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Defining Foreign Base Company Income: The Exclusions, Deductions, and Limitations

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Defining Foreign Base Company Income: The Exclusions, Deductions, and Limitations*

by
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Tax havens pose a challenge to tax policy by decreasing tax revenue and impeding allocational efficiency. To alleviate the problem of tax havens, the United States taxes its multinational corporations on much of the tax haven income derived by their foreign subsidiaries. Defining tax haven income, however, has proven difficult; the necessary provisions are among the most complex of the Internal Revenue Code. In this article, Professor Laity critically analyzes the exclusions, deductions, and limitations generally applicable in defining foreign base company income, the most significant component of tax haven income. Based upon his findings, he recommends several changes in the Code and its supporting administrative apparatus.

INTRODUCTION

This is the sixth article in a series dealing with the United States taxation of tax haven income.¹ As we shall see, the controlled foreign corporations of U.S. parent corporations generate several types of tax haven income. The United

1. The previous articles in this series are Eric T. Laity, *Defining Foreign Base Company Shipping Income and Oil-Related Income*, 20 VA. TAX REV. (forthcoming 2000) [hereinafter *Shipping Income*]; Eric T. Laity, *The Foreign Base Company Sales Income of Controlled Foreign Corporations*, 31 CORNELL INT'L L.J. 93 (1998) [hereinafter *Sales Income*]; Eric T. Laity, *The United States' Response to Tax Havens: The Foreign Base Company Services Income of Controlled Foreign Corporations*, 18 NW. J. INT'L L. & BUS. 1 (1997) [hereinafter *Services Income*]; Eric T. Laity, *Defining the Passive Income of Controlled Foreign Corporations*, 21 N.C. J. INT'L L. & COM. REG. 293 (1996); and Eric T. Laity, *Anatomy of Sections 951(a)(1)(B) and 956 of the Internal Revenue Code*, 14 VA. TAX REV. 71 (1994).

States currently requires its parent corporations to include much of this income within their own earnings.² Of the various types of tax haven income derived by controlled foreign corporations, foreign base company income is the most significant. Previous articles in this series have analyzed the separate categories of foreign base company income, each with its own constellation of inclusions, exclusions, and ordering rules. This article continues the series by analyzing the exclusions, deductions, and limitations that apply across the various categories of foreign base company income. Each of the separate categories isolates a type of tax haven operation of the controlled foreign corporation. The adjustments of general application combine those tax haven operations into a single, virtual entity. The Internal Revenue Code then taxes the entity's income to the United States parent corporation.

This article contains five parts. Part One deals with the general exclusions from foreign base company income, the application of which determines the controlled foreign corporation's gross foreign base company income. As shown below, the exclusions attempt to prevent double taxation by the United States. Part Two analyzes the rules that determine the entity's adjusted gross foreign base company income. These rules measure the difference between the controlled foreign corporation's tax haven operations and its complete operations. The ensuing adjustments, if any, may either expand its foreign base company income to absorb almost all of the corporation's income, or eliminate the corporation's foreign base company income altogether.

Part Three addresses the identification and allocation of deductions, processes that determine the entity's net foreign base company income. Before allocating the controlled foreign corporation's expenses between its tax haven operations and its other operations, we must consider three factors: the categories of foreign base company income, the separate concerns of tax haven insurance income, and the subsequent effort of the corporation's United States shareholders to comply with the foreign tax credit limitation. Part Four examines an exclusion, a limitation, and other rules concerning the treatment of foreign base company income. The application of these final items determines the controlled foreign corporation's adjusted net foreign base company income. They take into account the profitability of the corporation's tax haven operations over time, the current financial success of the corporation's overall operations, and the over-inclusiveness of some of the definitions for tax haven operations.

The goals of this series of articles remain unchanged: (1) to restate the relevant law with greater clarity than the original sources but with minimal loss of precision, (2) to draw out the implications of the original sources, (3) to give examples illuminating the original sources and their implications, (4) to analyze the original sources critically, and (5) to offer recommendations for change in the relevant provisions of the Internal Revenue Code, Treasury Regulations, other administrative apparatus, and the case law.

2. See I.R.C. § 951(a)(1) (2000). Controlled foreign corporations generally consist of the foreign subsidiaries of U.S. corporations. By definition, a controlled foreign corporation also includes foreign corporations with other ownership structures. See I.R.C. § 957(a) (2000).

In keeping with these goals, I recommend a number of changes in statutory provisions and administrative rules. (The recommendations are listed in the table of contents of this article and summarized in Part Five.) In addition, I offer several other contributions to the literature on controlled foreign corporations. These include a nine-step process for analyzing a controlled foreign corporation's net foreign base company income, the proper coordination of the deficit rules with the current earnings and profits limitation, and an explanation of the relationship between the foreign tax credit limitation and the income derived from a foreign subsidiary's tax haven operations.

I.

EXCLUSIONS FROM GROSS FOREIGN BASE COMPANY INCOME

The three exclusions of general application to all components of gross foreign base company income address the matter of double taxation by the United States. Under the Internal Revenue Code's international provisions, an item of a controlled foreign corporation's income may be subject to two levels of tax. First, under Subpart N.II.B, the item is subject to being taxed directly to the controlled foreign corporation. The taxation usually occurs pursuant to Code sections 881 and 882. Second, the item is subject to being taxed to the corporation's United States shareholders under Subpart N.III.F. Here, the taxation generally takes place under Code section 951(a).

Two of the general exclusions address the coordination of these preceding levels of taxation. The exclusion in Code section 952(b) attempts to prevent an item of income from being taxed to both the controlled foreign corporation and its United States shareholders. As we shall see, it only partially succeeds. The exclusion under Code section 951(e)(1) attempts the reverse. By preventing subpart F from overriding a tax expenditure, it ensures that both types of taxpayers are not taxed on a certain type of tax-favored income. An adverse decision by the World Trade Organization under the General Agreement on Tariffs and Trade (GATT), however, has limited its effectiveness.

The remaining general exclusion seeks to prevent multiple taxation by the United States at the level of the United States shareholder. As an item of previously included income is distributed up a chain of foreign subsidiaries toward the ultimate shareholder, the exclusion under Code section 959(b) prevents the United States shareholder from being taxed repeatedly on the item.

A. *U.S.-Source Effectively-Connected Income*

Any United States-source income effectively connected with a controlled foreign corporation's conduct of a trade or business in the United States is excluded from the corporation's gross foreign base company income.³ The United States generally taxes such income directly to the controlled foreign corpora-

3. I.R.C. § 952(b) (2000); Treas. Reg. § 1.954-1(a)(2) (2000).

tion.⁴ As a result, the exclusion protects the corporation's United States shareholders from double taxation by the United States. If a treaty exempts an item of such income from the United States taxation of the controlled foreign corporation, or if it reduces the rate of the United States tax, the controlled foreign corporation loses the exclusion, and it must include the item in its foreign base company income.⁵

The exclusion fails to address two other categories of income derived by a controlled foreign corporation. (The U.S. taxes both types of income directly to the corporation.) Those categories are foreign-source effectively-connected income,⁶ on the one hand, and U.S.-source income not effectively connected with the conduct of a U.S. trade or business,⁷ on the other. With regard to the former, the Code uses a mechanism outside of subpart F to prevent double taxation by the United States. Code section 864 excludes foreign-source income that falls within a controlled foreign corporation's subpart F income from its effectively-connected income.⁸ Consequently, the controlled foreign corporation's United States shareholders pay tax on such income, but the corporation does not.

In contrast, no mechanism to prevent double taxation by the United States exists with regard to U.S.-source income not effectively connected with the conduct of a trade or business in the United States. Currently, such income is taxed to the controlled foreign corporation under Code section 881, and to the corporation's United States shareholders under subpart F. Congress should expand the exclusion under Code section 952(b) to include U.S.-source income not effectively connected with the conduct of a trade or business in the United States.

Revenue Ruling 87-15 calls our attention to a second problem with the existing exclusion.⁹ Presently, Code section 952(b) excludes U.S.-source income effectively connected with the conduct of a trade or business in the United

4. See I.R.C. § 882(a)(1) (2000) (providing that any foreign corporation, including a controlled foreign corporation, be taxed by the United States on its income effectively connected to its conduct of a trade or business in the United States).

5. I.R.C. § 952(b) (2000). A treaty exemption from the branch profits tax of Code section 884, on the other hand, does not cause the loss of the exclusion. See I.R.C. § 952(b) (2000). The Service takes the position that the statutory exclusion from gross income given by Code section 883(a) for certain shipping income has the same effect as a treaty exemption and therefore causes such income to fall within foreign base company income. Rev. Rul. 87-15, 1987-1 C.B. 248. The revenue ruling expresses sound tax policy. Code section 883(a), however, expressly excludes such income from taxation under the entire income tax subtitle of the Code, including the subpart F provisions. The ruling is therefore wrong as a matter of law. For a proposal to limit the scope of Code section 883(a) by statutory amendment, see *Shipping Income*, *supra* note 1 (forthcoming 2000).

6. See I.R.C. §§ 11(a), (d), 882(a) (2000).

7. See I.R.C. § 881(a) (2000).

8. I.R.C. § 864(c)(4)(D)(ii) (2000).

9. Revenue Ruling 87-15, 1987-1 C.B. 248 addresses the exclusion under Code section 883(a) of certain shipping income from section 882 taxation. In the ruling, the Service takes the position that the section 883(a) exclusion has the same effect as a treaty exemption under Code section 952(b), therefore causing such income to fall within foreign base company income. The enactment of Code section 887, however, has partly alleviated the Service's concern. It imposes a 4% tax on U.S.-source gross transportation income exempt from taxation under Code section 883(a). See I.R.C. § 887(a), (b)(1) (2000). For further discussion of Revenue Ruling 87-15, see *supra* note 5 and accompanying text.

states from the controlled foreign corporation's subpart F income. Yet, Code sections such as section 883(a) exempt components of such income from direct federal taxation. If the purpose of an exclusion from subpart F income is to avoid double taxation by the United States, we should not make the exclusion available for income not directly taxed to the controlled foreign corporation. Instead, we can respond to the ruling's concern by requiring that Code sections 881 or 882 tax the income before the exclusion becomes available under Code section 952(b).

RECOMMENDATION ONE: Amend Code section 952(b) to exclude from the subpart F income of a controlled foreign corporation any item of income taxable to the corporation under Code sections 881 or 882, unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a United States treaty obligation.

B. Foreign Trade Income of a Foreign Sales Corporation

If a controlled foreign corporation is also a foreign sales corporation, its gross foreign base company income excludes its foreign trade income.¹⁰ Foreign trade income generally consists of income derived from selling or leasing property exported from the United States or from rendering specified professional services.¹¹ The potential overlap between a foreign sales corporation's foreign trade income and its foreign base company income occurs primarily within the categories of foreign base company sales and services income.¹² The exclusion of foreign trade income preserves the beneficial tax treatment of foreign sales corporations. Without it, subpart F's denial of a deferral to controlled foreign corporations would override the Code's tax benefits for foreign sales corporations.

Despite appearances, those tax benefits do not constitute a conventional tax expenditure. The tax benefits available to foreign sales corporations attempt to offset the disadvantage to United States businesses of the United States' reliance on a worldwide income tax without the use of a national sales tax. Under GATT, a member country may withdraw export sales from the tax base of its national sales tax. It cannot, however, exclude the income arising from its export sales from its income tax base.¹³ Hence, United States trading partners who rely in part on a national sales tax for funding may offer an exclusion from sales

10. See I.R.C. § 951(e)(1) (2000).

11. See I.R.C. §§ 923(b), 924(a), 927(a)(1) (2000). The principal professional services involved consist of engineering and architectural services rendered in connection with a foreign construction project. See I.R.C. § 924(a)(4) (2000).

12. Compare I.R.C. §§ 923(b), 924(a) (2000) (defining foreign trade income to include income derived from selling property exported from the United States or from rendering specified professional services) with I.R.C. § 954(d), (e) (2000) (defining foreign base company sales and services income to include income derived from selling property exported from the United States by a related person or from rendering specified professional services on behalf of a related person).

13. The remission of a direct tax, such as an income tax, constitutes an export subsidy and violates Article XVI(4) of GATT. The remission of an indirect tax, such as a consumption tax, does not constitute an export subsidy. Compare United States Tax Legislation (DISC), Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) 98 (1977) (holding that the exclusion from income tax under I.R.C. §§ 991-997 was the remission of a direct tax and thus a subsidy in violation of Article XVI(4) of

tax. The United States, on the other hand, cannot offer such an exclusion. To the extent trading partners exclude foreign-source income from the taxable income of their residents for purposes of their income tax, and to the extent trading partners impose a heavier sales tax burden than do the individual states of the United States, United States companies may appear to suffer a disadvantage.

