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A Study of the CFC-Legislation  
in the United States and Its  
Compatibility With International  
Law

Master thesis  
20 points

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International Corporate Taxation

Spring 2005

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# Summary

Globalization and the deregulation of currencies have had a negative impact on the domestic tax systems of states and the tax bases on which these rely. Tax policies of sovereign states have, historically, been the means of maintaining a high standard of public services why reduced tax bases could arguably be a threat to the welfare state. The proliferation of tax havens and increased use of tax deferral have led to a decrease of the domestic revenue in many countries. This problem was addressed in the United States in the 1930's and led to the creation of tax rules, which targeted accumulation of profits in corporations when they should be taxed to the shareholder directly.

It indirectly started with the "personal holding company" rules, which, however, only applied to domestic corporations. Corporations avoided these rules and its current taxation by incorporating subsidiaries in tax havens and harmful preferential tax regimes, where the profits accumulated tax-free. In order to impose tax on these profits Congress introduced the "foreign personal holding company" rules. Since these rules mainly targeted passive income that should be taxed by an American physical shareholder, they did not hinder the use of base companies in low tax states and their accumulation of profits. Subpart F, finally, targets accumulated income in foreign corporations, which are controlled by United States shareholders, and imposes current taxation on the American shareholders. The application of the American Subpart F rules is dependent on the interpretation of voting control. In order to eliminate the possibility of avoiding current taxation, by transferring control to foreign investors, the voting control is, in practice, determined with consideration of the actual control of the corporation. The "controlled foreign corporation" regime further includes rules regarding "foreign investment companies" and "passive foreign investment companies".

The recent proliferation of "controlled foreign corporation" regimes worldwide has raised the tax compliance requirements for corporations, which in many cases can be severe. Corporations are induced to restructure corporate groups and the ownership of foreign corporations to avoid these rules. An interesting question is whether the efforts of governments to protect the tax base, in practice, induce tax avoidance or if they are effective in protecting the tax revenue.

Today the use of current taxation on foreign source income is not controversial, as it very much was in the beginning of the enactment of CFC rules. The international tax field has changed over time and with it the principles of tax law. The existence of a customary tax law is thereby an important question when addressing the compatibility with international law. Not at least when discussing the VCLT and its importance in interpreting tax treaties. While the United States considers the Convention

binding as customary law in other areas, it is not applied in tax cases. An important aspect of the CFC regime is its relation to double tax treaties. If a domestic legislation, such as the CFC provisions, conflicts with an existing tax treaty, which regime has precedence? Depending on which country is at question the answer will be different. In many countries giving international obligations precedence is predominant. In the U.S. tax system, however, the last-in-time rule could lead to treaty override.

Although the U.S. tax systems, concerning "controlled foreign corporations", constitute a comprehensive regime, they still encounter problems, such as the easily manipulated concept of voting control. Over time, and as problems arise, the rules are improved and made even more aggressive. One aspect of the rules, however, is whether the United States, in its quest for revenue, is guilty of breach of international law.

# Preface

Studying the American comprehensive, and I must say very complex, CFC-legislation has been both interesting and awarding. Over the months I have crawled my way through countless cross-references and case law. Many hours have been spent in the underground room of the Faculty of Law with no natural light, where the collected American case law is found. Studying cases that range from 1888 to 2003 has given an insight in U.S. tax policies, that have been crucial in completing this thesis, not to mention very interesting.

I would like to take this opportunity to thank my supervisor Christina Moëll for the attentive supervision of this study, as well as for giving helpful advice.

# Abbreviations

AMT	Alternative Minimum Tax
CEN	Capital-Export Neutrality
CFC	Controlled Foreign Corporation
CIN	Capital-Import Neutrality
FIC	Foreign Investment Company
FPHC	Foreign Personal Holding Company
IRC	Internal Revenue Code
IRS	Internal Revenue Service
OECD	Organisation for Economic Co-Operation and Development
PFIC	Passive Foreign Investment Company
PHC	Personal Holding Company
TAMRA	the Technical and Miscellaneous Revenue Act of 1988
U.S.	the United States
U.S.C.	the United States Constitution
USD	United States Dollar
VCLT	the Vienna Convention on the Law of Treaties

# 1 Introduction

## 1.1 Background

The world economy is today facing the aftermath of the increasing globalization that has redefined our sense of territoriality. The free movement of capital has opened up the possibility for competition where states offer tax incentives in attempts to attract foreign investment. Tax deferral of a corporation's income in another state that should be taxed by the shareholder constitute a very interesting and equally complex area of international tax law.

The United States addressed this problem in the 1930's and over the next decades introduced a number of tax rules that today are known as "controlled foreign corporation" (CFC) rules. Following the deregulation of currencies in many European states the world economy was suddenly faced with numerous CFC-legislations. An interesting aspect following the emergence of this legislation is its relation to existing double tax treaties, as well as potential customary international law.

It is here important to make a distinction between *tax evasion* and *tax avoidance*. As Justice Reddy so eloquently put it, tax avoidance is "the art of dodging tax without breaking the law."<sup>1</sup> Tax evasion entails a direct violation of the law, and is not, as is the case with avoidance, dependent on the intention of the taxpayer to evade taxation. A criminal offence is, however, dependent on a wilful intention or tax fraud. The taxpayer's intention could further have an impact on the severity of the penalty.<sup>2</sup> Many countries have a general anti-avoidance rule as a response to what is considered to be abusive tax planning. The *business purpose rule*, and the *substance over form* rule are the two foremost used principles when it comes to anti-avoidance rules. The U.S. Supreme Court held that a corporate reorganization under the law, solely for tax purposes, did not qualify for tax benefits.<sup>3</sup>

Judge Learned Hand's statement, regarding tax avoidance, in *Gregory v. Helvering* is probably one of the most famous in United States tax law. It is often referred to in new cases, often by the defendant<sup>4</sup>, and states that "[a]ny one may arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."<sup>5</sup> Interestingly, it is rarely talked of Judge Hand's further reasoning on the requirement of a business

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<sup>1</sup> *McDowell & Co. Ltd v. CTO* 154 ITR 148 (1985).

<sup>2</sup> Rohatgi p. 342.

<sup>3</sup> *Gregory v. Helvering* 293 U.S. 465.

<sup>4</sup> I.e. taxpayer.

<sup>5</sup> 293 U.S. 465.



purpose. According to the judge it was evident that the aim of Congress was to approve only reorganizations having a business purpose, even if the transaction suited the verbal definition of corporate reorganization in the, at the time, applicable Revenue Act of 1928.<sup>6</sup> He further stated referring to the tax statutes of the Act, "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse, to the setting in which all appear, and which all collectively create."<sup>7</sup>

## 1.2 Purpose and Limitations

The purpose of this thesis is to address the problem of international corporate taxation in general and specifically the tax legislation regarding "controlled foreign corporations" and its compatibility with international law. In an attempt to elucidate the problems involved with this particular area of taxation a study of the American CFC-legislation will be presented.

Due to the extensive and complicated legislation in the United States, this study does not attempt at being comprehensive. The rules relevant for the purpose of understanding the underlying reasons for CFC rules and analysing the compatibility with international law are thus presented, while more specific and detailed regulations will be overlooked. Moreover, the American CFC-legislation consists of different tax systems all of which contribute to the comprehensive protection of foreign source income. While the tax systems will be briefly presented, the focus of this thesis will be on Subpart F. In other words, this thesis will address the question of who is targeted by the legislation, the question of how this is determined, and finally the question of the consequences application brings.

Moreover, the compatibility with international law will be discussed. Current taxation on foreign source income was in the beginning controversial and said to conflict with the internationally acknowledged practice dividing tax claims between residence and source countries. Today residence jurisdiction is even more expanded and the question of compatibility with international law still a reasonable one. Furthermore, in principle, conflict between domestic CFC-legislation and double tax treaties can arise. In the United States giving domestic statutes precedence over tax treaties is possible in certain situations. An interesting aspect is here whether such "tax treaty override" is compatible with international law. Important here is whether or not there is an international customary tax law, which could be applicable in these situations.

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<sup>6</sup> Garlock, Inc. v. Commissioner 489 F.2d 197 (1973).

<sup>7</sup> Gregory v. Helvering 293 U.S. 465.

## **1.3 Description of the Problem**

The question this thesis intends to answer is whether or not the American legislation concerning "controlled foreign corporations", is compatible with international law.

## **1.4 Method and Material**

The method used in this thesis is customary juridical in which the use of legislation, tax cases and doctrine has been elementary. Due to the complexity of the Internal Revenue Code, some assistance in understanding the rules has been sought in secondary sources.

Concerning the material used, reservation is made due to my lacking knowledge of the dignity of American authors of doctrine. Moreover, sources which convey reliance and confidence as well as being world renowned, such as Tax Law Review and Harvard Law Review, for example, was used in this study.

Regarding the references to the treasury regulations, information has been collected partly from case law and partly from doctrine, due to inability to use the primary source.

## **1.5 Disposition**

In the introductory chapter - Chapter 2 - the basic policies of international tax law are presented. The purpose is to put the "controlled foreign corporation" regulations in a wider context, and thus increase the understanding of the problems connected to the regulations. For this purpose I have selected a number of principles, which are by no means exhaustive. The chapter further presents the background to the rules, namely the use of foreign base companies and factors used in identifying low tax countries.

In chapter 3 the corporate tax policies in the United States are addressed. Concepts used in the regulations are explained to give a necessary understanding when tackling the U.S. tax system.

In chapter 4 the different tax systems constituting the "controlled foreign corporation" regulations are briefly explained, with emphasis on "foreign personal holding companies". The presentation of Subpart F is found in chapter 5. Since this tax system applies to U.S. shareholders of foreign corporations, which is the starting-point of this thesis, Subpart F is given more focus and an entire chapter is devoted to this significant piece of legislation.

Finally, in chapter 6, the compatibility with international law is discussed.

# 2 Aspects of International Tax Law

## 2.1 The Concept of International Tax Law

International tax law governs cross-border transactions. The legal parameters are primarily derived from public international law, which states the rights and obligations of states. The taxing rights of sovereign nations depend on fiscal jurisdiction, which includes both the right of legislation and the right of enforcement. There are two conflicting positions regarding the issue of fiscal jurisdiction. One is that a state's right to tax is without limitations, i.e. regardless of the effect on a foreign state. According to this there are no requirements of legal connection with a jurisdiction. It is, however, necessary that a connection exists between the taxpayer and the state.<sup>8</sup> The other position claims that the sovereign right to tax depends on the existence of a legally relevant connection between the state and the taxpayer.<sup>9</sup>

International tax problems occur when more than one state's tax interests coincide. The right to impose taxation is one of the most fundamental concepts of a state's sovereignty. Tax sovereignty would not give rise to international legal tax problems had there been a universally accepted principle on the boundaries of a state's taxation claim. Today, international tax law encounters two contradicting principles, namely the *domicile principle*<sup>10</sup> and the *source principle*. The domicile principle is based on the idea that a person resident in the state should be imposed tax on all his income, domestic as well as foreign. The source principle, on the other hand, states that taxation is connected to the state where a taxable income arises, without consideration as to where the taxpayer is resident.<sup>11</sup> A dilemma in the international tax law is that certain states favor the domicile jurisdiction<sup>12</sup> while others prefer the source jurisdiction.<sup>13</sup> Taxpayers often find themselves targeted by more than one state for taxable income. A taxpayer may be imposed tax in one state because of domicile, and in another state due to source income resulting in international juridical double taxation.<sup>14</sup> Herein lies the problem in international tax law: Which state should give up its tax claim?

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<sup>8</sup> E.g. residence, citizenship or incorporation.

<sup>9</sup> Rohatgi p. 11 f.

<sup>10</sup> Also referred to as the residence principle or the nationality principle.

<sup>11</sup> Lindencrona.

<sup>12</sup> Favored by European continental states.

<sup>13</sup> Favored by the Latin-American states.

<sup>14</sup> [International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods.] Introduction OECD Commentaries Paragraph 1.[3].

