

   "Trade receivables of related United States persons. Notwithstanding [§ 956(b)(2)], the term 'United States property' includes an account receivable or evidence of indebtedness arising out of the disposition of property described in § 1221(1), or the performance of services, by a United States person who is a related person (within the meaning of § 954(d)(3))."

3. These changes would effectively eliminate most related-party international factoring transactions.

4. The DISC-substitute provisions are discussed below at VI.

5. H.R. 4170 would also expand I.R.C. § 267 to provide that factoring discounts could no longer be deducted.

D. Construction Companies' Foreign Tax Credits

S. 1550 would allow U.S. construction firms to deduct as a business expense foreign tax imposed on U.S. construction contract services. The purpose of the bill is to cure the foreign tax credit limitation problem that arises when a foreign country taxes construction contract services performed in the United States.

E. Losses and Foreign Tax Credit Carryovers

1. S. 1584 would conform the treatment of overall domestic losses to the treatment accorded overall foreign losses. It would enact a mirror image of I.R.C. § 904(f) to allow a company to recapture domestic losses by recharacterizing subsequent domestic source income as foreign source income.

2. The bill would also extend the foreign tax credit carryover period to fifteen years (foreign tax credits were seemingly overlooked when other credits' carryover periods were
extended by recent legislation). Moreover, it would conform the FTC's carryover "ordering" rules to follow other credit carryover ordering rules. Thus it would permit foreign tax credits to be used in the order earned, rather than requiring the current year's credit to be claimed before a carryover can be used.

F. International Leasing
1. S. 1564 and H.R. 3110 would deny investment tax credits and limit Accelerated Cost Recovery System (ACRS) depreciation benefits in certain international leasing transactions.
2. The Treasury Department recommended, when testifying on S. 1564, that the proposed rules be modified so that lease financed exports of U.S. manufactured goods are not adversely affected.
3. The Treasury Department has also recommended that the bill's limitations be applied—with certain stated exceptions—where a U.S. citizen leases foreign-produced property to a foreign person subject to not more than a de minimis amount of U.S. tax. The Department stated that the transfer of tax benefits in such a situation "is clearly unjustified by tax or economic policy."

G. Thirty Percent Withholding Tax on Portfolio Interest
H.R. 3025 and S. 1557 would repeal the 30 percent withholding tax on portfolio interest.

H. I.R.C. § 267
H.R. 4170 would expand I.R.C. § 267 to apply to loss sales between a U.S. corporation and its foreign subsidiary, even if the loss was otherwise allowable under I.R.C. § 482. It would also affect DISC's, factoring and related-party expenses.

V. UNITARY TAX
A. In Container Corp. of America v. Franchise Tax Board, — U.S. —, 103 S. Ct. 2933 (1983), the United States Supreme Court approved California's unitary method of apportioning the income of multinational corporations for state corporate income tax purposes. The decision will have important ramifications.
B. California requires domestic corporations to pay franchise taxes based on the income generated within California. A three factor apportionment formula, based on property, payroll and sales of the corporation is used to determine the proportion of the corporate income attributable to California operations. If a
corporation has out-of-state subsidiaries deemed to be in a unitary business, their factors and income are included in the formula.

C. Container Corporation (Container) challenged California’s unitary tax method as a violation of the Due Process and Commerce Clauses of the Constitution. The Court stated that under the Due Process clause a state formula for apportioning income of a unitary business must be fair. Fairness, according to the Court, has two components: internal consistency and external consistency. Internal consistency means that if the formula was applied by every jurisdiction, no more than 100 percent of the unitary’s business income would be taxed. External consistency means that the formula actually reflects a reasonable sense of how income is generated. An apportionment formula may not discriminate against interstate or foreign commerce.

D. Container first contended that its subsidiaries did not constitute part of a unitary business. The California Court of Appeals agreed with the California Franchise Tax Board that Container and its subsidiaries constituted a unitary business. The United States Supreme Court stated that, if reasonably possible, it would defer to the judgment of state courts in deciding whether a particular set of activities constitutes a unitary business. The Supreme Court would not adjudicate the issue de novo, but would determine whether the state court applied the correct standards and, if so, whether its judgment “was within the realm of permissible judgment.” The Supreme Court determined that the California Court of Appeals decision was within the realm of permissible judgment.

The factors determining status as a unitary business were as follows:

1. Container’s officials established standards of professionalism, profitability and ethical practices to be observed by its foreign subsidiaries.

2. Container and its subsidiaries were engaged in the same line of work raising a permissible presumption that the operations complemented one another through more efficient use of Container’s resources.

3. There was a substantial “flow of value” from Container to its foreign subsidiaries as evidenced by:
   a. assistance in obtaining equipment and personnel;
   b. loan guaranties;
   c. direct loans at below market rates; and
d. technical assistance.
The Court felt that these factors distinguished *Container Corporation* from *ASARCO v. Idaho Tax Comm'n*, — U.S. —, 102 S. Ct. 3103 (1982) and *F.W. Woolworth Co. v. Taxation and Rev. Dept.*, — U.S. —, 102 S. Ct. 3128 (1982) in which businesses were found not to be unitary.

E. Container also asserted that the apportionment formula was unfair because there was no rational relationship between income attributed to California and the intrastate value of the enterprise. Container tried to show that foreign wage rates were lower and that consequently the formula unfairly inflated the income apportioned to higher wage U.S. operations. The Court stated that California payroll and other factors which may contribute to the profitability of the foreign production would not be reflected in Container's accounting. Although all apportionment formulas, even the three-factor formula, are necessarily imperfect, the Court found no evidence demonstrating that the margin of error inherent in the three-factor formula is greater than the margin of error inherent in the separate accounting urged by Container. Thus, the formula was not so unreasonable as to reach profits which were in no way attributable to transactions within California.

F. The Court then had to determine whether the apportionment method violated the Commerce Clause. Container argued that the method increased the risk of double taxation and impaired federal uniformity in an area where such uniformity is essential.

1. The Court stated that although there is no absolute rule against double taxation in the foreign commerce context, it deserves closer scrutiny. Double taxation, if it exists, depends on the facts of the particular case. Furthermore, the Court determined that double taxation would not be eliminated by adoption of an arm's-length method of pricing. The Commerce Clause does not require "simply for the sake of avoiding double taxation . . . California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation."

2. In determining whether application of the apportionment method would impair federal uniformity and prevent the government from speaking with one voice in international trade, the Court deferred to Congress and the Executive Branch. The Court noted that the Executive Branch did not
file an amicus curiae brief in the case, and that this fact, combined with other considerations, suggested that U.S. foreign policy was not seriously threatened by California's decision to apply the unitary method. Moreover, the Court observed that U.S. tax treaties did not cover tax activities of subnational government units. Congress had debated the unitary tax issue and had not enacted any legislation. Thus, the Court could not conclude that the California tax was preempted by federal law or inconsistent with federal policy.