Nevertheless, the tax benefits for foreign sales corporations are still suspect in economic terms. Economists usually view sales taxes as falling on consumers, and not on the companies that collect them. They generally see income taxes as falling on the taxpayer.¹⁴ An exclusion from sales tax thus benefits the consumer, while an exclusion from income tax benefits the exporter. Furthermore, the sales tax imposed by the consumer's own nation offsets the benefit to the consumer of the exclusion of export goods from the exporting nation's sales tax. Due to the difference between the incidence of a sales tax and an income tax, we could view the tax benefits for foreign sales corporations as constituting an export subsidy under GATT. Indeed, the European Union has successfully challenged the validity of the U.S. tax regime for foreign sales corporations.¹⁵

C. *Exclusion of Certain Dividends*

To determine the amount of foreign base company income taxable to a specific United States shareholder, a controlled foreign corporation will exclude all or part of any dividend received from another controlled foreign corporation from its own gross income.¹⁶ The dividend is excluded to the extent the corporation paid it out of earnings and profits previously taxed to that United States shareholder under Code section 951(a)(1).¹⁷ The recipient must also exclude from the dividend an amount equal to any ordinary income realized by a predecessor-in-interest to the United States shareholder pursuant to Code section 1248(a) or (f) when the predecessor disposed of its stock in the payor.¹⁸ The exclusion prevents U.S. shareholders from paying multiple taxes on foreign base company income as it moves up a chain of subsidiaries in the form of dividends.¹⁹

GATT) with *Zenith Radio Corp. v. United States*, 437 U.S. 443 (1978) (holding that the remission of an indirect tax was not a subsidy under United States trade law).

14. See, e.g., *Zenith Radio Corp.*, 437 U.S. at 455-57.

15. See United States—Tax Treatment for Foreign Sales Corporations, WT/DS 108 (2000).

16. See I.R.C. § 959(b) (2000).

17. I.R.C. § 959(b) (2000). A successor-in-interest of the United States shareholder may also take advantage of the exclusion. I.R.C. § 959(b). The full amount of the payor's subpart F income used to compute the pro rata inclusions of the payor's United States shareholders becomes eligible for the exclusion when distributed. Rev. Rul. 82-16, 1982-1 C.B. 106. As a result, if the payor's ultimate shareholders include any persons who are not United States shareholders, as defined in Code section 951(b), the payor may distribute to another controlled foreign corporation subpart F income that has never been included in the United States tax base and that is now excluded from the recipient's gross foreign base company income.

18. See I.R.C. § 959(b), (e).

19. A separate exclusion applies to dividends paid out of the payor's foreign base company shipping income, one of the components of foreign base company income. See I.R.C. § 954(b)(6)(B) (2000). The exclusion does not require previous taxation of the income from which the dividend arises to the United States shareholder. See *id.* It can thus cause the income to escape

Typically, the exclusion comes into play when a subsidiary of a controlled foreign corporation pays a dividend to the controlled foreign corporation out of the subsidiary's subpart F income. The United States shareholder's income would have included the subsidiary's subpart F income at the time the subsidiary earned it. By virtue of the rule, however, the subsidiary may distribute its earnings in the form of a dividend to its immediate shareholder without causing the distributed earnings to be included a second time in the income of the United States shareholder. (Without the exclusion, the dividend would constitute foreign personal holding company income—one of the categories of foreign base company income—in the hands of the recipient.²⁰) Although the dividend is excluded from the controlled foreign corporation's gross income with regard to the United States shareholder, it is nonetheless added to the recipient's earnings and profits.²¹

To determine whether a corporation has paid a dividend out of earnings and profits previously taxed to a United States shareholder, the Code and regulations provide tracing rules.²² The rules treat the recipient of the dividend as receiving income previously taxed to the United States shareholder before receiving income still taxable to that shareholder.

U.S. taxation altogether. For a discussion of the exclusion and a related recommendation that Congress delete Code section 954(b)(6)(B), see *Shipping Income*, *supra* note 1 (forthcoming 2000).

20. See I.R.C. § 954(c)(1)(A) (2000).

21. See Treas. Reg. § 1.959-3(b)(3)(c)(4) (2000).

22. See I.R.C. § 959(c), (e) (2000); Treas. Reg. § 1.959-3(b) (2000). The tracing rules divide the payor's earnings and profits into six categories and require the recipient and its United States shareholder to deem the dividend paid out of the six categories in succession, as I explain below.

The first category consists of the payor's current earnings and profits that the Code taxes to the United States shareholder under Code sections 951(a)(1)(B) and 956 (relating to earnings the payor invested in United States property). See I.R.C. §§ 316(a)(2), 959(c)(1)(A) (2000). The second category consists of the payor's accumulated earnings and profits that the Code taxed to the United States shareholder under those sections. See I.R.C. §§ 316(a)(1), 959(c)(1)(A) (2000). The third category consists of the payor's current earnings and profits attributable either to the payor's subpart F income or to any of the payor's subpart F income that the payor withdrew from qualified shipping operations and less-developed country operations, plus an amount of the payor's other current earnings and profits equal to the amount of ordinary income realized under Code section 1248(a) or (f) by a predecessor-in-interest to the United States shareholder. See I.R.C. §§ 316(a)(2), 951(a)(1)(A), 959(b), (c)(2), (e) (2000).

The fourth category consists of the payor's accumulated earnings and profits attributable either to the payor's subpart F income or to any of the payor's subpart F income that the payor withdrew from qualified shipping operations and less-developed country operations, plus an amount of the payor's other accumulated earnings and profits equal to the amount, if any, by which the ordinary income realized under Code section 1248(a) or (f) by a predecessor-in-interest to the United States shareholder exceeded the payor's current earnings and profits for purposes of the third category. See I.R.C. §§ 316(a)(1), 951(a)(1)(A), 959(b), (c)(2), (e) (2000). The fifth category consists of the payor's remaining current earnings and profits, if any. See I.R.C. §§ 316(a)(2), 959(c)(3) (2000). The sixth category consists of the payor's remaining accumulated earnings and profits. See I.R.C. §§ 316(a)(1), 959(c)(3) (2000).

Once the recipient and the United States shareholder have established these six categories, the tracing rules require those entities to allocate the dividend among the categories in the order given above, exhausting the earnings and profits in each category before moving on to the next category. See I.R.C. § 959(c) (2000). Within a category consisting of accumulated earnings and profits (which are the second, fourth, and sixth categories above), the dividend is allocated among the accumulated earnings and profits in the reverse order in which the payor accumulated those earnings and profits. See I.R.C. § 361(a) (2000); Treas. Reg. § 1.959-3(b) (2000).

II.

ADJUSTED GROSS FOREIGN BASE COMPANY INCOME

Now that we have considered the matter of potential double taxation by the United States, we are ready to measure the difference between the full operations and the tax haven operations of the controlled foreign corporation. We must measure the difference *before* we take deductions into account. Once we have considered the ramifications of the difference, we might not need to allocate and apportion deductions. If the difference between the corporation's tax haven operations and its full operations is great, the first adjustment eliminates most of a controlled foreign corporation's foreign base company income. If the difference is slight, the second adjustment increases foreign base company income to absorb almost all of the controlled foreign corporation's income.²³

A. *The De Minimis Rule*

If the total of gross foreign base company income and a controlled foreign corporation's section 953 insurance income equal less than 5% of the controlled foreign corporation's entire gross income, a *de minimis* rule will generally reduce gross foreign base company income to zero.²⁴ The *de minimis* rule applies, however, only if the sum of the corporation's gross foreign base company income and its section 953 insurance income equals less than \$1,000,000.²⁵ And even when the *de minimis* rule does apply, it fails to reduce the corporation's foreign base company income from related-person factoring or portfolio debt. Such components of foreign personal holding company income²⁶ are exceptions to the *de minimis* rule.²⁷

An anti-abuse rule prevents taxpayers from fracturing their tax haven operations among several controlled foreign corporations for the purpose of sheltering all of their foreign base company income under the *de minimis* rule.²⁸ The *de minimis* rule removes only foreign base company income and insurance in-

23. For taxable years beginning prior to January 1, 1987, if the branch rule treats a branch as a separate corporation, a controlled foreign corporation must apply the *de minimis* and full-inclusion rules separately to the branch and the remainder of the corporation. Treas. Reg. §§ 1.954-0(a)(3), 1.954A-1(d)(4) (2000). No such requirement appears in the regulations governing subsequent taxable years. See Treas. Reg. §§ 1.954-1(b)(4), 4.954-1(b)(4) (2000). But see S. REP. NO. 87-1881, at 246 (1962) ("Determinations, such as those required under section 954(b)(3) . . . , as to such branch income shall be made as though such branch were a separate controlled foreign corporation.").

24. I.R.C. § 954(b)(3)(A) (2000). We can generally determine the gross income of a controlled foreign corporation in the same way as the gross income of a domestic corporation. Treas. Reg. § 1.952-2(a)(1) (2000). The gross income of a manufacturing, merchandising, or mining business usually consists of the business' total sales less the cost of goods sold. Treas. Reg. §§ 1.61-3(a), 1.952-2(c)(4) (2000). Thus, whether direct labor costs should calculate into a controlled foreign corporation's gross income from the engineering, fabrication, and installation of offshore drilling platforms depends on whether the corporation derives sales income or services income from its operations. Rev. Rul. 86-155, 1986-2 C.B. 134, 135.

25. I.R.C. § 954(b)(3)(A) (2000).

26. See I.R.C. §§ 864(d)(1), (2)(C), 954(c)(1)(A) (2000).

27. Treas. Reg. § 1.954-1(b)(1)(i)(C) (2000). For a discussion of related-person factoring, see *Services Income*, *supra* note 1, at 27-34.

28. See Treas. Reg. § 1.954-1(b)(4) (2000).

come from a controlled foreign corporation's subpart F income. The other types of subpart F income, such as boycott income, remain unaffected by it.²⁹

B. The Full-Inclusion Rule

If the corporation's gross foreign base company income and gross section 953 insurance income together exceed 70% of the corporation's total gross income, a second adjustment—the full-inclusion rule—generally recharacterizes all of a controlled foreign corporation's remaining gross income as adjusted gross foreign base company income.³⁰ The full-inclusion rule has two exceptions. To begin with, it does not recharacterize the controlled foreign corporation's U.S.-source effectively-connected income as adjusted gross foreign base company income. Such income remains outside the bounds of foreign base company income.³¹ Nor does the full-inclusion rule prevent the application of the high-tax kickout rule. Consequently, items of the controlled foreign corporation's income included in its gross foreign base company income solely by application of the full-inclusion rule may face removal from the corporation's net foreign base company income if they are subject to a high rate of foreign income tax.³² No formal anti-abuse rule prevents a taxpayer from using a pair of related controlled foreign corporations to isolate foreign base company income from other income in order to shelter the other income from the effects of the full-inclusion rule.³³

The full-inclusion rule causes some items of gross income to become subject to double taxation by the United States. Although the operation of the full-inclusion rule excludes U.S.-source income effectively connected with the conduct by the controlled foreign corporation of a trade or business in the United States, two other categories of income remain affected by the rule. They consist of foreign-source income effectively connected with the controlled foreign corporation's conduct of a trade or business in the United States and U.S.-source income taxable under Code section 881.

By amending the regulations, we can easily avoid the problem of double taxation. The enactment of Recommendation One by Congress would provide

29. See I.R.C. § 954(b)(3)(A) (2000). The three types of subpart F income not subject to the *de minimis* rule are boycott income, bribery expenditures, and pariah-state income. See I.R.C. § 952(a)(3)(B), (4), (5) (2000).

30. See I.R.C. § 954(b)(3)(B) (2000). No part of the corporation's remaining gross income is recharacterized as adjusted gross insurance income. Treas. Reg. § 1.954-1(b)(1)(ii) (2000).

31. Treas. Reg. § 1.954-1(b)(1)(ii) (2000).

32. See I.R.C. § 954(b)(3)(B), (4) (2000); Treas. Reg. § 1.954-1(b)(1)(ii), (d)(6) (2000). See *infra* Part IV.C for a discussion of the high-tax kickout rule.