International transactions fall into one of two main categories namely "*inbound*" and "*outbound*" transactions. Inbound transactions constitute investments or business undertakings in the state made by foreign taxpayers. Outbound transactions cover transactions made by resident taxpayers in a foreign state. In taxation an inbound transaction involves foreign taxpayers, while an outbound transaction involves foreign income.<sup>15</sup> The United States tax regime includes systems specifically adopted for both types of transactions. Foreign taxpayers are imposed tax on income deriving from, or with a significant economic connection, to the United States. The taxation of United States taxpayers' foreign income, on the other hand, derives from the premise of worldwide taxation of their entire income. Given this starting-point, the United States then defer taxation<sup>16</sup> to the country owning source-jurisdiction.<sup>17</sup>

## 2.2 Sources of International Tax Law

The sources of international tax law include:<sup>18</sup>

- i. Multilateral international agreements,<sup>19</sup> secondary law of international communities of states,<sup>20</sup> mutual agreement procedures for equitable settlement of conflict of legal systems
- ii. Double tax treaties (comprehensive and limited)
- iii. Customary international law and general principles of law: The principles of law recognised by civilized nations in their national legal systems, statute law, customary law and judicial decisions and the practices of international organizations

## 2.3 Objectives of International Tax Systems

The globalization following the technological evolution has increased the movement of capital and consequently opened up for tax competition. States aim at attracting investments by offering low tax rates on income earned by foreigners.<sup>21</sup> The income tax is levied on capital from the tax base, regardless if the income is consumed or saved. Given the fact that taxpayers well provided with capital save more than the poor, the income tax, which includes income from capital is often more progressive than that which does not.<sup>22</sup> A progressive tax entails that the share of income a person pays in

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<sup>15</sup> Isenbergh I p. 9 note 1.

<sup>16</sup> Through the foreign tax credit for example.

<sup>17</sup> Isenbergh I p. 9.

<sup>18</sup> Rohatgi p. 11.

<sup>19</sup> E.g. the Vienna Convention on the Law of Treaties.

<sup>20</sup> E.g. European Community Law.

<sup>21</sup> Avi-Yonah, Harvard Law Review, p. 1575.

<sup>22</sup> E.g. consumption tax or payroll tax.

taxes increases as income increases.<sup>23</sup> The increase in tax competition and the mobility of capital allow investors to allocate capital to preferential tax regimes or tax havens and hence avoid taxation. The consequence is a weakened progressive effect of the income tax.<sup>24</sup>

Two factors have had an impact on corporations' ability to avoid taxation on foreign source income. These are the abolition of withholding taxation by developed states,<sup>25</sup> and the increasing number of tax havens worldwide. Source-countries that need the income deriving from foreign capital do not impose taxes for the obvious reason that they want the capital to stay within the state. Due to bank secrecy legislation in most tax havens, it is practically impossible for residence-countries<sup>26</sup> to impose tax on foreign income of residents in the case withholding tax is not levied by the source-country. Cross-border investment income is thereby in many cases exempt from taxes in both residence-and source-country.<sup>27</sup>

Tax competition does not only occur concerning capital income. An increasingly number of states offers reductions in the effective tax rate to foreign corporate investors in the competition for inbound investment.<sup>28</sup> These so called production tax havens offer corporations income free of source-country taxation. The United States is despite this careful with imposing taxation, and in particular current taxation, on these multinational corporations due to competitiveness reasons. Moreover, taxation could lead to an emigration of corporations seeking jurisdictions that do not tax foreign source income. As is the case with cross-border investment income, taxation is often exempt in both residence-and source-country.<sup>29</sup>

The objectives of international tax rules confer with the domestic since cross-border transactions are, in practice, taxed by states. The objectives concern tax fairness, competitiveness through fiscal measures, taxes on cross-border transactions and the balance between capital-export and capital-import neutrality.<sup>30</sup> The governing objectives may differ between states and also change over time. While certain states construct their tax legislation to create a favourable environment for businesses other states are aiming for maximising the tax revenue.<sup>31</sup>

The main objective of international tax law, and universally acknowledged, can be defined as ensuring that income is fully taxed once and is not taxed

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<sup>23</sup> Davies p. 272.

<sup>24</sup> Avi-Yonah, Harvard Law Review, p. 1576.

<sup>25</sup> The withholding tax of 30% on foreign residents, who earned portfolio interest income from sources within the United States, was abolished in 1984.

<sup>26</sup> When talking of the use of tax havens, residence-country is often referred to as home-state, while source-country is referred to as host-state.

<sup>27</sup> Avi-Yonah, Harvard Law Review, p. 1576 f.

<sup>28</sup> See 2.1 for definition.

<sup>29</sup> Avi-Yonah, Harvard Law Review, p. 1577.

<sup>30</sup> Rohatgi p. 1.

<sup>31</sup> Våra Skatter? p. 139.

twice.<sup>32</sup> International tax law targets juridical double taxation, i.e. the case where the same tax object and the same tax subject are taxed in two (or more) tax jurisdictions.<sup>33</sup> The juridical double taxation arises when more than one state have tax claims that coincide.<sup>34</sup>

## 2.4 Tax Neutrality

It is argued that tax neutrality is one of the basic principles of a good taxing system. In a market system it is said to promote economic efficiency and based on the idea that decisions concerning economic operations should not be affected by fiscal matters. Tax neutrality is claimed to exist when a tax system does not alter the rational choice of operating compared to a situation with no taxation, i.e. national neutrality.<sup>35</sup> Today, tax neutrality is discussed in a global perspective, driven by the aim to allocate investment capital in a worldwide economy as efficiently as possible.<sup>36</sup> This tax neutrality is referred to as *international equity*.<sup>37</sup> It is, however, impossible to achieve and uphold a completely neutral national tax system, much less seen in a global perspective. There is a lack in neutrality due to the fact that CFC income is currently taxed while dividend from domestic corporations can be deferred and hence also deferral of the taxation.<sup>38</sup> Tax neutrality can be achieved with the CFC rules on CFC income and dividend received directly, by conceding deduction of the tax paid in the foreign corporation when levying tax on CFC income in the shareholder state. Thus, the benefits of tax deferral are eliminated, which is the underlying purpose of the "controlled foreign corporation" tax regimes.<sup>39</sup>

It is impossible for one state to tackle the problems of international corporate taxation. A sovereign state only has jurisdiction to impede taxes that have a direct connection with the state in question. The objective of neutrality seen in the competition perspective is globally recognised. A tax system is neutral when taxation does not predominate the location of an investment.<sup>40</sup> The different tax systems, however, base their neutrality on two different concepts which are described below.

### 2.4.1 Capital-Export Neutrality

The concept of capital-export neutrality (CEN) is based on the idea that the tax imposed should be neutral on investment within the state and investment deriving from a foreign state. In other words, a taxpayer should not have tax incentives to give preference to foreign investment in relation to investment

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<sup>32</sup> Rohatgi p. 12.

<sup>33</sup> Introduction OECD Commentaries Paragraph 1.[3].

<sup>34</sup> Rohatgi p. 13.

<sup>35</sup> Chorvat.

<sup>36</sup> Helminen p. 11 f.

<sup>37</sup> Wenehed p. 139.

<sup>38</sup> Wenehed p. 227.

<sup>39</sup> Wenehed p. 227.

<sup>40</sup> Rohatgi p. 1.

in the state of residence.<sup>41</sup> This concept promotes global efficiency and is supported by the majority of developed states.<sup>42</sup> Tax deferral or the possibility to avoid taxation in the state of residence conflicts with the principle of CEN.<sup>43</sup>

CEN is not upheld if, for example, both the residence-country and the source-country tax an investment in the residence-country, while neither tax the income from an investment in the source-country. The result is that an investor would prefer to invest in the source-country rather than in the residence-country, even if the pretax profits were higher on the investment made in the residence-country. This results in a global efficiency loss since investments are not allocated to the most productive pre-tax location, i.e. highest profits.<sup>44</sup>

## 2.4.2 Capital-Import Neutrality

The concept of capital-import neutrality (CIN) is based on the idea that all investments deriving from the domestic market should be treated equally when taxation is concerned, regardless of the state of residence of the taxpayer.<sup>45</sup> This neutrality, which also can be referred to as competitive neutrality, promotes national efficiency. A concept which is favoured by the developing states.<sup>46</sup> CIN is not upheld if, for example, the source-country does not levy income tax on investment income deriving from citizens, while foreign investors in the source-country are taxed on their foreign investment income at their residence-country rate. This leads to a difference in net return on investment made by foreign investors and domestic investors. The result is a distortion of the international allocation of world savings.<sup>47</sup>

## 2.5 The Transactional Approach

The transactional approach<sup>48</sup> originates from the United States and entails that the type of income is given precedence over the tax rate imposed on the foreign corporation. This approach mainly includes income deriving from passive investments or passive income.<sup>49</sup> The United States further includes income, imposed a foreign tax which does not amount to at least 90 percent of the highest domestic corporate tax rate, in the Subpart F income.<sup>50</sup>

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<sup>41</sup> Våra Skatter? p. 140.

<sup>42</sup> Rohatgi p. 1.

<sup>43</sup> Helminen p. 200.

<sup>44</sup> Avi-Yonah, Harvard Law Review, p. 1604.

<sup>45</sup> Våra Skatter? p. 140.

<sup>46</sup> Rohatgi p. 1.

<sup>47</sup> Avi-Yonah, Harvard Law Review, p. 1605.

<sup>48</sup> [As opposed to the jurisdictional approach, which entails current taxation on all income deriving from a foreign corporation resident in certain states.] Wenehed p. 45.

<sup>49</sup> Income deriving from a business which do not engage in active operations.

<sup>50</sup> Wenehed p. 46 f.

According to this principle, the shareholder is taxed on a current basis for certain income deriving from a foreign corporation.

Passive income is regarded as a CFC income and is to be taxed by the shareholder. An income is considered passive when it accumulates without a connection to an active business. In other words, the investment could have been made directly by the shareholder. In many cases there are no financial incentives to have the corporation make the investment as opposed to the shareholder. Although the allocation of the investment could be tax related, that is not always the case.<sup>51</sup>

## 2.6 The Use of Foreign Base Companies

A base company can according to Gibbons be defined as "corporations or other limited-liability companies organized in a base country for the purpose of conducting third-country operations".<sup>52</sup> Notable is that the base country imposes low or no taxes, i.e. tax havens and preferential tax regimes. By incorporating a "foreign base company" taxpayers can achieve great tax benefits. The state with the right to taxation, on the other hand, loses part of its tax base. Characteristics of a foreign base company are:<sup>53</sup>

- Constitutes a legal person such as a corporation or equivalent, and is liable for tax in the state of incorporation.<sup>54</sup>
- The corporation is controlled, either through votes or shares, by shareholders who are not liable for tax in the preferential tax regime.
- The corporation in question is taxed more favourably in the preferential tax regime than other corporations in that state.
- The purpose for incorporating is to gain tax benefits in the residence state of the investor, or lower withholding tax.
- The main business is carried out in another state than the preferential tax regime.
- The activity of the base company is not necessarily connected to a geographical area. For example services within a corporate group and financial services.

The concept "foreign base company" was presented in the U.S. Internal Revenue Code when Subpart F was enacted.<sup>55</sup> The legislation does not state a definition. Accumulation in a foreign base company can, for example, arise when a U.S. corporation sells its products at a low price to a foreign subsidiary located in a tax haven country. The foreign base company then

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<sup>51</sup> Wenehed p. 65.

<sup>52</sup> Rapakko p. 18.

<sup>53</sup> Dahlberg p. 28.

<sup>54</sup> According to U.S. taxation. The United Kingdom, for example, applies the principle where determination is derived from the location of management or the place where the central administration is located. This approach eliminates the benefits of using mailbox companies.

<sup>55</sup> Rapakko p. 18.



sells the products at a high price to a second subsidiary which is responsible for the market sales of the products. Consequently, the corporate group accumulates profit in the country with the most favorable tax rates.<sup>56</sup>

### **2.6.1 Tax Deferral or Primary Sheltering**

A tax benefit that is achieved, by the use of a foreign corporation, is the possibility to tax deferral, or primary sheltering. This entails accumulation of income in the foreign base company, which would otherwise be taxable to the taxpayer in the residence state. Consequently, tax is deferred until the income is realized or distributed through a dividend. Since the corporate tax is low or nonexistent in the host state, the taxpayer receives substantial tax benefits. Moreover, the accumulation results in a greater capital available for reinvestment for the taxpayer, which obviously is an incentive for reallocation of capital. If the taxpayer invests the capital in the source state or a third state, the residence state faces a total tax reduction.<sup>57</sup>

Primary sheltering involves, for example, a parent company located and liable to tax in state A. Company A is liable to unlimited taxation, i.e. imposed tax on its worldwide income. In order to avoid taxation the parent company establishes a subsidiary in state B, which imposes low or no taxation. Part of the business is transferred to the subsidiary which results in lower tax for the corporate group.<sup>58</sup>

### **2.6.2 Secondary Sheltering or Direct Conduit**

Repatriation of the accumulated income from a foreign base company, through a dividend for example, often results in the loss of the tax benefits achieved by primary sheltering. The parent company is levied tax in the state of incorporation when the capital is distributed. Secondary sheltering is the generic term of the methods in avoiding taxation following repatriation. One way is to repatriate income that is tax free in the hands of the receiver.<sup>59</sup> These are merely examples of possible corporate structures where base companies are used, and will not be further addressed in this thesis.

