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Perspectives on the Deferral Of U. S. Taxation of the Earnings of Foreign Corporations

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Introduction

A central element of the U. S. tax regime imposed on the foreign earnings of U. S. persons—and during much of the history of U. S. taxation the one with the greatest power to move the imagination of tax lawyers—is the possibility of deferring U. S. taxation of the income of foreign corporations. This possibility results from the separate legal identity of corporations in the U. S. tax system, which regards a corporation as a taxpayer separate from its shareholders. A foreign corporation, even when owned by Americans, is a separate person that sometimes operates beyond the reach of the U. S. taxing power.

When foreign corporations owned by U. S. persons are not subject to current U. S. taxation, the tax regime they enjoy is known as “deferral,” because the earnings of foreign corporations owned by Americans are not exposed to U. S. income tax until they are actually returned to U. S. shareholders as dividends or other gains constituting currently taxable income. U. S. tax is accordingly deferred on foreign earnings that remain undistributed.

The deferral of U. S. taxation, given the time value of money, offers an obvious reward, with the constraint that deferral is worthwhile only when the sum of foreign income taxes imposed on a corporation is significantly lower than the U. S. rate that would be imposed absent deferral. Recent decreases in the marginal rates of U. S. taxation have doubtless blunted the value of deferral in a range of situations. It remains true, though, when foreign taxes are either very small or zero, that protracted or indefinite deferral approaches the value of total exemption from U. S. tax. And there are still economic environments outside the United States where taxation is benign. The final benefit of deferral arises when shares of foreign corporations that have escaped U. S. taxation receive a fair market value basis upon the death of their individual owners. From one generation to the next, deferral becomes exemption.

Virtually the entire system of U. S. taxation of overseas operations can be understood as an elaborate corollary of (and reaction to) the basic premise that foreign corporations are separate taxpayers. As it stands today, U. S. taxation of foreign income is a complex, even Byzantine, mix of deferral and current taxation bound together in a complex of statutory rules. In broadest overview, deferral remains possible for active business operations undertaken through foreign corporations. It is not available, however, for a variety of “tax haven” operations, conducted through so-called controlled foreign corporations, i.e., corporations under the actual control or ownership of a small number of U. S. shareholders. The passive investment income and tax haven earnings of controlled foreign corporations are immediately taxable to their U. S. shareholders. In addition, some operations of noncontrolled foreign corporations fall within the reach of current U. S. taxation under several recent statutory changes. The incomes of most
foreign passive investment companies are now exposed to immediate U. S. taxation, and the movement of assets in and out of noncontrolled foreign corporations is now subject to a number of special rules triggering the current recognition of gain and loss by U. S. shareholders.

This pattern of taxation has evolved by accretion over the past 50 years, and as in many other segments of the U. S. tax system, it is not easy to find either larger implications or a unifying design. Compulsively, I will attempt to do so anyway. The following pages present the current system of deferral in overview, with particular emphasis on the more recently enacted provisions, along with a few observations on matters of policy.

Recent Provisions. The sphere of deferral has been notably eroded by several recent additions to the Code. These include in particular the new rules of Sections 367(d) and 482 governing transfers of intellectual property to foreign corporations, the enlargement of the scope of current taxation of controlled foreign corporations under Subpart F, and perhaps most importantly the introduction of a new income tax regime for passive foreign investment companies in which U. S. persons own shares. Also bearing significantly on the value of deferral is the repeal of the tax preference for capital gains in the 1986 Tax Reform Act. The cumulative force of these provisions may not be fully appreciated even by many tax lawyers.

Academic Versus Lawyerly Perspectives. Before venturing further into the labyrinth of present law, I should reveal my own basic attitude on deferral, as well as certain assumptions that I hold about my audience’s. My impression in general is that tax lawyers rather like deferral. It brings measurable tax benefits to clients with overseas operations and enshrins those benefits in an almost overwhelmingly complex web of rules that it falls to the lawyer to untangle. In this regard I would imagine that partners almost surely think more highly of deferral than do associates.

On the other end of the spectrum, most tax academics think rather ill of deferral. Where it prevails, deferral tends to misallocate capital. It is a tenet of international finance that capital should be induced to flow where real (i.e., pretax) returns are the highest. A regime of current worldwide taxation serves this end better than deferral, which may induce investment in low-tax environments for real returns that are lower than those available elsewhere. In its present gerrymandered form, deferral has the additional vice of inducing the creation of costly and cumbersome structures for foreign investment, groaning under the weight of transactional complexities created for the sole purpose of capturing the remaining possibilities of deferral.

There is, I should add, an intellectually coherent defense of deferral on a “second best” theory, to wit that deferral serves to offset other burdens imposed by the U. S. income tax system on foreign investment, such as the denial of investment credits and accelerated cost recovery for capital assets used outside the United States. That defense was more plausible, however, before the 1986 Act, which eliminated most of the special investment incentives even in the domestic economic environment.

Deferral over the Years

With biases fully disclosed, let us take a quick survey of how we got where we are.