G. The Court specifically stated that it did not decide the situation where a foreign parent company is involved. (See K below.)

H. The dissent thought that California's unitary tax was contrary to the Commerce Clause. It argued that California's apportionment method inherently leads to double taxation which, if the arm's-length method was applied, could be avoided if jurisdictions resolved their different applications of the method. The dissent also argued that the unitary tax seriously implicates a foreign policy which must be left to the federal government because in actuality the tax is imposed on the income of foreign subsidiaries and therefore discourages U.S. investment in foreign countries. The dissent also argued that the California tax would be unconstitutional as applied to foreign-based multinationals due to discrimination in taxation between domestic and foreign multinationals.

I. Business groups are lobbying for congressional action to prohibit the use of the world-wide combined reporting method. The groups include the National Association of Manufacturers, the U.S. Chamber of Commerce, the National Foreign Trade Council and the Committee on State Taxation. The United Kingdom is also involved in an effort to persuade the U.S. government to join Container Corporation in its petition. The United Kingdom campaign is being spearheaded by a group of forty multinationals. Canada's Minister of Finance, Marc LaLonde, wrote to Treasury Secretary Regan to express concern about the unitary tax. The Japanese government has also expressed opposition to the unitary tax. The Netherlands reportedly refused to sign a new treaty until the unitary tax issue is resolved. Its Administration rejected the "water's edge" approach of its Cabinet council and formed a task force of state and industry representatives to achieve a solution. In contrast, after the Court's Container decision, Florida adopted a unitary system of taxation similar to that of California.
Two foreign based multinationals filed suit objecting to California's unitary tax.

1. Alcan Aluminum Ltd., a Canadian corporation, filed suit in New York on the grounds that the unitary tax method is unconstitutional, and sought declaratory and injunctive relief. The Franchise Tax Board moved to dismiss, but Alcan argued that neither it nor its subsidiary could raise the Commerce Clause claims in state court. In May 1982 the court ordered Alcan's action stayed pending the outcome of the Container Corporation case. The court refused to dismiss the suit under the Anti-Injunction Act, based on the Ninth Circuit's holding in Capital Industries-EMI Inc. v. Bennett, 681 F.2d 1107 (9th Cir. 1982), which held that California courts did not provide a remedy to a foreign parent corporation. The court subsequently dismissed the case for lack of standing. The Second Circuit affirmed. Alcan intends to file a petition for certiorari with the Supreme Court and has urged the Reagan administration to support its petition.

2. Shell Petroleum N.V. also filed suit objecting to the unitary method. The California Franchise Tax Board requested information from Shell when auditing two of its subsidiaries, Shell Oil and Scallop Holding Inc. Shell Petroleum sued to prevent California from assessing taxes against Shell Oil and Scallop. The district court dismissed for lack of standing and because the controversy was not ripe. The Ninth Circuit affirmed on June 30, 1983. Shell Petroleum, N.V. v. Graves, 709 F.2d 593 (9th Cir. 1983). The Ninth Circuit held that Shell Petroleum did not suffer direct injury independent of its subsidiaries, and therefore rejected Shell's claim that it had standing under the United States-Netherlands Treaty of Friendship, Commerce and Navigation. Shell would have had standing to sue if it were a domestic corporation and the treaty put it in the same position as a domestic corporation. Shell has also filed for Supreme Court review.

VI. DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISC)

A. Ever since the DISC provisions were enacted in 1971, countries in the European community have argued that DISC violates the General Agreement of Tariffs and Trade (GATT). After many discussions and reports, the United States finally decided in 1982
to eliminate DISC and replace it with a GATT-legal substitute. As mentioned previously, on August 4, 1983, H.R. 3810 and S. 1804 (Foreign Sales Corporation Act of 1983) placed the Administration’s proposal before Congress.

1. The proposal replaces DISC with a foreign sales corporation (FSC) which would be effective for taxable years beginning on or after January 1, 1984. To qualify as an FSC, the corporation must be incorporated outside of the United States, although it may be incorporated in Guam, the Virgin Islands, the Commonwealth of Northern Marianas or American Samoa. The corporation must also
   a. maintain an office outside the United States;
   b. maintain a summary of its permanent books at its foreign office, although complete books and records must be available in the United States;
   c. have at least one director who is a nonresident of the United States; and
   d. hold a distribution license or sales agency agreement with respect to products purchased from or sold on behalf of a related supplier. The corporation must also file an election to be treated as an FSC.

2. An FSC will be exempt from U.S. tax on a portion of income from its export sales. Foreign trading income is defined as gross income attributable to foreign trading gross receipts. Foreign trading gross receipts are similar to qualified export receipts of a DISC except that foreign trading gross receipts do not include dividends from foreign export corporations, interest on any obligation which is a qualified export asset or gross receipts from the sale or exchange of qualified export assets. FSC export property is essentially the same as DISC export property. Foreign trading gross receipts do not include interest, dividends, income from intangibles or other types of investment income.

3. An FSC has foreign trading gross receipts only if management of the corporation takes place outside the United States and only if the economic processes with respect to a transaction also take place outside the United States.
   a. Management of an FSC takes place outside the United States if:
      1) all board of directors’ and shareholders’ meetings occur outside the United States;
2) the principal bank account is outside of the United States; and
3) all dividends, legal and accounting fees and salaries of officers and directors are disbursed from bank accounts maintained outside of the United States.

b. Economic processes take place outside the United States if for any transaction:
   1) the corporation has participated outside the United States in the solicitation, negotiation or making of the contract relating to the transaction; and
   2) the foreign direct costs equal or exceed 50 percent of the total direct costs incurred by the FSC in connection with the transaction.

c. An alternative to the 50 percent test exists if 85 percent of the direct costs attributable to at least two of the following activities are incurred by the FSC:
   1) advertising and sales promotion;
   2) processing customer orders and arranging for delivery (outside the United States);
   3) transportation of the product from the time of acquisition by the FSC to delivery to the customer;
   4) determination and transmittal of a final invoice or statement of account and receipt of payment; and
   5) assumption of credit risk.

d. The requirements that economic processes occur outside the United States is intended to make an FSC GATT-legal. Under GATT there is no illegal export subsidy if the processes generating the income occur outside the exporting country.

4. According to the December 1982 GATT understanding, arm’s-length pricing principles must govern transfer of export property from a U.S. supplier to its related FSC. For administrative convenience, however, a taxpayer may use one of two pricing rules for allocating income to the FSC. An FSC may earn the greater of (a) 1.83 percent of foreign trading gross receipts derived from the sale of export property or (b) 23 percent of combined taxable income of the FSC and the person which is attributable to foreign trading gross receipts derived from the FSC’s sale of property. An FSC may use these administrative rules only if all of the activities described above in 3.c. and all of the activities relating to solicitation,
negotiation and making of the sales contract have been performed by the FSC or by another person acting under contract with the FSC. Income earned by an FSC using the 1.83 percent method may not exceed 46 percent of the combined taxable income of the FSC and its related supplier.