## **2.7 Harmful Preferential Tax Regimes and Tax Havens**

OECD has listed the four following factors to identify harmful preferential tax regimes:<sup>60</sup>

- i. No or low effective tax rates

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<sup>56</sup> Isenbergh II p. 16.

<sup>57</sup> Rapakko p. 28.

<sup>58</sup> Dahlberg p. 32 f.

<sup>59</sup> Dahlberg p. 33 f.

<sup>60</sup> OECD Report, Harmful Tax Competition: An Emerging Global Issue, pp. 23, 27.

- ii. "Ring fencing" of regimes
- iii. Lack of transparency
- iv. Lack of effective exchange of information

The report states that a low or zero effective tax rate on the relevant income is a necessary starting-point for an examination of whether a preferential tax regime is harmful. "Ring fencing" includes, for example, excluding residents from benefiting from the tax rules, and prohibiting corporations benefiting from the rules from operating in the domestic market. The lack of transparency, in many cases, hinders residence-countries from taking defensive measures.<sup>61</sup>

Regarding tax havens OECD listed following factors:

- i. No or only nominal taxes
- ii. Lack of effective exchange of information
- iii. Lack of transparency
- iv. No substantial activities

The first factor, no or only nominal taxes, is a necessary starting-point in determining whether a country constitutes a tax haven or not. Another distinguishing factor is advanced secrecy regarding taxpayers who benefit from the low or no tax jurisdiction. This secrecy can derive from either laws or administrative practices. Furthermore, the lack of transparency in the operation of the legislative, legal or administrative provisions is an indication of tax haven practices. Finally, the absence of a requirement of substantial activity in the country in question, indicates that the purpose of the tax system is to attract foreign investment or transactions that are purely tax driven.

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<sup>61</sup> E.g. favorable application of laws and regulations, negotiable tax provisions, and a failure to make widely available administrative practices.

# 3 Corporate Tax Policies in the U.S.

## 3.1 Taxing Power

Taxing power of the United States derives from the Constitution under Article 1, section 8, which states that Congress has the power "to lay and collect taxes, duties, imports and excises....".<sup>62</sup> The Sixteenth Amendment grants Congress extensive power to impose income tax.<sup>63</sup> Although, the case *Cook v. Tait* deals with an individual taxpayer and not a corporation, it gives an indication of the aggressiveness of tax policy in the United States. Moreover, in *Welch v. Henry*,<sup>64</sup> the Supreme Court held that "the enactment or amendment of a tax statute that applies retroactively will be held unconstitutional only where "the nature of the tax and the circumstances in which it is laid [are] so harsh and oppressive as to transgress the constitutional limitation."<sup>65</sup>

### 3.1.1 National Power vs. Taxing Power

In the present case the Court established that Congress has power to tax income received by a native citizen of the United States, domiciled abroad, from property situated in a foreign country. The plaintiff argued that, given the fact that both the taxpayer and the property, on which tax was levied, were situated outside the territorial limits of the United States, the power to tax was excluded. In the case *United States v. Goelet*, the Court went as far as claiming that the question of power was determined wholly irrespective of the owner's permanent domicile in a foreign country.<sup>66</sup>

In *United States v. Bennett*<sup>67</sup> the relation between national power and taxing power of a state was clarified. While the taxing power encounter at its borders the taxing power of other states and hence is limited by them, there is no limitations on the national power. It was further stated that a citizen's property, however situated outside the territorial limits, benefits from the United States. The principle deriving from this argument is that "the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, it being in or out of the United States, and was not

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<sup>62</sup> Isenbergh I p. 9 f.

<sup>63</sup> Ault p. 132.

<sup>64</sup> 305 U.S. 134, 147.

<sup>65</sup> The house of representatives and the senate constitute the congress. The house of representatives propose bills while the senate is given the right to make legal changes in the proposition. The Committee of ways and means then bring about a compromise between the ideas of the parties. Wenehed p. 235.

<sup>66</sup> *Cook v. Tait* 265 U.S. 47.

<sup>67</sup> 232 U.S. 299.

and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen. The consequence of the relations is that the native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country and the tax be legal - the government having power to impose the tax."<sup>68</sup> This attitude towards taxation could become a problem in the international arena, as other countries may find the United States proclaimed jurisdiction extended beyond reason. This will be further discussed in the concluding chapter regarding the "controlled foreign corporation" legislation's compatibility with international law.

## 3.2 Corporate Taxation

In U.S. taxation a corporation has the status of a separate legal identity. The corporation is therefore liable for tax on corporate income. Any distribution from the corporation, such as dividend, is however to be further taxed by the shareholders.<sup>69</sup> This concept of separate legal identities open up the possibility to structure a corporate group<sup>70</sup> so that a foreign entity is placed between business activity in a foreign state and the American owners, and thus limits the United States jurisdiction to taxation.<sup>71</sup> The result presented itself in the foreign personal holding company where American taxpayers placed income-producing assets in a wholly owned corporation situated in a preferential tax regime.<sup>72</sup> If the taxpayer then invested these assets in the United States, the dividends and interest would be levied the more favourable withholding tax applicable to foreign taxpayers.<sup>73</sup>

The U.S. tax system impede corporate tax rates on taxable income. The taxable income is gross receipts minus the cost of goods sold. The legislation does not make a distinction in general between sources of income which is common in many European states. The taxable income is the result when deductions are made from the gross income.<sup>74</sup>

The principle of international tax jurisdiction on corporations is, in the United States, based on the place of incorporation. The corporation is liable to tax on its worldwide income. In the case incorporation is under another state's legislation, the corporation is considered a foreign corporation. Foreign corporations are subject to tax according to the source principle. Distinction is made between U.S. source income and foreign source income.<sup>75</sup>

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<sup>68</sup> Cook v. Tait 265 U.S. 47.

<sup>69</sup> McDaniel/Ault p. 25.

<sup>70</sup> [An affiliated group of corporations is a chain of corporations connected to a common parent by stock ownership of at least 80 percent.] Isenbergh I p. 206 note 3.

<sup>71</sup> Isenbergh II p. 1.

<sup>72</sup> See 2.7 for a definition.

<sup>73</sup> Isenbergh II p. 2.

<sup>74</sup> McDaniel/Ault p. 19.

<sup>75</sup> McDaniel/Ault p. 38 f.

Profits are taxed by the corporation in the year it's earned while the individual shareholder is taxed on received dividend. The corporate tax rates are progressive.<sup>76</sup>

### **3.2.1 Foreign Corporations**

A common feature in U.S. taxation is dealing with United States persons that conduct foreign operations through one or more foreign corporations. The tax regime targeting foreign income of foreign corporations differs, from the regime applicable to domestic corporations, since U.S. taxation does not have jurisdiction, at least not directly. As a starting-point a foreign corporation is a foreign taxpayer. If the corporation is owned by United States shareholders, however, these shareholders have an economic interest in the foreign corporation. For U.S. tax purposes the foreign corporation is treated as a foreign taxpayer.<sup>77</sup>

The U.S. tax system makes a distinction between foreign corporations dominantly owned or controlled by United States persons and foreign corporations in which American influence is less substantial. The importance of this distinction is further addressed in chapter 5.3.

### **3.2.2 The Definition of a Corporation For the Purposes of CFC Rules**

The concept of a corporation in the legislation includes associations, joint-stock corporations, and insurance corporations. The tax system has special rules for certain types of corporations, such as banks, regulated investment corporations, and real estate investment trusts.<sup>78</sup>

When dealing with a foreign entity it is firstly important to make the distinction between true corporate entities and other organizations. A corporation is, for tax purposes, considered a separate taxpayer, while partnerships, for example, are seen as a form of direct ownership, or flow-through entities. Consequently, non-corporate entities are taxed directly to the owners.<sup>79</sup>

An organization is treated as a corporation, for tax purposes, if it displays a preponderance of corporate characteristics, even if not chartered as a corporation. Among the most important characteristics you find limited liability, unlimited life, centralization of management, and free transferability of interests. The result is that almost all chartered corporations, in practice, are corporations for tax purposes. Even though many limited partnerships are registered under state law, they are for tax purposes treated as flow-through entities.<sup>80</sup>

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<sup>76</sup> Wenehed p. 235.

<sup>77</sup> Isenbergh I p. 456 f.

<sup>78</sup> McDaniel/Ault p. 18.

<sup>79</sup> Isenbergh I p. 459.

<sup>80</sup> Isenbergh I p. 459.

When determining whether foreign entities are to be considered corporations under U.S. tax law or not, the IRS have in a ruling<sup>81</sup> stated that the same characteristics apply as in classifying domestic entities. Given the owners' individual liability for the entity's debts and lack of transferability of interests in the entity, an unlimited company is considered a partnership for U.S. income tax purposes. It is here necessary to weigh the characteristics to foreign corporate norms, a fact that often makes the determination difficult.<sup>82</sup>

### 3.2.3 Nationality of Entities

Corporations are considered resident where they are incorporated, and can thereby be regarded as either domestic or foreign. The U.S. approach to corporate income taxation is that a domestic corporation is liable for tax on its worldwide income. Foreign corporations are taxed on income deriving from the U.S. Unlike many other states, the determining factor in this tax system is incorporation. A different approach, which is used by other states,<sup>83</sup> is that the location of management and actual control constitutes the determining factor of residence of a corporation. While both approaches have as well advantages as disadvantages there is a distinct difference in how easily they are policed. Using incorporation, as the United States does, is easy to administer but also the easiest to manipulate.<sup>84</sup> Giving the location of management precedence, eliminates the possibility to manipulation to a degree, but is also more time consuming to administer and supervise.<sup>85</sup>

Nationality jurisdiction for corporations has changed over time and today a rule that permits countries to tax "controlled foreign corporations", as if they were nationals themselves, could be said to have been adopted. The question whether a customary international tax law exists or not is discussed in chapter 6.2.

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<sup>81</sup> Rev.Rul. 88-8, 1988-2 I.R.B.4.

<sup>82</sup> Isenbergh I p. 460.

<sup>83</sup> E.g. United Kingdom.

<sup>84</sup> [As shown recently by so-called inversion transactions in which corporations shifted their nominal country of incorporation to Bermuda while retaining all of their headquarters and management in the United States.] Avi-Yonah, Tax Law Review.

<sup>85</sup> Avi-Yonah, Tax Law Review.

# 4 The U.S. CFC-Legislation

The American CFC-legislation consists of four different tax systems. These regard "foreign personal holding companies", "subpart F", "foreign investment companies", and "passive foreign investment companies". Although the different tax systems coincide in certain provisions, they constitute a comprehensive system in minimizing or eliminating the benefits of tax deferral of certain income.<sup>86</sup>

## 4.1 Personal Holding Companies

The legislation regarding so called "personal holding companies" (PHC) entered into force in 1934 and constitutes the foundation from which the CFC-legislation was created. The rules apply only to American shareholders and American corporations but are part of the evolution of CFC-legislation why it is briefly presented in this thesis. Moreover, this tax regime is today considered to be applicable on foreign corporations, which is discussed in the concluding chapter of this thesis. In the 1930's the corporate tax rate in the U.S. was substantially lower than that of physical persons. A way of avoiding this higher tax was to invest in a corporation which was de facto controlled by the investor. This results in higher reinvestments and subsequently better earnings.<sup>87</sup>

The PHC-rules apply to American corporations with no more than five physical shareholders, whom together hold more than 50 percent of the corporate value.<sup>88</sup> The PHC-legislation defines income which is considered passive and hence applicable to the rules. The definition has been transferred to other parts of the CFC-legislation. PHC-income mainly derives from profits from passive investments, such as interests, dividends and royalties.<sup>89</sup>

In many cases the allocation of income to a corporation in a preferential tax regime, where the tax rate is lower than that the investor is liable for, leads to tax benefits. In the United States, however, the tax rules entail that the additional tax impeded on accumulated PHC-income results in a higher tax rate than if the investor receives dividend directly. Consequently, the benefits of personal investment in passive assets through a domestic corporation was eliminated. In order to circumvent the rules and avoid PHC-income the shareholders could manipulate the requirement of ownership. The composition of income within the corporation can also be held below the limit of 60 per cent.<sup>90 91</sup>

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<sup>86</sup> Wenehed p. 283.

<sup>87</sup> Wenehed p. 242 f.

<sup>88</sup> IRC § 552(a)(1).

<sup>89</sup> Wenehed p. 248 f.

<sup>90</sup> Wenehed p. 249.

<sup>91</sup> IRC § 552(a)(1).

