Defining Foreign Base Company Shipping Income and Oil-Related Income

Eric T. Laity, Oklahoma City University School of Law

Available at: https://works.bepress.com/eric_laity/7/
DEFINING FOREIGN BASE COMPANY SHIPPING INCOME
AND OIL-RELATED INCOME

Eric T. Laity*

TABLE OF CONTENTS

I. INTRODUCTION 233

II. FOREIGN BASE COMPANY SHIPPING INCOME 236
   A. Components of Foreign Base Company
      Shipping Income 237
       1. Income from the Use of a Vessel or
          Aircraft in Foreign Commerce 238
       2. Income from Directly Related
          Services 240
       3. Incidental Income 244
       4. Income from the Sale of a Vessel or
          Aircraft 245
       5. Income from Space and Ocean
          Activities 245
       6. Certain Dividends, Interest and
          Gains 246
          (a) The Requisite Payor or Issuer
              RECOMMENDATION ONE 252
          (b) Attribution to Foreign Base
              Company Shipping Income 252
              (i) Attributing Dividends 253
              (ii) Attributing Interest 254
              (iii) Attributing Gain 255
       7. Income from Partnerships, Trusts,
          and Estates 256
   B. The Country-of-Incorporation Exclusion 257
      RECOMMENDATION TWO 262
C. Ordering Rules 264
D. Exclusion for Others’ Shipping Income 265
   RECOMMENDATION THREE 266
E. Contingent Exclusion for Certain Shipping Income 267
   RECOMMENDATION FOUR 268

III. FOREIGN BASE COMPANY OIL-RELATED INCOME 268
A. Threshold Test: The Large Producer Requirement 269
B. Other Screens: The Analogue to Country-of-Incorporation Exclusions 270
C. Ordering Rules 271
   RECOMMENDATION FIVE 273
D. Components of Foreign Base Company Oil-Related Income 274
   1. Processing Income 275
   2. Transportation Income 277
      RECOMMENDATION SIX 279
   3. Distribution and Sales Income 279
   4. Gain from the Disposition of Certain Assets 280
   5. Income from Directly Related Services 281
   6. Facts-and-Circumstances Income 282
   7. Certain Dividends and Interest 283
   8. Subpart F Inclusions 286
   9. Income from Partnerships, Trusts, and Estates 286

IV. CONCLUDING OBSERVATIONS AND SUMMARY OF RECOMMENDATIONS 287

Tax havens pose a challenge to tax policy by decreasing tax revenue and impeding allocational efficiency. Part of the United States’ response to the problem of tax havens is to tax U.S. multinational corporations on much of the tax haven income derived by their foreign subsidiaries. Defining tax
haven income has proven to be difficult; the necessary provisions are among the most complex in the Internal Revenue Code. In this Article, Professor Laity critically analyzes the definitions of two categories of tax haven income. His analysis includes recommendations for change in the Internal Revenue Code and its supporting administrative apparatus.

I. INTRODUCTION

The Internal Revenue Code (Code) requires a United States parent corporation to include various amounts derived by its controlled foreign corporations within its own income.¹ Controlled foreign corporations consist primarily of the foreign subsidiaries of United States multinational corporations, although foreign corporations with other ownership structures are included within the definition of a controlled foreign corporation.² Among the

¹See I.R.C. § 951(a)(1). The United States has several tax regimes with the potential to overlap with its regime governing controlled foreign corporations. The overlapping regimes are those applicable to foreign investment companies, foreign personal holding companies, and passive foreign investment companies. An overlap arises when a foreign corporation falls not only within the definition of a controlled foreign corporation, but also falls within the definition of a foreign investment company, a foreign personal holding company, or a passive foreign investment company. The Code provides ordering rules to police the boundaries between these four regimes. If the controlled foreign corporation falls within the definition of a foreign investment company and has made the election under Code section 1247 to distribute most of its income to its shareholder, the United States parent corporation has no inclusions whatsoever under Subpart F, the Code’s regime governing controlled foreign corporations. See I.R.C. § 951(c). In those circumstances, the provisions governing foreign investment companies take priority over Subpart F. Subpart F, in turn, takes priority over the regimes governing foreign personal holding companies and passive foreign investment companies in specified circumstances. See I.R.C. § 951(f). Income of the foreign subsidiary that is included in the parent’s income by being classified as Subpart F income cannot be included a second time as undistributed foreign personal holding company income of a foreign personal holding company or as the income of a passive foreign investment company that is a qualified electing fund. See I.R.C. § 951(d), (f). In those circumstances, Code section 951(a)(1)(A)(i) trumps Code sections 551(b) and 1298. See id.
²See I.R.C. § 957(a).
items of income taxed to the United States parent corporation is the controlled foreign corporation's foreign base company income, the primary component of tax haven income.\textsuperscript{3} The Code defines foreign base company income as comprising five categories.\textsuperscript{4} Three of those categories have been analyzed by previous articles in this series: foreign personal holding company income, foreign base company sales income, and foreign base company services income.\textsuperscript{5} In general terms, foreign personal holding company income consists of passive income and easily manipulable financial income.\textsuperscript{6} Foreign base company sales or services income is created by routing a related person's sales or services through a tax haven jurisdiction with the assistance of the controlled foreign corporation.\textsuperscript{7} The remaining categories of foreign base company income, foreign base company shipping income and foreign base company oil-related income, are analyzed in this Article.

The two remaining categories of foreign base company income are distinctive in their focus on specific industries. In the absence of the two categories, much of the income otherwise captured within their scope would fall within another category of foreign base company income. For example, the foreign base company shipping income arising from a controlled foreign corporation's performance of transportation services for a related person would otherwise fall within foreign base company services

\textsuperscript{3} See I.R.C. §§ 951(a)(1)(A)(i), 952(a)(2).
\textsuperscript{4} See I.R.C. § 954(a).
\textsuperscript{6} See I.R.C. § 954(c).
\textsuperscript{7} See I.R.C. § 954(d), (e).
income.\textsuperscript{8} By having these special-purpose categories of foreign base company income, the Code avoids some of the limitations of the more general categories. In particular, the categories of foreign base company shipping income and oil-related income generally dispense with the requirement that a related person figure in the transactions giving rise to foreign base company income.\textsuperscript{9} Avoiding those limitations allows the Code to impose a stricter tax regime upon the industries within the ambit of foreign base company shipping income and foreign base company oil-related income than would otherwise be possible.

In addition to focusing on specific industries, the two remaining categories of foreign base company income share similarities in their statutory structures. Both, for example, trace disfavored types of income derived by foreign entities through dividends, interest, and distributive shares of partnership income into the hands of controlled foreign corporations.\textsuperscript{10} Those similarities offer assistance in statutory and regulatory interpretation and suggest that the two categories be analyzed together.