5. Exempt Foreign Trade Income
   a. The exempt foreign trade income of an FSC is treated as not effectively connected with the conduct of a trade or business in the United States. All foreign trade income other than exempt foreign trade income, all interest, dividends, royalties and other investment income and all carrying charges received by an FSC shall be treated as effectively connected with the conduct of a trade or business conducted through a permanent establishment in the United States.

   b. If the administrative pricing rules are used, the exempt foreign trade income of an FSC is 17/23 of its foreign trade income. If arm's-length pricing under I.R.C. § 482 is used, the exempt foreign trade income of an FSC is 34 percent of its foreign trade income. Consequently, an FSC must file a U.S. tax return and will pay U.S. tax on a portion of its income.

   c. Distributions made by an FSC to its shareholders shall first be charged against earnings and profits attributable to foreign trade income, and a 100 percent dividends received deduction will be allowed under I.R.C. § 245. Thus, the exempt foreign trade income is not taxed to the FSC when earned, nor is it taxed to shareholders when distributed.

6. The qualified asset test for DISC's is not carried over to FSC's. An FSC may therefore invest in any type of property. See, however, note 9 below concerning purchasing trade receivables.

7. A jointly controlled group of corporations may not have both an FSC and a DISC. DISC's remain available to small exporters. Accumulated DISC income generated after 1983 will be subject to an interest charge, however, at a rate equivalent to the average investment yield of U.S. treasury bills with 52 week maturities auctioned during the one year period ending September 30. The I.R.C. § 995 (deemed distribution) rules are modified: before, 57.5 percent of the DISC's taxable income (in addition to other special types of
income) was deemed distributed; now, however, the taxable income attributable to qualified export receipts in excess of ten million dollars is deemed distributed. Thus a DISC remains a viable option for corporations exporting less than ten million dollars of goods per year.

8. A DISC and an FSC must have the same taxable year as does the shareholder with the highest percentage of voting power. Most taxpayers had a DISC taxable year one month after the parent’s taxable year so the deemed distribution would be put in a different taxable year from the year in which the parent received a deduction for the commission paid. That practice would now be stopped. The legislation also proposes that all accumulated DISC income prior to December 31, 1983, be treated as previously taxed income; thus, tax deferral becomes tax forgiveness.

9. The legislation also contains provisions designed to curtail receivables factoring, discussed in section IV (C) above.

B. Several DISC cases have been decided during the past year. In *CWT Farms, Inc. v. Commissioner*, 79 T.C. 86 (1982), the Tax Court held that demand obligations under which a DISC is liable to its parent are not producer’s loans. Under DISC regulations, a producer’s loan must have a stated maturity date not more than five years from the date the loan was made. A demand obligation does not satisfy this requirement.

1. Because demand obligations are not producer’s loans, the DISC in *CWT Farms* did not satisfy the 95 percent qualified assets test.

2. There was also an issue as to whether the DISC satisfied the 60-day payment rule. Because the DISC allegedly had not done so, the IRS held that its commission receivable was not a qualified export asset. Because demand loans were held not to be producer’s loans the court did not decide this issue. The taxpayer, however, petitioned for a rehearing because it needed to know the amount of the deficiency distribution which was affected by whether the commission receivable was qualified or unqualified.

3. The rule requiring payment of a commission to the DISC by its related supplier within sixty days was considered reasonable by the *CWT* court at the rehearing. The court also determined that it was fair to apply the regulation retroactively to CWT
Farms, because the regulation had been published in proposed form prior to the time of payment.

4. The CWT Farms case represents the only case relating to DISC's which the IRS has won.

C. In Durbin Paper Steel Company v. Commissioner, 80 T.C. 252 (1983), the Tax Court held the DISC regulation that only money or property (other than a note) must be paid for DISC stock to be invalid. The regulation provided that property received by the DISC in return for its stock does not include a note or other evidence of indebtedness if a shareholder is the obligor. The court also held that the requirement that a DISC must maintain a bank account is invalid because the statute nowhere required that a corporation keep a separate bank account to qualify as a DISC.

D. Probably as a result of lost court battles, in November 1982 the IRS modified Treas. Reg. § 1.933-1(1) so that it no longer requires a written supplier's agreement to use the safe harbor pricing methods for a DISC under I.R.C. § 994.

VII. SECTION 367

A. New “Outbound B” Regulations
The Treasury Department issued proposed regulations under I.R.C. § 367(b) on December 27, 1982. The regulations reversed the Service's position on transactions falling under both I.R.C. §§ 367(a) and 367(b). Temporary Treasury Regulation § 7.367(b)-4(b) provided that in the event of overlap between §§ 351 or 361 and the § 368(a)(1)(B) reorganization provisions, the transaction was to be considered a §§ 351 or 361 exchange; thus, a § 367(a) ruling had to be obtained. This regulation was criticized because the parenthetical in § 367(a) provided that § 367(a) was not to apply if stock or securities of a foreign gain are not recognized if (a) the shareholder treats the exchange under § 367(a), and (b) files a request for a finding that the transfer was not principally motivated by tax avoidance; or (c) if the exchange falls within 367(a)(2). Moreover, if the transferee corporation is a controlled foreign corporation after the transfer, and the exchanging shareholder is a U.S. shareholder of the corporation whose stock is exchanged both before and after the transfer, and of the transferee corporation after the transfer, no gain shall be included in income.

B. Section 367(a) Declaratory Judgments
1. The IRS issued an action on decision on November 15, 1982, in Kaiser Aluminum and Chemical Corp. v. Commissioner, 76
T.C. 325 (1981). Kaiser requested a § 367 ruling that the transfer of stock it owned in an Australian alumina producing corporation to another Australian corporation in which it held a 45 percent interest was not done principally for tax avoidance purposes.

2. The IRS issued an adverse ruling and Kaiser sued in Tax Court for a declaratory judgment. The court held in favor of Kaiser after determining that the stock of the Australian subsidiary required Kaiser to supply the subsidiary with a proportionate amount of bauxite capacity as well as a proportionate amount of operating expenses. In exchange, the shareholders received a proportionate amount of alumina processed from the bauxite. The subsidiary’s shareholders were prohibited from transferring their stock to another party without the permission of the other shareholders and the subsidiary’s debenture holders. The court found that the stock was not in the nature of a liquid or passive investment and thus the IRS erred in mechanically classifying it as stock within the meaning of the § 367 guidelines in Rev. Rul. 68-23, 1968-1 C.B. 21.