33. Such a rule does exist for taxable years of a controlled foreign corporation beginning after December 31, 1986 and on or before November 6, 1995. See Treas. Reg. §§ 1.954-0(a)(2), 4.954-1(b)(4) (2000). The anti-abuse rule in effect for those taxable years is discussed in Private Letter Ruling 89-29-031 (April 24, 1989). Note that the current anti-abuse rule contained in Treasury Regulation section 1.954-1(b)(4) applies only to the *de minimis* rule, unlike the rule given in Treasury Regulation section 4.954-1(b)(4), which applies to both the full-inclusion rule and the *de minimis* rule for taxable years beginning after December 31, 1986 and on or before November 6, 1995.

the necessary statutory basis for the amended regulation, which I state as follows:³⁴

RECOMMENDATION TWO: Amend Treasury Regulation section 1.954-1(b)(1)(ii) to exclude any income taxable to the controlled foreign corporation under Code sections 881 or 882 from recharacterization as gross foreign base company income pursuant to the full-inclusion rule of Code section 954(b)(3)(B).

III.

DEDUCTIONS: NET FOREIGN BASE COMPANY INCOME

Once we have compared the controlled foreign corporation's tax haven operations to its complete operations and made the required adjustments to the corporation's gross foreign base company income, we may turn to the analysis of the corporation's net foreign base company income. This category of income consists of the corporation's adjusted gross foreign base company income, less various deductions.³⁵ Although the general idea of reducing foreign base company income by its attendant expenses is simple enough to express, the exact process requires nine steps: (1) the identification of the corporation's possible deductions; (2) the offset of interest income and expense between related controlled foreign corporations; (3) the division of the corporation's adjusted gross foreign base company income into specific items of income; (4) the isolation of any same-country insurance income within the corporation's adjusted gross foreign base company income; (5) the isolation of the corporation's deductions related to its same-country insurance income; (6) the allocation and apportionment of deductions to the corporation's same-country insurance income that also constitutes foreign base company income; (7) the allocation and apportionment of deductions that relate to less than all of the controlled foreign corporation's gross income as a class; (8) the allocation and apportionment of related-person interest expense; and (9) the allocation and apportionment of all remaining deductions.³⁶

The multi-step process exhibits two unusual characteristics. First, the process associates deductions with particular categories of a controlled foreign corporation's foreign base company income, and not simply with its foreign base company income as a whole. The focus on discrete categories of income stems from a general prohibition against allowing a deficit in one category of foreign base company income to offset a surplus in another category.³⁷ As a result of the ban, the taxpayer must compute the net amount in each category separately.

34. See *supra* Part I.B for the text of Recommendation One.

35. See Treas. Reg. § 1.954-1(a)(5) (2000).

36. See Treas. Reg. § 1.954-1(c) (2000). Treasury Regulation section 1.954-1(c)(i) suggests that the process consists of four steps. However, after analyzing those four steps and the remaining material of Treasury Regulation section 1.954-1(c), it becomes clear that the full process consists of nine discrete steps.

37. This requirement is implicit in Code section 954(b)(5). It requires the reduction of five individual categories of foreign base company income by separately allocable deductions, rather than the reduction of the composite foreign base company income by such deductions. Treasury Regulation section 1.954-1(c)(1)(ii) makes the requirement explicit. A loss within a particular category of foreign base company income may, however, reduce the overall subpart F income inclusion

Second, the process not only links expenses to separate categories of foreign base company income, but also to specific items of income within each category. By working at this level of detail, the process prepares the controlled foreign corporation's foreign base company income for eventual analysis by the corporation's United States shareholders under the foreign tax credit limitation.³⁸

A. Identifying Possible Deductions

We may begin the process of calculating a controlled foreign corporation's net foreign base company income by identifying the expenses available to reduce the corporation's adjusted gross foreign base company income.³⁹ To identify the available deductions, one generally treats the controlled foreign corporation as if it were a domestic corporation.⁴⁰ The regulations supply the necessary directives about the controlled foreign corporation's books of account, accounting principles, tax accounting methods, translation of amounts into United States dollars, and foreign exchange gain or loss.⁴¹ But the regulations do not treat the controlled foreign corporation as a domestic corporation in all respects. Departures from the principles applicable to domestic corporations in-

through the workings of the earnings and profits limitation of Code section 952(c); *see infra* Part IV.B.

An exception exists to the general rule that a deficit in one category of foreign base company income cannot offset income in another category. *See* Treas. Reg. § 1.954-2(g)(3) (2000). Under Treasury Regulation section 1.954-2(g)(3), a controlled foreign corporation's United States shareholders may elect to exclude foreign currency gain or loss from the corporation's foreign personal holding company income. They must then include the gains and losses in the specific categories of subpart F income to which such gains and losses relate. Such an election may result in the reduction of an item of foreign base company income by a related foreign currency loss, a loss which would otherwise reduce the corporation's foreign personal holding company income.

Although the regulations refer to a second exception, *see* Treas. Reg. §§ 1.954-1(c)(1)(ii), 1.954-2(g)(4) (2000), the reference in fact relates to a limited offset within the single category of foreign personal holding company income. The offset may occur if the controlled foreign corporation's United States shareholders elect, under Treasury Regulation section 1.954-2(g)(4), to treat as foreign personal holding company income all of the corporation's foreign currency gains and losses from section 1256 contracts that, in the absence of Code section 988(c)(1)(D), would constitute section 988 transactions. If the shareholders have made the election, and the corporation has a net loss in its foreign currency transactions, the loss may be apportioned to and offset other elements of foreign personal holding company income. Treas. Reg. §§ 1.954-1(c)(1)(ii), 1.954-2(g)(2)(i) (2000). Without the election, only the controlled foreign corporation's net foreign currency gain is included in its foreign personal holding company income. I.R.C. § 954(c)(1)(D) (2000).

38. The foreign tax credit limitation requires the separation of a United States shareholder's taxable foreign-source income into nine categories (or baskets, in the working language of U.S. international tax lawyers). *See* I.R.C. § 904(d)(1), (3)(B) (2000). The categories differ from the five categories of foreign base company income, and an analysis under the foreign tax credit limitation therefore requires the shareholder to re-divide a controlled foreign corporation's foreign base company income into a different set of categories.

39. We could also begin by dividing the controlled foreign corporation's adjusted gross foreign base company income into specific items of income. However, in light of the later step of offsetting interest payments between related controlled foreign corporations, beginning with the identification of deductions is preferable. The interest offset will reduce the amount of income that must be broken into separate items of income, thus reducing the effort involved in that complex step.

40. *See* Treas. Reg. § 1.952-2(b)(1) (2000).

41. *See* Treas. Reg. § 1.952-2(c)(2) (2000).

clude both a denial of the capital loss carryback and carryover⁴² and a denial of the net operating loss deduction.⁴³ If the controlled foreign corporation also constitutes a foreign sales corporation, calculation of the corporation's net foreign base company income does not take into account the deductions apportioned or allocated to its foreign trade income.⁴⁴

B. Interest Offsets Between Related Controlled Foreign Corporations

Interest paid by the controlled foreign corporation to a related controlled foreign corporation offsets any interest income received from the other corporation.⁴⁵ The corporation can only offset interest payments; no other type of payment can be offset.⁴⁶

C. Defining Items of Foreign Base Company Income

Having offset interest income and expense between related controlled foreign corporations, we may now divide the corporation's adjusted gross foreign base company income into separate items of income, as those items are defined by regulation.⁴⁷ Depending on the type of income involved, we use one of two methods for defining a foreign corporation's items of income.

First, for a controlled foreign corporation's foreign personal holding company income that also constitutes passive income for purposes of the foreign tax credit, we define an item of income by crossing the seven components of foreign personal holding company income with the following four groups of income:⁴⁸ (1) income from sources within the controlled foreign corporation's country of operation;⁴⁹ (2) income from sources outside the corporation's country of operation and subject to a foreign withholding tax rate of 15% or more;⁵⁰ (3) foreign-source income subject to a foreign withholding tax rate of less than 15% but more than zero;⁵¹ and (4) foreign-source income subject to no foreign withholding tax.⁵² In addition to the twenty-eight items of income that may result from this matrix, specific circumstances may create more items of income. We must

42. See Treas. Reg. § 1.952-2(c)(5)(i) (2000).

43. See Treas. Reg. § 1.952-2(c)(5)(ii) (2000).

44. See I.R.C. § 951(e)(1) (2000). The Code eliminates the entire deduction from consideration under subpart F, and not simply the portion of the deduction allocated and apportioned to foreign sales income. See *id.* The Code is overly broad, of course, but in light of the World Trade Organization's ruling against the foreign sales corporation regime as a whole, see *supra* note 15 and accompanying text, amending the Code provision is not worthwhile.

45. See Treas. Reg. §§ 1.904-5(k)(2), 1.954-1(c)(1), 1.954-2(b)(4)(ii)(B)(2) (2000).

46. See Treas. Reg. § 1.954-1(c)(1) (2000).

47. See Treas. Reg. § 1.954-1(c)(1)(i)(A) (2000).

48. See Treas. Reg. § 1.954-1(c)(1)(iii)(B) (2000). Treasury Regulation section 1.954-1(c)(1)(iii)(A)(1) refers to only five types of foreign personal holding company income. Subsequent to the regulation's promulgation, however, the Taxpayer Relief Act of 1997 added two additional components to foreign personal holding company income, for a total of seven. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1051, 111 Stat. 788, 940 (amending I.R.C. § 954(c)(1)).

49. Treas. Reg. §§ 1.904-4(c)(4)(i), 1.954-1(c)(1)(iii)(B) (2000).

50. Treas. Reg. §§ 1.904-4(c)(3)(i), 1.954-1(c)(1)(iii)(B) (2000).

51. Treas. Reg. §§ 1.904-4(c)(3)(ii), 1.954-1(c)(1)(iii)(B) (2000).

52. Treas. Reg. §§ 1.904-4(c)(3)(iii), 1.954-1(c)(1)(iii)(B) (2000).

segregate any item of rent or royalty to which we directly allocate an item of rent or royalty expense as a separate item of income.⁵³ We must also segregate a controlled foreign corporation's distributive share of partnership income from a partnership not subject to the look-through rules, but only if the distributive share constitutes passive income under Treasury Regulation section 1.904-5(h)(2)(i).⁵⁴ That will generally hold true if the partner has less than a 10% interest in the partnership.⁵⁵

Second, in the case of the controlled foreign corporation's foreign base company income other than its passive foreign personal holding company income, we separate the income into the 108 items of income created by crossing the nine categories (or baskets) of the foreign tax credit limitation with the twelve kinds of foreign base company income.⁵⁶ Those twelve kinds of income consist of the seven components of foreign personal holding company income, the four categories of foreign base company income other than foreign personal holding company income, and the extra category of full-inclusion foreign base company income.⁵⁷ The aggregate income in each of the 108 categories constitutes a single item of income.⁵⁸

By applying the two methods described above, a given corporation can potentially separate its foreign base company income into more than 136 items. Although simply using the five categories of foreign base company income would seem sufficient for calculating the corporation's net foreign base company income,⁵⁹ the foreign tax credit limitation requires a United States shareholder to divide its subpart F inclusion among the various baskets specified by Code section 904(d)(1).⁶⁰ The detailed breakdown of a controlled foreign corporation's foreign base company income thus facilitates the United States shareholder's task.

53. See Treas. Reg. §§ 1.904-4(c)(5)(i), 1.954-1(c)(1)(iii)(B) (2000).

54. See Treas. Reg. §§ 1.904-4(c)(5)(ii), 1.954-1(c)(1)(iii)(B) (2000).

55. See Treas. Reg. § 1.904-5(h)(2)(i) (2000).

56. See Treas. Reg. § 1.954-1(c)(1)(iii)(A) (2000) (listing ten of the twelve kinds of foreign base company income).

57. See *id.* Full-inclusion foreign base company income consists of the controlled foreign corporation's income that is characterized as foreign base company income solely by virtue of the full-inclusion rule of Code section 954(b)(3)(B); see *supra* Part II.B for a discussion of such income.

58. See Treas. Reg. § 1.954-1(c)(1)(iii)(A) (2000). The number of items of income defined by this second matrix will actually total less than 108. Certain categories of foreign base company income fall within only some of the nine baskets of the foreign tax credit limitation. For example, foreign base company shipping income falls entirely within the shipping income basket for purposes of the foreign tax credit limitation. See I.R.C. § 904(d)(1)(D), (2)(D) (2000). The controlled foreign corporation with more than one qualified business unit for purposes of Code sections 985 to 989 (dealing with foreign currency transactions) may have to compute its items of income separately for each unit. See Bruce W. Reynolds & Gary J. Melcher, *New Subpart F Regs. Impose Data-Gathering Burdens on Shareholders*, 6 J. INT'L TAX'N 532, 533 (1995). A controlled foreign corporation with more than one qualified business unit should also consider the branch rule of Code section 954(d)(2). See *Sales Income*, *supra* note 1, at 110-127, 145-148.