## 4.2 Foreign Personal Holding Companies

The PHC-rules did not prevent a taxpayer from investing in a foreign corporation due to tax incentives. The outcome was that the tax deferral in foreign corporations had a more negative impact on the U.S. tax base than before the PHC-rules were incorporated. In 1937 a "foreign personal holding company" legislation (FPHC) was introduced.<sup>92</sup> The legislation rendered current taxation possible of a foreign corporation's American shareholder on his PHC-income. U.S. shareholders are taxed directly on the income of a FPHC-company and hence eliminates the tax benefits of using a foreign corporation.<sup>93</sup> The current taxation of the taxpayer is the result of a state's limited jurisdiction to tax entities liable for tax in a foreign state. The use of current taxation also constitutes the greatest difference between the PHC-rules and the FPHC-rules.<sup>94</sup>

The legislation is applicable to a certain type of corporation defined in the rules and only on certain income. The definition of a "foreign personal holding company" is a foreign corporation:<sup>95</sup>

- i. in which more than 50 percent<sup>96</sup> of the total combined voting power of all classes of stock<sup>97</sup> or the total value of the stock is owned directly or indirectly, at any time during the taxable year, by five or fewer U.S. individuals<sup>98</sup>, and
- ii. which derives at least 60 percent of its gross income in the form of foreign personal holding company-income.

If a corporation receives the status of a "foreign personal holding company", 50 percent of its gross income, instead of 60, constituting foreign personal holding company-income suffice to keep the status for the following year. The corporation will be considered a FPHC-company for the following three years to prevent manipulation with income from one year to another.<sup>99</sup> The concept of indirect ownership includes ownership through corporations and partnerships.<sup>100</sup> FPHC-income includes practically all passive income such as passive investment income, securities gains, gains commodities transactions, estate and trust income, income from personal service contracts, income from the use of corporate property by a shareholder,

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<sup>92</sup> These rules are today codified in IRC sections 551 through 558.

<sup>93</sup> Isenbergh II p. 2 f.

<sup>94</sup> Wenehed p. 251.

<sup>95</sup> IRC § 552(a)(1).

<sup>96</sup> Redefined in the 1986 Tax Reform Act.

<sup>97</sup> Subsequently shareholders were deprived of the possibility to use vote differentiation of shares to circumvent the rules.

<sup>98</sup> A citizen or resident of the United States.

<sup>99</sup> Wenehed p. 254.

<sup>100</sup> Isenbergh II p. 3.



income from the factoring of foreign receivables, and rents.<sup>101</sup> Gains from transactions in stocks and securities as well as gains from commodities transactions are netted against losses, when determining the gross income. This due to the fact that foreign corporations would be treated as "foreign personal holding companies" merely because of trading operations, either profitable or unprofitable.<sup>102</sup>

## 4.2.1 Taxation of U.S. Shareholders

When a corporation has been labelled a FPHC the American shareholder is levied tax on his income in the foreign corporation. The income is treated as a constructive dividend. Indirect ownership, through an interposed foreign entity<sup>103</sup>, is treated as direct ownership and imposed tax under IRC section 551.<sup>104</sup>

The shareholder is to include, as a dividend, the amount that would have been received as a dividend, had the foreign corporation made a distribution to its shareholders for the taxable year in his gross income. The shareholder is imposed tax on this "dividend" in the year in which the taxable year of the distributing corporation ends. When establishing the taxable income from the foreign corporation, consideration is taken to the shareholders relative interest in the corporation by determining what the amount would have been of a dividend to that particular shareholder, had an actual distribution been made.<sup>105</sup>

The relative interest is determined differently when a foreign corporation is a "foreign personal holding company" on the last day of its taxable year, from when this status ends during the taxable year. In the first situation the entire amount of the shareholder's proportional share of "undistributed personal holding company income" for the year is included under section 551 IRC. The determination is somewhat more complicated in the second situation. The amount included under section 551 IRC is a portion of the shareholder's share of "undistributed personal holding company income", measured by the ratio of the part of the year preceding the last day of "foreign personal holding company" status over the entire taxable year. When determining taxation of a dividend under section 551(b), the earnings and profits account of the foreign corporation is disregarded.<sup>106</sup>

The entire income, i.e. both active and passive, of a "foreign personal holding company" is currently taxed to the U.S. shareholders. Consequently, foreign corporations which raises both active and passive income, should make certain that the active business operations will predominate, in order to avoid application of the FPHC rules. As is the case with operating

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<sup>101</sup> Isenbergh II p. 3 f.

<sup>102</sup> Isenbergh II p. 5.

<sup>103</sup> I.e. a trust or a corporation.

<sup>104</sup> See Supplement A.

<sup>105</sup> Isenbergh II p. 6.

<sup>106</sup> Isenbergh II p. 6 f.

through direct branches, losses from active business operations can offset passive income. If the foreign corporation during the taxable year has distributed dividends, this amount reduces the "undistributed foreign personal holding company income". Deduction is also conceded to dividends that the corporation as well as the shareholders have agreed to but have not been distributed. The tax system treats the undistributed income of U.S. shareholders as having been distributed and reinvested in the "foreign personal holding company".<sup>107</sup> Thus the U.S. shareholder's basis in the shares is accordingly increased by the amount of the proportionate share of the dividend.<sup>108</sup>

## 4.2.2 Coordination with Subpart F

Following the Revenue Act of 1984 income falling within both the FPHC-rules and Subpart F, is taxable only under Subpart F.<sup>109</sup> Income taxable under one of the provisions are taxable without regard for the other set of rules. Before the 1984 Act the FPHC-provisions were given precedence. The underlying purpose of this transfer in precedence was that the prior rules opened up the possibility to avoid certain taxation under Subpart F by qualifying as a "foreign personal holding company". An example, was that investment of previously untaxed income in the United States, might have escaped U.S. taxation.<sup>110</sup>

## 4.3 Foreign Investment Companies

Section 1246 of the IRC concerns the "foreign investment company" and initially was a countermeasure against allocating passive investment by U.S. persons to offshore tax havens. The "passive foreign investment company" rules which were enacted in the 1986 Act, included stronger measures. Thus, the importance of the FIC rules is limited why they are overlooked in this thesis.

## 4.4 Passive Foreign Investment Companies

The "passive foreign investment company" rules (PFIC) are not dependent on American ownership or control. The rules eliminate the benefit of deferral of U.S. taxation on a foreign entity's passive investments by imposing current taxation on U.S. shareholders.<sup>111</sup> Any foreign corporation is a "passive foreign investment company" if "[1] 75 percent or more of the gross income of such corporation for the taxable year is passive income, or [2] the average percentage of assets (by value) held by such corporation

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<sup>107</sup> Isenbergh II p. 9 f.

<sup>108</sup> [IRC §551(e): Actual inclusion is necessary for this basis adjustment, however, not mere includability.] Isenbergh II p. 10 note 9.

<sup>109</sup> Under IRC section 951(d).

<sup>110</sup> Isenbergh II p. 12 f.

<sup>111</sup> Isenbergh II p. 129 f.

during the taxable year which produce passive income is at least 50 percent."<sup>112</sup> Passive income for the purposes of these rules is practically the same as "foreign personal holding company income".<sup>113</sup>

Holding entities that own substantial interests in active businesses are not targeted by the PFIC rules. This result is achieved partly by the treatment of income deriving from related persons,<sup>114</sup> and partly by section 1296(c). According to the look-through rules a foreign corporation owning 25 percent or more of the stock of another corporation is considered, for the purpose of these rules, to hold directly its proportionate share of the assets of the other corporation and received a proportionate share of the income deriving from the other corporation. Thus, a foreign holding company which owns all the shares of an active business corporation and nothing else is not considered a "personal foreign investment company".<sup>115</sup>

If a foreign corporation is considered a PFIC its U.S. shareholders are taxed according to one of two tax systems. The shareholder is either currently taxed or taxed when income is de facto received by the shareholder. The first alternative, current taxation, applies to corporations that fulfill certain requirements set up by the IRS. A corporation liable for current taxation is called a "qualified electing fund".<sup>116</sup>

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<sup>112</sup> IRC § 1296(a).

<sup>113</sup> IRC § 1296 Excludes [1] income derived in the active conduct of a banking or insurance business by a corporation which is predominantly a financial intermediary, or [2] interest, dividends, rents, or royalties from a related person paid from income that is not itself passive income.

<sup>114</sup> See footnote 114.

<sup>115</sup> Isenbergh II p. 131 f.

<sup>116</sup> Wenehed p. 291.

# 5 Subpart F

## 5.1 Background

The PHC-and FPHC-legislation both aimed at income of physical persons and hence targeted passive income. They did not, however, target the increasing number of foreign corporations, owned by American shareholders, working at minimising their tax burden on income deriving from certain international businesses.<sup>117</sup> The corporations in question fall under the definition of a foreign base company.<sup>118</sup> Base companies are used as a middle hand between related juridical persons or between related juridical person and a third party. It is common that the foreign corporation is a wholly owned subsidiary of an American corporation and is located in a low-tax state.<sup>119</sup>

Developments that led to an increasing deficit, and subsequently Subpart F, was according to the Kennedy Administration that the United States and other states' tax systems gave foreign investment preferential treatment. It was stated that accumulation of income in a foreign corporation and subsequently tax deferral, which resulted in a discrepancy in the taxation of profits deriving from domestic and foreign investment, i.e. neutrality is not upheld. Lack of neutrality in taxation gives rise to tax incentives as to where investments should be allocated. Corporations with foreign subsidiaries were said to exploit the U.S. tax system through tax deferral and tax haven deferral.<sup>120</sup>

Subpart F was enacted in order to deter United States taxpayers from using related "foreign base companies" located in tax haven countries to accumulate income in the corporation instead of in the hands of the taxpayer. Subpart F eliminates the tax deferral benefits in these cases by requiring United States taxpayers to include in his current taxable income his share of the foreign base company income of a "controlled foreign corporation".<sup>121</sup> The U.S. tax system deemed income sheltered in a foreign entity to be distributed to the resident shareholders,<sup>122</sup> by way of referring to a fictive dividend.<sup>123</sup> The controversy, at the time, derived from imposing tax on a fictive dividend, i.e. a distribution which has not yet been realized.<sup>124</sup> Whether or not this taxation was constitutional was discussed in

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<sup>117</sup> Wenehed p. 256.

<sup>118</sup> E.g. Holding-companies, middle hand in export/import to/from the U.S., and captive insurance-companies.

<sup>119</sup> Wenehed p.257 f.

<sup>120</sup> Wenehed p. 257 f.

<sup>121</sup> Koehring Co. v. Commissioner 583 F.2d 313 (7th Cir. 1978).

<sup>122</sup> The deemed dividend rule.

<sup>123</sup> The fictive distribution approach.

<sup>124</sup> Helminen p. 201.

the United States. Given that current taxation only is imposed on undistributed profits controlled by the shareholder it was found constitutional.

## 5.2 Current Taxation of U.S Shareholders Under Subpart F

The application of the Subpart F rules, and its current taxation of U.S. shareholders, is dependent on the American control of the foreign corporation. Even if this formal requirement is not fulfilled, a corporation can get the status of a CFC, if the U.S. shareholders de facto own control.

In section 957(a)<sup>125</sup> a "controlled foreign corporation" is defined as "any foreign corporation if more than 50 percent of [1] the total voting power of all classes of stock...entitled to vote, or [2] the total value<sup>126</sup> of the stock, is owned...by United States shareholders on any day during the taxable year of such foreign corporation." In theory foreign corporations that do not have more than 50 percent U.S. ownership or control will not fall under Subpart F. As is shown below, this is not consistent with practice in real life. This aspect is discussed in chapter 5.3.

A United States shareholder is, according to section 951(b), "[a United States person...who owns...10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.]" The Code defines a United States person as any individual or resident of the United States and any domestic corporation or other domestic entity.<sup>127</sup> In order to be considered a "controlled foreign corporation" the requirements in both these sections must be fulfilled.<sup>128</sup>

A U.S. shareholder is currently taxed only if he is a U.S. shareholder of a "controlled foreign corporation" on the last day of CFC status. Consequently, a shareholder could be taxed for the entire year's earnings due to recently acquired shares. In theory, it is possible for a shareholder to avoid taxation by transferring the shares before the last day of CFC status. The IRC, however, includes provisions that eliminate the tax benefits of anticipatory transfers of shares.<sup>129</sup>

The purpose of Subpart F is to minimize the benefits of tax deferral and to ensure that income does not go untaxed. The United States does, however, concede tax deferral, if the income is sufficiently taxed outside the territory. This indicates that the purpose of tax deferral is not tax induced. A sufficient taxation must exceed 90 percent of the highest corporate tax rate

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<sup>125</sup> See Supplement A.

<sup>126</sup> The 1986 Tax Reform Act presented an amendment according to which ownership of more than 50 percent of the total corporate value constitutes control.

<sup>127</sup> Isenbergh II p. 26 f.

<sup>128</sup> Isenbergh II p. 27.