3. In the action on decision, the IRS recommended acquiescence in result only. The IRS agreed that tax avoidance was not the principal purpose of the transfer but it did not agree with the Tax Court’s reliance on the substantial evidence rule as the standard for reviewing § 367 determinations. The court’s standard for review was first set forth in Dittler Brothers, Inc. v. Commissioner, 72 T.C. 896 (1979), and has been applied in subsequent § 367(a) declaratory judgment cases.

C. The IRS proposed regulations under I.R.C. § 367(a) on December 27, 1982. The proposed regulations do not differ significantly from the current temporary regulations and the interpretation set forth in rulings.

D. The Tax Court recently decided Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983).

1. The IRS argued that tax was due on the transfer of a contract to manage a Saudi Arabian hospital to a Cayman Island subsidiary. The contract was preliminarily negotiated by the U.S. parent but the Cayman Island subsidiary conducted substantive negotiations and signed the contract. The court held that no transfer occurred because no legally enforceable rights were transferred to the subsidiary.
2. The court, however, allocated 75 percent of the subsidiary's profits to the U.S. parent because the subsidiary used the parent's intangibles and the parent performed services for the subsidiary.

VIII. AGE OF DISCOVERY

A. If the age of discovery of evidence in tax cases has not already arrived in the United States, it soon will. Discovery in international cases will undoubtedly be the subject of substantially increased IRS attention.

B. Toyota Motor Corporation

1. On February 4, 1983, the U.S. Justice Department filed a petition to enforce subpoenas against Toyota Motor Corporation, a Japanese parent corporation of a U.S. subsidiary, in federal district court (Los Angeles).

2. The information sought included direct and indirect costs of materials, labor and other expenses involved in the manufacture and sale of Toyota models in the Japanese home market, as well as retail pricing data on sales in Japan. The IRS sought marketing studies, evaluation of competition, distributor and dealer profit margins and other documents.

3. Toyota objected in part because it viewed the government's request as "the first instance . . . [in which] the IRS has claimed the right to inspect the books and records of a foreign-based parent firm of a U.S. subsidiary."

4. The subpoena enforcement proceeding prompted the Japanese foreign minister to threaten retaliatory action against U.S. companies doing business in Japan, on the floor of the Japanese Diet. The Japanese government protested through diplomatic channels on March 4, 1983, claiming that the U.S. Government's attempt to obtain Toyota's data violated international law.

5. On April 8, 1983, the district court held that it had jurisdiction over the Japanese parent company. *United States v. Toyota Motor Corp.*, 561 F. Supp. 354 (C.D. Cal. 1983). The court then denied the IRS's request for information which the court found either did not exist, was irrelevant to the audit or would be too difficult to retrieve. *United States v. Toyota Motor Corp.*, 569 F. Supp. 1158 (C.D. Cal. 1983).

6. On August 15, 1983, Toyota filed a notice of appeal and a motion for a stay to halt immediate enforcement of the
subpoena pending the appeal. On August 22, 1983, the Justice Department filed an appeal from the decision to the extent that it was denied access to certain information. Interestingly, the Justice Department indicated that it was determining whether or not to pursue the appeal. The district court denied the stay and the U.S. Court of Appeals affirmed the denial.


C. Marc Rich & Co., A.G.

1. Marc Rich & Co., A.G. is a Swiss corporation based in Zug, Switzerland that owns, among other things, stock in a subsidiary corporation doing business in the United States.

2. In March 1982 a federal grand jury in the Southern District of New York began investigating an alleged tax evasion scheme in which $20 million of 1980 taxable income was shifted from the subsidiary doing business in the United States to the Swiss parent company. On April 15, 1982, a grand jury subpoena addressed to the Swiss parent company was served on the subsidiary doing business in the United States. The Swiss parent moved unsuccessfully to quash the subpoena. The Second Circuit affirmed. 707 F.2d 663 (2d Cir. 1982), cert. denied, 103 S. Ct. 3555 (1983).

3. On June 29, 1983, the district court judge imposed a $50,000-a-day fine pending delivery of the documents. The judge had previously caused restraining orders to be served on several companies doing business with Marc Rich, ordering them to freeze up to $2.7 million of the Swiss company’s assets. Marc Rich paid at least $1.35 million in fines to the court. The company finally agreed to supply the records, but was discovered trying to take documents out of the United States to Switzerland. See New York Times, Aug. 15, 1983, at A1, col. 6; Wall Street Journal, Aug. 15, 1983, at 3, col. 2.

4. On July 5, 1983, the Swiss Ambassador met with officials from the State and Justice Departments and urged U.S. attorneys to follow procedures for bilateral cooperation. On July 22, 1983, the Swiss government sent a diplomatic note expressing concern about the Marc Rich case. The Swiss government finally seized the documents from the company’s Swiss headquarters and stated that it would not release them without

5. In September 1983 Marc Rich, Pincus Green and the subsidiary were indicted for tax fraud. On October 25, 1983, the district court upheld a $90 million jeopardy assessment.


7. The courts of three countries, two governments, and a grand jury, then, are involved in what is essentially a transfer pricing case.

D. Governmental Treaty Shopping

In United States v. Bache Halsey Stuart, Inc., 563 F. Supp. 898 (S.D.N.Y. 1982), aff'd in an unreported decision (2d Cir. 1982), a federal district court enforced a subpoena issued by the IRS, pursuant to the United States-Netherlands Tax Treaty, in connection with the Netherlands' efforts to determine the tax liability of a Dutch resident. The Dutch government sought information pertaining to a Swiss bank account that it presumably could not obtain under the Netherlands-Switzerland Treaty. The case can only be described as governmental "treaty shopping."

E. No Discovery Permitted Where Foreign Law Violated

1. In United States v. First National Bank of Chicago, 699 F.2d 341 (7th Cir. 1983), the Seventh Circuit denied enforcement of an IRS subpoena directed to a U.S. bank seeking disclosure of certain records in the bank's branch in Athens, Greece.

2. The court held that the bank had adequately demonstrated that compliance would subject its employees to the risk of substantial criminal penalties under Greek law and that a balancing of competing interests weighed against compelling disclosure.

3. Although the court of appeals reversed the judgment of the district court, it remanded the case for consideration of an order requiring the bank to make a good faith effort to secure permission to make the information available.

4. The court distinguished an Eleventh Circuit case that reached a different result. In that case (1) the bank had not made a good faith effort to comply with the subpoena; (2) the grand jury was conducting both a tax and narcotics investigation, and
(3) under Bahamian law, disclosure with the customer's consent was not a criminal offense, and the Bahamian court's power to permit a disclosure was not to be as strictly limited. See United States v. Bank of Nova Scotia, 691 F.2d 1384 (11th Cir. 1982).