59. The five categories of foreign base company income consist of foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income. See I.R.C. § 954(a) (2000).

60. See I.R.C. § 904(d)(3)(B) (2000).

D. Isolating Same-Country Insurance Income

After defining the controlled foreign corporation's separate items of adjusted gross foreign base company income, we should isolate the items that constitute same-country insurance income. We must isolate such income because the method of allocating and apportioning deductions to it differs from the method used for the rest of the corporation's foreign base company income.⁶¹ A controlled foreign corporation derives same-country insurance income by insuring risks within its country of incorporation.⁶² Part or all of a controlled foreign corporation's same-country insurance income may fall within its foreign base company income. For example, same-country insurance income might fall within foreign personal holding company income, a category of foreign base company income.⁶³ One should not confuse same-country insurance income with section 953 insurance income, a separate component of subpart F income. A controlled foreign corporation derives section 953 insurance income by insuring risks located outside its country of incorporation, not within it.⁶⁴

E. Isolating Deductions Related to Same-Country Insurance Income

From the deductions we identified in Step A, we now isolate the deductions related to the controlled foreign corporation's same-country insurance income within its adjusted gross foreign base company income. We need to isolate those deductions because their allocation and apportionment differs from that of other deductions.⁶⁵ Isolating the deductions makes it possible to compute the corporation's net foreign base company income derived from same-country insurance income.

F. Allocating and Apportioning Deductions Related to Same-Country Insurance Income

To allocate and apportion the deductions related to the controlled foreign corporation's same-country insurance income that is also adjusted gross foreign

61. See Treas. Reg. § 1.954-1(c)(2) (2000).

62. See *id.*

63. See I.R.C. § 954(c) (2000). But see I.R.C. § 954(i) (2000) (excluding the qualified insurance income of a qualified insurance company from the definition of foreign personal holding income for purposes of subsection (c)(1)). From the ordering rules of Treasury Regulation section 1.954-1(e)(4), we may infer that at least some types of insurance income, before the application of ordering rules, can also fall within foreign base company shipping income or foreign base company oil-related income. See Treas. Reg. § 1.954-1(e)(4)(A), (B) (2000). (The specific ordering rules of Treasury Regulation section 1.954-1(e)(4) need updating. For a discussion of the rules and a recommended solution, see *Shipping Income*, *supra* note 1 (forthcoming 2000).)

64. See I.R.C. § 953(a)(1) (2000).

65. Compare Treas. Reg. § 1.954-1(c)(1)(i)(B), (D) (2000) (reducing the amounts of items of income other than passive foreign personal holding income by the expenses allocable and apportionable to the items under sections 861, 864 and 904(d)) with Treas. Reg. § 1.954-1(c)(2) (2000) (using the method set forth in Code section 953 to allocate and apportion deductions relating to foreign base company income that concerns insurance or indemnity contracts).

base company income, we use the rules prescribed for allocating and apportioning expense to section 953 insurance income.⁶⁶

Some of those deductions may also relate to the corporation's foreign base company income that is not same-country insurance income. If so, two different methods of allocation and apportionment govern the deductions. First, we must allocate and apportion the deductions to the same-country insurance income according to the rules of Code section 953.⁶⁷ But we must also allocate and apportion the deductions to the corporation's other foreign base company income according to the rules of Code sections 861, 864, and 904(d).⁶⁸ Inconsistent allocations thus become a possibility. In what order should we apply the two methods? The Code and regulations fail to inform us.

I see three possible solutions to this ordering problem. (1) The first possibility would give priority to the allocation and apportionment of deductions to same-country insurance income. Thus, we might use the specialized method of Code section 953 to allocate and apportion a deduction among the following three categories of income: same-country insurance income that is also foreign base company income, section 953 insurance income,⁶⁹ and all of the controlled foreign corporation's other income. Then we would use the generic method of Code sections 861, 864, and 904(d) to allocate and apportion the amount of the deduction already allocated and apportioned by the specialized method to all other income of the corporation. We would distribute it between the corporation's foreign base company income that is not also same-country insurance income, on the one hand, and its income that is not foreign base company income, on the other. (The second step could also incorporate the allocation and apportionment of expense among the separate items of income of foreign base company income, as required by Steps G and I below.)

(2) A second possible solution involves giving priority to the allocation and apportionment of deductions to foreign base company income. Thus, we could initially use the generic method to allocate and apportion a deduction between all foreign base company income (including same-country insurance income), and all other income of the controlled foreign corporation. Then, we would need to implement a second level of allocation and apportionment in two phases. First, we would use the specialized method of Code section 953 to allocate and apportion that part of the deduction already allocated and apportioned to foreign base company income between same-country insurance income and all other foreign base company income. Second, we would use the specialized method to allocate and apportion that portion of the deduction already allocated and apportioned to all income other than foreign base company income. We would distribute it between Code section 953 income and all other income that is not

66. See Treas. Reg. § 1.954-1(c)(2) (2000).

67. See Treas. Reg. § 1.954-1(c)(2) (2000).

68. See Treas. Reg. § 1.954-1(c)(1)(B), (D) (2000).

69. Section 953 insurance income is a relevant category since it, like foreign base company income, is taxed to the controlled foreign corporation's United States shareholders on a net basis. See I.R.C. §§ 952(a)(1), 954(b)(3)(C) (2000).

foreign base company income. (We would then need a third level of allocation and apportionment to distribute expense according to Steps G and I among the separate items of foreign base company income.)

The complexity of the second possible solution argues against its adoption. The proposal also contains another drawback. It would prevent the use of the specialized section 953 method to allocate and apportion deductions between section 953 insurance income and any same-country insurance income that constitutes foreign base company income. Because they lie in different classes of income during the first round of allocation and apportionment, we would initially allocate and apportion deductions relating to both kinds of insurance income according to the generic method, not the specialized one.

(3) The third possible solution keeps the two kinds of insurance income together during the first round of allocation and apportionment. First, the proposal allocates and apportions the deduction, using the generic method, among three classes of income: insurance income generally (including section 953 insurance income and any same-country insurance income that is also foreign base company income), foreign base company income that is not same-country insurance income, and all other income. Then, using the specialized method, we would allocate and apportion the amount of the deduction allocated and apportioned to insurance income generally among the categories of section 953 insurance income, same-country insurance income that is also foreign base company income, and all other insurance income. (We could build the allocation and apportionment required by Steps G and I into the first level of allocation and apportionment.)

We can evaluate the three proposals on the basis of their simplicity and their exploitation of the specialized method of allocating and apportioning deductions to insurance income and their simplicity. The first and third proposals have the merit of preserving the use of the specialized method in the allocation and apportionment of deductions between section 953 insurance income and same-country insurance income. The second proposal does not. The first proposal has the additional merit of using the specialized method to control the initial allocation and apportionment of deductions to any type of insurance income. The third proposal does not. The first and third proposals are simpler than the second proposal, since the second proposal requires three levels of allocation and apportionment. But I am unable to determine, *a priori*, whether the first proposal is simpler than the third proposal. In the case of allocating and apportioning deductions, complexity adds significantly to the compliance costs of taxpayers and the administrative costs of the government—costs that detract from fiscal efficiency.

On the basis of the first method's simplicity and exploitation of the specialized method of allocation and apportionment for deductions related to insurance

income, I suggest that we adopt it.⁷⁰ This could be done by amending a regulation.

RECOMMENDATION THREE: This recommendation contains two parts. First, amend Treasury Regulation section 1.954-1(c)(1) by adding the following phrase at the beginning of the first sentence of the provision: "Subject to § 1.954-1(c)(2)." Second, amend Treasury Regulation section 1.954-1(c)(2) by adding the following sentence at the end of the provision: "In the event that such a deduction also relates to gross foreign base company income not so attributable, the deduction shall first be allocated and apportioned under the rules of Code section 953 to foreign base company income that is so attributable; the remaining portion of such a deduction shall then be allocated and apportioned under the rules of Code sections 861, 864, and 904(d) to foreign base company income that is not so attributable."

G. Allocating and Apportioning Certain Other Deductions

Next, we turn to the computation of the controlled foreign corporation's net foreign base company income not derived from same-country insurance income. The remaining steps of the process of reducing a controlled foreign corporation's adjusted gross foreign base company income by its attendant expenses concern the allocation and apportionment of deductions related to such income. We now allocate and apportion the deductions definitely related to less than all of the controlled foreign corporation's gross income as a class to the controlled foreign corporation's items of adjusted gross foreign base company income.⁷¹ We use the method of allocation and apportionment given under Code sections 861, 864, and 904(d).⁷²

H. Related-Person Interest Expense

We then turn to the deduction for related-person interest expense allocable to passive income under Treasury Regulation section 1.904-5(c)(2).⁷³ Such interest expense consists of interest paid by the controlled foreign corporation to any of its United States shareholders.⁷⁴ The Code and regulations allocate and apportion this interest to the separate items of the controlled foreign corpora-

70. I may be giving undue deference to the Code section 953 method of allocating and apportioning deductions related to insurance income. I invite comment on this point from readers.

71. See Treas. Reg. § 1.954-1(c)(1)(i)(B) (2000).

72. *Id.*

73. See Treas. Reg. § 1.954-1(c)(1)(i)(C) (2000).

74. See Treas. Reg. § 1.904-5(c)(2)(i) (2000). Such related-person interest expense consists of interest paid by the controlled foreign corporation to any related person to whom the foreign tax credit look-through rules apply. *Id.* The look-through rules apply only to the United States shareholders of the corporation. See I.R.C. § 904(d)(3)(A) (2000). As a result, only interest paid by the controlled foreign corporation to any of its United States shareholders qualifies as related-person interest.

For tax years beginning after December 31, 2002, the look-through rules will also apply to shareholders in non-controlled section 902 corporations. See I.R.C. § 904(d)(4) (2000). However, no controlled foreign corporation can also constitute a non-controlled section 902 corporation. See I.R.C. § 904(d)(2)(E)(i) (2000). Furthermore, by definition, a shareholder in a non-controlled section 902 corporation owns at least 10% of the voting stock of the corporation. See I.R.C. §§ 902(a), 904(d)(2)(E)(i) (2000). In the case of a controlled foreign corporation, such a shareholding makes the shareholder a United States shareholder. See I.R.C. § 951(b). Thus, even for tax years begin-

tion's passive foreign personal holding company income.⁷⁵ Apparently, we are to use the method of Code sections 861, 864, and 904(d) to allocate and apportion related-person interest expense. Related-person interest expense may not reduce passive foreign personal holding company income below zero.⁷⁶ We must therefore allocate the remainder of related-person interest, if any, among the categories of income other than passive income.⁷⁷

I. Allocating and Apportioning the Remaining Deductions

Having allocated and apportioned the deduction for related-person interest expense allocable to passive income, we now address the controlled foreign corporation's remaining deductions. We must allocate and apportion the remaining deductions to the items of the corporation's adjusted gross foreign base company income: (1) items of passive foreign personal holding company income and (2) the other items of the controlled foreign corporation's adjusted gross foreign base company income.⁷⁸ In allocating and apportioning these final deductions, we must use the method of Code sections 861, 864, and 904(d).⁷⁹

J. The Treatment of Losses

Once we have reduced the individual items of the controlled foreign corporation's adjusted gross foreign base company income by their attendant expenses, we may generally consolidate the net items into the five categories of foreign base company income. In general, a loss within a given item of income may offset the income left within another item of income, as long as the two items of income fall within the same category of foreign base company income. A loss within one category of foreign base company income may not offset income within another category.⁸⁰

There is an exception to the general rule permitting losses to offset income within a category of foreign base company income. In the case of foreign personal holding company income, the Code confines some components of foreign personal holding company income to the excess of gains over losses.⁸¹ As a

ning after December 31, 2002, related-person interest expense consists of interest paid by the controlled foreign corporation to any of its United States shareholders.

75. See I.R.C. § 954(b)(5) (2000); Treas. Reg. § 1.954-1(c)(1)(i)(C) (2000). See *supra* Part III.C for a description of the separate items of a controlled foreign corporation's passive foreign personal holding company income. Except to the extent provided by regulation, interest paid or accrued by the controlled foreign corporation to another controlled foreign corporation related to one of the first corporation's United States shareholders must also be allocated to the first corporation's passive foreign personal holding company income. I.R.C. § 954(b)(5) (2000). Treasury Regulation section 1.954-1(c)(1)(i)(C) makes no mention of such interest. It thus appears that one must still allocate such interest to the controlled foreign corporation's passive personal holding company income.