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

In keeping with those goals, this Article recommends a number of improvements in statutory provisions and administrative rules.\textsuperscript{11} In addition, the Article contributes to the literature on controlled foreign corporations in other ways, by

\begin{footnotesize}
\textsuperscript{8} See I.R.C. § 954(e).
\textsuperscript{9} Compare I.R.C. § 954(d)(1), (e)(1)(A) (requiring a related person) with I.R.C. § 954(f), (g) (generally not requiring a related person).
\textsuperscript{10} Compare I.R.C. § 954(f) with I.R.C. §§ 907(c)(3), 954(g)(1).
\textsuperscript{11} The location in this Article of those formal recommendations may be found in the Article's table of contents.
\end{footnotesize}
(i) analyzing the inclusion of certain interest, dividends, and gain from the disposition of securities within foreign base company shipping income, an analysis that brings coherence to the Code's use of the indirect foreign tax credit of section 902 to describe the desired degree of relation between payor and recipient;\(^\text{12}\) (ii) identifying shortcomings in two exclusions that are not properly coordinated with the primary provisions to which they relate;\(^\text{13}\) (iii) giving a coherent reading of the rather strained relationship between foreign oil-related income and foreign base company income, a relationship brought about by the Code's incorporation of much of section 907(c) into section 954(g), the lack of extensive regulations under Code section 954(g), and the resulting need to resort to the regulations under section 907(c) to construe section 954(g);\(^\text{14}\) (iv) drawing attention to the need for a formal ordering rule between offshore insurance income and foreign base company income;\(^\text{15}\) and (v) drawing attention to developments in transcontinental pipelines that are not yet addressed by the Code.\(^\text{16}\)

II. FOREIGN BASE COMPANY SHIPPING INCOME

Foreign base company shipping income generally consists of income derived from foreign or international shipping operations, either by sea or by air. See Treas. Reg. § 1.954-6. Income derived from trucking operations is not included and thus is subject to the less restrictive regime governing foreign base company services income. No related person generally is required to participate in the activity giving rise to foreign base company shipping income, and hence the phrase, "foreign base company," in the category's title is something of a misnomer for those readers fresh from battle with the concepts of foreign base company sales income or foreign base company services income. For the most part, the regulations defining foreign base company shipping

\(^{12}\) See infra Part I.A.6.
\(^{15}\) See infra Parts I.B and I.D.
\(^{14}\) See infra Part II.D.
\(^{15}\) See infra Part II.C.
\(^{16}\) See infra Part II.D.2.
income refer to foreign corporations generally, and not just controlled foreign corporations, as deriving foreign base company shipping income. This more generic approach owes its use to the fact that foreign base company shipping income includes certain dividends, interest, and gain attributable to non-controlled foreign corporations' foreign base company shipping income. See Treas. Reg. §1.954-6(b)(v). Hence, the definition of foreign base company shipping income must apply to the income of non-controlled foreign corporations as well.

A. Components of Foreign Base Company Shipping Income

The Code defines foreign base company shipping income to consist of six components, and the regulations add another component for a total of seven.\(^\text{17}\) Five of the components arise from the controlled foreign corporation's operations, and the other two components arise from the corporation's investments. In the event that an item of income falls within two or more components, the taxpayer may choose the proper classification of the item.\(^\text{18}\) There is no ordering rule resolving conflicts between components of foreign base company shipping income to dictate the choice to the taxpayer. In any event, no item of income is to be included in foreign base company shipping income twice.\(^\text{19}\) The choice between components may depend in part on the availability of the country-of-incorporation exclusion, which is available for only the first component of foreign base company shipping income discussed below.\(^\text{20}\)


\(^{18}\) See Treas. Reg. § 1.954-6(h)(3).

\(^{19}\) See id.

\(^{20}\) See I.R.C. § 964(b)(7), (f).
1. **Income from the Use of a Vessel or Aircraft in Foreign Commerce**

The first component of foreign base company shipping income consists of the income arising from the use of a vessel or aircraft in foreign commerce, including income from the leasing of a vessel or aircraft for use in foreign commerce.\(^{21}\) We may define foreign commerce as the use of a vessel or aircraft to transport property or passengers between two ports, at least one of which is outside the United States.\(^{22}\) The two ports may be located in the same foreign country, although in that case the country-of-incorporation exclusion might apply, as discussed below. The regulations give three examples of vessels not used in foreign commerce: a trawler, a factory ship, and an oil drilling ship.\(^{23}\) The common thread among the examples appears to be the fact that the vessels perform services other than transportation; putting into a second port is not essential to rendering those services, although it might occur. In contrast, a cruise ship is considered to be engaged in foreign commerce as long as it puts into at least one foreign port.\(^{24}\) Although a cruise ship arguably is engaged primarily in providing entertainment, having at least one destination establishes a role in transportation sufficient for the regulations to view the vessel as engaged in foreign commerce.

More surprisingly, vessels that serve other vessels used in foreign commerce are themselves considered to be engaged in foreign commerce, to the extent of such service.\(^{25}\) Such vessels include lighters and beacon lightships, according to the regulations.\(^{26}\) The regulations' treatment is broad enough to capture tugboats that serve vessels engaged in foreign commerce.\(^{27}\)

\(^{21}\)See I.R.C. § 954(f). Foreign base company shipping income arising from the chartering of a vessel includes the revenue arising from demurrage, deadweight, and lay-up charges. See Treas. Reg. § 1.954-6(c)(2).

\(^{22}\)See Treas. Reg. § 1.954-6(b)(3)(i).

\(^{23}\)See id. The income arising from the use of such vessels may fall within the fifth component of foreign base company shipping income. See infra Part I.A.5.

\(^{24}\)See Treas. Reg. § 1.954-6(b)(3)(i).

\(^{25}\)See Treas. Reg. § 1.954-6(b)(3)(iv).

\(^{26}\)See id.

\(^{27}\)See id. The income arising from the use of a tugboat is classified explicitly as
Hence, the use of vessels that serve as part of a port's infrastructure may give rise to foreign base company shipping income.

The relevant regulation refers only to vessels as it elaborates on the definition of foreign commerce to include service craft; there is no reference to aircraft.\textsuperscript{28} With the advent of the hub-and-spoke method of organizing airline routes, one might think that the scope of the regulation needs to be expanded to include foreign feeder aircraft as service craft. Just as lighters bring cargo to ocean-going vessels, so too do feeder aircraft bring passengers to long-distance flights. But such feeder aircraft already are engaged in foreign commerce: they fly between two airports, at least one of which is outside the United States. Hence, there is little need to include aircraft within the service-vessel regulation; few aircraft operate within a single airport.