F. New § 982: Foreign-Based Documentation Requests
1. On July 6, 1983, the IRS issued guidelines for formal document requests under I.R.C. § 982. Regulations have not yet been issued.
2. Section 982, enacted under TEFRA, provides special rules for formal requests for discovery of foreign-based documentation. If the taxpayer fails to comply with the request, the court, in a civil tax proceeding, must bar introduction of evidence of the foreign-based documentation covered by the formal request.
3. The statute has a reasonable cause exception, but imposition by a foreign jurisdiction of civil or criminal penalties on the taxpayer (or any other person) for disclosing the requested documentation does not constitute reasonable cause. Internal Revenue Manual Transmittal 4233-24 (July 6, 1983), Exhibit 500-15.

G. Section 6038A
Section 6038A “Information With Respect to Certain Foreign-Owned Corporations,” requires that a domestic corporation controlled by a foreign corporation, or a foreign corporation engaged in trade or business in the United States, must furnish much new information. The yet-to-be-released form will require disclosure of the members of the reporting corporation's controlled group with whom the reporting corporation transacted during the taxable year.

IX. FOREIGN TAX CREDITS
A. New Creditability Regulations
On April 5, 1983, the IRS proposed the third set of foreign tax credit regulations published during the past four years, the first set published by the Reagan Administration. Prior versions had been strongly criticized. The most recent proposed regulations have been considered far more reasonable than the regulations proposed earlier. Issued in final form on October 12, 1983, the regulations took effect on November 14, 1983. The most interesting addition is a “dual capacity taxpayer” provision which applies primarily to extractive industry taxpayers. These
taxpayers, and others who receive a specific economic benefit, establish what portion, if any, of their payment to a particular foreign government is a tax. A foreign levy may then be split into creditable and noncreditable portions.

B. There have been a number of interesting IRS rulings regarding foreign tax credits.

1. United Kingdom
   a. LTR 8239019 stated that dividends paid by a United Kingdom subsidiary to its U.S. parent company—at least those paid prior to April 25, 1980, the effective date of the United States-United Kingdom Treaty—must be treated as paid from earnings and profits of the year for which the ACT offsets mainstream tax. If the ruling is indeed more than a transitional rule, it fails to follow Ex. 4 of the Treaty’s technical explanation, which uses the standard § 902 LIFO approach.
   b. LTR 8241009 dealt with U.S. tax treatment of payment for the use of group relief losses. It involved the U.S. subsidiary of a U.K. parent company and presumably also applies to a U.S. parent company with a U.K. subsidiary. The voluntary nature of the downstream payment caused it to be characterized as a contribution to capital.

2. Germany
   LTR 8303027, which took two and a half years to issue, held the German corporate tax to be creditable. The delay in issuing the ruling apparently occurred because an Organschaft was involved. The ruling discusses at length the refund aspect of the German split rate system. No opinion, however, was expressed with respect to § 902 computations.

3. Switzerland
   b. Rev. Rul. 76-39 dealt with the accruability of the Swiss National Defense Tax. The Swiss subsidiary’s tax for 1965 was based on 1965 income. The tax for 1966 was assessed on the basis of the average income for 1965 and 1966. Tax for 1967 and 1968 would be assessed on the basis of the same average income for 1965 and 1966. The revenue
ruling held that tax for 1967 and 1968 could not be accrued at year-end 1966, because all events had not yet occurred which fixed the fact and amount of the liability; the Swiss subsidiary might go out of business and not owe tax for those years.

c. Rev. Rul. 83-85 and LTR 8246001 concerned a Swiss subsidiary that incurred a loss in a later year. Even though Swiss tax was due, the fact that the company had a deficit in its earnings and profits account, as determined by application of U.S. tax principles, meant that the U.S. parent would not be able to claim a credit for Swiss tax paid in that year.

4. Italy

LTR 8323094 dealt with the status as creditable foreign income taxes of amounts paid under the recent Italian tax amnesty, where the U.S. taxpayer paid ILOR on royalties it received from Italian sources. The ruling held that this payment would not be considered payment of a “noncompulsory amount” under the temporary foreign tax credit creditability regulations.

C. In *Champion International Corp. v. Commissioner*, 81 T.C. 424 (1983), the Tax Court discussed computation of deemed paid foreign tax credits where the foreign subsidiary has a net operating loss. The foreign country allowed a net operating loss carryback, so Rev. Rul. 74-550 was distinguished. The court held that the denominator, as well as the numerator, in the § 902 fraction is reduced by the loss carryback, as the taxpayer had contended.

**X. TEFRA REVIEW**

**A. Dividend and Interest Withholding**

Section 3451 imposed a 10 percent withholding tax on payments of dividends and interest that generally would not, but sometimes could, apply to international transactions. The 10 percent withholding tax was later repealed.

**B. Puerto Rico Operations**

Major revisions were made to § 936, a “tax sparing” provision encouraging U.S. companies to manufacture in Puerto Rico. The revisions could have a material effect on the future of transfer pricing. Under § 936(h), profit split pricing can be used when the U.S. parent buys goods from its § 936 subsidiary. Regulations are expected to be issued shortly.
C. New Reporting Form
Several I.R.C. sections were amended to provide for the newly issued Form 5471 to be used in reporting foreign operations.

D. Section 6038A
New § 6038A was discussed above in Section VIII(G). It imposes a reporting obligation on domestic and foreign corporations engaged in business in the United States and controlled by a foreign person. Neither the form nor the proposed regulations have been published.

E. Foreign Partnerships
Regulations have not yet issued under new § 6031(f), which states:
"Except to the extent otherwise provided in regulations, in the case of any partnership, the tax matters partner [the general partner designated as the tax matters partner in regulations or the general partner having the largest profits interest] of which resides outside the United States or the books of which are maintained outside the United States, no loss or credit shall be allowed to any partner unless § 6031 [the partnership tax return filing requirement] is complied with for the partnership's taxable year in which such deduction or credit arose at such time as the Secretary prescribes by regulations."

F. Section 6046A
The new § 6046A return (similar to Form 959), when published, must be filed by any U.S. person who acquires an interest in a foreign partnership, disposes of any portion of an interest in a foreign partnership or whose proportional interest in a foreign partnership substantially changes.

G. New International Withholding System
There have been no developments under the TEFRA provision that states:
"Not later than 2 years after the date of the enactment of this Act [September 4, 1982], the Secretary of the Treasury or his delegate shall prescribe regulations establishing certification procedures, refund procedures, or other procedures which ensure that any benefit of any treaty relating to withholding of tax under sections 1441 and 1442 . . . is available only to persons entitled to such benefit." I.R.C. § 342.