The possibility of deferral of U. S. taxation was nearly absolute in the early years of the U. S. income tax. The tax sheltering possibilities for benignly taxed foreign operations were correspondingly nearly unlimited.

Foreign Personal Holding Companies. The first and simplest adaptation devised by taxpayers to the possibility of deferral was the so-called foreign personal holding company. An individual would transfer income-producing assets (or assets ripe with unrealized gains) to a wholly owned corporation chartered in a low-tax foreign jurisdiction. Assets held or sold in such entities might attract no current income tax whatsoever. Even if the assets were actually invested in the United States, the resulting dividends would be taxed at the relatively low flat rate withholding taxes imposed on foreign taxpayers.

The response of the U. S. tax system to these possibilities was a set of statutory provisions (adopted in 1937 and now codified in Code Sections 551 through 558) limiting deferral for “foreign personal holding companies.” These rules aim rather narrowly at what have been called “incorporated pocketbooks”—foreign investment entities owned and controlled by a small number of U. S. individuals. The income of a foreign personal holding company is taxed directly to their U. S. shareholders, which eliminates the tax advantage of using a foreign corporation.

The foreign personal holding company rules reach only a narrowly defined class of corporations with a specific type of income. A “foreign personal holding company” is a foreign corporation (1) in which more than 50 percent of the total combined power of all classes of stock 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 and (2) which derives at least 60 percent of its gross income in the form of “foreign personal holding company income.” The latter is a mix of various types of passive investment income and tax shelter income.

Foreign “Base Companies.” For 25 years after their enactment, the foreign personal holding company rules stood as the only statutory encroachment on the regime of tax deferral. When it bites, the tax on foreign personal holding companies is quite fearsome, but its range is narrow. It does not reach corporations owned and controlled by more than five individuals, or

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corporations (even closely held) with a preponderance of active business income. Widely owned enterprises, and in particular foreign subsidiaries of publicly owned U.S. corporations, are left entirely unscathed.

It is hardly surprising that operations conducted through foreign corporations flourished beyond the reach of the foreign personal holding company rules. A number of tax-motivated structures became widespread. A common theme of these ventures was the shift of income from high-tax to low-tax environments without incurring real economic risks in the latter.

A foreign corporation organized to operate as a center of accounting profit severed from its economic moorings is known as a "base company." A U.S. enterprise selling goods overseas, for example, might sell them in bulk at a low price to a foreign subsidiary in a tax haven country (the base company), which would in turn sell them at a high price to a second subsidiary (possibly a lower-tier subsidiary of the same enterprise) engaged in selling the goods in their market of destination. The resale by the base company would be set at the highest possible price, resulting in a large profit in a tax-favored environment, while the foreign corporation engaged in final distribution in a high-tax jurisdiction would have a correspondingly high cost basis in the goods and would be unlikely to make a taxable profit. The pattern overall is a deflection of income from the place of manufacture and distribution to a tax haven entity serving as a conduit. The permutations and combinations of uses of base companies are nearly endless.

The 1962 Legislation: Subpart F. The first large-scale break in the armor of deferral came with the adoption of Subpart F in the Revenue Act of 1962. In 1961 the Kennedy Administration proposed doing away with deferral for all foreign corporations controlled by U.S. persons. The broad ground for this position was the bias induced by deferral in favor of overseas investment against domestic investment. In the Administration's view, current U.S. taxation of controlled foreign corporations across the board would restore a measure of neutrality to investment decisions across national boundaries, and was accordingly more efficient. The Administration also expressed a more specific concern about abuses of offshore tax havens. The bill sent to Congress by the Administration in 1961 imposed current taxation on the U.S. shareholders of essentially all controlled foreign corporations. The U.S. business community responded that overseas operations were on the whole legitimate business undertakings rather than tax haven maneuvers, and that the competitive posture of U.S. enterprises in overseas markets would be devastated if they were taxed more heavily than their competitors from other countries.

Whatever its merit—and in truth it has rather little—this response met with sympathy in Congress, and has also framed the public debate over deferral ever since. The House of Representatives adopted a scaled-down version of the Administration's bill that imposed current taxation on various types of tax haven operations, on income attributable to intangible property used overseas, and on foreign profits used to create new overseas ventures. In the Senate, the reach of the legislation was cut back even further, current taxation being limited to passive income and tax haven income (in the form of various types of base company income), while deferral was continued for income from active business operations. The legislation finally adopted in 1962 as Subpart F essentially contained the Senate's version of the bill.

The 1962 version of Subpart F embodied the view that the decision by a U.S. firm to engage in business in a low-tax environment is itself acceptable (and not in itself a "tax haven" operation), but that the receipt of passive income offshore and the deflection of income to low-tax jurisdictions away from the country of actual economic activity are abuses. Subpart F as originally adopted (and still today) attempts in effect to distinguish between "legitimate" overseas undertakings and "bad" tax haven operations.

The 1962 Act also introduced Section 1248, which largely curtailed the possibility of capturing gains from liquidations or sales of controlled foreign corporations as capital gains. Together, Subpart F and Section 1248 established a separate tax regime for controlled foreign corporations, to a great extent still in place.