The Code creates a country-of-incorporation exclusion from the first component of foreign base company shipping income. See Treas. Reg. §1.954-6(b)(3)(i)(B). Excluded from foreign base company shipping income is the income derived by a foreign corporation from the use of an aircraft or vessel in transportation of property or passengers between two ports within the foreign country in which the corporation is incorporated, provided that both the foreign corporation is created or organized and the aircraft or vessel is registered in that country.\textsuperscript{29} The exclusion is keyed to the income recipient's country of incorporation; the place of incorporation of other persons is irrelevant. For example, the income derived by a lessee from the use of a ship registered in the lessee's country of incorporation between two points within that country qualifies for the exclusion, regardless of the country of incorporation of the ship's owner. So, too, the rental income derived by the owner of a ship, registered in the owner's country of incorporation and used by the lessee between two points within

\begin{footnotesize}
\begin{itemize}
\item foreign base company shipping income in the circumstances described in Treasury Regulations section 1.954-6(d)(2)(iv) and (3)(i), which deals with the second component of foreign base company shipping income.
\item See Treas. Reg. § 1.954-6(b)(3)(iv).
\item See I.R.C. § 954(b)(7); see also Treas. Reg. § 1.954-6(b)(3). The Code defines the exclusion in terms of the income derived by a controlled foreign corporation; the regulations generalize the exclusion to apply to all foreign corporations.
\end{itemize}
\end{footnotesize}
that country, qualifies for the exclusion, regardless of the lessee's country of incorporation.\textsuperscript{30} The country-of-incorporation exclusion is not available for income falling within other components of foreign base company shipping income.\textsuperscript{31}

The country-of-incorporation exclusion excludes much of the income derived from the use of service vessels. As long as the service vessel is registered in the country of its use and the foreign corporation is incorporated in that country as well, the exclusion applies: a service vessel's ports of origin and destination are identical and thus in the same country. The country-of-incorporation exclusion is available to a service vessel even if the long-distance vessel it serves flies a flag of convenience. See Treas. Reg. § 1.954-6(b)(3). This makes sense under the principles of Subpart F. A multinational enterprise should be able to specialize in offering port services around the world. As long as it creates a separate controlled foreign corporation in each country it serves and registers its vessels locally, it should qualify for the benefit of tax deferral.

2. \textit{Income from Directly Related Services}

The second component of foreign base company shipping income consists of income arising from the performance of services directly related to the use of a vessel or aircraft in foreign commerce.\textsuperscript{32} The regulations define three subcomponents of income from directly related services, which can roughly be described as income from services rendered to related operators, income from services rendered by operators to shippers, and residual income that the controlled foreign corporation has elected to include in foreign base company shipping income. See Treas. Reg. § 1.954-6(d). In more precise terms, the first subcomponent

\textsuperscript{30}These two examples are taken from \textsc{Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976}, at 233, \textit{reprinted in} 1976-3 C.B. 1, 245.

\textsuperscript{31}Compare I.R.C. § 954(b)(7) with I.R.C. § 954(f) (using identical language of income derived by a foreign corporation "from, or in connection with, the use (or hiring or leasing for use) of an aircraft or vessel in foreign commerce."

\textsuperscript{32}See I.R.C. § 954(f).
consists of income derived from the performance of designated services for an owner, lessor, lessee, or operator of a vessel or aircraft used in foreign commerce.\textsuperscript{33} The client must be related to the service provider,\textsuperscript{34} and hence the services are sometimes referred to as intragroup services.\textsuperscript{35} The list of designated services contains few surprises, once one understands that commercial services available at seaports and airports generally are included.\textsuperscript{36} The less intuitive services include container services rendered during the course of inland haulage and the licensing of intellectual property rights developed and used in the course of foreign base company shipping operations.\textsuperscript{37} An example in the regulations interprets the list to include the arranging for, and the supervision of, the construction of a vessel to be used in foreign commerce.\textsuperscript{38}

The second subcomponent of directly-related services income consists of income derived from the performance of services

\textsuperscript{33} See Treas. Reg. § 1.954-6(d)(2).
\textsuperscript{34} See Treas. Reg. § 1.954-6(d)(2). The relevant definition of related person is contained in Code section 954(d)(3) and Treasury Regulations section 1.954-1(f). Treas. Reg. § 1.954-1(f)(1). The regulations’ definition of the first subcomponent of directly related services income is somewhat difficult to parse. The regulations describe the underlying services as “services performed for a person who is the owner, lessor, lessee[,] or operator of an aircraft or vessel used in foreign commerce, by such person or by a person related to such person” and which fall into one of several categories of services. Treas. Reg. § 1.954-6(d)(2). There are two unusual aspects to this definition. First, the definition does not limit service providers to controlled foreign corporations. This is due to the fact that, in connection with the analysis of the sixth component of foreign base company shipping income (certain dividends, interest, and gains), foreign corporations other than controlled foreign corporations will be said to derive foreign base company shipping income. Second, the definition refers to service providers as possibly deriving income by performing services for themselves. Yet, under United States tax principles, one cannot derive income by performing services for oneself. The definition refers to such phantom income because it is needed in the analysis of the third subcomponent of directly-related services income. The foreign corporation will not derive actual income by providing services for itself, but the imputed income from such services will be used for the purpose of qualifying for an election.
\textsuperscript{35} See, e.g., Treas. Reg. § 1.954-6(d)(2).
\textsuperscript{36} See Treas. Reg. § 1.954-6(d)(2).
\textsuperscript{37} See Treas. Reg. § 1.954-6(d)(2)(iii), (vii).
\textsuperscript{38} See Treas. Reg. § 1.954-6(d)(7)(Ex. 1).
for a passenger, consignor, or consignee. The services must be performed by the service provider as the operator of a vessel or aircraft in foreign commerce, or as a person related to such an operator. If the service provider is neither the operator of a vessel or aircraft in foreign commerce nor related to such an operator, it cannot derive income within the second subcomponent of directly-related services income. Hence, the typical customs broker or freight forwarder does not derive foreign base company shipping income if it is unrelated to the operator of the vessel or aircraft. The passengers, consignors, or consignees may be either related or unrelated to the service provider; their relationship is irrelevant to the classification of the service provider's income. The regulations list representative services, but the list is not exhaustive. The list overlaps to a significant extent with the list of services used to define the first subcomponent of directly-related services income. Among the less intuitive services on the list are

\[39\] See Treas. Reg. § 1.954-6(d)(3).
\[40\] See id.
\[41\] The service provider may instead derive income from space and ocean activities, the fifth component of foreign base company shipping income, if it renders services to passengers on board ship as an independent concessionaire. See Tech. Adv. Mem. 93-27-003 (Feb. 25, 1993) (holding that the provision of food and beverage service aboard a cruise ship by an independent concessionaire gives rise to income from space and ocean activities and therefore to foreign base company shipping income); see also Tech. Adv. Mem. 93-27-001 (Feb. 12, 1993) (holding that the performance of gambling concession services aboard a cruise ship by an independent concessionaire gives rise to income from space and ocean activities and therefore to foreign base company shipping income). Income from space and ocean activities is discussed infra Part I.A.5 of this article.
\[42\] See Treas. Reg. § 1.954-6(d)(7)(Ex. 2). The drafting history of the regulation gives two other illustrations: services performed by an independent stevedoring company and services performed by an independent trucking company. See Memorandum from Donald C. Alexander, Acting Commissioner of Internal Revenue, to Charles M. Walker, Assistant Secretary of State (Apr. 12, 1976)(1976 TM LEXIS 15, *7-*8). The drafting history states that, in general, the income of an independent service company should not be treated as foreign base company shipping income. See id. Note, however, that such income may be derived from space and ocean activities and thus fall within the fifth component of foreign base company shipping income. See infra Part I.A.5.
\[43\] See Treas. Reg. § 1.954-6(d)(3).
\[44\] See id.
barber shop and other services rendered to passengers aboard ship.\textsuperscript{45}