<sup>129</sup> Isenbergh II p. 38.

in the United States.<sup>130</sup> The U.S. shareholder is entitled to exemption of the foreign tax, including income tax, that derives from the income.<sup>131</sup> If the foreign tax is 90 percent of the U.S. tax, the tax imposed is hence only marginal. The income imposed current taxation must not exceed the foreign corporation's profit available for distribution, according to American rules.<sup>132</sup> Losses deriving from certain income, that is not Subpart F income, could eliminate or decrease the Subpart F income, and subsequently the current taxation. In order to decrease Subpart F income, the shareholder can locate business, showing deficit, to the foreign corporation.<sup>133</sup>

Section 951(a)(1)<sup>134</sup> states that "if a foreign corporation is a "controlled foreign corporation" for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder of such corporation and who owns stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends."<sup>135</sup> When U.S. control is established, it is thus this section that determines whether or not current taxation will be imposed.

For the purpose of Subpart F indirect ownership through layers of foreign entities, could lead to imposed current taxation on a U.S. shareholder on account of shares not actually owned.<sup>136</sup>

## 5.3 Subpart F Income

The shareholder is subjected to current taxation on the part of income that constitutes U.S. shareholder income. The ownership of related persons is not included, despite the fact that this ownership is included in the control test.<sup>137</sup> Current taxation is imposed on a U.S. shareholder's so called "pro rata share" of the amounts taxable under Subpart F.<sup>138</sup> The "pro rata share" is defined in IRC section 951(2).<sup>139</sup>

Subpart F income consists of certain insurance income, "base company income", international boycott income, income used for bribery, and income deriving from a state, of which taxes are not exempt from U.S. taxes. The reason underlying this last addition is political claiming that the U.S. tax

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<sup>130</sup> The highest corporate tax is 35 percent, why sufficient taxation is considered fulfilled at a rate of 31,5 percent or higher. Wenehed p. 287 note 39.

<sup>131</sup> Wenehed p. 287.

<sup>132</sup> § 952 (c)(1)(A), § 964 (earnings and profits).

<sup>133</sup> Wenehed p. 288.

<sup>134</sup> See Supplement A.

<sup>135</sup> [Current taxation under Subpart F can be delayed as much as 11 months through the use of unmatched taxable years.] Isenbergh II p. 38.

<sup>136</sup> Isenbergh II p. 39.

<sup>137</sup> The control test determines whether U.S. ownership constitutes control of the foreign corporation.

<sup>138</sup> Isenbergh II p. 37.

<sup>139</sup> See Supplement A.

system should not benefit states with which the United States either has poor relations with or of which they do not approve.<sup>140</sup> Grounds for denied exemption are lack of diplomatic relations with the country in question, the foreign country has repeatedly supported acts of international terrorism, and countries with governments which the United States does not recognize.<sup>141</sup>

The Subpart F income is limited to the earnings of profits of the corporation for that year.<sup>142</sup> Thus, currently taxable income can be offset by the CFC's losses regardless from which activity they derive from.<sup>143</sup>

If the "base company income" constitutes a substantial part of the total income of a foreign corporation, the total income will be treated as "base company income". In order for the "base company income" to taint other income, it is required that these exceed 70 percent of the total income of a Subpart F company.<sup>144</sup>

"Base company income" is not currently taxed if this income falls below 5 percent of the total income of the foreign corporation, or if 5 percent of the total income exceed one million USD, the Subpart F income must not exceed one million USD.<sup>145</sup>

The U.S. tax system makes a distinction between passive income and active business profits.<sup>146</sup> In order for Subpart F to be inapplicable, the foreign corporation must show a substantial activity, and at least part of it must be carried out directly by the CFC.<sup>147</sup> Following the Portanova<sup>148</sup> case, a requirement of direct involvement of a taxpayer in activity, is part of the concept of "trade or business", which makes it more difficult for a foreign corporation to cross the threshold set up in section 954(c)(2)(A).<sup>149 150</sup>

## 5.4 The Deemed Dividend Rule

The U.S. shareholder is currently taxed on Subpart F income, as if this was a dividend from a foreign corporation.<sup>151</sup> Since the United States apply the classical system to taxation of a dividend, the shareholder is fully taxed without exemption of the tax paid by the corporation. The classical corporate tax system entails that income is taxed at the corporate level and

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<sup>140</sup> Wenehed p. 285.

<sup>141</sup> Isenbergh I p. 488.

<sup>142</sup> IRC § 952(c)(1)(A).

<sup>143</sup> Isenbergh II p. 43.

<sup>144</sup> Wenehed p. 286.

<sup>145</sup> Wenehed p. 287.

<sup>146</sup> Isenbergh I p. 227.

<sup>147</sup> A requirement demanding that 25 percent of the costs must be borne by an "organization" of the CFC in a foreign country.

<sup>148</sup> Portanova v. United States 690 F.2d 169.

<sup>149</sup> See Supplement A.

<sup>150</sup> Isenbergh II p. 86 ff.

<sup>151</sup> IRC §§ 960(a), 902.

distributions of such income is taxed further at shareholder level.<sup>152</sup> A U.S. shareholder, which is a corporation and owns at least 10 percent of the votes in the foreign corporation, can however exempt both the foreign tax paid by the shareholder, and the income tax that the distributing corporation paid. Since Subpart F income which is taxed currently to the shareholder, is considered a dividend, this possibility of exemption exists also on American tax for the U.S. shareholder at CFC taxation. Indirect credit is also conceded for physical owners, if they choose to be CFC taxed as a corporation.<sup>153</sup>

Since currently taxed income is a fictive dividend, there is an obvious risk of double taxation, when a real dividend is received. Double taxation is avoided by not taxing dividend, which has been subjected to current taxation. Exemption is also conceded for a fictive withholding tax in connection with the current taxation.<sup>154</sup>

Subpart F makes a distinction between active business operations and tax-haven operations. Tax deferral is allowed in the first case while the second is taxed currently to U.S. shareholders. In practice several active business operations fall under the Subpart F. These are, however, considered as having tax shelter potential.<sup>155</sup> The legislation aims at targeting mainly passive income.

## 5.5 The Concept of Control

In U.S. tax law the concept of voting control is the determining factor of whether a foreign corporation constitutes a "controlled foreign corporation" or not. In the attempt to avoid the rules, corporations started shifting voting control to foreign investors. These investors were often guaranteed a limited dividend, as payment for the help in avoiding taxation. Investors were carefully chosen, but it still meant a great risk for the corporation to lose part of the control. Since the corporations had to transfer 50 percent of voting control, in order to avoid Subpart F, the foreign investors could induce a deadlock situation, hindering the operations of the corporation. The benefits of avoiding taxation had to be weighed against the risk of a passive partner becoming a hostage taker.<sup>156</sup>

In the Treasury Regulations referring to section 957,<sup>157</sup> i.e. the definition of a "controlled foreign corporation", it is stated that in certain circumstances the nominal contribution of voting power will be ignored when it is not consistent with the reality of control.<sup>158</sup> Concerning shifting of formal voting power, the Regulations state:<sup>159</sup>

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<sup>152</sup> Ault p. 142.

<sup>153</sup> Wenehed p. 288.

<sup>154</sup> Wenehed p. 288 f.

<sup>155</sup> Isenbergh II p. 22.

<sup>156</sup> Isenbergh II p. 28 f.

<sup>157</sup> See Supplement A.

<sup>158</sup> *Koehring Co. v. Commissioner* 583 F.2d 313 (7th Cir. 1978).

<sup>159</sup> Treasury Regulations 1.957-1(b).



"Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained."

The Regulations claim that the fact that a person owns stock entitled to vote, does not in itself mean that the shareholder has the voting power referred to in section 957 IRC. An agreement, whether express or implied, that any shareholder will not vote or will vote only in a specified manner, or that shareholders not formally having a majority of the total combined voting power will exercise voting power as if they did, leads to the nominal ownership of the voting power being disregarded. In the case an agreement is found, the determination of which shareholders actually hold such voting power will be based on said agreement. The Regulations further give a method useful when the occurrence of separate classes of voting stock is to be determined, namely the "tri-test":

"Where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded [1] if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, [2] if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and [3] if a principal purpose of the arrangement is to avoid the classification of such foreign corporation under section 957 IRC."

Moreover, the Regulations provide that U.S. shareholders will be treated as having control [1] if they have the power to elect a majority of the board of directors (or of the corresponding governing group under local law); [2] if they have the power to elect all the members of the board of directors and also have the power directly or through an agent to break a deadlock of the board of directors; or [3] if in some other way they can exercise indirectly the powers of a board of directors.<sup>160</sup> No negative inference can be drawn from this statement. The lack of power to elect a majority of directors does not negate control if a major interest is held in other respects.<sup>161</sup>

Critics argue that the Regulations' treatment of control as an active part of business operations that must always be used is questionable. In practice, the power of voting is its mere existence. Moreover, in a successful business the owners are often willing to leave the operational part of the business to the management. Isenbergh argues that the failure to vote can, in practice, be in itself a reason to disregard voting power, which casts doubt on the validity of the regulation given its breadth.<sup>162</sup> The statute's formulation suggests that control is a function of voting power, and not of who actually

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<sup>160</sup> Treasury Regulations 1.957-1(b)(1).

<sup>161</sup> Treasury Regulations 1.957-1(c).

<sup>162</sup> Isenbergh II p. 31.

votes, which is the Regulations' interpretation. In their attempt to eliminate abuse, this very feature makes the Regulations questionable, according to Isenbergh.<sup>163</sup> It is, however, unquestionable that in many cases, the transfer of control in a foreign corporation is to avoid CFC rules and thereby tax induced. Taken literally, the Regulations would apply to all structures designed to avoid the status of a CFC. The notion that simply by designing to avoid being a CFC the structure becomes one is, however, not justifiable. Isenbergh uses an example to elucidate the problem stating, [t]hat this feature of the regulations is overwrought can best be understood by imagining a regulation denying a charitable deduction to taxpayers making charitable contributions in the hope of obtaining one."<sup>164</sup> The following cases address the problem of determining what constitutes voting control and give a good insight on the purpose of the United States' CFC rules.

### **5.5.1 Kraus v. Commissioner<sup>165</sup>**

In 1965 each of the taxpayers sold part of the common shares in the Liechtenstein corporation Kraus Reprint, Ltd. (KRL), and subsequently realizing a substantial gain. The corporation KRL was owned by the Kraus family, which owned common shares, and a number of foreign investors, who were preferred shareholders.<sup>166</sup> The taxpayers in the Kraus family were all United States taxpayers and jointly owned 50 percent of the voting stock. The foreign investors represented the remaining 50 percent of the voting stock. The basic question the Court was to answer, was whether or not KRL was a "controlled foreign corporation" within the meaning of IRC section 957(a)<sup>167</sup>, so that the gain realized upon the sale of its common stock by the taxpayers, resulted in the receipt of dividend income as provided by IRC section 1248(a).<sup>168</sup> According to this section a gain realized by United States shareholders on the sale of foreign stock shall be treated as a dividend (rather than as a capital gain) to the extent of the earnings and profits of the foreign corporation attributable.

The taxpayers claimed that because the ownership of the corporation was 50 percent U.S. and 50 percent foreign ownership, the IRC § 957(a) did not apply. The section states that "controlled foreign corporation" means any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote. The Tax Court stated that it is conceded that 50 percent of the voting stock of KRL was held by the common stockholders, all of whom were United States shareholders. The other 50 percent was owned by preferred shareholders, none of whom were United States shareholders. The Tax Court held that the

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<sup>163</sup> Isenbergh II p. 31.

<sup>164</sup> Isenbergh II p. 31.

<sup>165</sup> 490 F.2d 898

<sup>166</sup> Preference shares = shares (often with no voting rights) which receive their dividend before all other shares and which are repaid first (at face value) if the company is liquidated.

<sup>167</sup> See Supplement A.

<sup>168</sup> See Supplement A.

voting preferred stock was merely a device utilized to give the appearance of compliance with section 957(a) and that KRL was in fact a "controlled foreign corporation". Moreover, the articles of incorporation stated that:

- i. [Preferred stock could be transferred "only with the approval of the Board of Directors" and approval could be denied "on the basis of important reasons". If preferred stock was acquired pursuant to an act of law (e.g., inheritance, matrimonial regime, bankruptcy), the board could deny registration if the corporation or its shareholders declared that they would acquire the shares at the real value at the time the application for registration was made.
- ii. The preferred shares could be repaid or redeemed by the corporation after not less than three months' notice at par value, plus any past due and current dividends to the day of redemption.]