Recent Enlargements of the Reach of Subpart F

While the major elements of the 1962 enactment survive today as the baseline tax regime for controlled foreign corporations, the provisions of Subpart F have been tightened several times since 1962, and major changes were introduced in the 1986 Act. In the present version, current U.S. taxation reaches far more overseas economic activity of controlled foreign corporations than did the 1962 Act, while the repeal of the capital gains preference in the 1986 Act reduced Section 1248 to a bystander role.

Expanded Notion of "Control" Under Subpart F. Subpart F imposes current taxation on the U.S. shareholders of "controlled" foreign corporations only, making control a major threshold of taxation under Subpart F. A controlled foreign corporation under the 1962 Act was one in which U.S. shareholders held over half the voting power. The 1986 Act enlarged the class of "controlled" foreign corporations under Subpart F to include those in which U.S. shareholders own more than half of the value, even without voting control.1 Either beneficial owner...

1 A controlled foreign corporation is defined in Section 957(a) as "any foreign corporation if more than 50 percent of (1) the total voting power of all classes of
ship or voting control by U. S. persons now exposes a foreign corporation to current U. S. taxation under Subpart F. It is no longer possible to avoid current U. S. taxation of foreign corporations by shifting voting power to a group of foreign investors who are not major equity holders. The wonderfully accommodating foreign banks of yesteryear that would hold issues of voting preferred stock and occasionally send someone to a director’s meeting, while consistently manifesting a healthy indifference to the day-to-day management of the corporation, have largely disappeared from the scene. It is important to note, though, that current taxation under Subpart F is still imposed only on U. S. persons who have a measure of voting power in controlled foreign corporations. A correlation between some implicit power to force a realization of gains (i.e., control) and current U. S. taxation is thus still an element of Subpart F.

Expanded Range of Subpart F Income. While Subpart F still rests overall on a basic distinction between active business operations (for which deferral is allowed) and tax haven operations (which are taxed currently to U. S. shareholders), several types of foreign income have moved across the boundary under recent provisions, and the distinction is now less crisp than in 1962. When Subpart F was first adopted, foreign base company income (the central category of Subpart F income) included only passive investment income and income from tax haven arrangements between related taxpayers. No income from active business transactions with unrelated persons (even though conducted in low tax jurisdictions) was subject to current U. S. taxation. Enlargements of base company income in 1975, 1982, and most importantly 1986, brought foreign shipping income, foreign oil related income, and a far broader range of financial income within the class.

The most important of these changes is the enlarged inclusion of passive-type income within Subpart F in the 1986 Act, principally through the addition of financing income earned by banks and insurance companies to the class of foreign personal holding company income, even when it is derived from active business operations. This is a significant departure from the principle that Subpart F aims strictly at tax haven structures, though it remains the case that the operations reached by Subpart F have the common trait of being relatively easy to steer into a low tax environment, even when an active business is involved. A better encapsulation of Subpart F in its present sway would be that it reaches foreign operations in which relatively liquid or relatively mobile capital is a dominant factor.

New Treatment of Deficits of Controlled Foreign Corporations

A less visible, but equally important way in which the 1986 Act reduced the scope of deferral was the introduction of a new regime for the earnings deficits of controlled foreign corporations. Before the 1986 changes, accumulated deficits in earnings and profits of controlled foreign corporations from prior years reduced the earnings and profits of the current year. This resulted, roughly, in a system of loss carryforwards under Subpart F.

The 1986 Act brought significant limitations to the effect of prior deficits on the includible income of U. S. shareholders of controlled foreign corporations. Deficits are now taken into account only within specific lines of activity that generate earnings themselves subject to current taxation. Under Section 952(c)(1)(B)(i), the amount of Subpart F income includible by a U. S. shareholder for any taxable year and attributable to a “qualified activity” is reduced by the shareholder’s “pro rata share of any qualified deficit.” The key terms of art here, of course, are the “qualified activity” and the “qualified deficit.” A “qualified deficit” is a deficit in earnings from a prior taxable year of a controlled foreign corporation (but later than 1986) “attributable to the same qualified activity as the activity giving rise to the income being offset.” Prior year's deficits in earnings can offset only income from qualified activities and must originate with these activities. Thus base company sales or services income cannot be reduced by prior deficits, nor can the investment income of nonfinancial institutions.

The new rules on deficits curtail sharply the potential tax benefit from the acquisition of loss corporations by controlled foreign corporations, a practice widely followed before the 1986 Act with gratifying results. The changed treatment of earnings deficits of foreign corporations after 1986 roughly mirrors the constraints imposed on transfers of loss corporations generally in Section 382. The new rules are not invariably less favorable than pre-1986 law, however. A “qualified deficit’ from a prior year will now reduce Subpart F income from the same activity. Before, a prior deficit would reduce all earnings and might therefore have no effect on Subpart F income if there were enough other income. On balance, though, the new regime is far more severe.

stock . . . entitled to vote, or (2) the total value of the stock, is owned . . . by United States shareholders on any day during the taxable year of such foreign corporation.” Because more than 50 percent ownership or control is required, an exactly equal partnership between foreign persons and Americans escapes Subpart F.