The third subcomponent of directly-related services income consists of certain residual income that the foreign corporation elects to recharacterize as foreign base company shipping income.\textsuperscript{46} The election may prove useful either to simplify a foreign corporation's allocation and apportionment of deductions or in United States shareholders' foreign tax credit planning. A foreign corporation may elect to characterize all of the income from a facility as foreign base company shipping income if more than seventy percent of the corporation's gross income from the facility is foreign base company shipping income.\textsuperscript{47} The seventy-percent requirement must be met either during the current taxable year or, at the option of the foreign corporation, during the three-year period comprising the current taxable year and the two preceding taxable years.\textsuperscript{48} The foreign corporation must use the facility in connection with designated services.\textsuperscript{49} The list of permitted services is identical to the list used to describe intragroup services. Due to the nature of the services, the requisite facilities usually are located at seaports or airports and used to provide services to shipping; training facilities for pilots and crews are included, however.\textsuperscript{50} What counts as a separate facility is a question of fact, although the regulations suggest that all services rendered by a foreign corporation within a single port area usually will be considered as having been rendered at a single facility.\textsuperscript{51} In determining whether seventy percent of a foreign corporation's gross income from a facility constitutes foreign base company shipping income, the imputed value of the corporation's services performed for itself is taken into account.\textsuperscript{52} This measure, of

\textsuperscript{45} See Treas. Reg. § 1.954-6(d)(3)(iii).
\textsuperscript{46} See Treas. Reg. § 1.954-6(d)(1)(ii).
\textsuperscript{47} See Treas. Reg. § 1.954-6(d)(4).
\textsuperscript{48} See \textit{id}. The election is made annually.
\textsuperscript{49} See \textit{id}.
\textsuperscript{50} See Treas. Reg. § 1.954-6(d)(2)(vi), (4).
\textsuperscript{51} See Treas. Reg. § 1.954-6(d)(5)(ii).
\textsuperscript{52} See Treas. Reg. § 1.954-6(d)(5)(i), (6). The principles of Code section 482 apply for purposes of calculating the controlled foreign corporation's imputed income. See \textit{id}. 
course, makes it easier for the corporation to meet the seventy-percent threshold, since services performed by the foreign corporation for itself will likely give rise to imputed intragroup services income and thus imputed foreign base company shipping income. The imputed income is used only to determine whether the foreign corporation is entitled to exercise the election. If the foreign corporation makes the election, only its actual income and not its imputed income is reclassified as foreign base company shipping income.

3. **Incidental Income**

The third component of foreign base company shipping income consists of the incidental income derived from foreign base company shipping operations. Foreign base company shipping operations are defined as the business from which the foreign corporation derives income falling within the first two components of foreign base company shipping income, that is, either income derived from the use of an aircraft or vessel in foreign commerce or the income derived from services directly related to such use of an aircraft or vessel. Hence, the third component of foreign base company shipping income consists of income incidental to the conduct of operations that give rise to income within the first two components of foreign base company shipping income. The regulations list a number of examples of such incidental income. Examples include gain from the disposition of assets used by the foreign corporation for the production of income within the first two components of foreign base company shipping income. Also included is any income from the working capital needed in the foreign corporation's foreign base company shipping operations or from the temporary investment of funds earmarked for future

---

53 The definition of intragroup services includes services performed by a controlled foreign corporation for itself. See Treas. Reg. § 1.954-6(d)(2).
54 See Treas. Reg. § 1.954-6(d)(5)(iii).
55 See Treas. Reg. § 1.954-6(e)(1).
56 See Treas. Reg. § 1.954-6(b)(2).
57 See Treas. Reg. § 1.954-6(b)(1)(iii).
58 See Treas. Reg. § 1.954-6(e)(2).
purchases of tangible assets for use in foreign base company shipping operations;\textsuperscript{60} such items are now properly categorized as foreign personal holding company income and fall outside foreign base company shipping income.\textsuperscript{61}

4.  \textit{Income from the Sale of a Vessel or Aircraft}

The fourth component of foreign base company shipping income consists of the income derived from, or in connection with, the sale or other disposition of a vessel or aircraft used in foreign commerce.\textsuperscript{62} Whether a vessel is used in foreign commerce is determined with reference to the seller's activities, rather than the buyer's activities.\textsuperscript{63} The commission income of a foreign corporation brokering the sale appears to fall within this component of foreign base company shipping income.

5.  \textit{Income from Space and Ocean Activities}

The fifth component of foreign base company shipping income consists of income arising from activity conducted in space or on or under water beyond the jurisdiction of any state,

\textsuperscript{60} See Treas. Reg. §§ 1.954-6(e)(2)(ii), 1.955A-2(b)(2)(i), (iii).

\textsuperscript{61} See I.R.C. § 954(c), (f). The last sentence of Code section 954(f), giving priority to the classification of foreign personal holding company income, was added after the promulgation of regulations section 1.954-6 by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 505, § 13235(h); regulation section 1.954-6 was promulgated by Treasury Decision 7894 (1983). Prior to the addition of the last sentence of Code section 954(f), the general directive of Code section 954(b)(6) would have governed. That section provides that income falling within the definition of foreign base company shipping income is not to be classified as any other type of foreign base company income. Code section 954(b)(6) was added to the Code by the Tax Reform Act of 1975, Pub. L. No. 94-12, 89 Stat. 61.

\textsuperscript{62} See I.R.C. § 954(f). Any interest earned by the seller on a purchase money mortgage on the vessel or aircraft is said by the regulations to constitute income that falls within the third component of foreign base company shipping income. See Treas. Reg. § 1.954-6(e)(2)(vii). However, such interest constitutes foreign personal holding company income, I.R.C. § 954(c), and therefore falls outside of foreign base company shipping income, I.R.C. § 954(f).

\textsuperscript{63} See Treas. Reg. § 1.954-6(b)(1)(iv).
regardless of whether the activity qualifies as foreign commerce.\textsuperscript{64} Income arising from the use of a trawler, factory ship, drilling ship, or cruise ship, which may be excluded from the first component of foreign base company shipping income for failing to meet the foreign commerce requirement, falls within this fifth component. The income derived from operating an independent concession aboard a cruise ship falls within this component as well.\textsuperscript{65} The provision of international telecommunications services by satellite falls outside the definition of space or ocean activity, and thus the income derived from such services falls outside this component of foreign base company shipping income.\textsuperscript{66}

6. \textit{Certain Dividends, Interest, and Gain}

The last two components of foreign base company shipping income are derived from investments made by foreign corporations in other entities who themselves conduct shipping operations. The

\textsuperscript{64}See I.R.C. §§ 863(d)(2), 954(f). If the income is transportation income within the meaning of Code section 863(c)(3), it falls outside of the fifth component of foreign base company shipping income. See I.R.C. § 863(d)(2)(B)(i). Transportation income, if it is derived from foreign commerce, falls within either the first or second component of foreign base company shipping income. Compare I.R.C. § 863(c)(3) with I.R.C. § 954(f). The distinction between transportation income and income from space and ocean activities matters because the source rules for the two types of income differ. Compare I.R.C. § 863(c) with I.R.C. § 863(d); see also Christopher Kelly, \textit{Federal Income Taxation of Space and Ocean Activities}, 14 INT'L TAX J. 69, 71-74 (1988) [hereinafter \textit{Space and Ocean Activities}].