76. See Treas. Reg. § 1.904-5(c)(2)(ii)(C), (D) (2000).

77. See Treas. Reg. § 1.904-5(c)(2)(ii)(D) (2000).

78. See Treas. Reg. § 1.954-1(c)(1)(i)(D); (iii)(A), (B) (2000).

79. See Treas. Reg. § 1.954-1(c)(1)(i)(D) (2000).

80. See Treas. Reg. § 1.954-1(c)(1)(ii) (2000).

81. The components include foreign currency gain, gain from commodities transactions, and gain from the disposition of certain property. See I.R.C. § 954(c)(1)(B), (C), (D) (2000).

result, it limits the availability of a loss to reduce income within a category. The Code does not permit the components to have a negative balance. Any surplus losses within such a component of foreign personal holding company income cannot be used to offset income elsewhere within foreign personal holding company income.

We should keep in mind, however, that losses not offsetting income may still affect the total inclusion of the controlled foreign corporation's United States shareholders through the workings of the current earnings and profits limitation.⁸²

IV.

ADJUSTED NET FOREIGN BASE COMPANY INCOME

To arrive at a controlled foreign corporation's adjusted net foreign base company income, we must make four adjustments to its net foreign base company income.⁸³ These adjustments cannot occur until the corporation's foreign base company income has been reduced by its attendant expenses. Consequently, the adjustments must wait until the determination of the controlled foreign corporation's net foreign base company income.

The deficit rules make the first adjustment. They take into account previous deficits incurred by the controlled foreign corporation in its tax haven operations, together with certain current deficits incurred by selected affiliates in their tax haven operations.⁸⁴ Incurring a deficit in a tax haven operation may seem like an oxymoron, but recall that at least two categories of foreign base company income may have significant start-up costs or experience significant price swings in the cost of raw materials: foreign base company shipping income and foreign base company oil-related income.

Two other adjustments link the income of the controlled foreign corporation's tax haven operations to the financial success of the corporation's complete operations. The following discussion considers whether such a linkage should occur. Subjecting a controlled foreign corporation's tax haven income to tax may be advisable, despite the existence of offsetting losses in the corporation's other operations. The adjustments either limit foreign base company income to the controlled foreign corporation's current earnings and profits,⁸⁵ or recapture as foreign base company income any amounts previously excluded from the corporation's foreign base company income by the current earnings and profits limitation.⁸⁶

The fourth adjustment excludes highly-taxed income from the tax base of foreign base company income.⁸⁷ Although such income arguably belongs

82. See *infra* Part IV.B.

83. See Treas. Reg. § 1.954-1(a)(5), (7) (2000).

84. See I.R.C. § 952(c)(1)(B), (C) (2000).

85. See I.R.C. § 952(c)(1)(A) (2000).

86. See I.R.C. § 952(c)(2) (2000).

87. See I.R.C. § 954(b)(4) (2000). Note, however, that the exception does not apply to foreign base company oil-related income as defined in Code section 954(a)(5).

outside the category of tax haven income, it has fallen within the sweep of subpart F through the broad mechanisms the subpart uses to describe tax haven operations.

A. *The Deficit Rules*

Under the primary deficit rule, the United States shareholder benefits from past losses incurred by the controlled foreign corporation within its tax haven operations. Under a secondary rule, the shareholder may benefit from current tax haven losses incurred by certain affiliates of the controlled foreign corporation.

1. *The Primary Rule*

In general terms, the primary deficit rule reduces the United States shareholder's subpart F inclusion by past losses in the controlled foreign corporation's tax haven activities. More precisely, the rule reduces the shareholder's inclusion attributable to any of the five categories of foreign base company income or section 953 insurance income by the shareholder's pro rata share of a deficit in the corporation's accumulated earnings and profits attributable to activity giving rise to that type of income, subject to various requirements.⁸⁸ A deficit may only offset subpart F income arising from the same type of activity that gave rise to the deficit.⁸⁹ For example, a deficit arising from activity that, if profitable, would have generated foreign base company sales income may only offset foreign base company sales income. Furthermore, foreign personal holding company income and section 953 insurance income may only experience offsets if the controlled foreign corporation engages in specified lines of business. To offset a deficit against section 953 income, the corporation must predominantly engage in the active conduct of an insurance business. To offset a deficit against foreign personal holding company income, the corporation must predominantly engage in the active conduct of either an insurance business or a banking, financing, or similar business.⁹⁰ A controlled foreign corporation may

88. See I.R.C. § 952(c)(1)(B) (2000). The corporation must have constituted a controlled foreign corporation during the year in which it incurred the deficit. See I.R.C. § 952(c)(1)(B)(ii) (2000). In calculating its pro rata share of a deficit, the United States shareholder must use the smaller of its ownership interests from the current year and the deficit year. I.R.C. § 952(c)(1)(B)(iv) (2000). Depending on the category of foreign base company income involved, a shareholder may reach for deficits from various years. A shareholder may reach deficits incurred during activities giving rise to foreign base company shipping income or foreign personal holding company income if they arose in a tax year beginning after 1986. See I.R.C. § 952(c)(1)(B)(ii) (2000). In contrast, a shareholder may reach deficits incurred during activities giving rise to foreign base company oil-related income if they occurred in tax years beginning after 1982. See *id.* Finally, a shareholder may reach deficits incurred during activities giving rise to either foreign base company sales income or foreign base company services income if they were incurred in tax years beginning after 1962. See *id.*

89. See I.R.C. § 952(c)(1)(B)(ii)(I) (2000).

90. See I.R.C. § 952(c)(1)(B)(iii)(V), (VI); (v), (vi) (2000). The corporation must meet the predominant line of business criterion both during the year in which it incurs the deficit and the year in which the deficit rule applies. See I.R.C. § 952(c)(1)(B)(v), (vi) (2000).

not use a deficit to offset a subpart F inclusion to the extent that the deficit has offset subpart F inclusions in past years.⁹¹

2. *The Secondary Rule: An Election*

Deficits incurred by a small set of persons related to the controlled foreign corporation in their own tax haven operations may also decrease the United States shareholder's subpart F inclusion.⁹² In this case, the reduction occurs within the controlled foreign corporation's subpart F income; it affects the shareholder's inclusion only indirectly.⁹³ Unlike the primary deficit rule, which is mandatory, the secondary rule is optional at the election of the controlled foreign corporation.⁹⁴ Moreover, the related person's deficit must occur in the person's current earnings and profits, rather than in the person's accumulated earnings and profits.⁹⁵ Before the controlled foreign corporation elects to take the deduction, the available deficits in the controlled foreign corporation's accumulated earnings and profits must have already reduced the shareholder's subpart F inclusion under the primary deficit rule.⁹⁶ The deficits transferred from the related person must offset income arising from the same kind of activity as gave rise to the deficits.⁹⁷ Thus, a controlled foreign corporation must use a deficit of a related person arising from activity that, when profitable, gives rise to foreign base company oil-related income only to offset the corporation's foreign base company oil-related income.

The related person must consist of a corporation incorporated in the same foreign country as the controlled foreign corporation.⁹⁸ Furthermore, the related corporation must either wholly own, or be wholly-owned by, the controlled foreign corporation.⁹⁹ The ownership may occur directly, or indirectly through one

91. See I.R.C. § 952(c)(1)(B)(ii)(II) (2000).

92. See I.R.C. § 952(c)(1)(C)(i) (2000).

93. See *id.*

94. Compare I.R.C. § 952(c)(1)(B)(i) (2000) (stating that the amount of the shareholder's inclusion *shall* be reduced [emphasis added]) with I.R.C. § 952(c)(1)(C)(i) (2000) (stating that a controlled foreign corporation *may elect* to reduce the amount of its subpart F income [emphasis added]).

95. See I.R.C. § 952(c)(1)(C)(i) (2000). The relevant earnings and profits are those of the related person for a taxable year ending with or within the taxable year of the controlled foreign corporation with respect to which United States tax is being determined for the United States shareholder.

96. See I.R.C. § 952(c)(1)(C)(iii) (2000).

97. See I.R.C. § 952(c)(1)(C)(i) (2000). In *Stanford v. Commissioner*, 152 F.3d 450 (5th Cir. 1998), the taxpayer argued unsuccessfully that a deficit incurred by a controlled foreign corporation in rendering administrative and managerial services to its wholly-owned subsidiary should offset the subsidiary's foreign personal holding company income derived in the active conduct of a banking business. The taxpayer argued, in the language of the statute, that the deficit of the parent controlled foreign corporation was "attributable to" the subsidiary's banking business, since the subsidiary used the parent's services in that business. The Fifth Circuit held that the deficit was not so attributable. *Id.* at 459. Instead, the court required that an entity engaged in a qualifying activity generate the offset. *Id.* at 463 (J. Benavides dissenting). Note that the parent's administrative and managerial services, if profitable, would not have generated foreign personal holding company income.

98. I.R.C. § 952(c)(1)(C)(ii) (2000).

99. *Id.*

or more intermediate companies in a chain.¹⁰⁰ Finally, the two corporations cannot be sibling corporations; that is, the relationship between them must consist of more than having a common parent corporation.¹⁰¹ Under these conditions, the related person will itself constitute a controlled foreign corporation.

Code section 952(c)(1)(B) is unclear as to whether a controlled foreign corporation must have an overall deficit in its accumulated earnings and profits before its United States shareholder must use the primary deficit rule. Furthermore, Code section 952(c)(1)(C) is unclear as to whether a related person must have an overall deficit in its current earnings and profits before the controlled foreign corporation may elect to use the secondary deficit rule. If our goal is to measure a corporation's tax haven income accurately over time, an overall deficit should not be required in either case. Moreover, the Code refers to "any deficit" in the earnings and profits of a given year.¹⁰² Such language suggests that a corporation may have multiple deficits in a single taxable year and that the existence of a relevant deficit is to be determined activity by activity. The following recommendation would adopt this reading of the Code:

RECOMMENDATION FOUR: Provide in regulations under Code section 952(c)(1)(B) and (C) that the deficit rule of section 952(c)(1)(B) applies even if the controlled foreign corporation has no overall deficit in earnings and profits during the year in which the corporation has a deficit attributable to a qualified activity; and that the deficit election of section 952(c)(1)(C) is available even if the qualified chain member has no overall deficit in earnings and profits during the year in which the member has a deficit attributable to a qualified activity.

3. *Coordinating the Deficit Rules with the Current Earnings and Profits Limitation*

The deficit rules act independently of the current earnings and profits limitation; they reduce the shareholder's subpart F inclusion regardless of whether the corporation's subpart F income is reduced by the current earnings and profits limitation. Furthermore, a qualified deficit reduces the shareholder's subpart F inclusion, even if the corporation's current earnings and profits exceed the sum of its current subpart F income and any deficit in its accumulated earnings and profits. The current earnings and profits limitation focuses on losses incurred by the controlled foreign corporation outside its tax haven operations. The deficit rules, on the other hand, focus on losses incurred within tax haven operations. Finally, whereas the limitation concerns the corporation's losses contemporaneous with its tax haven income, the primary deficit rule addresses the losses that precede the corporation's current tax haven income.

The Code does not truly specify the order of application of the deficit rules and the current earnings and profits limitation. Instead, it merely implies that one should apply the primary deficit rule after the current earnings and profits limitation. The deficit rule reduces the shareholder's inclusion, which presup-

100. *Id.*

101. *Id.*

102. I.R.C. § 952(c)(1)(B)(ii), (C)(i) (2000).

poses prior application of all limitations of the controlled foreign corporation's subpart F income. But the Code also requires that the controlled foreign corporation, rather than the shareholder, apply the secondary deficit rule after application of the primary rule. (Treasury Regulation section 1.954-1(a)(5) calls for application of the primary deficit rule when computing the controlled foreign corporation's subpart F income. The regulation postdates the addition of the primary and secondary deficit rules to Code section 952(c).)

The order of application makes a difference. Consider the controlled foreign corporation with current-year net foreign base company oil-related income of \$1000, current earnings and profits of \$700 reflecting losses in its other operations, and a deficit of \$400 in past years from its foreign base company oil-related operations. Does its adjusted net foreign base company income equal \$300 or \$600? If the corporation must first offset its current foreign base company oil-related income with the deficit attributable to its past foreign base company oil-related activity, and then apply the current earnings and profits limitation, its adjusted net foreign base company income equals \$600. On the other hand, if the corporation must first apply the limitation and then the offset, its adjusted net foreign base company income equals \$300. The \$600 figure should be the correct answer. The corporation has derived tax haven income of \$600 over the years, and the amount of its current earnings and profits justifies conceptualizing the entire amount as a current dividend (of sorts) to the United States shareholder.