New United States shareholder is defined in Section 951(b) as “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.” Only United States shareholders within this definition are subject to current taxation under Subpart F.

The four “qualified activities” are those giving rise to (1) foreign base company shipping income, (2) foreign base company oil related income, (3) insurance income (but only for an insurance company), and (4) foreign personal holding income (in the hands of a financial institution).
The 1986 Act also repealed Section 952(d) (known as the chain deficit rule), under which the earnings and profits of corporations in a chain of corporations were reduced by deficits in earnings and profits of other members of the chain. The effect of the rule was that all the deficits in earnings of the members of a chain were aggregated and could reduce Subpart F income.

Overall, the chain deficit rule was similar in its effect to direct ownership of the underlying assets of the foreign corporations by their U.S. shareholders. Its repeal makes losses arising in separate foreign entities far more costly, and is in this respect fully consistent with the increased severity toward losses manifested by the 1986 Act generally.

The Repeal of the Capital Gains Preference

Capital Gains in the New World. Section 1248, long a centerpiece of the tax regime imposed on controlled foreign corporations, faded into the background after the repeal in the 1986 Act of preferred rates of tax for capital gains. The capital gains preference explained both the existence and the mechanics of Section 1248.

Before the adoption of Subpart F in 1962, the sale by a U.S. person of shares of a foreign corporation, like the sale of any other shares, produced capital gains. If the earnings of the foreign corporation had been untaxed or lightly taxed outside the United States, the U.S. capital gains tax (at the time much lower than the U.S. tax on ordinary income) would ultimately be the only tax imposed on the foreign earnings, even after their effective "repatriation" through the sale of shares. The resulting tax regime for foreign earnings was notably less onerous than the domestic regime. A deferred tax at capital gains rates might be the only tax cost of foreign operations. Subpart F brought current U.S. taxation to certain foreign earnings and some indirect repatriations.

Within its four corners, Subpart F left open the possibility of capital gains from the liquidation or sale of foreign corporations, because it did not reach the non-tax-haven operations of controlled foreign corporations or sales of shares of controlled foreign corporations. Section 1248 filled the gap left open by Subpart F in the 1962 Act, by taxing gains from the liquidation or sale of shares of a controlled foreign corporation as dividends, to the extent the gains are attributable to earnings on which U.S. taxation has been deferred. In effect, Section 1248 prevents the repatriation of foreign earnings at capital gains rates.

A minor paradox is that Section 1248, originally conceived to cut down the potential benefit of converting ordinary income to capital gain, now tends to be favorable to taxpayers in the situations where it applies. This is so because, for corporate shareholders, the constructive dividend that results from a sale of shares under Section 1248 has, like any other dividend, the effect of pulling out "deemed paid" foreign income taxes that may produce foreign tax credits. The capital gain that would result from the sale of the shares would have no such effect. Section 1248 is thus now essentially a measure of tax relief, which softens the tax consequences of sales by U.S. corporations of shares of foreign subsidiaries. Without Section 1248(a), a U.S. parent corporation would have to arrange an explicit dividend distribution before any sale of shares in order to preserve the credit, and even then could not be sure that the Revenue Service would not recast this "stripping" dividend as part of the proceeds of the sale of shares.

Offshore Investment Funds. The third Belle of the 1962 Ball, the taxation of foreign investment companies under Section 1246, was left a wallflower in the wake of the 1986 changes. The central mechanism of Section 1246 is the same as that of Section 1248: denial of the capital gains preference to sellers of shares of foreign entities. With the leveling of the capital gains preference in the 1986 Act, Section 1246 lost most of its bite. Meanwhile, the 1986 Act introduced far stronger provisions on offshore passive investment in the form of a new tax regime imposed on "passive foreign investment companies," which is discussed below. Like many superannuated tax provisions, however, Section 1246 did not die in 1986, but faded into a twilight of semi-relevance. It still haunts the Code, and hence these pages.

Under Section 1246, gain from the sale of shares of a "foreign investment company" is taxed as ordinary income to the extent attributable to the company's post-1962 earnings. The point of Section 1246 was to prevent an offshore mutual fund from converting ordinary investment income into capital gains. Even with Section 1246, however, the possibility of deferral remained, since the income accumulated by an investment entity in a tax-sheltered environment attracted U.S. tax only upon distribution or sale of shares.

In addition, Section 1246 reaches only foreign investment companies in which U.S. persons hold more than 50 percent ownership. The reasons for the adoption of a threshold of control by U.S. persons are elusive. Investment companies are rarely controlled by individual shareholders in any event. The practical effect of the control requirement was that U.S. investors could join with foreign investors to achieve a tax result that they could not achieve on their own. To the extent other high-tax foreign jurisdictions had similar rules, one could imagine the degree of international cooperation that tended to result. Investors in St. Louis with a taste for foreign assets were more likely to seek their fellows in Stockholm than in Minneapolis.