H. Penalty for Understatement of Tax
Regulations proposed in March 1983 raise as many questions as they answer. "Substantial authority" or "disclosure" is necessary to avoid the penalty. Disclosure is not sufficient to avoid the
penalty in the context of a tax shelter, as defined. Moreover, in addition to substantial authority, the taxpayer must reasonably believe that the reported tax treatment was more likely than not the proper tax treatment.

I. **Section 338**
Regulations have not been proposed under § 338 which provides that a taxpayer may elect to treat a stock purchase as an asset acquisition. Due to many unanswered questions the IRS has sought taxpayer assistance in drafting regulations under § 338 applicable to international acquisitions.

J. **Section 982**
Section 982 governs requests for “foreign-based documentation,” as discussed above in Section VIII(F). The IRS Manual now contains guidelines, but regulations have not been proposed.

**XI. MISCELLANEOUS DEVELOPMENTS**

**A. Debt-Equity: Section 385 Regulations**

1. The Treasury Department’s proposed regulations on debt-equity characterization under § 385 were withdrawn in May 1983.

2. Treasury Department officials nevertheless maintain that the project could be resurrected. At an August 18, 1983, hearing, a Treasury official stated that “the future of the § 385 project is still under active review, and we are considering a number of alternatives.” Treasury officials have suggested that these alternatives include abandoning the project and asking Congress to repeal § 385, issuing a simplified version of the final rules and creating a number of safe harbors for small businesses or issuing regulations that primarily restate the statute’s broad guidelines.

3. At the hearing, disagreement became apparent:
   a. The American Bar Association “fully supports the view that the proposed revisions and the final rules should not be adopted.” The ABA’s chairman, however, also argued that the project should produce an end product. The American Institute of Certified Public Accountants also favors issuing regulations (with necessary simplification and clarification).
   b. Corporate sector testimony favored abandoning the project. The National Association of Manufacturers supports “withdrawal of the debt-equity regulations and does not encourage any further attempts by the Internal
Revenue Service to draft regulations.” The Tax Executives Institute agreed, urging the Treasury “to press for outright repeal of § 385.”

B. National-Standard: Characterization of Loss on Repayment of Foreign Currency Loan

*National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983), addressed characterization (capital vs. ordinary) of a loss incurred on repayment of foreign currency debt. The Tax Court held that the loss constituted an ordinary loss because the repayment of debt does not involve a sale or exchange. The IRS will undoubtedly appeal.

C. Subpart F

1. LTR 8317008 sets forth an important IRS pronouncement regarding § 954(b)(4)’s “not availed of to reduce tax” exemption from Subpart F income. LTR 8114015 was a previous landmark ruling that held that the taxpayer, an off-shore drilling company, had Subpart F service income. That ruling will undoubtedly be the subject of future litigation. In what presumably was a final effort to settle the case, technical advice was sought under Subpart F “not availed of to reduce tax” provisions.

2. LTR 8317008 dealt with three alternative fact patterns involving a controlled foreign corporation (CFC) organized in country Z (assume country Z is Bermuda) that receives foreign base company services income in country Y (assume country Y is in the Middle East).
   a. The CFC pays no taxes to country Y pursuant to a tax holiday.
   b. Country Y taxes are paid by an unrelated person who hires the CFC to perform oil drilling services.
   c. Country Y selectively enforces its tax and does not enforce it against the CFC.

3. The IRS started its analysis by citing Rev. Rul. 82-226, 1982-2 C.B. 156, and stating that the term “item of income” for § 954(b)(4) purposes means any income the receipt of which can be distinguished from other income on the basis of source, underlying transaction or any other meaningful aspect. Determining what constitutes an “item of income” is important in determining the effective rate of tax under § 954(b)(4) mechanical tax rate comparison tests. The ruling also states that the phrase “all the income of the corporation”
refers to all the income of the CFC, from whatever source derived.

4. LTR 8317008 states that the effective rate of actual tax is determined by dividing the total income taxes paid to all foreign countries, with respect to the item of income by the amount of the item of income, taking into account all deductions properly allocable thereto. The CFC's "hypothetical" tax (for purposes of the mechanical tax rate comparison test) is determined by dividing the hypothetical income tax that would have been imposed on the item of income under the regulation's factual assumptions by the amount of the item of income, also taking into account all deductions properly allocable thereto.

5. The IRS next addressed the situation in which no taxes are paid due to a tax holiday. The ruling states: "The critical question is whether a country Y corporation would be eligible for the same or similar tax holiday" in determining the hypothetical tax that would have been paid if the Bermuda company were a country Y corporation. (One of the regulation's "income assumptions" for computing hypothetical tax is that the Bermuda company is a country Y corporation).

6. Assume that country Y is Saudi Arabia. The Bermuda company could qualify for an exemption from Saudi Arabian tax if it were engaged, for example, in construction activity through a 75 percent owned Saudi Arabian limited liability partnership, provided that the 25 percent minority interest is owned by a Saudi Arabian. Effecting a hypothetical reincorporation of the Bermuda company in Saudi Arabia, however, results in the "tax holiday" being unavailable because the company is 100 percent foreign-owned. On the other hand, the Bermuda company might be assumed to be only 75 percent non-Saudi Arabian owned following its hypothetical reincorporation. The regulations state that "actual facts" should be applied. Resolution of how "actual facts" should be applied in this situation is of critical importance in determining whether the "not availed of" rules offer relief.

7. LTR 8317008 does not discuss the hypothetical share-ownership question. It does resolve—unfavorably for the taxpayer—the question of whether the tax holiday's tax
exemption automatically carries over in computing the hypothetical tax. Qualification for the tax holiday must be retested.

8. When the CFC’s taxes are actually paid on the CFC’s behalf by an unrelated person who hires the CFC to perform oil drilling services, the taxes are considered paid by the CFC. Therefore the Bermuda company’s actual and hypothetical tax rates must be computed according to the assumption that the Bermuda company pays the country Y tax.

9. When country Y’s tax is selectively enforced, LTR 8317008 states:

"The hypothetical effective rate of tax is the amount [that the CFC] would have paid under the law of country Y assuming such law was enforced and making such other assumptions as to source, receipt, allocation of income, type of establishment, place of doing business, and place of creation, management, and control as provided in [Treas. Reg.] § 1.954-1(b)(3)(iii)(b)."

10. The results of such a calculation could be devastating: the actual tax might be zero, but the hypothetical tax could be substantial. This holding seems to clearly conflict with the "actual facts" provision in the regulations.