Thus, the appropriate order of application seems to consist of a reduction in the corporation's subpart F income by application of the deficit rules, and then by the application of the current earnings and profits limitation. No regulations have yet been promulgated for the deficit rules. When promulgated, however, the regulations should reflect this order of application.

RECOMMENDATION FIVE: Provide in regulations under Code section 952(c)(1)(B) and (C) that the controlled foreign corporation's net foreign base company income is to be reduced first by the application of the rule given in Code section 952(c)(1)(B), then by the application of the rule given in Code section 952(c)(1)(C) if the corporation elects to use that rule, and then by the application of the limitation given in Code section 952(c)(1)(A).

B. Current Earnings and Profits Limitation

The deficit rules take into account losses that a controlled foreign corporation incurs in its tax haven operations. The current earnings and profits limitation, on the other hand, concerns losses incurred by a controlled foreign corporation in its non-tax haven operations. The limitation restricts a controlled foreign corporation's subpart F income, which includes its foreign base company income, to the corporation's earnings and profits for the current tax year.¹⁰³ To the extent the controlled foreign corporation has incurred losses in its non-tax haven operations during the current year, the losses reduce the corpo-

103. I.R.C. § 952(c)(1)(A) (2000).

ration's overall earnings and profits below the level of the earnings and profits attributable to its tax haven operations.

Under the limitation, the Code treats a subpart F inclusion as if it were a dividend distributed by the controlled foreign corporation to its United States shareholders. Since the Code treats an actual distribution by a corporation to its shareholders as a dividend for tax purposes only to the extent of the corporation's earnings and profits,¹⁰⁴ the earnings and profits limitation on subpart F income defines the deemed dividend under subpart F. As with a number of subpart F features, the correlation between a subpart F inclusion and a dividend is imprecise, and the pairing only serves as a general analogy.¹⁰⁵

Should we allow losses from non-tax haven operations to offset the controlled foreign corporation's earnings from its tax haven operations? If the goal of subpart F is to suppress tax haven operations, the limitation does not make sense. The Code should tax a controlled foreign corporation's earnings from tax haven operations regardless of the corporation's overall profitability. On the other hand, if subpart F simply attempts to remove the benefit of tax deferral from legitimate activities and to tax United States shareholders currently on the income available for repatriation, the limitation makes more sense. Of course, subpart F has multiple and conflicting purposes, reflecting its legislative history. The subpart arguably serves three purposes: (1) to suppress foreign base company sales and services income, (2) to tax currently, but not suppress, foreign base company shipping and oil-related income, and (3) to treat foreign personal holding company income as a frequently legitimate type of revenue subject to manipulation as to source.

Even if the limitation makes sense on the basis of taxing earnings available for repatriation, the Code should expand the limitation to reflect a controlled foreign corporation's potential distribution of dividends from accumulated earnings and profits. Accumulated earnings and profits not previously taxed to the United States shareholder are attributable to profitable non-tax haven operations in past years. The Code should add those earnings to the corporation's current earnings and profits for purposes of the limitation. Because the limitation does not take accumulated earnings and profits into account, it gives an incentive to United States shareholders, in any year in which the controlled foreign corporation incurs losses in its non-tax haven operations, to route foreign base company sales and services transactions through the corporation in order to generate foreign base company sales and services income up to the amount of the loss.

I recommend retaining the limitation, but expanding the pool of earnings and profits available to cover a subpart F inclusion to the controlled foreign corporation's accumulated earnings and profits. At the same time, we should preserve the possibility of a nimble subpart F inclusion; that is, a subpart F inclusion covered by the corporation's current earnings and profits even when

104. See I.R.C. § 316(a) (2000).

105. For some of the differences between a constructive dividend and a subpart F inclusion, see AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION* 214-21 (1987).

the corporation has a deficit in its accumulated earnings and profits in excess of its current earnings and profits.

RECOMMENDATION SIX: Amend Code section 952(c)(1) to provide that a subpart F inclusion shall be limited to the sum of the controlled foreign corporation's current earnings and profits plus the positive balance, if any, of its accumulated earnings and profits.

For purposes of the limitation, the Code calculates the earnings and profits of the controlled foreign corporation in much the same way as the earnings and profits of a domestic corporation. The taxpayer must then make adjustments to take into account matters distinctive to subpart F and to prevent double taxation by the United States of items within the controlled foreign corporation's income. I take these matters up below.

1. Defining Current Earnings and Profits

Calculation of the earnings and profits of a controlled foreign corporation resembles the calculation of the earnings and profits of a domestic corporation.¹⁰⁶ In computing earnings and profits for purposes of subpart F, the Code relieves controlled foreign corporations of several requirements incumbent upon domestic corporations.¹⁰⁷ As with domestic corporations, controlled foreign corporations compute their current earnings and profits without regard to distributions made to shareholders during the year.¹⁰⁸ The controlled foreign corpo-

106. I.R.C. § 964(a) (2000). The regulations specify the various changes the controlled foreign corporation must make to its book accounting principles and tax accounting standards to calculate its earnings and profits. The regulations also detail the manner and effect of making tax elections on behalf of the controlled foreign corporation. *See* Treas. Reg. §§ 1.964-1(a), (b), (c) (2000); Temp. Treas. Reg. § 1.964-1T(g) (2000). In the event the branch rule of Code section 954(d)(2) treats a branch of the controlled foreign corporation as a separate corporation, the branch and the remainder of the controlled foreign corporation reunite into a single entity for purposes of the current earnings and profits limitation. Treas. Reg. § 1.954-3(b)(3) (2000). For a methodology for computing a controlled foreign corporation's earnings and profits, *see* Mark A. Kramer, *Calculating Earnings and Profits Under Code Section 964*, 26 INT'L TAX J. 1, 11-16 (2000).

107. Most controlled foreign corporations need not compute their earnings and profits on the assumption of straight-line depreciation. *See* I.R.C. §§ 312(k)(4), 964(a) (2000). Corporations that derive 20% or more of their gross income from sources within the United States are the exception to the rule. *See* I.R.C. § 312(k)(4) (2000). Unlike domestic corporations, controlled foreign corporations may generally calculate their earnings and profits without regard to changes in their LIFO recapture amounts. Additionally, they may use the installment and completed contract methods for recording income. I.R.C. §§ 312(n)(4), (5), (6), 952(c)(3) (2000). To the extent the three alternative calculation methods increase the controlled foreign corporation's earnings and profits by an amount previously distributed by the corporation to its shareholders, the corporation may not use them. I.R.C. § 952(c)(3) (2000).

108. *Compare* I.R.C. § 316(a)(2) (2000) (computing a domestic corporation's earnings and profits without diminution for distributions made during the taxable year) *with* Treas. Reg. § 1.952-1(c)(1) (2000) (computing a controlled foreign corporation's earnings and profits without diminution for distributions made during the taxable year). The similarity in treatment of a domestic corporation and a controlled foreign corporation seems puzzling at first sight. Surely, one might think, a distribution made to a United States shareholder by a controlled foreign corporation ought to reduce any subpart F inclusion of the shareholder. Both the distribution and the subpart F inclusion, one might reason, are included in the United States shareholder's gross income. Thus, preserving the appearance of identical treatment for domestic and foreign corporations would apparently result in double taxation of the United States shareholder by the United States. The puzzle is solved by Code section 959(a). The section excludes a distribution from a United States shareholder's gross income

ration cannot reduce its earnings and profits by the amount of any bribes constituting subpart F income.¹⁰⁹ Nor may a controlled foreign corporation reduce its earnings and profits by the amount of foreign income taxes it pays.¹¹⁰ A controlled foreign corporation computes its earnings and profits in its functional currency, translating the earnings and profits into United States dollars only when it must take the earnings and profits into account for purposes of determining a United States shareholder's tax (*i.e.*, when it uses the earnings and profits to calculate the limitation on the controlled foreign corporation's subpart F income).¹¹¹

The controlled foreign corporation may not reduce its earnings and profits by the amount of its highly taxed income excluded from its foreign base company income by Code section 954(b)(4). If not for the requirement that the taxpayer apply the earnings and profits limitation to the corporation's foreign base company income prior to the application of the high-tax exclusion, the failure to deduct the highly taxed income might lead to the substitution in the subpart F inclusion of an equal amount of income otherwise excluded by the earnings and profits limitation.¹¹²

2. *Adjustments to Current Earnings and Profits*

Once the controlled foreign corporation has calculated its current earnings and profits, it must reduce them by blocked income and increase them by distributions received from other controlled foreign corporations excluded from the recipient's gross income by Code section 959(b).

a. *Blocked Income*

Currency or other restrictions imposed by a foreign country may prevent the controlled foreign corporation from distributing earnings and profits to its U.S. shareholders. For purposes of the earnings and profits limitation, the corporation must reduce its current earnings and profits by the amount of such

to the extent the distribution is made out of a controlled foreign corporation's subpart F income previously taxed to the United States shareholder. Despite the exclusion provided by section 959(a), the United States shareholder may recognize a foreign exchange gain or loss at the time of the actual distribution due to a fluctuation in exchange rate between the time of the taxable inclusion and the actual distribution. The Code characterizes the gain or loss as ordinary and treats it as having the same source as the taxable income inclusion. I.R.C. § 986(c)(1) (2000).

109. See I.R.C. §§ 952(a), 964(a) (2000).

110. See Treas. Reg. § 1.954-1(d)(7)(ii) (2000).

111. I.R.C. § 986(b) (2000). The controlled foreign corporation must use the averaged exchange rate for its taxable year. I.R.C. § 989(b)(3) (2000). The appropriate exchange rate for an inclusion under Code section 951(a)(1)(B), which governs an investment in United States property as described in Code section 956, is the spot rate on the last day of the controlled foreign corporation's taxable year. I.R.C. § 989(b) (2000).

112. See Treas. Reg. §§ 1.952-1(e)(4), 1.954-1(a)(5), 1.954-1(d)(4)(ii) (2000). Note, too, that the earnings and profits limitation applies to all kinds of subpart F income, while the high-tax exclusion applies to only two kinds (namely, foreign base company income and insurance income). Hence, the computation of adjusted net foreign base company income must await the application of the earnings and profits limitation across all kinds of subpart F income.

blocked earnings and profits.¹¹³ The controlled foreign corporation does not need to be a first-tier subsidiary of the United States shareholder. The shareholder may hold its stock in the corporation indirectly, via a shareholding in an intermediate foreign corporation.¹¹⁴ According to the Code, *any* foreign country may impose the legal restrictions that block the distribution of the earnings and profits to the United States shareholder of a controlled foreign corporation.¹¹⁵ As a result, a currency restriction imposed by a foreign country on distributions made by a corporation intermediate between the controlled foreign corporation and its United States shareholder would satisfy the statutory provision.¹¹⁶

A foreign currency restriction might not consist of an outright ban on currency conversions. Some restrictions take the form of a licensing requirement, with requests for licenses being refused when the nation's central bank needs to conserve its foreign currency reserves. To qualify under the restriction, the controlled foreign corporation must demonstrate that it sought a license, and that the government turned down its request.¹¹⁷ Thus, a controlled foreign corporation that has no intention of making a distribution and does not apply for a license to convert currency into United States dollars causes its United States shareholder

113. I.R.C. §964(b) (2000). The restriction must generally consist of either a restriction on the conversion of foreign currency into United States dollars or a ban on the distribution of dividends. Treas. Reg. § 1.964-2(b)(2) (2000). The relevant period for testing whether a restriction exists is the last ninety days of each tax year and the first sixty days of the following tax year. Treas. Reg. § 1.964-2(b)(1) (2000). The regulations will ignore a currency restriction unless it is accompanied by a ban on the export of property of a type normally owned by the controlled foreign corporation for use in its business and readily converted into United States currency. Treas. Reg. § 1.964-2(b)(3) (2000). Furthermore, the regulations will ignore a currency restriction if a conversion into United States dollars occurs, despite the legal restriction. Treas. Reg. § 1.964-2(c)(2)(ii) (2000). Finally, the regulations will ignore restrictions imposed voluntarily. Treas. Reg. § 1.964-2(b)(4) (2000).