The appellant argued that since ownership did not exceed 50 percent of the combined voting power of all the classes entitled to vote, the clear and unambiguous language of section 957(a) led to the application of a mechanical test of stock ownership irrespective of actual voting power. This question was raised and answered in *Garlock, Inc. v. Commissioner*.<sup>169</sup>

In that case the Court found it significant that the taxpayer had carefully sought out parties who understood both the motives of the transfer of control and how the corporation would be operated. Another important aspect to disregard nominal voting control was that the arrangement saw to it that the preferred shareholders would have no interest in disturbing the taxpayer's continued control. The Court concluded that the preferred shareholders' voting power in this case was illusory.<sup>170</sup>

The Court of Appeals held, in *Kraus v. Commissioner*, that a corporation with 1000 shares of common stock owned by the taxpayer and 1000 shares of preferred stock with equal voting rights owned by foreign investors was a "controlled foreign corporation" under the treasury regulation<sup>171</sup> giving full consideration to legal and equitable aspects of ownership, as opposed to mere mechanical number of votes.

The Treasury Regulations provide, inter alia, that any arrangement to shift formal voting power away from United States shareholders "will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957." In the case in question, the percentage of mathematical voting power of the

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<sup>169</sup> 489 F.2d 197 (1973).

<sup>170</sup> *Garlock, Inc. v. Commissioner* 489 F.2d 197 (1973).

<sup>171</sup> Treasury Regulations 1.957-1(b)(2).

preferred shareholders (50 percent) was substantially greater than its proportionate share of the corporate earnings.

The Tax Court concluded that the taxpayer never intended to lose any voting control in KRL and that the preferred shareholders did not show any intention to use the voting power nominally carried by their stock. Although given the fact, that it is legal to create a corporate structure aiming to minimize taxes,<sup>172</sup> the Court had to decide whether or not a real transfer of voting power took place. If the arrangement in reality meant no change in control of the corporation, it is likely that the purpose was tax induced, in order to avoid KRL from being labelled as a "controlled foreign corporation". Guidance in determining whether a corporation is a CFC or not, can often be found in the relationship between the shareholders. In the current case the new preferred shareholders were selected as to not intervene in the operational control in KRL. There was no arrangement for the breaking of a deadlock in voting, although the redemption of any dissident stockholder's shares at par value could be said to solve this problem should it arise. Presence of a preferred shareholder at meetings was lacking in all cases but one. The Court of Appeals concluded that while no single factor of the aforementioned might in itself be sufficient to establish that KRL was a "controlled foreign corporation", the sum total established it beyond any doubt.

### **5.5.2 Koehring Co. v. Commissioner<sup>173</sup>**

Koehring acquired a Panamanian corporation which was renamed Koehring Overseas Corporation (KOS). The new wholly owned subsidiary was responsible for the overseas marketing of Koehring products. In 1963, around the time Subpart F was enacted,<sup>174</sup> Koehring arranged a transfer of voting control in KOS to the English corporation Newton Chambers. After the transfer Koehring represented 45 percent, and Newton Chambers 55 percent of the voting shares. The new Board of Directors of KOS was constituted, of which two directors were elected by Koehring and three by Newton Chambers. At the time the two parties were connected in a licensing contract, which stated that Newton Chambers was to sell only Koehring products.

The Court found that the Newton Chambers directors' actions were of a passive nature more consistent with the theory that Koehring held operational control than that it was a joint international sales subsidiary actively dominated by Newton Chambers. Moreover, when the transfer of control took place Newton Chambers did not attempt to replace existing management, which was closely identified with Koehring, with executives more loyal to Newton Chambers. No Newton Chambers directors were authorized to draw checks on behalf of KOS, even though at least two

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<sup>172</sup> See the statement made by Judge Learned Hand in *Gregory v. Helvering* presented in 1.1.

<sup>173</sup> 583 F.2d 313 (1978).

<sup>174</sup> Subpart F was enacted in 1962.

Koehring directors (not officers of KOS) were so authorized. The annual report of KOS in 1963, furthermore stated that the Newton Chambers investment in the corporation was nominal.

Consequently, the IRS argued that the implied agreement between the parties effectively permitted Koehring to exercise operating control over KOS. Koehring claimed that the lack of formal restrictions,<sup>175</sup> and the fact that Newton Chambers represented 55 percent of the voting shares, rendered former cases<sup>176</sup> inapplicable in this case. IRS, on the other hand, argued that the absence of formal restrictions does not eliminate the possibility of finding the purpose of an arrangement for retaining operational control. In the present case, an informal side agreement constituted that Koehring would keep the actual control of KOS. The Court concluded that Koehring continued to enjoy the tax deferral benefits of off-shore earnings accumulation, by retaining operational control coupled with a 100 percent interest in the earnings of KOS after allowance for the limited preferred dividend, Subpart F was intended to eliminate.

### **5.5.3 C.C.A., Inc. v. Commissioner<sup>177</sup>**

In this case the voting power was divided 50-50 percent between United States shareholders and foreign investors. The IRS argued that the albeit demonstrable possession of equal voting power be disregarded, because the preferred shareholders had no reason ever to use such powers because they possessed only the limited right to a fixed dividend. The Court found nonetheless that 50 percent of the voting power had in fact been shifted to non-U.S. shareholders and that the intention to avoid the reach of Subpart F did not in itself prevent success in doing so. The IRS has refused to accept this ruling. Following the Tax Reform Act of 1986 , a shift of voting power to foreign shareholders as was the case here, is not sufficient to avoid being labelled as a "controlled foreign corporation".<sup>178</sup>

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<sup>175</sup> I.e. restrictions on the transferability of the shares, call provisions, provisions giving the stockholders the right to force the redemption of their shares, etc.

<sup>176</sup> E.g. *Garlock, Inc. v. Commissioner* 489 F.2d 197, and *Kraus v. Commissioner* 490 F.2d 898.

<sup>177</sup> 64 T.C. 137.

<sup>178</sup> *Isenbergh II* p. 32 f.

# 6 Compatibility with International Law

## 6.1 International Law vs. International Tax Law

International tax law differs from international law in many respects. Jurisdiction is based on residence rather than nationality<sup>179</sup> and regarding property and foreign income source jurisdiction is used instead of territoriality.<sup>180</sup> International tax law expands the scope of nationality jurisdiction to an extent not found elsewhere in international law.<sup>181</sup>

Most countries associate nationality with the concept of citizenship. The United States, however, claims the right to tax its citizens on foreign source income when they live permanently in another country.<sup>182</sup> Justification is derived from the notion that citizens benefit from the government regardless of where they are domiciled.

In the tax field countries have adopted a definition of nationality, which is applicable in tax matters. This definition of residence is based on a mere physical presence in the state for a minimum number of days. While the United States derives jurisdiction from this principle alone, other countries supplement it with a "fiscal domicile test".<sup>183</sup>

## 6.2 Existence of Customary International Tax Law?

The emergence of a rule permitting countries to tax "controlled foreign corporations" on their foreign source income, in practice directly, is interesting since it in the beginning was a breach of international law. Initially, the U.S. Courts evaded the forbidden direct taxation of a foreign corporation on its foreign source income by incorporating "the deemed dividend rule".<sup>184</sup> Since international tax law did not admit the residence state to tax the corporation, the U.S. tax authorities currently taxed the United States shareholders on income deriving from the foreign corporation.

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<sup>179</sup> [The activities, interests, status, or relations of a state's nationals outside as well as within its territory.] Avi-Yonah, Tax Law Review.

<sup>180</sup> [Conduct that, wholly or in substantial part, takes place within a state's territory.] Avi-Yonah, Tax Law Review.

<sup>181</sup> Avi-Yonah, Tax Law Review, p. 2.

<sup>182</sup> Established by the Supreme Court in *Cook v. Tait* 265 U.S. 47. See also *United States v. Bennett* 232 U.S. 299 and *United States v. Goelet*.

<sup>183</sup> Avi-Yonah, Tax Law Review, p. 2.

<sup>184</sup> See 5.4.

Current taxation was introduced in the United States due to the proliferation of corporations shifting income to a corporation incorporated in tax havens, in order to accumulate the profits free of taxation. This problem originated in the U.S. approach to nationality jurisdiction for corporations, in which a corporation easily can change situs of incorporation while retaining headquarters with management and de facto operational control in the United States.<sup>185</sup>

The solution was the FPHC rules which taxed the U.S. shareholders on a deemed dividend of the accumulated passive income of the FPHC. When adopting these rules the United States considered it a breach of international law to tax a FPHC (a foreign national) directly on foreign source income. The adoption of Subpart F expanded the use of the deemed dividend rule further. The compatibility with international law was not contested by other states, and instead the proliferation of CFC rules followed.

In *Eder v. Commissioner*,<sup>186</sup> Judge Frank of the Second Circuit upheld the deemed dividend rule without discussing its international law implications. At the time, this rule resulted in an extensive expansion of United States residence taxing jurisdiction. This due to the fact that taxing a deemed dividend is economically equivalent to taxing a foreign corporation directly on foreign source income. Since no other countries questioned the compatibility with international law, but rather adopted similar legislations themselves, it could be argued that the CFC concept has become part of customary law. Some countries have gone as far as abandoning the deemed dividend concept and instead apply direct taxation of the shareholders, by pass-through principle, on the foreign corporation's income. Avi-Yonah argues that this change in the jurisdictional rule, in practice, means that the requirement of a deemed dividend is obsolete. Moreover, that it may be possible to tax a "controlled foreign corporation" directly on its foreign source income, only due to the residents' control.<sup>187</sup>

In the United States this change has readily been embraced, and the IRS goes as far as believing that the PHC regime apply directly to foreign corporations, regardless that this entails taxing a corporation on foreign source income. Interestingly, in 1937 when the PHC rules were adopted, it was clear that the United States did not have jurisdiction to tax foreign corporations on foreign source income. It was, in fact, so clear that Congress did not think to specifically state that foreign corporations did not apply. Furthermore, the reason the FPHC rules were adopted was lack of jurisdiction. The IRS argues that under the new understanding of jurisdictional limits, the PHC rules as well as the FPHC rules apply to foreign corporations. Deriving residence jurisdiction to foreign corporations on the mere fact that they are controlled by nationals constitutes a great distinction from ordinary international law.<sup>188</sup>

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<sup>185</sup> See 5.5.

<sup>186</sup> 138 F.2d 27, 28-29 (2d Cir. 1943).

<sup>187</sup> Avi-Yonah, Tax Law Review.

<sup>188</sup> Avi-Yonah, Tax Law Review.

The expansion of nationality jurisdiction in the tax area is derived from the "first bite at the apple rule", adopted by the League of Nations in 1923. This rule states that the source jurisdiction has the primary right to tax income arising within it, and the residence (nationality) jurisdiction is obligated to prevent double taxation by granting an exemption or a credit. The expansion of residence jurisdiction to "controlled foreign corporations" does, thereby not affect the source jurisdiction's right to tax the foreign corporation first, since residence jurisdiction only applies when the source jurisdiction refrains from taxation. It does, however, lead to complaints from source jurisdictions claiming that their right to grant tax holidays to foreign investors is limited. In response it could be argued that the restricted application of CFC rules to passive income alleviates this problem.<sup>189</sup>

From the 1930's to the 1960's a universally acknowledged rule of customary international law prohibited taxing foreign corporations on foreign source income. The rule was at the time considered binding. Consequently, the United States constructed the deemed dividend rule to avoid an outright breach. With the proliferation of CFC regimes, many countries did not use the deemed dividend rule, but rather taxed the foreign corporation directly, why the United States no longer considered it binding. Thus, the application of the PHC regime to foreign corporations was considered justifiable.<sup>190</sup>

Given the wide use and acceptance of the expanded nationality jurisdiction for corporations, it is argued that the CFC concept has become part of customary international law. Academics argue that the incorporation of the residence principle in many treaties and the extent in which it is used globally, that it can be considered part of customary international law.<sup>191</sup> If there is a customary law it would mean that the U.S. approach to jurisdiction would be put in question.

## 6.3 Tax Treaty Override

In the United States statutory law and treaties are under constitutional principles of equal status. In a case where domestic legislation and treaty provisions conflict, the later is given precedence, i.e. *Lex posterior derogat priori* prevails. The consequence is that inconsistent domestic legislation can override treaty obligations. The courts have, however, required that the legislative intent to override a treaty obligation must be clearly expressed.<sup>192</sup>

### 6.3.1 *Kappus v. Commissioner*<sup>193</sup>

In this case two United States citizens, the Kappuses, resided in Canada. The Kappuses claimed a credit against their U.S. tax for all of the taxes paid

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<sup>189</sup> Avi-Yonah, Tax Law Review.

<sup>190</sup> Avi-Yonah, Tax Law Review.

<sup>191</sup> Avi-Yonah, Tax Law Review.

<sup>192</sup> Ault p. 467.