4 See, e.g., Waterman Steamship v. United States, (CA-5 1970) (purported dividend preceding sale of shares by a corporation held part of the purchase price).
The Relation Between Deferral and Control

There is a longstanding relation in the U. S. tax system, evident in all the provisions canvassed thus far, between the current taxation of foreign corporations and the exercise of control by U. S. persons. This remains so, although to a lesser degree, under present law. It is worth considering why this is so and whether it should be, especially since the importance of control as a threshold of taxation has begun to erode.

The association of current taxation with control in U. S. tax law is closely linked to the notion of realization, an underpinning of income taxation extolled in Eisner v. Macomber and virtually unchallenged ever since. An investor who cannot force a distribution of earnings is viewed as not having "realized" income to a degree that warrants taxation. There is an apparently deep-rooted sense of the "unfairness" of taxing someone on amounts that have not been reduced to a liquid form of possession and control. Certainly some attitude has manifested itself in every income tax course I have ever taught through the earnest assertion of students that "of course" one "cannot" tax pure accretions to wealth in the hands of people who may not have the immediate wherewithall to pay the tax. Owners of unrealized gains, I am sure, gain much solace at the long-standing readiness of legislators to accept this and similar propositions without question, just as Voltaire rejoiced that his tailor believed in Hell (and was hence less likely to steal from him).

This respectful view of realization is vulnerable to close scrutiny, however. The owner of unrealized gains called upon to pay a tax can borrow the necessary funds, or at a minimum (conceding that access to credit is far from universal) borrow them from the Treasury. What I mean by this is that the actual payment of a tax imposed on unrealized gains can be deferred until realization, with interest determined from the time of accrual. Under such a system there would be no actual payment of tax before realization, but the amount of tax would not be tied to the time of realization. Realization would simply be the occasion of payment, but not of reckoning the tax. For these reasons, only the payment of tax need be deferred until gain is realized to alleviate possible hardships of nonliquidity.

The case, if any, for tying the actual reckoning of taxation to realization (that is, an event of quantifiable possession and control) is not one of fairness, but of administrative convenience and difficulty of valuation. It is no doubt difficult across a broad range of situations to identify and measure the actual accrual of gains. Unrealized gains don't send their owners greeting cards as they accrue, unless they derive from widely traded assets that can be periodically marked to market. Even this undeniable point, however, hardly argues for the assumption that all gains accrue at precisely the moment of realization. Few assumptions indeed are less plausible.

It is far more realistic, in the absence of better evidence, to deem gains from long-held assets to have accrued ratably over their owner's holding period. When ultimately realized, the gains would then be taxed with an interest factor to reflect this plausible assumption. Under such a regime, it would seem entirely reasonable to give the owners of investment assets the option to be taxed on the actual accrual of gains, if those can be demonstrated.

What I have just described, which may sound like science fiction or the fantasies of a tax professor gone mad, is, more or less, the income tax regime imposed in the 1986 Act on foreign passive investment companies, a method noteworthy in its departures from prior norms of U. S. taxation. Considering how radical it is, the new system of taxation of passive foreign investment companies has attracted surprisingly little attention, none favorable. Essentially, the new regime eliminates deferral, without regard for control or realization, for all foreign investments of U. S. persons in assets producing passive income. It also introduces a pattern of taxation that could rather easily be generalized to all U. S. interests in foreign corporations and spell the end of deferral altogether.

Passive Foreign Investment Companies

Introduction. The 1986 Act brought a new tax regime for "passive foreign investment companies" (or PFICs, in the acronymic patois of tax folk). Unlike the taxation of foreign personal holding companies or foreign investment companies under pre-1987 law, the taxation of PFICs does not depend on any threshold of ownership or control by U. S. persons. Even the most atomized holdings in PFICs give rise to current taxation (or the equivalent) for U. S. persons who hold their shares. Readers by now familiar with the inexorable course of development of the U. S. tax laws need hardly be told that the provisions governing PFICs bring a new order of complexity to the realm previously occupied only by foreign personal holding companies and foreign investment companies subject to Section 1246.

The taxation of PFICs is built around the idea of denying to U. S. persons (and hence capturing for the U. S. Treasury) the value of deferral of U. S. taxation on all passive investments channeled through foreign entities. The rules achieve this end either in the obvious way—current taxation of U. S. investors in PFICs—or in the more oblique way of imposing an interest charge on the deferred distributions and gains of those investors.

The central elements in the taxation of PFICs are (1) the definition of a PFIC, and (2) the tax...
regime imposed on U. S. owners of shares. The most notable feature of the former is that any foreign entity holding passive investments may be a PFIC, regardless of the extent of U. S. ownership or control. The unique feature of the latter is the interest charge (equivalent to the value of deferred U. S. taxes) imposed on the realized gains of U. S. shareholders unless they elect current taxation of their share of the PFIC earnings.

**Passive Foreign Investment Company Defined.** A “passive foreign investment company” (PFIC) is any foreign corporation 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 during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent.”8 A PFIC is thus an entity that receives mainly investment income or holds mainly investment assets. “Passive income” is here defined to include dividends, interest, certain rents and royalties, annuities, gains from the sale of financial assets, commodities gains, and gains from currency translation, unless derived from an active banking or insurance business.7

**Taxation of U. S. Shareholders of PFICs.** Once a foreign corporation crosses the threshold of being a PFIC, its U. S. shareholders are subject to a special (indeed unique) income tax regime. The elements of this regime turn first on whether the PFIC has elected to be taxed as a “qualified electing fund.” The baseline system of taxation of nonelecting PFICs (codified in Section 1291) undercuts both deferral and the realization requirement engrained in U. S. tax law.