Voluntary restrictions include the restriction created by the payment of a stock dividend that reduces the corporation's earnings and profits. *Id.* (A stock dividend unaccompanied by a reduction in the par value of the issuer's stock constitutes an example of such a dividend.) The allocation of earnings and profits to a reserve also creates problems. Although the regulations will not respect an arbitrary reserve, Treas. Reg. § 1.964-2(b)(4) (2000), they will respect a mandatory reserve under foreign law, Treas. Reg. § 1.964-2(b)(5) (2000). They will respect the mandatory reserve only to the extent the year's required increase in the reserve exceeds the controlled foreign corporation's accumulated earnings and profits. Treas. Reg. § 1.964-2(b)(5)(i) (2000). For this purpose, the controlled foreign corporation's accumulated earnings and profits do not include undistributed income already taxed to a United States shareholder under either subpart F or the foreign personal holding company provisions. Treas. Reg. § 1.964-2(b)(5)(ii) (2000).

114. See I.R.C. §§ 958(a), 964(b) (2000).

115. See *id.*

116. If the controlled foreign corporation can pay a dividend directly to the United States shareholder (and thus avoid a restriction imposed on the intermediary in the chain of ownership), and if the United States shareholder owns 80% or more of the stock of the controlled foreign corporation either directly, indirectly, or by attribution, the corporation may not treat the earnings and profits as blocked. See Treas. Reg. § 1.964-2(b)(2) (2000). For example, a foreign currency restriction might block a first-tier foreign subsidiary from paying a dividend to the United States shareholder. It might not, however, block the first-tier subsidiary from directing a second-tier subsidiary to remit any dividend otherwise payable to the first-tier subsidiary directly to the United States shareholder, in satisfaction of the first-tier subsidiary's obligation to the United States parent. In such a case, the foreign currency restriction would not reduce the second-tier subsidiary's earnings and profits.

117. See Treas. Reg. § 1.964-2(b)(6) (2000). If it can demonstrate the futility of such a request, the controlled foreign corporation can refrain from making the application. *Id.*

to have a full inclusion of subpart F income. In contrast, the controlled foreign corporation that intends to make a distribution and seeks such a license, only to have a partial distribution approved, shelters the remainder of the intended distribution from subpart F.¹¹⁸

Upon removal of the restriction blocking the distribution of the controlled foreign corporation's earnings and profits, the income of the United States shareholder will include the subpart F income attributable to those earnings and profits.¹¹⁹

b. Distributions Received from Other Controlled Foreign Corporations

Any dividend received from another controlled foreign corporation and excluded from the recipient's gross income by Code section 959(b) increases the controlled foreign corporation's earnings and profits.¹²⁰ The other corporation pays such a dividend out of earnings and profits attributable to income already taxed to the United States shareholder.¹²¹ The recipient does not necessarily add the dividend to its current earnings and profits. Instead, it must credit the addition to its earnings and profits for the year in which the United States shareholder was taxed on the payor's earnings.¹²² The addition retains its character under the groupings of Code section 959(c).¹²³ Such treatment prevents the imposition of a second United States tax on the U.S. shareholder when the recipient distributes the additional earnings and profits to its own shareholders.

In general, any distribution received from another controlled foreign corporation becomes part of the earnings and profits of the recipient, even if the recipient must exclude the distribution from its gross income.¹²⁴ Code section 312(f)(2) provides the two exceptions to the general rule. The first exception applies if the distribution reduces the recipient's basis in the stock with respect to which the distribution is made. The second exception applies if the distribution causes the reallocation of the recipient's basis in such stock between the stock and any property received in the distribution.¹²⁵ In either case, the recipient cannot include the distribution in its earnings and profits.

118. See Treas. Reg. § 1.964-2(c)(5)(b) (2000).

119. See Treas. Reg. § 1.964-2(c)(1)(i) (2000). For purposes of the current earnings and profits limitation, one adds the released earnings and profits to the earnings and profits for the year in which the corporation derived the released earnings and profits. Treas. Reg. § 1.964-2(c)(1)(ii) (2000).

120. See Treas. Reg. § 1.959-3(b)(3)(c)(4) (2000). The full amount of the dividend is not included in the controlled foreign corporation's earnings and profits. Instead, the corporation must first subtract the amount of any foreign taxes paid with respect to the distribution. See Treas. Reg. § 1.959-3(d) (2000). The foreign taxes include any withholding taxes imposed on the distribution, in addition to any foreign income taxes imposed on the recipient on the basis of residence. See *id.*

121. See *supra* Part I.C for an analysis of the exclusion for certain distributions under Code section 959(b).

122. See Treas. Reg. § 1.959-3(b)(3)(c)(4) (2000).

123. See Treas. Reg. § 1.959-3(b) (2000).

124. See I.R.C. §§ 312(f)(2), 964(a); see also Rev. Rul. 86-33, 1986-1 C.B. 287 (stating that a controlled foreign corporation must include a dividend excluded from its gross income by virtue of Treasury Regulation section 1.955A-3(c)(1) in its earnings and profits).

125. I.R.C. §§ 312(f)(2) (2000).

3. *Application of the Limitation*

When the current earnings and profits limitation reduces a controlled foreign corporation's subpart F income, the corporation must allocate the reduction among the various elements of its subpart F income. The limitation comes into play when the corporation incurs losses in its non-tax haven operations. The losses reduce the corporation's overall earnings and profits for the taxable year from its level of earnings and profits based solely on its subpart F income.

The allocation process attempts to reduce the elements of the corporation's subpart F income most closely allied to its losses. More precisely, the process allocates the reduction in a corporation's subpart F income to items of subpart F income derived from operations most similar to the operations creating the losses. The baskets established by the foreign tax credit limitation help determine similarity. The corporation must generally allocate the reduction to items of subpart F income falling within the same baskets as the losses.

Recall that a United States shareholder must allocate its portion of a controlled foreign corporation's subpart F income among the various baskets used to calculate the foreign tax credit limitation.¹²⁶ When allocating the reduction in its subpart F income under the current earnings and profits limitation, the controlled foreign corporation anticipates its shareholder's use of the baskets.¹²⁷ The application of the limitation is best understood as postulating an identical set of baskets at the level of the controlled foreign corporation. We might refer to those baskets as the "controlled foreign corporation" or "CFC" baskets.

After a preliminary step, the process of allocation proceeds in two stages.

a. *The Preliminary Step: Classifying Baskets*

The controlled foreign corporation begins the process by allocating its subpart F income, calculated prior to the application of the limitation, among the CFC baskets.¹²⁸ The corporation then allocates its current earnings and profits among those baskets.¹²⁹ It compares the subpart F income in each basket to the current earnings and profits in the basket, classifying the baskets according to the results of the comparison. The first class of basket consists of those without earnings and profits, or even a deficit in earnings and profits.¹³⁰ The second class of basket consists of CFC baskets with earnings and profits that are less than the subpart F income in the same baskets.¹³¹ The last class of basket consists of all remaining baskets containing any subpart F income. They have less subpart F income than current earnings and profits.¹³²

The allocation of the reduction in the controlled foreign corporation's subpart F income then proceeds in earnest. The first stage of the process requires

126. See I.R.C. § 904(d)(1), (3) (2000).

127. See Treas. Reg. § 1.952-1(e)(1) (2000).

128. See *id.*

129. See *id.*

130. Treas. Reg. § 1.952-1(e)(1)(i) (2000).

131. Treas. Reg. § 1.952-1(e)(1)(ii) (2000).

132. See Treas. Reg. § 1.952-1(e)(1)(iii) (2000).

allocation of the reduction in subpart F income *among* the various CFC baskets. The second stage requires allocation of the reduction *within* each CFC basket affected by the first stage of allocation.

b. First Stage: Allocation Among Baskets

The first stage consists of three possible rounds of allocation. In the first round, the controlled foreign corporation allocates the reduction to the baskets of the first classification.¹³³ If the subpart F income in the first classification of baskets exceeds the reduction required by the limitation, the corporation prorates the reduction among the baskets of the first classification on the basis of the subpart F income contained in the baskets.¹³⁴

If the subpart F income in the first classification of basket does not fully absorb the reduction required by the limitation, the corporation proceeds to the second round of the first stage. In the second round, the corporation allocates the excess reduction to the second type of basket, to the extent of the subpart F income contained in those baskets.¹³⁵ If the amount of subpart F income in the second type of basket exceeds the amount of the required reduction, the corporation prorates the reduction among the baskets on the basis of the subpart F income in each basket. It disregards the amount by which a specific basket's subpart F income exceeds that basket's current earnings and profits.¹³⁶ In particular, the reduction in a basket's subpart F income may amount to more than the excess of the basket's subpart F income over the basket's earnings and profits. The second round of allocation may thus leave a basket with less subpart F income than its current earnings and profits.¹³⁷

If the first two classifications of baskets fail to fully absorb the reduction required by the current earnings and profits limitation (meaning no subpart F income remains in any of the baskets of the second classification), the controlled foreign corporation moves to the third round and allocates the remaining reduction to the last kind of CFC basket.¹³⁸ Again, if the amount of subpart F income in the baskets of the third classification exceeds the amount of the reduction allocated, the corporation prorates the reduction among the baskets according to the amount of subpart F income in each basket.¹³⁹

133. *See id.*

134. *See id.*

135. *See* Treas. Reg. § 1.952-1(e)(1) (2000).

136. *See id.*

137. During the second round of allocation, the process may leave baskets with less subpart F income than earnings and profits, which would make the baskets identical to those in the third classification. Nevertheless, the corporation does not interrupt the second round to include baskets of the third classification. The allocation process will proceed to baskets of the third classification only if the second round exhausts all of the subpart F income contained in baskets of the second classification.

138. *See* Treas. Reg. § 1.952-1(e)(1) (2000).

139. *See id.*

c. *Second Stage: Allocation Within Baskets*

The corporation must now allocate the reduction distributed to each CFC basket among the categories of subpart F income within each basket.¹⁴⁰ There are sixteen possible intra-basket categories of subpart F income. They consist of the four categories of subpart F income other than foreign base company income, the four categories of foreign base company income other than foreign personal holding company income, the category of full-inclusion foreign base company income, and the seven categories of foreign personal holding company income.¹⁴¹ Based upon the amount of subpart F income in each category, the corporation performs a pro rata allocation among the sixteen categories.¹⁴²

The two-stage process ultimately allocates the reduction in subpart F income among specific items of the controlled foreign corporation's income, as those items are defined in Part III.C. Recall that the controlled foreign corporation had to separate its foreign base company income into items of income in preparation for allocating and apportioning its deductions against its foreign base company income. It defined the separate items of income by crossing the baskets of the foreign tax credit limitation with the various kinds of foreign base company income. The application of the current earnings and profits limitation achieves a similar result. By first allocating the necessary reduction among the CFC baskets (which mirror the baskets of the foreign tax credit limitation), and then among the categories of subpart F income within each CFC basket, the process isolates the separate items of income defined in Part III.C. Both the process of allocating deductions and the process of applying the current earnings and profits limitation anticipate the United States shareholder's need to analyze its subpart F inclusion under the foreign tax credit limitation. The need justifies much of the remarkable complexity in the two processes.

C. *The Exclusion for Highly-Taxed Income*

If a foreign country has imposed a tax on an item of income at an effective rate greater than 90% of the highest marginal rate of the United States corporate income tax, the United States shareholders of a controlled foreign corporation may elect to exclude the item of income from the corporation's net foreign base company income.¹⁴³ Items of income that fall within the definition of foreign

140. Treas. Reg. § 1.952-1(e)(2) (2000).

141. Treas. Reg. §§ 1.952-1(e)(2), 1.954-1(c)(1)(iii)(A)(1), (2) (2000). Foreign personal holding company income now includes seven categories, rather than the five categories listed in Treasury Regulation section 1.954-1(c)(1)(iii)(A)(1) (2000). See *supra* note 47, regarding the amendment of Code section 954(c) by The Taxpayer Relief Act of 1997.

142. See Treas. Reg. § 1.952-1(e)(2) (2000). Thus, the process treats the sixteen intra-basket categories as equal in rank. That is, one does *not* first prorate among the five divisions of subpart F income, then prorate the reduction allocated to foreign base company income among its five subdivisions, and then prorate the reduction allocated to foreign personal holding company income among its seven subdivisions. The corporation prorates the entire reduction allocated to a CFC basket just once among the sixteen categories of subpart F income.