\textsuperscript{65}See Tech. Adv. Mem. 93-27-003 (Feb. 25, 1993) (holding that the provision of food and beverage service aboard a cruise ship by an independent concessionaire gives rise to income from space and ocean activities and therefore to foreign base company shipping income); see also Tech. Adv. Mem. 93-27-001 (Feb. 12, 1993) (holding that the performance of gambling concession services aboard a cruise ship by an independent concessionaire gives rise to income from space and ocean activities and therefore to foreign base company shipping income). If the concessionaire is related to the operator of the ship, its income may fall within directly-related services income, the second component of foreign base company shipping income. Directly-related services income is discussed supra Part I.A.2 of this article.

\textsuperscript{66}See I.R.C. §§ 863(d)(2)(B)(ii), 954(f). Unless the income from providing international telecommunications services by satellite falls within foreign base company services income, such income falls outside of Subpart F income entirely. \textit{See Space and Ocean Activities, supra} note 64, at 79-80.
sixth component — certain interest, dividends, and gain — can be derived only by controlled foreign corporations. The seventh component — certain income from partnerships, trusts, and estates — can be derived by controlled and non-controlled foreign corporations alike. The drafting history of the regulations tells us that the sixth component was limited to controlled foreign corporations because of the administrative difficulty of extending it to non-controlled foreign corporations; neither the Service nor the taxpayer was likely to have access to the information needed to quantify the component. The effect of the requirement that only controlled foreign corporations can derive income within the sixth component of foreign base company shipping income is to eliminate the need to trace an item of income beyond the payor in order to determine its character. Without the requirement, for example, the receipt of a dividend by a controlled foreign corporation from a non-controlled foreign corporation that might be attributable to the payor's foreign base company shipping income would require an analysis of the dividends received by the payor to determine whether any such dividends were in turn attributable to foreign base company shipping income of a prior payor. With the requirement, dividends paid by the prior payor are by fiat excluded from the sixth component of foreign base company shipping income.

The sixth component of foreign base company shipping income consists of certain interest income, dividends, and gains attributable to foreign base company shipping income. The interest and dividends in question are those that are received from a foreign corporation the dividends from which are eligible for the deemed-paid foreign tax credit of Code section 902. Note that the payors of interest must be corporations; only corporations make distributions that are eligible for the section 902 credit. Interest received from non-corporate payors may well fall within foreign

68 See Treas. Reg. § 1.954-6(g)(1).
70 See I.R.C. § 954(f)(1).
71 See id.
personal holding company income, another category of foreign base company income. The gain in question is the gain arising from the disposition of stock or obligations issued, again, by a foreign corporation the dividends from which are eligible for the section 902 foreign tax credit. Our analysis will first take up the type of payor or issuer required and then the matter of attributing items of income or gain to foreign base company shipping income.

(a) The Requisite Payor or Issuer

The Code defines the requisite payors and issuers as those “in respect of which taxes are deemed paid under section 902.” The Code does not specify the taxpayer who is deemed to have paid the payor’s or issuer’s taxes under Code section 902. As noted below, the regulations implicitly restrict the taxpayer in question to a U.S. shareholder of the controlled foreign corporation receiving the interest or dividend or realizing the gain. See Treas. Reg. 1.954-6(f)(1). Hence, the section 902 requirement results in the payor or issuer being related to the controlled foreign corporation through a common U.S. shareholder. Thus, the regulations exclude from foreign base company shipping income any interest paid to a creditor controlled foreign corporation by a member of an unrelated U.S. multinational group out of the payor’s foreign base company shipping income, together with any gain arising from the disposition of the underlying obligation. Such interest and gain may qualify as foreign personal holding company income, however. With regard to the requisite payors and issuers, the regulations give them further definition by requiring them to belong to either of two groups of corporations.

The first group consists of those corporations with regard to which the controlled foreign corporation itself is deemed to pay

---

72 See I.R.C. § 954(c).
73 See I.R.C. § 954(f)(1).
74 Id.
75 See I.R.C. § 954(c).
76 See Treas. Reg. § 1.954-6(f)(1)(ii). The regulation mentions a third group of payor, but the group, less developed country shipping companies, is obsolete. See id. at §1.954-6(f)(1)(iii). The group relates to a former version of Code section 955. See id.
foreign taxes for purposes of the calculations under Code section 902.\textsuperscript{77} A foreign corporation is deemed to pay foreign taxes under section 902 only for purposes of calculating the foreign taxes deemed to be paid by a U.S. corporation higher in the foreign corporation's chain of ownership; foreign corporations generally cannot qualify for the indirect foreign tax credit.\textsuperscript{78} Hence, the requirement that the controlled foreign corporation itself be deemed under section 902 to pay foreign taxes of the payor or issuer means that a U.S. corporate shareholder, direct or indirect, of the controlled foreign corporation also will be deemed to pay those taxes.\textsuperscript{79} With this in mind, we see that the first group of payors and issuers consists of corporations that are direct or indirect subsidiaries of the controlled foreign corporation and that meet section 902's limitation on the number of tiers of subsidiaries recognized for purposes of the indirect foreign tax credit and the section's minimum requirements for indirect ownership by the controlled foreign corporation.\textsuperscript{80} Some of these payors and issuers will not be controlled foreign corporations themselves, even though later in the analysis we will attribute dividends and interest paid by them to their own foreign base company shipping income. Entities other than controlled foreign corporations may derive foreign base company shipping income.\textsuperscript{81}

\textsuperscript{78} See I.R.C. § 902(a).
\textsuperscript{79} In the event that all of the U.S. shareholders of the controlled foreign corporation are individuals, the regulations provide that the U.S. shareholders, as defined in Code section 951(b), will be deemed to be domestic corporations for purposes of identifying the requisite payors and issuers. See Treas. Reg. § 1.954-6(f)(2)(ii).
\textsuperscript{80} See I.R.C. § 902(b).
The regulations define the second group of payors and issuers as controlled foreign corporations that are related for purposes of Code section 954(d)(3) to the controlled foreign corporation receiving the interest or dividend or realizing the gain.\(^2\) Code section 954(d)(3) provides that a corporation is related to a controlled foreign corporation either if the corporation controls or is controlled by the controlled foreign corporation or if the corporation is controlled by the same person or persons that control the controlled foreign corporation.\(^3\) Control, for this purpose, is defined as the ownership of more than fifty percent of the stock of the payor or issuer, in terms of either voting power or value.\(^4\) This threshold of control is significantly greater than the requirements of Code section 902, which generally require ownership of ten percent of the stock of the payor of a dividend.\(^5\) The requirement that the payor or issuer be related to the recipient within the meaning of Code section 954(d)(3) implies that the two controlled foreign corporations will have a common U.S. shareholder within the meaning of Code section 951(b), and thus a common U.S. shareholder. Once again, the regulations implicitly require that a U.S. shareholder of the receiving or realizing controlled foreign corporation be among the deemed taxpayers under Code section 902 with respect to the paying or issuing corporation.