U. S. shareholders of nonelecting PFICs are subject to U. S. tax on their realized gains (dividends, other distributions, sales of shares, liquidations, etc.), but with an important twist. A U. S. person who receives an “excess distribution in respect of stock” of a PFIC is required to compute taxable income in a special way. It is not simple, so you will want either to move slowly through the following paragraphs or perhaps to skip them altogether and take my conclusions on faith.

*First, we determine when there is an “excess distribution.”* Despite the term, an excess distribution can result either from an actual distribution or from a sale of shares or a liquidation of a PFIC, in which event the excess distribution includes the gain recognized by the selling shareholder. An excess distribution is “the excess . . . of . . . the amount of the distributions . . . received by the taxpayer . . . during the taxable year . . . over 125 percent of the average amount received in respect of such stock by the taxpayer during the 3 preceding taxable years (or, if shorter, the portion of the taxpayer’s holding period before the taxable year).”9

Upon a disposition of shares, the entire gain is treated as an excess distribution.

In somewhat rough fashion, excess distributions are a measure of the relative rates at which PFICs receive earnings and distribute them, or, somewhat more obliquely, the extent of deferral of U. S. taxation that results from the exclusion of foreign earnings from the currently taxable income of U. S. shareholders. To illustrate, suppose a PFIC with a sole U. S. shareholder makes no distributions for 10 years, then distributes $1,000 to the shareholder. One hundred and twenty-five percent of the average amount received in the preceding three years (0) is zero. The full $1,000 is thus an excess distribution. Suppose instead the PFIC has distributed $100 per year. Now the excess distribution is $875. Suppose finally that the PFIC has distributed $1,000 per year. There is no excess distribution. If the U. S. shareholder sells the shares of the PFIC at a gain of $1,000, there is an excess distribution of $1,000, regardless of the distributions made in prior years.

**Taxation of Excess Distributions from PFICs.** An excess distribution received by a U. S. shareholder from a PFIC (and properly identified under the rules just canvassed) is then allocated to the shareholder’s holding period of the PFIC stock and taxed under the regime of Section 1291. Under Section 1291(a)(1)(A), the excess distribution is allocated “ratably” to each day in the taxpayer’s holding period. The U. S. shareholder’s gross income for the current year includes, as ordinary income, the amount of the excess distribution allocated to the current year and to the part of the holding period before the company was a PFIC. This inclusion accounts for only part of the excess distribution, and does so in a perfectly conventional way. The remainder of the excess distribution—and this the new part—gives rise to a “deferred tax amount.” The deferred tax amount is added as a direct increase to the taxpayer’s U. S. income tax for the current year. More or less as its name suggests, the deferred tax amount is the sum of a notional amount of tax attributable to the excess distribution and an interest factor.

Specifically, the deferred tax amount is the sum of an “aggregate increase in taxes” and an “aggregate amount of interest” thereupon. The former is determined by multiplying the amounts of excess distributions attributable to taxable years not reached by Section 1291(a)(1)(B) by the highest individual or corporate income tax rate applicable in that year. The latter is determined for each of the annual components of the “aggregate increase in taxes” by applying the statutory interest rate for tax obligations under Section 6621 to each component for the period from the filing date of the year of the component to the filing date of the year of the excess distribution. The tax on notional prior distributions is thus determined at the highest marginal

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6 IRC Sec. 1296(a).
7 IRC Sec. 1296(b).
8 IRC Sec. 1296(b)(2).

rates in the Code (themselves not enormously fearsome since the flattening of all rates in the 1986 Act), plus interest to make up for deferral.

This article does not aim at an exhaustive description of the mechanics of PFIC taxation, and the reader might well find the above slightly too compressed for comfort. The upshot, though, is that gains of U. S. shareholders of PFICs are taxed at levels that tend to eliminate the advantage of deferral.

Deferral and Realization in the PFIC System. A notable feature of this tax regime is that it may, in fact, more than compensate for deferral. Full current taxation of the earnings of PFICs under standard U. S. tax concepts would still reach only their realized gains. The system of Section 1291 reaches the unrealized gains of PFICs to the extent they are reflected in distributions or captured by shareholders through dispositions of shares. Increases in the value of the assets of PFICs are allocated ratably to the entire holding period of the shares even if realization of the gains by the PFIC itself came later (or not at all). Thus the sale of shares of a PFIC holding only appreciated securities triggers a tax cost imputed to the entire holding period, while a direct sale of the securities by the U. S. shareholders would result in a tax cost measured only by realized gains in the year of sale. These and similar possibilities reveal that the taxation of PFICs under Section 1291 has the unique feature of being potentially more severe even than full current taxation of the income of foreign corporations. It can also be less severe, when for example the gains of a PFIC are realized early in the holding period of a U. S. shareholder but are attributed ratably to the entire period in determining the deferred tax amount under Section 1291.