143. See Treas. Reg. § 1.954-1(d)(1) (2000). The effective rate of foreign taxation is determined by reference to the amount of foreign taxes that would be deemed paid with regard to the item of income by the United States foreign tax credit if the item were taxed to the corporation's United

base company oil-related income, however, are not eligible for the election.¹⁴⁴ Nor is portfolio interest within the meaning of Code section 881(c).¹⁴⁵ Although the exclusion is not available for highly-taxed items of foreign base company oil-related income or portfolio interest, it is unlikely that such highly-taxed items will attract substantial U.S. tax for the United States shareholders. When the items are included in the shareholders' income, the United States foreign tax credit will minimize the United States tax levied upon them.¹⁴⁶

Shareholders may elect to exclude highly-taxed income on an item-by-item basis, with the exception of highly-taxed passive foreign personal holding company income.¹⁴⁷ They must make the election with regard to all such income or none of it.¹⁴⁸ When they make the election on the basis of individual items of income, the items are defined in the same manner as they are for allocating and apportioning the controlled foreign corporation's deductions.¹⁴⁹ As a result, even when shareholders make the election on the basis of individual items of income, a certain blending of foreign tax rates may occur. The blending takes place when those items consist of composites of income arising from a number of separate transactions.¹⁵⁰

States shareholders. See Treas. Reg. § 1.954-1(d)(3) (2000). For purposes of the computation, the foreign tax credit limitation is ignored, except with regard to any foreign personal holding company income that falls within the passive basket of the limitation; for those items of income, the amount of foreign taxes deemed paid is adjusted to the amount taken into account for purposes of applying the high-tax kickout from the passive basket of the foreign tax credit limitation. Compare Treas. Reg. § 1.954-1(d)(3)(i) (2000) (concerning the treatment of income other than passive foreign personal holding company income) with Treas. Reg. § 1.954-1(d)(3)(ii) (concerning the treatment of passive foreign personal holding company income). The amount of foreign taxes so calculated is not reduced by a subsequent reduction in the actual foreign tax arising from a distribution by the controlled foreign corporation of earnings attributable to the item of income. Treas. Reg. § 1.954-1(d)(3)(i) (2000). Hence, the computation of the foreign tax paid ignores the effect of a foreign country's integration of its corporate and individual income taxes via a reduction in corporate tax upon a distribution of corporate earnings. In the event of a distribution, the effective rate of foreign tax is determined separately for each corporation in the chain of distribution. Treas. Reg. § 1.954-1(d)(2) (2000). The foreign tax base for the computation is increased by the amount of foreign taxes deemed paid with regard to the item of income, rather than by the amount actually paid or accrued under foreign tax principles. Treas. Reg. § 1.954-1(d)(2)(ii) (2000).

144. I.R.C. § 954(b)(4) (2000).

145. Treas. Reg. § 1.954-1(d)(1) (2000). This regulatory provision appears to lack statutory authority. Perhaps the regulation's rationale lies in the United States' failure to tax portfolio interest to the controlled foreign corporation. The drafters of the provision may have concluded that the income should not receive the additional benefit of the deferral of shareholder taxation. See AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION* 223 (1987). In the context of the high-tax kickout, however, such reasoning seems misplaced. The required high rate of foreign tax substantially assures that the United States shareholder has not received the benefit of deferring U.S. income tax. The U.S. foreign tax credit will absorb almost all of the U.S. tax otherwise due on the income.

146. See I.R.C. § 960(a)(1) (2000).

147. Compare Treas. Reg. § 1.954-1(d)(1) (2000) (referring to individual items of income) with Treas. Reg. § 1.954-1(d)(4)(i) (2000) (requiring the aggregation of passive foreign personal holding income).

148. Treas. Reg. § 1.954-1(d)(4)(i) (2000).

149. See Treas. Reg. § 1.954-1(d)(1) (2000). See *supra* Part III.C for the definition of items of income used to allocate and apportion the controlled foreign corporation's deductions.

150. A limited blending of foreign tax rates may also occur by virtue of the requirement that one use the Code section 960 rules to determine the effective rate of foreign taxation. See Treas.

1. *Coordinating the Exclusion with Other Rules*

We determine the effective rate of foreign tax after applying the current-year earnings and profits limitation.¹⁵¹ The limitation may reduce the amount of a specific item of income, but will not reduce the amount of foreign tax paid with regard to that item; hence, the limitation indirectly increases the rate of foreign tax borne by the now-reduced item of income.¹⁵² Furthermore, the workings of the high-tax exclusion may override the full-inclusion rule. If a high-tax election excludes net foreign base company income attributable to more than 90% of a controlled foreign corporation's adjusted gross foreign base company income (as measured prior to the application of the full-inclusion rule), the regulations suspend the operation of the full-inclusion rule.¹⁵³

2. *The Exclusion and the Foreign Tax Credit*

Although the availability of the foreign tax credit may seem to make the high-tax exclusion redundant, the high-tax exclusion gives the United States shareholder greater flexibility in its foreign tax credit planning. The exclusion avoids a loss of foreign tax credit when the foreign tax credit limitation prevents the crediting of the foreign tax assessed on the highly taxed item of income. It permits the United States shareholder to defer the foreign tax credit until the controlled foreign corporation makes a distribution. Ideally, the corporation will make the distribution at a time when the foreign tax credit limitation favors the shareholder. The high-tax exclusion may also benefit the United States shareholder by separating, for purposes of the foreign tax credit limitation, items of income from several controlled foreign corporations. It can thus prevent the undesirable blending of income.

D. *Current Earnings and Profits Recharacterized as Inclusions*

If a controlled foreign corporation must reduce its subpart F income by the current earnings and profits limitation, it will recapture the foregone subpart F income in subsequent years, when the corporation's current earnings and profits exceed the corporation's current subpart F income.¹⁵⁴ Recaptured amounts are not subject to the *de minimis*, full-inclusion, or high-tax rules.¹⁵⁵ We therefore

Reg. § 1.954-1(d)(3) (2000). The rules include the pooling of foreign taxes over a multi-year period, but they remain subject to the separate-baskets requirement of the foreign tax credit. See I.R.C. §§ 902(a), (c)(2), 904(d)(1), 960(a)(1) (2000).

151. See Treas. Reg. § 1.954-1(d)(4)(ii) (2000).

152. See Treas. Reg. § 1.954-1(d)(4)(iii) (2000).

153. See Treas. Reg. § 1.954-1(d)(6), (7)(ii) (2000). The controlled foreign corporation may use its adjusted gross insurance company income in conjunction with its adjusted gross foreign base company income to meet the more-than-ninety-percent test.

154. I.R.C. § 952(c)(2) (2000). The current earnings and profits subject to recharacterization include earnings and profits attributable to income that would fall within subpart F income but for the operation of the *de minimis* rule. See Treas. Reg. § 1.954-1(a)(7) (2000). The controlled foreign corporation's full-inclusion income in past years does not reduce the corporation's recharacterization requirement. Treas. Reg. § 1.954-1(b)(3) (2000).

155. See Treas. Reg. § 1.954-1(a)(7) (2000).

apply the high-tax rule before recharacterizing any surplus current-year earnings and profits as subpart F income.

1. *Allocating the Recaptured Amount*

When the current earnings and profits limitation reduces a controlled foreign corporation's subpart F income, the amount of the reduction in each item of income reduced by the limitation becomes a recapture account.¹⁵⁶ The items of income consist of those defined for purposes of allocating and apportioning the corporation's deductions.¹⁵⁷ When the corporation generates a surplus in its current earnings and profits over its current subpart F income, it must complete a pro rata allocation of the surplus amount among its recapture accounts.¹⁵⁸ The proration of the recaptured amount can thus produce small amounts of recapture over a large number of recapture accounts. The recaptured amounts become subpart F income for the United States shareholder and retain their separate categorizations in the hands of the shareholder.¹⁵⁹

2. *Effect of Distributions on Recapture Accounts*

Distributions made by the controlled foreign corporation may reduce the amounts held in recapture accounts.¹⁶⁰ When Code section 959(c)(3) deems a distribution to be made out of earnings and profits not yet taxed to a United States shareholder, the distribution is deemed to be made first out of the amounts held in recapture accounts, and then out of the corporation's earnings and profits.¹⁶¹ To the extent the distribution is deemed to be made out of recapture accounts, the corporation and its United States shareholders must prorate the distribution among those accounts.¹⁶²

In a year in which the controlled foreign corporation generates a surplus of current earnings and profits over its current subpart F income and makes a distribution to its shareholders, recapture of the subpart F income occurs before the analysis of the distribution.¹⁶³ The recaptured amounts—now taxed to United States shareholders as subpart F income—subsequently fall within Code section 959(c)(2). They are then deemed distributed before any of the controlled foreign corporation's earnings and profits described by Code section 959(c)(3).¹⁶⁴ As a result, the Code still requires distribution of suspended amounts before distribution of earnings and profits not yet taxed to United States shareholders.

156. See Treas. Reg. § 1.952-1(f)(2)(i) (2000). See *supra* Part IV.B.3 for the allocation among a controlled foreign corporation's items of income of a reduction in its subpart F income due to the current earnings and profits limitation.

157. See Treas. Reg. § 1.952-1(f)(2)(i) (2000). See *supra* Part III.C for an analysis of a controlled foreign corporation's items of income. Such items do not arise from individual transactions, but instead consist of aggregates of income falling within certain groupings.

158. See Treas. Reg. § 1.952-1(f)(2)(ii) (2000).

159. See *id.*

160. Treas. Reg. § 1.952-1(f)(2)(iii) (2000).

161. Treas. Reg. § 1.952-1(f)(3)(ii) (2000).

162. *Id.*

163. Treas. Reg. § 1.952-1(f)(3)(i) (2000).

164. See I.R.C. § 959(c) (2000).

Before crediting the suspended amounts to the distribution, however, the corporation must first recapture the amounts, and the Code must tax those amounts to the United States shareholders.

V.

CONCLUDING OBSERVATIONS AND SUMMARY OF RECOMMENDATIONS

The activities of a controlled foreign corporation that give rise to foreign base company income do not necessarily exhaust the corporation's activities. To calculate foreign base company income, the Code in effect creates a synthetic entity within the confines of the controlled foreign corporation. It then measures the synthetic entity's net income. To facilitate the process, the Code provides for a number of exclusions, deductions, and limitations on foreign base company income. Some of the adjustments measure the difference in identity between the synthetic persona and the controlled foreign corporation. If the difference is slight, the Code enlarges the synthetic persona, and the persona completely displaces the actual entity (the full-inclusion rule). If the difference is great enough, the synthetic persona drops away (the *de minimis* rule).

Other adjustments isolate the synthetic entity's net income arising from the controlled foreign corporation's activities. The adjustments occur in three steps. First, the Code allocates and apports the deductions of the controlled foreign corporation between the entity's tax haven operations and its other operations. The Code also bounds the tax affairs of the synthetic persona by a key determinant of the actual entity—the current earnings-and-profits limitation. Finally, the Code's high-tax exclusion adjusts the boundary between the controlled foreign corporation and its synthetic persona. It does so by ending the tax-haven analysis of items of net income for which the effective tax rate in the foreign jurisdiction proves substantially the same as the effective tax rate in the United States.

In this article, I have recommended six changes in the law governing the taxation of the United States shareholders of controlled foreign corporations. RECOMMENDATION ONE generalizes the language of Code section 952(b) to improve the coordination of the corporate and shareholder levels of U.S. taxation of the controlled foreign corporation's income. RECOMMENDATION TWO amends the regulations concerning the full-inclusion rule to complement the change proposed by Recommendation One. RECOMMENDATION THREE amends the regulations to solve an ordering problem in the allocation and apportionment of deductions simultaneously related to two different kinds of income: adjusted gross foreign base company income that is also same-country insurance income, and adjusted gross foreign base company income that is not same-country insurance income.

Recommendations Four and Five consist of regulations to be promulgated under Code section 952(c)(1)(B) and (C). RECOMMENDATION FOUR provides that no overall deficit in earnings and profits need occur before a controlled foreign corporation becomes subject to the primary deficit rule. It also states that

no overall deficit in the earnings and profits of a related person is required before the controlled foreign corporation may elect the benefit of the secondary deficit rule. RECOMMENDATION FIVE coordinates the application of the deficit rules with the application of the current earnings and profits limitation: the controlled foreign corporation ought to apply the primary deficit rule first, the secondary deficit rule second (if the corporation elects to use it), and the current earnings and profits limitation last. Finally, RECOMMENDATION SIX amends Code section 952(c)(1) to expand the current earnings and profits limitation. That limitation should include the controlled foreign corporation's accumulated earnings and profits as a measure of the permissible income inclusion for the corporation's United States shareholders.