The regulations’ definition of this second group is both overly broad and overly narrow. The regulation is overly broad because it attempts to include all controlled foreign corporations related to the controlled foreign corporation receiving the payment or realizing the gain. Not all related controlled foreign corporations can be included in this second group according to

\(^2\) See Treas. Reg. § 1.954-6(f)(1)(ii)(B). This second group was added to the regulations in response to a now obsolete public comment. See T.D. 7894, 1983-1 C.B. 149, 152. The comment pointed out that investments in such related controlled foreign corporations qualified for a then-existing exclusion from foreign base company shipping income for investments in shipping assets and apparently suggested that the returns on such investments should be included in foreign base company shipping income. See id.

\(^3\) I.R.C. § 954(d)(3).

\(^4\) See id.

\(^5\) See I.R.C. § 902(a), (b).
Code section 954(f)(1). The provision requires payors and issuers to be such that taxes are deemed paid under Code section 902 with respect to them.\textsuperscript{86} That requirement in turn requires that a related corporation be sufficiently high in the corporate hierarchy for a U.S. shareholder to be credited under section 902 with taxes paid by the related corporation.\textsuperscript{87} Not all controlled foreign corporations meet that requirement. Hence, the second group of payors and issuers must be restricted to corporations with regard to which a U.S. shareholder can qualify for the indirect foreign tax credit.

The second group is overly narrow for two reasons. First, the regulations restrict the membership of the group to controlled foreign corporations. See Treas. Reg. 1.954-6(1)(ii)(B). Code section 954(f)(1) is more inclusive and refers to any foreign corporation with respect to which taxes are deemed paid under Code section 902. Second, the regulations restrict membership to related corporations, in the strong sense of relation found in Code section 954(d)(3). See Treas. Reg. 1.954-6(1)(ii)(B). Code section 954(f)(1) is more inclusive and refers to any foreign corporation that meets the weak sense of relation found in Code section 902. Both restrictions may reflect a concern that the necessary information about a payor's or issuer's own foreign base company shipping income would be difficult to obtain if the payor or issuer is not a related controlled foreign corporation. But by definition, these payors and issuers are sufficiently beholden to U.S. shareholders under Code section 902 to furnish the necessary information about the foreign taxes they have paid. Hence, there seems to be no administrative difficulty in making the group of payors and issuers under Code section 954(f)(1) congruent with the group of corporations the dividends from which are eligible for the indirect tax credit under Code section 902.

We can address these problems with the second group of payors and issuers by narrowing the group to include only those corporations in respect of which foreign taxes can be deemed paid

\textsuperscript{86} See I.R.C. \S 954(f)(1).
\textsuperscript{87} See I.R.C. \S 902(a), (b). Section 902(b) generally limits the number of tiers of eligible foreign subsidiaries to six, with the proviso that subsidiaries in tiers four through six must be controlled foreign corporations.
under Code section 902 and then expanding the group to include corporations other than controlled foreign corporations. If this approach is taken, the first and second groups of payors and issuers could be consolidated into a single group, since the modified second group would include all payors and issuers now included within the first group.  

The recommendation may be stated as follows:

RECOMMENDATION ONE: Amend Treasury Regulations section 1.954-6(f)(1)(ii) to read in its entirety as follows: “The foreign corporations referred to in subdivision (i) of this paragraph (f)(1) are foreign corporations in respect of which a U.S. shareholder of the first corporation would be deemed under section 902(a) to pay taxes.”

(b) Attribution To Foreign Base Company Shipping Income

In order for dividends or interest received by a controlled foreign corporation to constitute foreign base company shipping income, the dividends or interest must be attributable to the payor’s own foreign base company shipping income. Similarly, in order for gain realized by a controlled foreign corporation from the disposition of stock or obligations of a foreign corporation to constitute foreign base company shipping income, the gain must be attributable to the issuer’s own foreign base company shipping income. The payor’s or issuer’s own foreign base company shipping income does not include dividends or interest received from another foreign corporation or gain realized from the disposition of another foreign corporation’s stock or obligations,

---

88 Treasury Regulations section 1.954-6(f)(ii)(C), could also be deleted at this time; it was made obsolete by the repeal of former Code section 955 dealing with investment of earnings in less developed countries.
89 The conditional mood, “would be deemed,” is preferable to the indicative mood, “is deemed,” because the definition then dovetails with the provisions of Treasury Regulations section 1.954-6(f)(2). Those provisions specify that the definitions of the groups apply regardless of whether the payor actually pays any taxes or dividends. See Treas. Reg. § 1.954-6(f)(2).
90 See I.R.C. § 954(f)(1).
91 See id.
unless the payor or issuer is itself a controlled foreign corporation. The attribution of a dividend or interest payment to the payor’s foreign base company shipping income follows generally intuitive methods, but the attribution of gain to an issuer’s foreign base company shipping income does not.

(i) Attributing Dividends

The portion of a dividend attributable to foreign base company shipping income is calculated by reference to the source of the earnings and profits out of which the dividend is paid. Thus, attribution is a matter of attributing the payor’s earnings and profits to its foreign base company shipping income. In most instances, the matter is settled by resort to Code section 316(a).

The exception lies with a dividend paid by a controlled foreign corporation on stock owned indirectly by one of its own U.S. shareholders through a foreign corporation. This happens when the controlled foreign corporation receiving the dividend is a link in the chain of ownership between the paying controlled foreign corporation and its U.S. shareholder. A special rule is needed in this case because, to the extent that a dividend is paid out of income already taxed to a U.S. shareholder under Subpart F, the dividend is excluded from the recipient’s foreign base company income.

Moreover, other Code authority provides that a dividend paid by a controlled foreign corporation out of its foreign base company shipping income is excluded from the recipient’s foreign base company income if the recipient lies within the payor’s chain of ownership. Therefore, in the case of a dividend paid by a controlled foreign corporation to another controlled foreign


93 See Treas. Reg. § 1.954-6(f)(4).

94 See id.

95 See I.R.C. § 959(b).

96 See I.R.C. § 954(b)(6)(B).
corporation serving as a link in the chain of ownership between the paying corporation and its United States shareholder, the matter of attributing the payor’s earnings and profits to its foreign base company shipping income is settled by resort to Treasury Regulations section 1.959-3.  