Although the PFIC system of taxation largely blunts the realization requirement, it is not strictly the same as the elimination of realization altogether. Section 1291 does not reach gains as they actually accrue, but treats them as arising evenly over a holding period. Literally, it ignores the moment of accrual of gains. Those who recoil in horror at the thought of taxes imposed before any liquid proceeds of a transaction are received by a taxpayer will note that no actual payments of U. S. tax need ever be made by U. S. shareholders of a PFIC until they have received actual amounts from their shares.

Another novel aspect of the taxation of PFICs is that the tax imposed on shareholders under Section 1291 is not tied to the earnings and profits of the entity. The tax base of the U. S. shareholders is simply the total amount of distributions or gains upon sale. Distributions attributable to capital or unrealized appreciation of assets are nonetheless subject to tax in the shareholders’ hands. This is the first instance in the Code so far as I know of a tax regime for corporate distributions that operates without any regard for the earnings of the distributing entity. Just such a system—indeed the elimination of the entire concept of “earnings and profits”—has been urged in academic circles, however.6

A final safeguard of the tax imposed by Section 1291 is the carryover of the basis of shares in a PFIC after the death of a shareholder. Shares of a PFIC either retain their basis (or take a fair market basis if it is lower) upon the shareholder’s death, unless the shareholder was at all times during the holding period of the PFIC stock a nonresident alien individual. A similar rule of carryover basis at death applies to foreign personal holding companies and foreign investment companies subject to Section 1246, but does not apply to controlled foreign corporations generally.

Transfers of Intangible Property to Foreign Corporations

Movements of Assets to Foreign Corporations. Together, Subpart F and Section 1248 create a separate tax regime for controlled foreign corporations and their U. S. shareholders; the rules governing the taxation of foreign passive investment companies have a similar effect. As a result, one can discern four distinct corporate income tax environments. There is the domestic corporate environment, with straightforward current taxation of worldwide income. There is the controlled foreign corporation environment—a mix of current taxation and deferral, with eventual taxation of foreign earnings as ordinary income. There is the PFIC environment, which spells current taxation of passive investment income or the equivalent, backed up by deferred interest charges. And there is the wholly foreign (or noncontrolled foreign corporation) environment, generally with full deferral and capital gains taxation at the end. In shorthand, these different tax environments can be described as domestic corporate solution, controlled foreign corporate solution, PFIC solution, and wholly foreign corporate solution respectively.

Section 367. These environments are not airtight. Assets constantly move between them. Foreign corporations receive capital from domestic corporations, distribute dividends back, and so on. In the wholly domestic setting, the Code contains an extensive set of rules governing the movement of assets into, out of, and within corporate solution, codified as Subchapter C. There is a set of adaptations of these rules to patterns involving foreign corporations in Section 367, which modifies the nonrecognition rules of Subchapter C in the international tax environment. Section 367 holds a particular prism to the corporate tax rules to make them mesh with the tax regime imposed on controlled foreign corporations and other foreign corporations without loss of revenue to the U. S. Treasury.

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Sections 367(d) and 482—Notional Contingent Payments. Section 367(d) (introduced in 1984 and modified in 1986) created an entirely new income tax regime for transfers by U. S. persons of intangible property to foreign corporations. Rather than require recognition of gain upon transfer, Section 367(d) treats intangible property transferred to a foreign corporation as giving rise to a stream of payments over its useful life. The U. S. transferor of intangible property is treated as having sold the property to the foreign corporation in exchange for a series of payments contingent upon the productivity, use, or disposition of the property. The transferor is then taxed over the life of the property as though a stream of contingent payments which "reasonably reflect" the property's value in use had actually been received in exchange for the transfer.

A further qualification of Section 367(d), added in 1986, is that the amount taken into income by the transferor during the life of the transferred property must "be commensurate with the income attributable to the intangible [property]." In effect, the actual income stream produced by the property transferred (however it may be determined) is imputed to the transferor under Section 367(d) during the life of the property.

On its face, Section 367(d) applies only to transfers of property that would otherwise be entitled to nonrecognition of gain (at least partially) under Sections 351 or 361. And until the 1986 Act, this was indeed the whole story. Under the 1984 Act, a notional contingent sale was deemed to arise under Section 367(d) only upon transfers meeting the threshold requirement for nonrecognition under Subchapter C. A simple end run around this regime was available to transfers that failed the requirements for nonrecognition.

While the 1986 Act did not change the apparent terms of Section 367(d), a modification of Section 482 further changed the stakes in this realm. Section 482 (which deals generally with the allocation of income and deductions from transactions between related taxpayers) now contains the following final sentence: "In the case of any transfer (or license) of intangible property ... the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." One can still escape the clasp of Section 367(d) by engineering a recognition transaction, but that escape does one no good, because one is thrown thereby into the embrace of Section 482.