11. A subjective test also offers relief under I.R.C. § 954(b)(4). The test requires a showing that neither the creation of the CFC nor effecting the transaction had as a significant purpose a substantial reduction of income tax. LTR 8317008 holds that the effective U.S. tax rate that would have been imposed on the item of income had the CFC been incorporated in the United States may be relevant, depending upon the facts of the particular case. The letter states:

For example, if a CFC was performing off-shore drilling activities in an area in which no country exercised taxing jurisdiction, the effective rate of tax that would have been imposed with respect to an item of foreign base company services income by the United States would be relevant in determining whether the creation of the CFC or the effecting of the transaction through such corporation has as a significant purpose a substantial reduction of income taxes.
D. Section 1256(g): Foreign Currency Forward Sales Contracts

1. Under the Technical Corrections Act of 1982, signed into law in January 1983 certain foreign currency forward sales contracts are subject to §1256's marking to market and other rules, although regulations can exclude contracts "if [§1256's] application thereto would be inconsistent" with §1256 purposes. Unfortunately, the purpose of §1256(g) is not entirely clear. Section 1256 covers gains and losses from regulated futures contracts; certain other rules also apply.

2. H.R. 3805, the Technical Corrections Act of 1983, would amend §1256(g) to include contracts in currencies, in addition to those traded through regulated futures contracts. The Technical Corrections Act of 1982 brought only the latter type of contract within the purview of §1256.

3. This is an important new rule. It is unclear, however, whether or not it applies to corporate currency hedging contracts (which may not qualify as "hedging" in a tax sense). The Treasury Department recently sought taxpayer assistance in drafting regulations under §1256(g). The scope of the regulations could be very important.

4. Regulations have also not issued under §1256(g)'s sister provision, §1092, which denies a loss in the context of offsetting positions with respect to personal property.

   a. The Treasury Department should make it clear that this provision, enacted to eliminate tax deferral in commodities straddles transactions, does not apply to foreign currency transactions.

   b. The American Bar Association commented:
      
      The broad scope of §1092 might be interpreted as applying to foreign currency transactions to which it probably was not intended to apply . . . [R]egulations should be adopted under §1092 which make it inapplicable to foreign currency transactions which are ordinary and necessary in the conduct of a taxpayer's business, particularly those transactions which may otherwise be precluded by virtue of the interest and carrying cost capitalization requirements of §263(g) of the Code.

      Section 263(g) was part of ERTA's antistraddle legislation.
E. **General Counsel’s Memoranda Now Available**

1. Just as private letter rulings became available in 1977, General Counsel’s Memoranda [GCM] are now available. When the IRS Technical Branch requests a technical interpretation by the Chief Counsel’s Office, Interpretative Division, a GCM is written. Moreover, revenue rulings are often discussed in GCM’s prior to their publication. GCM’s can be enlightening: they usually are written in much greater detail than are private letter rulings.

2. More than one hundred pre-1982 GCM’s deal with international tax issues. They are reviewed in a British publication called *Taxes International*, beginning with the December 1982 issue.
   a. The history of the captive insurance company issue and developments concerning foreign tax creditability can be traced in GCM’s written during the 1970s.
   b. IRS views on back-to-back loans, the treatment of foreign losses for deemed paid foreign tax credit purposes, and numerous issues under Treas. Reg. § 1.861-8 (1979) (allocation of deductions for foreign tax credit limitation purposes), are discussed in GCM’s. The IRS’ new stance on the accruability of the Swiss Defense Tax, discussed in Section IX above, is discussed in GCM 36085 (November 18, 1974).
   c. GCM’s are now an important area of research for U.S. tax practitioners.

F. **Definition of “Trade or Business”**

1. Foreign corporations are subject to U.S. tax on income effectively connected with a U.S. trade or business.

2. Definition of the term “trade or business” is in a process of subtle change that has not yet affected international transactions.

3. The Tax Court adopted an expansive “all events” test in holding that a gambler was engaged in a trade or business for purposes of determining whether gambling losses constituted items of tax preference. *Ditunno v. Commissioner*, 80 T.C. 362 (1983). The court overruled *Gentile v. Commissioner*, 65 T.C. 1 (1975) (also involving a gambler), and held that “trade or business” status no longer requires “holding oneself out to others as engaged in selling goods and services.” Chief Judge Tannenwald dissented, stating that the court’s decision “will
wreak havoc on the concept of trade or business." *Ditunno*, 80 T.C. at 372.

a. LTR 8319044, for example, involved a foreign architectural/engineering consulting company. The company's administration is based in a foreign country and it performs the majority of its services in that country. All of its clients are located outside of the United States and it performs most of its work under contract with an entity in the country in which it is based.

b. Recently, however, the foreign corporation has had four nonresident alien employees performing services in the United States. Additional staff will be hired during the next year. The employees are stationed in the United States to work with a U.S. engineering concern performing other services for a common client under a contract to design a freeway system in the foreign company's home country. The foreign corporation will perform engineering services in the United States only for its home-country client. Services will not be rendered which result in compensation from United States enterprises.

c. The IRS refused to rule on whether the foreign company is subject to U.S. tax, *i.e.*, whether it is engaged in a U.S. trade or business, on the grounds that the issue involved a question of fact. The IRS does not rule on questions of fact.

d. Query what the effect of *Ditunno* will be on the foreign corporation involved in this letter ruling. The foreign corporation did not hold itself out to others in the United States as engaged in selling goods or services in the United States. But if gambling gives rise to a trade or business, perhaps this foreign corporation's U.S. activities do so as well. The effect of *Ditunno* is uncertain.

4. Investment Activities

Home office expenses were deductible in *Moller v. United States*, 553 F. Supp. 1071 (1982) in which a married couple maintained offices in two residences for the purpose of conducting investment activities. Each of the taxpayers kept regular office hours and devoted from 40-42 hours per week to investment activities. They were investors, not traders, but they were engaged in carrying on a trade or business. *Whipple v. Commissioner*, 373 U.S. 193 (1963), and *Higgins v.*
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Commissioner, 312 U.S. 212 (1941) were distinguished since the taxpayers in those cases did not conduct sufficient activity to constitute a trade or business.

a. Moller is significant in finding that investment activity, by itself, can give rise to a trade or business, albeit in the context of substantial investment activities.

b. There has been substantial foreign venture capital investment in the United States. What the effect of Moller on venture capital investments in the United States will be if substantial investment activity is associated with the investment (such as might be involved in partnership investments) is unknown.

G. Guam and the American Virgin Islands

1. In 1982 there was much discussion about using Guam as a vehicle for investing in the United States and as a new base for Eurobond offerings. (One publication even reported that a named investment banking firm had an “exclusive” on the use of Guam as a base for Eurobond offerings).


3. Certain U.S. tax groups disagreed with this approach and hearings were held. The American Bar Association, for example, recommended withdrawal of the regulation but stated that “as a policy matter, it is difficult to quarrel with the Treasury’s desire to eliminate this exception, particularly given Guam’s attempt to capitalize on it.”