Once the amount of the payor’s earnings and profits attributable to foreign base company shipping income is known, the fraction of such earnings and profits within the earnings and profits out of which the dividend is paid becomes the fraction of the dividend that is attributed to foreign base company shipping income.  

(ii) Attributing Interest

The portion of an interest payment attributable to foreign base company shipping income generally is calculated by reference to the source of the payor’s gross income during a stipulated period of time. The relevant period consists of the payor’s three taxable years ending prior to the year in which the interest payment is made. The fraction of the payor’s gross income during the three-year period that consists of foreign base company shipping income becomes the fraction of the interest payment that is attributed to foreign base company shipping income. The Service has the authority to adjust both the gross income and the foreign base company shipping income of the payor as necessary, especially to take into account the formation or liquidation of subsidiaries or the occurrence of a corporate reorganization during the three-year period.

A different method is used when the payor is a controlled foreign corporation. Interest paid by a controlled foreign corporation...
corporation is attributable to its foreign base company shipping income by the same method used to allocate the interest, as an expense, to its foreign base company shipping income for purposes of calculating the corporation's deductions from gross foreign base company income.\textsuperscript{103}

\textit{(iii) Attributing Gain}

Gain derived from the sale of stock or obligations generally is attributed to foreign base company shipping income in the manner used for attributing interest. See Treas. Reg. § 1.954-6(f)(5)(i). Thus, the fraction of the issuer's gross income during the past three years that consists of foreign base company shipping income becomes the fraction of the gain attributed to foreign base company shipping income.\textsuperscript{104} Once again, the Service has the authority to adjust both the gross income and the foreign base company shipping income of the issuer as necessary, especially to take into account various events treated under Subchapter C.\textsuperscript{105} The regulations assume, no doubt for administrative convenience, that all of the appreciation in the value of corporate stock occurs during the last three years of an investor's holding period and that the investor's holding period is at least three years long. See Treas. Reg. § 1.954-6(f)(6). The regulations' use of a three-year period is more intuitive for attributing interest payments to foreign base company shipping income; the proposition that current interest payments are made out of current and recent income is plausible.

The computations are adjusted under a look-through rule in the event that the issuer is a controlled foreign corporation that in turn owns at least ten percent of the stock of another controlled foreign corporation. See Treas. Reg. § 1.954-6(f)(5)(iv). In that event, a pro rata share of the subsidiary's gross income, less any dividends received by the issuer, is added to the issuer's own gross income.\textsuperscript{106} In addition, a pro rata share of the subsidiary's foreign base company shipping income, less any dividends paid to the

\textsuperscript{103} See Treas. Reg. § 1.954-6(f)(5)(ii).
\textsuperscript{104} See Treas. Reg. § 1.954-6(f)(5)(i).
\textsuperscript{105} See Treas. Reg. § 1.954-6(f)(5)(v).
issuer out of the subsidiary's foreign base company income (whether shipping income or not), is added to the issuer's own foreign base company shipping income.\textsuperscript{107} This look-through rule does not apply to the calculations for attributing interest or dividends to foreign base company shipping income.\textsuperscript{108}

A loss from the disposition of stock or an obligation is allocable to foreign base company shipping income to the same extent that gain from such disposition would have been allocable.\textsuperscript{109} The extent to which such a loss is deductible from foreign base company shipping income is determined under principles applicable to domestic corporations\textsuperscript{110} and the rules given in Treasury Regulations section 1.954-1(c).

7. Income from Partnerships, Trusts, and Estates

The seventh and last component of foreign base company shipping income consists of a foreign corporation's distributive share of partnership income to the extent that such income would have been foreign base company shipping income had the income been realized by the partner directly.\textsuperscript{111} This explicit component prevents the Brown Group phenomenon from arising in foreign base company shipping operations. See Brown Group, Inc. v. Commissioner, 77 F.3d 217 (8th Cir. 1996). The Brown Group phenomenon is the use of a partnership to shelter a controlled foreign corporation's foreign base company sales income from the effects of Subpart F.\textsuperscript{112} The drafting history of the regulation points out that, when it is necessary to determine whether a

\textsuperscript{107} See Treas. Reg. § 1.954-6(f)(5)(iv)(B).
\textsuperscript{108} See Treas. Reg. § 1.954-6(f)(5)(ii). The reader may question this statement as it pertains to interest. Note that Treasury Regulations section 1.954-6(f)(5)(ii) overrides section 1.954-6(f)(5)(i) by the express terms of the latter section. The look-through rule, found in section 1.954-6(f)(5)(iv), pertains only to section 1.954-6(f)(5)(i) by its own terms and thus is overridden by section 1.954-6(f)(5)(ii).
\textsuperscript{109} See Treas. Reg. § 1.954-6(h)(4)(iii).
\textsuperscript{110} See Treas. Reg. § 1.954-6(h)(4)(i).
\textsuperscript{111} See I.R.C. § 954(f)(2); see also Treas. Reg. § 1.954-6(g)(1).
\textsuperscript{112} For a discussion of the Brown Group phenomenon, Brown Group, Inc. v. Commissioner, 77 F.3d 217 (8th Cir. 1996), see Sales Income, supra note 5, at 97-99.
customer is a related person, as, for example, in calculating directly-related services income, the relevant inquiry is whether the customer is related to the partner and not whether the customer is related to the partnership.\textsuperscript{113}

The regulations expand the seventh component of foreign base company shipping income to include most of the corporation's income from trusts and estates to the extent that such income would have been foreign base company shipping income had the income been realized by the corporation directly.\textsuperscript{114} Gain from the disposition of an interest in a trust or estate cannot be included in the corporation's foreign base company shipping income.\textsuperscript{115} The regulations are silent on the question of whether a foreign corporation should include the gain from the disposition of a partnership interest in its foreign base company shipping income. Such gain does not seem to fall within incidental income, the third component of foreign base company shipping income, which is the likeliest candidate for encompassing the gain from the sale of a partnership interest; recall that incidental income is tied to assets that give rise to income falling within the first two components of foreign base company shipping income.