Broader Implications of Sections 367(d) and 482. Section 367(d) spells a substantial erosion of the deferral of U. S. taxation on the earnings of foreign corporations. Under Section 367(d) a portion of overseas income, even resulting from an active business, is forcibly brought within the reach of U. S. taxation to the extent it is attributable to intangible property originating in the United States. With the additional effect of the 1986 change in Section 482, virtually all income attributable to intangible property created in the United States is now subject to current U. S. taxation, without regard for the structure used to produce the income.

As an erosion of deferral, this result is the more remarkable as it reaches both active business income otherwise unaffected by subpart F and income received by uncontrolled foreign corporations. Transfers subject to Section 367(d) therefore include far more than transfers to controlled foreign corporations. When the post-1986 treatment of passive foreign investment companies is considered as well, it is apparent that the sphere of deferral of U. S. taxation of foreign income earned through foreign entities is now markedly more confined.

Concluding Perspective

Taking a step back from this accumulation of provisions, it is apparent that the domain of deferral as a baseline tax regime for foreign operations of U. S. persons is much reduced compared to what it was only five years ago. Almost all foreign passive investment is now subject to current U. S. taxation. So is a broad range of foreign financial operations, when they are either controlled or owned by U. S. persons. To be sure, an important core of deferral survives. Active manufacturing or marketing operations can still be carried out overseas by U. S. enterprises without current U. S. taxation. Firms like IBM and Ford can still conduct much of their foreign business beyond the immediate reach of the U. S. Treasury, although theirs are precisely the kind of overseas operations most likely to encounter moderate or even high levels of foreign taxation. And even for active overseas businesses, full deferral in the future will be preserved only for operations that involve no intellectual property originating in the United States.

What this means more concretely is that the offshore tax paradise is harder to reach. Some aspects of the new regime can perhaps be made concrete with an example drawn from a realm where people have frequently sought—and found—tax advantage in the past. If you set out tomorrow to make and distribute a motion picture outside the United States, you can no longer simply transfer the underlying intellectual property to a foreign corporation at low tax cost. You must transfer cash and acquire the intellectual property from an unrelated person or create it from scratch abroad. In the good old days (only three years ago), your foreign corporation did not also have to distribute the movie as a condition of preserving deferral. It could be sold shortly after it was made. Now there must be active distribution before any sale, unless the picture constitutes inventory in the hands of the foreign entity that produced it, which means that the entity must produce many pictures overseas and sell them. And a footfault will cost you more. If you are
overzealous in promoting the picture overseas through your own domestic efforts, you may expose the gains of your foreign entity to a whole new level of tax, the U. S. branch profits tax, along with the baseline U. S. corporate income tax, and ultimately a third level of U. S. tax on your dividends. Deferral is not categorically beyond reach, but there have never been as many shoals along the way.

One can plausibly ask if the game is still worth the candle. It would be hard to imagine a system more Byzantine than the present multi-tiered complex, wherein it is necessary (1) to keep track of almost all the earnings of foreign corporations owned to a significant extent by Americans in order (a) to distribute them between categories that have and have not been subject to U. S. taxation and (b) match them with relevant foreign income taxes, and (2) to follow the movement of assets among several different income tax environments.

As tax planners, to be sure, we might have a stake in the survival of this Ptolemaic regime. But suppose that we had resolved nonetheless to bring all foreign income beneficially owned by U. S. persons within the reach of current U. S. taxation. How might we do it? The preceding pages actually provide a road map, or perhaps more precisely a practice run, in the system of taxation of passive foreign investment companies. Some variant of the PFIC system could be extended to all foreign corporations in which U. S. persons own shares.

The PFIC system largely pacifies one objection commonly raised against the elimination of deferral, to wit that the transactional difficulty of measuring U. S. stockholders’ shares of the current income of foreign entities, especially if they have relatively small and dispersed ownership, would be prohibitive. The PFIC system of taxation provides a near equivalent of current taxation without the burden of measuring the earnings of foreign corporations that do not expressly accept it. Placing all foreign corporations and their U. S. shareholders under the PFIC regime would unquestionably end deferral and also, I believe, reduce the overall transactional complexity of U. S. taxation of foreign income. I must admit that I have indulged the suspicion that the framers of the PFIC provisions conceived them as the vanguard (or camel’s nose, if you prefer) of the end of deferral.10

But why stop there? Some version of the PFIC regime could serve to blunt the realization requirement across the entire range of equity interests in corporations, both foreign and domestic. With some modification it could even be used to bring about the integration of corporate and individual taxation. That is, if shareholders of corporations were put to a choice of current taxation on the earnings of corporations or ultimate taxation of their gains from shares with an interest factor, the corporate-level income tax could itself simply be abolished. The possibilities are dizzying. And I should add in closing that while such a rationalization of the tax system might well in the very longest run simplify the landscape enough to reduce the work of our remote successors in the tax bar, in the career of a single tax lawyer the long run never comes. The work of getting from here to there would keep us busy for our lifetimes. Our children, perhaps, would become artists. 

10 A similar small erosion of the possibility of deferral was recently introduced in the domestic income tax environment as well. Under the 1987 and 1988 Acts, deferral gains derived from certain large installment sales are subject to an interest charge designed to offset the value of the deferral of taxation under the installment method of reporting.