<sup>193</sup> 337 F.3d 1053 (D.C. Cir. 2003).



to Canada on their Canada-source income, leaving them with no U.S. tax liability. The Commissioner argued that section 59(a)(2)<sup>194</sup> of the IRC, limits the allowable foreign tax credit to 90 percent of a taxpayer's alternative minimum tax liability.<sup>195</sup> The Kappuses claimed that this section violates the terms of a tax treaty between the United States and Canada. Judge Garland stated that even if the Kappuses were correct that the treaty and statute were in conflict, the statute must prevail under the last-in-time rule.

The Court further referred to the case *Pekar v. Commissioner*,<sup>196</sup> in which the Court held that the AMT is intended to prevent a taxpayer with substantial income from avoiding significant tax liability through the use of exemptions, deductions, and credits.<sup>197</sup> The Kappuses argued that section 59(a)(2) was in direct conflict with the U.S.-Canada Tax Treaty, and that in such a circumstance the most recent provision must govern under the last-in-time rule. Despite the fact that the Treaty entered into force in 1984, two years before the enactment of section 59(a)(2), the Kappuses contended that amendments to the Treaty ratified in 1995 and 1997 implicitly repealed § 59(a)(2) and represented the most recent relevant enactments. The Tax Court responded by claiming that the Treaty and the statute were not in conflict, and that even if they were, the statute would prevail as the last in time because nothing in the subsequent amendments conflicted with the Statute.<sup>198</sup> The paragraphs disputed in this case were 1 and 4(a)(b) of Article XXIV of the U.S.-Canada Tax Treaty, which in relevant parts read:

1. [In the case of the United States, subject to the provisions of paragraphs 4, 5, and 6, double taxation shall be avoided as follows: In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a citizen or resident of the United States...as a credit against the United States tax on income the appropriate amount of income tax paid or accrued to Canada...
  
4. Where a United States citizen is a resident of Canada, the following rules shall apply:

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<sup>194</sup> See Supplement A.

<sup>195</sup> An alternative minimum tax (AMT) is applicable to a corporation when the income, according to the AMT rules, exceed the taxable income according to ordinary tax rules. The AMT rules include certain income that is favorably treated in the ordinary tax rules why it is possible to get a different result in the taxable income. The tax rate of the AMT is 20 percent after a deduction of USD 40,000 has been made from the AMT income. Isenbergh I p. 18.

<sup>196</sup> 113 T.C. 158 (1999).

<sup>197</sup> *Kappus v. Commissioner* 337 F.3d 1053 (D.C. Cir. 2003) p. 1054 n. 1.

<sup>198</sup> *Kappus v. Commissioner* p. 1054.

- (a) Canada shall allow a deduction from the Canadian tax in respect of profits, income or gains which arise...in the United States, except that such deduction need not exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen; and
- (b) for the purpose of computing the United States tax, the United States shall allow as a credit against United States tax the income tax paid or accrued to Canada after the deduction referred to in subparagraph (a).]<sup>199</sup>

The Kappuses contended that under paragraph 4(b), the United States is required to grant a credit for the entire amount of the Canadian tax that they paid on the income they earned in Canada while residing there. The Commissioner's interpretation of paragraph 1, entailed that the statute, limiting foreign tax credit to 90 percent, fell under "the limitations of the law of the United States."<sup>200</sup>

In the case of conflicting treaty provisions and domestic statutes which relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either.<sup>201</sup>

The Kappuses contended that harmonization was not possible due to the fact that the Treaty flatly barred the application of section 59(a)(2). Consequently, the provision last in time, the Treaty, must prevail. The Commissioner, on the other hand, contended that the two could be read in harmony. Regardless if they could not, the statute was in any case the last in time.<sup>202</sup>

The question laid before the Court concerned the interpretation of the Article XXIV of the Treaty. The Commissioner claimed that section 59(a)(2) was an example of a limitation of the law of the United States which is stated in paragraph 1. The Kappuses argued that because the limitation "subject to the provisions of paragraphs 4, 5, and 6" preceded the underlined proviso (argued by the Commissioner) and therefore modified it. They further argued that paragraph 4(b) required that United States citizens who resided in Canada were fully credited for their Canadian taxes. The Commissioner disagreed in the contention that the order of the phrases were controlling. Moreover, even if it was, paragraph 4 did not bar the application of the statute. In the Commissioner's view that paragraph did not impose a substantive obligation on the United States to grant a tax credit, but rather

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<sup>199</sup> Kappus v. Commissioner p. 1055.

<sup>200</sup> See Supplement A.

<sup>201</sup> Whitney v. Robertson 124 U.S. 190; see also Xerox Corp. v. United States 41 F.3d 647.

<sup>202</sup> Kappus v. Commissioner p. 1056.

"merely provides rules for determining the order in which deductions or credits for taxes paid to the other jurisdiction are to be applied when the same income is subject to tax by both."

The Court decided that the question whether the Treaty and statute could be harmonized or not, did not need to be resolved due to the last-in-time rule.<sup>203</sup> When a statute conflicts with a treaty, the later of the two enactments prevails over the earlier under the last-in-time rule. The Court derived basis for this position in *Whitney v. Robertson*,<sup>204</sup> in which the rule and its rationale were articulated by the Supreme Court. [If the treaty contains stipulations which are self-executing, that is, require no legislation to make them operative, to that extent they have the force and effect of a legislative enactment. Congress may modify such provisions, so far as they bind the United States, or supersede them altogether. By the Constitution a treaty is placed on the same footing, and made of like obligation, with an act of legislation. Both are declared by that instrument to be the supreme law of the land, and no superior efficacy is given to either over the other. When the two relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either; but if the two are inconsistent, the one last in date will control the other...]

The Court refers to *Breard v. Greene*,<sup>205</sup> in which was held that "[a]n Act of Congress...is on a full parity with a treaty, and...when a statute which is subsequent in time is inconsistent with a treaty, the statute to the extent of conflict renders the treaty null." Interesting in this case was that the appellant argued that his conviction and sentence to death should be overturned because the state authorities violated the Vienna Convention by failing to inform him that, as a foreign national, he had a right to contact the Paraguayan Consulate. Because he filed this motion in the Federal District Court and not already in the state court, he failed to exercise his rights under the Vienna Convention in conformity with the laws of the United States and the state laws. Furthermore, the Court held that "although treaties are recognized by our Constitution as the supreme law of the land, that status is no less true of provisions of the Constitution itself, to which rules of procedural default apply."

In *Kappus v. Commissioner*, the Court continued to determine which provision, the Treaty or the statute, was the latest expression of the sovereign will. Section 59(a)(2) did not specifically address the relationship between its requirements and those of applicable tax treaties. Not long after the section was enacted, the Congress clarified this in the Technical and

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<sup>203</sup> The Court came to a similar conclusion in *South African Airways v. Dole* 817 F.2d 119 where the Court held "assuming arguendo the existence of a conflict between a treaty and statute, and resolving the case on the basis of the last-in-time principle"; see also *Jamieson v. Commissioner* 132 F.3d 1481 where the outcome was "holding, in a case prior to the amending protocols, that § 59(a)(2) prevailed over the U.S.-Canada Tax Treaty under the last-in-time principle without determining whether they were in conflict."

<sup>204</sup> 124 U.S. 190.

<sup>205</sup> 523 U.S. 371.

Miscellaneous Revenue Act of 1988 (TAMRA), which today is codified in 26 U.S.C. § 7852(d)(1):

(c) Treaty Obligations.-

- (1) In General.-For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.

According to the TAMRA report, this provision was intended to codify the last-in-time principle as applied to tax treaties and statutes.

- (2) Certain amendments to Apply Notwithstanding Treaties.-The following amendments made by the [Tax] Reform Act [of 1986] shall apply notwithstanding any treaty obligation of the United States in effect on the date of the enactment of the Reform Act:

- (B) The amendments made by title VII of the Reform Act [of which section 59(a)(2) was a part] to the extent such amendments relate to the alternative minimum tax foreign tax credit.<sup>206</sup>

According to TAMRA, the Court held, it was crystal clear that Congress intended the 90 percent cap on the AMT foreign tax credit to supersede any preexisting treaty obligation with which it conflicted.

The Kappuses argued that the ratification of two subsequent protocols to the Treaty in 1995 and 1997 had the effect of re-establishing the Treaty (as amended) as the latest expression of the sovereign will. The Court responded that these protocols did not address section 59(a)(2), nor did they amend paragraphs 1 or 4 of Article XXIV, the provisions at issue in this case. The appellants argued, however, that the protocols effectively supersede section 59(a)(2) because any protocol to an international convention, regardless of the protocol's content, implicitly reaffirms the signatories' commitment to the entire underlying treaty. "Thus, the appellants contend that we should regard the entire U.S.-Canada Tax Treaty as having been readopted in full when the Third and Fourth Protocols were ratified, and that the readopted Treaty trumps section 59(a)(2) under the last-in-time rule."

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<sup>206</sup> TAMRA § 1012(aa)(2)(codified at 26 U.S.C. § 861).

The Kappuses relied solely on their theory of implied reaffirmation, or as they call it "the doctrine of implied repeal". In *South African Airways v. Dole*,<sup>207</sup> the Court held that "repeals by implication are not favored, and are never admitted where the former can stand with the new act."<sup>208</sup> The Court concluded that the protocols plainly were not "absolutely incompatible" with section 59(a)(2) because their text neither bars its application nor modifies any treaty provision that bars it. Furthermore, the best way to harmonize section 59(a)(2) with the protocols is to assume that the latter were not intended to repeal the former. "That means reading the protocols as doing nothing more than amending the provisions of the original treaty that they specifically address."<sup>209</sup>

As a last resort the Kappuses claimed that the protocols implicitly repeal the intervening statute based on a well-settled principle of international law. The appellants base their claim on Article 40(5) of the Vienna Convention on the Law of Treaties.<sup>210</sup> This claim was disregarded by the Court due to its inapplicability in this case.<sup>211</sup>

Interestingly the ruling in this case in practice led to double taxation and thus, the treaty override should not be justifiable in the treaty context.<sup>212</sup> Furthermore, the fact that the Kappuses did not invoke the VCLT earlier in the process and on what basis they finally did, shows the insignificance of the Convention in U.S. tax law.

## **6.4 Does the U.S. Tax System Constitute A Breach of International Law?**

The question regarding the compatibility with international law in this thesis is threefold:

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<sup>207</sup> 817 F.2d 119.

<sup>208</sup> See *Chew Heong v. United States* 112 U.S. 536 in which the Court stated "holding that one statute will never be read to repeal another absent [positive repugnancy..., and even then the old law is repealed by implication only pro tanto, to the extent of the repugnancy]; see *Johnson v. Browne* 205 U.S. 309 where the Supreme Court stated [A later treaty will not be regarded as repealing an earlier statute by implication, unless the two are absolutely incompatible, and the statute cannot be enforced without antagonizing the treaty]; see *Xerox Corp. v. United States* 41 F.3d 647 where it was stated that [Tacit abrogation of prior law will not be presumed and, unless it is impossible to do so, treaty and law must stand together in harmony.].

<sup>209</sup> The Court conceded that a protocol could effectively reenact an underlying treaty, but that they may not construe one as implicitly doing so when the effect is to abrogate an intervening statute. In particular cases, the language and drafting history of a protocol may evidence the parties' intention to recommit themselves to their preexisting treaty obligations. There were no such evidence in this case.

<sup>210</sup> The United States has signed but not ratified the VCLT.

<sup>211</sup> E.g. Article 40 applies only to multilateral treaties, does not say anything about the situation where both states were parties to the original treaty etc.

<sup>212</sup> Avi-Yonah, Tax Law Review.

1. Does current taxation and subsequently direct taxation of foreign source income comply with international law?
2. Does the U.S. tax system's disregard of the VCLT comply with international law?
3. Does the tax treaty override in U.S. tax law comply with international law?

[1] Taxing shareholders currently for undistributed income in a foreign corporation does, in practice, mean that the foreign corporation is taxed directly by a foreign jurisdiction. The use of "controlled foreign corporation" rules is a way of circumventing the international principle, stating that a country does not have jurisdiction to tax foreign tax subjects. It is, however, arguable if this principle still is binding to states. The fact that many countries have abandoned the "deemed dividend rule" for direct taxation, is an indication that the rule has lost its status of a binding principle.

In international law passive conduct of states may contribute to the emergence of a customary rule, or enforce an existing rule.<sup>213</sup> By analogy with this interpretation the change towards accepting direct taxation of foreign corporations seem to be heading towards an international customary law, as the "deemed dividend rule" was in the beginning of CFC taxation. Today, the United States is considering the "deemed dividend rule" obsolete and imposes tax directly on foreign corporations.

The "deemed dividend rule" was, when enacted by the United States undoubtedly, a breach of international law. Despite the pretence that taxation was levied on a dividend, in practice, the foreign corporation was taxed on its foreign source income which universally was considered a breach of customary law. The evolution of the CFC rules could, however, arguably support the direct taxation, and it is today difficult to claim that it constitutes a direct breach of international law.