4. Guam recently filed suit against the United States, seeking an injunction against application of the regulation.

H. Entity Characterization

1. Entity characterization continues to be an important area for tax practitioners. The well-known “limited liability company” regulations were withdrawn on April 4, 1983, with an announcement that “after consideration of these [public] comments, the Internal Revenue Service has decided to withdraw the proposed regulations. The [I.R.S.] is undertaking a study of the rules for the classification of entities for federal
tax purposes with special focus on the significance of the characteristic of limited liability.” 48 Fed. Reg. 14,389 (April 4, 1983). The limited liability company regulations, proposed on November 17, 1980, would have treated all entities with limited liability as corporations for U.S. tax purposes without regard to other criteria in § 7701 regulations.

2. A number of private letter rulings deal with entity characterization. LTR 8309062 involved a syndicated investment in U.S. real estate by German nationals. A Gesellschaft mit beschränkter Haftung (GmbH), or private limited liability company, was organized to acquire, construct, lease, sell and administer commercial real estate in the United States. The GmbH would own all assets acquired for described “business enterprises” and would sell silent participation interests to a trustee. The trustee in turn would make a public offering of the silent participation interest in Germany.

a. The IRS concluded that the arrangement would be classified as a partnership for U.S. federal income tax purposes because it lacked the corporate characteristic of limited liability. Furthermore, bankruptcy of the GmbH would cause dissolution of the arrangement by operation of German law.

b. Thus the ruling held that distributions to a participant would not constitute “dividends” paid by a German company to a nonresident alien within the meaning of Article XIV(1) of the United States-Germany Income Tax Treaty. Income from enterprise would represent income from real property situated in the United States and accordingly would be taxed pursuant to Article IX(1) of the Treaty.

c. The conclusion of partnership classification of the Stille Gesellschaft was subject to the requirements of Rev. Proc. 74-14, 1974-1 C.B. 436, and Rev. Proc. 72-13, 1972-1 C.B. 735, the “tax shelter” partnership classification.

d. The IRS had proposed issuing a prior version of this letter ruling as a revenue ruling. See GCM 38199 (December 14, 1979). The GCM recommended against it because the issue involved questions of German law that the IRS did not independently verify.
3. Irish Partnership
LTR 8309019 involved a U.S. parent company that structured its Irish operation by forming a subsidiary in "country B." The country B subsidiary in turn formed an Irish subsidiary. The two subsidiaries then formed an Irish partnership to manufacture goods in Ireland. The IRS ruled that the Irish partnership would be classified as a partnership for U.S. tax purposes. A prior ruling issued in 1982, LTR 8222012, held similarly.

I. Transfer Pricing
The Tax Court has not yet decided the widely anticipated Puerto Rico-related § 482 transfer pricing cases of Eli Lilly & Co., No. 5113-76 (T.C. filed June 9, 1976), and 19606-80 and G.D. Searle & Co., No. 12836-79 (T.C. filed Sept. 5, 1979). Decisions are expected any day, however.

J. Houdaille Industries' Petition re Japanese Trading Practices
1. Houdaille Industries petitioned the U.S. government to deny investment tax credits for Japanese-made machine tool goods under § 48(a)(7)(D), which empowers the President to eliminate eligibility for the investment tax credit if a foreign government discriminates against the United States by tolerating an international cartel or maintaining a nontariff trade restriction.
2. The Senate, in the closing moments of its 1982 session, passed a "sense of the Senate" resolution urging the President to act affirmatively on Houdaille's petition. The matter was the subject of articles in the Wall Street Journal, March 29, 1983, at 1, col. 6, and Business Week, April 11, 1983, at 34.
3. The Administration decided against Houdaille. Business Week reported that the Administration apparently feared retaliation by other countries which may begin using their own tax systems as a trade weapon. Business Week also reported that Japan unilaterally decided to curtail exports and raise prices on its machine tool products exported to the United States and the EEC.

K. Foreign banks: The "Offshore Booking Rule"
1. Treas. Reg. § 1.864-4(c)(5)(iii)(a) sets forth special rules for applying the "business activities" test to a banking, financing or similar business to determine whether a foreign corporation engaged in such a business in the United States has income effectively connected with that business.
2. This regulation can be important for foreign banks: it treats income earned by foreign banks as effectively connected with a U.S. trade or business only if the debt instrument is recorded on the books and records of the bank's U.S. office. Recording a loan on the books of the bank's foreign office prevents the income from being treated as effectively connected.

3. On November 4, 1982, the IRS proposed a revision of Treas. Reg. § 1.864-4(c)(5)(iii)(a) that would eliminate the "offshore booking" safe harbor.

L. McDermott Reorganization

1. The McDermott Group effected an interesting transaction that decontrolled its foreign subsidiaries for Subpart F purposes. The U.S. parent company's Panamanian subsidiary purchased the U.S. parent company's stock which is publicly held and traded on the New York Stock Exchange.

2. This reversed the parent-subsidiary relationship so that the U.S. parent company became one of the Panamanian company's subsidiaries and effectively decontrolled the Panamanian company's foreign subsidiaries by removing them from the reach of Subpart F.

3. McDermott, in its shareholder communication, stated:

   "The principal purpose of the reorganization is to enable the McDermott group to retain, reinvest and redeploy earnings from operations outside of the United States without subjecting such earnings to U.S. income tax. This will enable the McDermott group to compete more effectively with foreign companies by taking advantage of additional opportunities for expansion which require long-term commitments, the redeployment of assets and the reinvestment of earnings. The reorganization will also result in direct shareholder participation in the accumulated and future profits of [the Panama company] earned abroad rather than shareholder participation in such foreign earnings only after they are first distributed to [the U.S. parent company] and subjected to corporate income tax at a rate substantially higher than the average rate prevailing in the areas in which [the Panama company] operates. Finally, the reorganization will permit [the Panama company] to invest its accumulated foreign earnings in the United States without federal
income tax being imposed on the [U.S. parent] upon the making of such investment.”

4. The McDermott Group expects the IRS to assert that a deficiency of approximately $200 million is due as the result of a dispute about treatment of certain foreign earnings under Subpart F. In dispute are the 10 percent shelter of § 954(b)(3) and the Subpart F service income rules of § 954(e). The reorganization apparently is designed to prevent this type of exposure in the future.

5. Such a restructuring is not for everyone. McDermott’s stock was depressed so that shareholders, who participated in a taxable exchange, generally had losses. Moreover, the Panamanian company apparently had substantial operations and ownership of foreign subsidiary corporations.

M. Section 482: Hospital Corp. of America

1. Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983), dealt with a Cayman Island subsidiary that performed services managing a hospital in Saudi Arabia.

2. The IRS tried to allocate 100 percent of the subsidiary’s income to the U.S. parent company. The IRS argued that the parent’s reputation and expertise led to the contract and enabled the subsidiary to perform thereunder.

3. The court held that 75 percent of the subsidiary’s income should be allocated to the U.S. parent company.