[2] The United States often clarifies that they have signed but not ratified the VCLT. However, in areas other than taxation, the United States considers the VCLT customary law and consequently binding. Furthermore, by signing the Convention the United States is not supposed to act contrary to it.

The Court stated that when interpreting a treaty, "the terms thereof are given their ordinary meaning in the context of the treaty and are interpreted, in accordance with that meaning, in the way that best fulfills the purposes of the treaty."<sup>214</sup> In the Xerox case the Court provided that extrinsic evidence

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<sup>213</sup> Villiger p. 18.

<sup>214</sup> Xerox Corp. v. United States 41 F.3d 647; see United States v. Stuart 489 U.S. 353 ["interpreting a treaty to carry out the intent or expectations of the signatories."]; Kolovrat v. Oregon 366 U.S. 187 ["a treaty should be interpreted to carry out its purpose."]; Valentine v. United States 299 U.S. 5 ["it is our duty to interpret the treaty according to its terms. These must be fairly construed, but we cannot add or detract from them."].

should rarely be depended on when interpreting a treaty unless the treaty terms are unclear or unclear as applied to the situation that has arisen. This due to the problems connected with reconstructing all of the considerations and compromises that led to the treaty. The Court does, however, concede that extrinsic material is helpful in many cases in understanding the treaty and its purposes. In *Air France v. Saks*<sup>215</sup> the Court stated that "[i]n interpreting a treaty it is proper, of course, to refer to the records of its drafting and negotiation."<sup>216</sup>

The Xerox case involves a technical disputed article, which will only briefly be presented. In Article 23 of the treaty the purpose of the same is stated as the elimination of double taxation of United Kingdom corporate dividends to United States shareholders. The Article further provides that "the United States shall allow credit for the appropriate amount of tax paid to the United Kingdom." In the Federal Claims Court it was stipulated that Article 23(1)(c) provides a tax credit to the U.S. shareholder for ACT<sup>217</sup> paid by the UK corporation, by treating the ACT as an income tax imposed on the UK corporation paying the dividend. The government claimed that the Treaty permits the United States to reverse that tax credit unless or until the ACT is set off against mainstream corporation tax in the United Kingdom.

The problem lies in the fact that the Treaty does not mention such a condition on the allowance of foreign tax credit in the United States for ACT paid in the United Kingdom. Based on this, Xerox argues that this omission is strong evidence that this restrictive condition was not intended by the signatories. The consequence of this interpretation is that the purpose of avoiding double taxation on profits is defeated. In changing the effect of the Treaty as is the case here, Xerox argues that it should not be inferred by omission of a condition. Furthermore, the Treaty could not have omitted stating this condition explicitly when the Treaty was renegotiated. According to Xerox the plain meaning of the Treaty, in the context of its purpose, renders the government's interpretation unjustifiable. The government, on the other hand, claims that the United States always intended to restrict the availability of the ACT credit to U.S. taxpayers as was done in the present case, and that this view was known to and accepted by both signatories.

While the government relied on the Treasury's Technical Explanation and Revenue Procedure, Xerox relied on the plain language of the Treaty itself, its ratification history, and testimony of the chief negotiators for the United States and the United Kingdom.

The Federal Claims Court referred to the statement made in *Choctaw Nation of Indians v. United States*<sup>218</sup> which provides "[t]reaties are construed more

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<sup>215</sup> 470 U.S. 392.

<sup>216</sup> See *Great-West Life Assurance Co. v. United States* 678 F.2d 180 ["the ultimate question remains what was intended when the language actually employed...was chosen, imperfect as that language may be."].

<sup>217</sup> A certain tax for corporations.

<sup>218</sup> 318 U.S. 423.

liberally than private agreements, and to ascertain their meaning we may look beyond the written words to the history of the treaty, the negotiations, and the practical construction adopted by the parties." In *Maximov v. United States*,<sup>219</sup> the Supreme Court held that the analysis, however, must begin with the text of the treaty and the context in which the written words are used.

In the conclusion of the case the Court of Appeals referred to *Maximov v. United States*<sup>220</sup> where the issue of interpretation was settled. In that case the treaty's meaning was considered plain and unambiguous and the interpretation thus should not be contrary to the treaty's clear purpose of avoidance of double taxation. It was considered inappropriate for courts to depart from the purpose and import of a treaty, particularly when there is no indication that application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories.<sup>221</sup>

The *Xerox* case is interesting regarding the interpretation of treaties. While the IRS relied on Article 31<sup>222</sup> of the VCLT for interpretation, which seems to be the natural solution, the Court of Appeals disregarded these sources and relied instead on affidavits submitted by the treaty negotiators. The affidavits were claimed to state what the parties meant but dated later than the conclusion of the treaty. The parties were at the time of the establishment of the affidavits in private practice, and thereby had no immediate interest in protecting the fisc. Regardless, this source is according to the Convention of inferior status and should not solely be used for interpreting a treaty.

It is arguable that even though the United States has not ratified the VCLT, its disregard of the Convention is a breach of international law. This due to the Convention's status of customary law. The U.S. position of regarding the Convention as binding in other areas than taxation further supports this conclusion.

[3] Tax treaties are written agreements concluded between two or more states. The VCLT provides, in accordance with *pacta sunt servanda*, that this agreement is binding for the contracting states and must be performed by the states in good faith.<sup>223</sup> The reason given for the disregard of treaties in tax cases, is that since tax treaties are slow to renegotiate, there is a need for the treaty override. Tax law is, of course, constantly changing but does that justify a breach of an international agreement?

A tax treaty is binding between the contracting states, and cannot be revised by one party, without the consent of the other. The purpose of a treaty is to

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<sup>219</sup> 373 U.S. 49.

<sup>220</sup> 373 U.S. 49.

<sup>221</sup> *Maximov v. United States* p. 54.

<sup>222</sup> See Supplement B.

<sup>223</sup> VCLT Article 26.



eliminate juridical double taxation, and facilitate a fair apportionment of the tax revenue between the parties. In practice, the contracting states waive part of their sovereign right to taxation, in favor of the other party. When the United States unilaterally change the prerequisite of an existing treaty by giving precedence for domestic legislation, this constitutes a breach of the treaty and thereby also international law. The fact that the treaty concerns taxation should not change the obligation to follow it. If following the reasoning aforementioned in part [2] the VCLT is considered customary international law and is therefore binding.<sup>224</sup> It is, of course, arguable if in certain cases treaty override is in fact justifiable when considering the purpose of the treaty. It is, however, difficult to create a principle stating when a treaty override is justifiable, and furthermore which party that is to decide that question. The conclusion must therefore be that in theory the treaty override is a breach of international law. In practice the question remains, whether the rapidly changing nature of tax law justifies a breach of an international agreement or not.<sup>225</sup>

In *Kappus v. Commissioner* the Court discussed the interpretation of the treaty without addressing the question of compatibility with international law. What is self evident for the United States I consider somewhat arbitrary. Studying the U.S. tax system I find myself intrigued by the aggressiveness shown in its tax policies. Moreover, I find it remarking that the United States derives justification for domestic law superseding treaty provisions from the case *Whitney v. Robertson*. While talking about the ever changing tax law and the need to revise when problems arise, interpretation of which provision precedes the other is derived from a case held in 1888. As capital becomes more mobile and consequently harder to allocate to related countries for tax purposes, will other countries be forced to take more drastic measures to capture revenue?<sup>226</sup>

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<sup>224</sup> Regardless that the United States has not ratified the VCLT.

<sup>225</sup> The "controlled foreign corporation" regime's compatibility with tax treaties is not addressed in this thesis. The decision to overlook this aspect is based on three factors. [1] The application of a "saving clause" in U.S. tax treaties, [2] the omission of the often disputed Article 7 of the OECD Model Tax Treaty in U.S. tax treaties, and [3] the position taken by the OECD to generally consider CFC regimes not to conflict with tax treaties. Regarding the CFC regime the United States claims that it is not conflicting with existing tax treaties. Partly due to the "saving clause" found in most treaties. In this clause the United States reserves the right to refrain from using the tax treaty on a U.S. taxpayer regarding American taxation. The CFC legislation does in these cases not conflict with the treaties. Furthermore, the use of a fictive dividend might prevent the CFC rules in conflicting with treaties in which no "saving clauses" are found.

<sup>226</sup> Noren.

# Supplement A - Relevant Internal Revenue Sections

## § 59(a)

### (2) Limitation to 90 percent of tax.-

(A) In general.-The alternative minimum tax foreign tax credit for any taxable year shall not exceed the excess (if any) of-

- (i) the pre-credit tentative minimum tax for the taxable year, over
- (ii) 10 percent of the amount which would be the pre-credit tentative minimum tax...

## § 951. Amounts included in gross income of United States shareholders

### (b) Amounts included.-

(1) **In general.**- If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958 (a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends-...

(2) **Pro rata share of subpart F income.**- The pro rata share referred to in paragraph (1)(A)(i) in the case of any United States shareholder is the amount-

(A) which would have been distributed with respect to the stock which such shareholders owns (within the meaning of section 958(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

(B) the amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been

received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year.

For purposes of subparagraph (B), any gain included in the gross income of any person as a dividend under section 1248 shall be treated as a distribution received by such person with respect to the stock involved. ...

**(3) Limitation on pro rata share of previously excluded subpart F income withdrawn from investment.-...**

**(c) United States shareholder defined.-** For purposes of this subpart, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958 (a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

**§ 952. Subpart F income defined**

**(a) In general.-** For purposes of this subpart, the term "subpart F income" means, in the case of any controlled foreign corporation, the sum of-

(1) insurance income (as defined under section 953)

(2) the foreign base company income (as determined under section 954),

(3) an amount equal to the product of-

(A) the income of such corporation other than income which-

(i) is attributable to earnings and profits of the foreign corporation included in the gross income of a United States person under section 951 (other than by reason of this paragraph), or

(ii) is described in subsection (b),

multiplied by

(B) the international boycott factor (as determined under section 999)...

(b) Exclusion of United States income.- In the case of a controlled foreign corporation, subpart F income does not include any item of income from sources within the United States which is effectively connected with the conduct by such corporation of a trade or business within the United States unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States...

**(c) Limitation.-**

**(1) In general.-**

**(A) Subpart F income limited to current earnings and profits.-** For purposes of subsection (a), the subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such taxable year.

#### **§ 957. Controlled foreign corporations; United States persons**

**(a) General rule.-** For purposes of this subpart, the term "controlled foreign corporation" means any foreign corporation if more than 50 percent of-

- (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or
- (2) the total value of the stock of such corporation,

is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

**(a) United States person.-** For purposes of this subpart, the term "United States person" has the meaning assigned to it by section 7701(a)(30)...

#### **§ 958. Rules for determining stock ownership**

**(a) Direct and indirect ownership.-**

**(1) General rule.-** For purposes of this subpart (other than section 960(a)(1)), stock owned means-

- (A) stock owned directly, and
- (B) stock owned with the application of paragraph (2).

**(2) Stock ownership through foreign entities.-** For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person...

**(b) Constructive ownership.-** For purposes of sections 951(b), 954(d)(3), 956(c)(2), and 957, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of the controlled foreign corporation under section 957, except that-

**(1)** In applying paragraph (1)(A) of section 318(a), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

**(2)** In applying subparagraphs (A), (B), and (C) of section 318(a)(2), if a partnership, estate, trust or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote.

**(3)** In applying subparagraph (C) of section 318(a)(2), the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C).

**(4)** Subparagraphs (A), (B), and (C) of section 318(a)(3) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person...

**§ 1248. Gain from certain sales or exchanges of stock in certain foreign corporations**

**(a) General rule.-** If-

- (1) a United States person sells or exchanges stock in a foreign corporation, and
- (2) such person owns, within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of the sale or exchange when such foreign corporation was a controlled foreign corporation (as defined in section 957),

then the gain recognized on the sale or exchange of such stock shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary) to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation. For purposes of this section, a United States person shall be treated as having sold or exchanged any stock if, under any provision of this subtitle, such person is treated as realizing gain from the sale or exchange of such stock...

# Supplement B - Vienna Convention on the Law of Treaties

## **Part III. OBSERVANCE, APPLICATION AND INTERPRETATION OF TREATIES**

### **Section 1. Observance of treaties**

Article 26. Pacta sunt servanda

Every treaty in force is binding upon the parties to it and must be performed by them in good faith.

### **Section 3. Interpretation of treaties**

Article 31. General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
  - a. any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;
  - b. any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
  - a. subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
  - b. any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
  - c. any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32. Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

- a. leaves the meaning ambiguous or obscure; or
- b. leads to a result which is manifestly absurd or unreasonable.



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