B. The Country-of-Incorporation Exclusion

The country-of-incorporation exclusion excludes from a foreign corporation's foreign base company income any income arising from the use of a vessel or aircraft between two points within its country of incorporation, as long as the vessel or aircraft is registered in that country.\textsuperscript{116} The exclusion is available only for

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{114}] See Treas. Reg. § 1.954-6(g)(1). Only trust and estate income described in Code sections 652(a), 662(a), 671, or 691(a) is eligible to be included in a foreign corporation's foreign base company shipping income. See Treas. Reg. § 1.954-6(g)(1), (3).
\item[\textsuperscript{115}] See Treas. Reg. § 1.954-6(g)(3).
\item[\textsuperscript{116}] See I.R.C. § 954(b)(7); see also Treas. Reg. § 1.954-6(b)(3). The Code defines the exclusion in terms of the income derived by a controlled foreign corporation. See I.R.C. § 954(b)(7). The regulations generalize the exclusion to apply to all foreign
\end{itemize}
\end{footnotesize}
the first component of foreign base company shipping income. 117
The exclusion indirectly affects income falling within the sixth and
seventh components of foreign base company shipping income,
insofar as the dividend, interest, gain, distributive share of
partnership income, or trust or estate income is attributable to
income excluded from the first component of foreign base company
shipping income by the country-of-incorporation exclusion. When
the exclusion applies, it excludes the income not only from foreign
base company shipping income but from foreign base company
income generally. 118

Should the exclusion be extended to other components of
foreign base company shipping income? In principle, yes.
Country-of-incorporation exclusions are the method by which
Subpart F accommodates the political process’s concern for capital
import neutrality, that is, for lowering the tax burden on a foreign
operation of a U.S. multinational so that it is comparable to the tax
burden borne by its indigenous competitors. Hence, a country-of-
incorporation exclusion should be available for every category of
foreign base company income and for each component of foreign
base company shipping income, in the absence of a competing
factor. In considering the extension of the country-of-incorporation
exclusion for the first component of foreign base company shipping
income to additional components of foreign base company shipping
income, we need first to consider the structure of country-of-
incorporation exclusions generally and then the application of the
shipping version of the exclusion to the specific components of
foreign base company shipping income.

Country-of-incorporation exclusions typically have two
requirements. First, the multinational’s foreign operation must be
conducted by a subsidiary incorporated in the country where the
operation is located. The purpose of this requirement is to subject
the foreign operation to the same residence-based foreign income
taxation as the local competitors. See I.R.C. § 954(f). (The purpose

corporations. See Treas. Reg. § 1.954-6(b)(3).
117 Compare I.R.C. § 954(b)(7) with I.R.C. § 954(f) (using the identical language of
income derived “from, or in connection with, the use (or hiring or leasing for use)
of any aircraft or vessel in foreign commerce”).
118 See I.R.C. § 954(b)(7).
is not always realized, however, since a number of countries impose residence-based taxation on corporations on the basis of the situs of the corporation's management and control rather than on the basis of its place of incorporation.) Second, only the income of the local subsidiary that arises from operations conducted within the territory of its country of incorporation is excluded from U.S. taxation under Subpart F, since some countries exclude from their income tax bases income derived by residents from sources outside their territory.

The country-of-incorporation exclusion for foreign base company shipping income reinforces the second requirement by the addition of a registration requirement. See I.R.C. § 954(b)(7). Not only must the income arise from the use of a vessel or aircraft between two points within the foreign corporation's country of incorporation; the vessel or aircraft used to generate the income must be registered in that country. See Treas. Reg. § 1.954-6(b)(3). This additional requirement exists apparently to increase the likelihood that the income generated by the use of the vessel or aircraft is in fact taxed by the local country. Under international principles of jurisdiction, the flag state of a vessel or aircraft has the authority to enact law, including tax law, governing activities aboard the vessel or aircraft.\(^{119}\) For this reason, it is sometimes said that a ship or plane is considered by international law to be part of the territory of the flag state.\(^{120}\)

Because the purpose of the registration requirement is to reinforce the sourcing of the income to the foreign corporation's country of incorporation, it is immaterial to the exclusion whether other persons are incorporated in the country in which the services are rendered. For example, the income derived by a lessee from the use of a ship registered in the lessee's country of incorporation between two points within that country qualifies for the exclusion, regardless of the country of incorporation of the ship's owner. So, too, the rental income derived by the owner of a ship, registered in the owner's country of incorporation and used by the lessee

\(^{120}\) See id.
between two points within that country, qualifies for the exclusion, regardless of the lessee's country of incorporation.\textsuperscript{121}

Extending the country-of-incorporation exclusion to other components of foreign base company shipping income raises few problems. In connection with the second component of foreign base company shipping income, that of directly related services income, we need to address the requirement that the vessel or aircraft be registered in the foreign corporation's country of incorporation. This requirement could at times be nonsensical, since no vessel or aircraft is used to derive some of the items of directly-related services income. For example, directly related services income includes income derived from the licensing of intellectual property developed and used in the course of foreign base company shipping operations. In such a case, the licensor uses no vessel or aircraft to derive its royalty income. Hence, the local registration requirement makes sense only for income the taxation of which by the controlled foreign corporation's country of incorporation on the basis of residence depends upon the situs of registration of the vessel or aircraft.

Even when the local registration requirement should apply, the foreign corporation would not necessarily own or operate the vessel or aircraft in question. For example, the foreign corporation might derive income from rendering services to passengers aboard a ship owned by a related person. In such a case, the foreign corporation would need to look to the place of registration of a vessel owned by the related person. If the foreign corporation rendered services aboard multiple vessels, it would need to trace its services to specific vessels in order to determine whether the local registration requirement were met. Furthermore, the exclusion should be available to a foreign corporation rendering directly related services regardless of the country of incorporation of its client. Conceivably, the foreign corporation might qualify for the exclusion, while its client (possibly a related person) does not qualify due to the client's incorporation in another country.

\textsuperscript{121}These two examples are taken from \textsc{Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976}, at 233, \textit{reprinted in} 1976-3 C.B. (vol. 2) 1, 245.
Extending the country-of-incorporation exclusion to incidental income, the third component of foreign base company shipping income, would be straightforward. Incidental income consists primarily of gain arising from the disposition of assets used in generating income falling within the first two components of foreign base company shipping income. The gain from disposing of an asset could be excluded to the extent that the income from the asset had been excluded from foreign base company shipping income. An appropriate time frame for measuring the extent to which the asset’s income had been excluded would be the three-year period preceding the taxable year in which the disposition takes place. This is the same period of time used in quantifying the sixth component of foreign base company shipping income, and using the same period for the country-of-incorporation exclusion would simplify administration and compliance.

A similar approach could be used for extending the country-of-incorporation exclusion to income derived from the sale of a vessel or aircraft, the fourth component of foreign base company shipping income. The gain from the disposition of a vessel or aircraft would fall within the exclusion to the extent that the income generated by the use of the vessel or aircraft qualified for the exclusion during the prior three years. The period of time needs to be uniform with that used to apply the exclusion to incidental income, since the taxpayer may choose between the two components of foreign base company shipping income when an item of income falls within both components.

The expanded country-of-incorporation exclusion generally would not apply to any income from space and ocean activities, the fifth component of foreign base company shipping income, since by definition such activities generally take place beyond the territorial jurisdiction of any country. A possible exception concerns the income derived from the use of a satellite. In the event that income from satellite operations is sourced in the future

---

122 See the discussion of incidental income supra Part I.A.3.
123 See Treas. Reg. § 1.954-6(f)(5)(i), (6).
124 See Treas. Reg. § 1.954-6(h)(3).
125 See I.R.C. §§ 863(d)(2), 954(f).
to the country in which the satellite is registered, the income should be eligible for the exclusion as long as the foreign corporation deriving the income was incorporated in that country.\footnote{At present, the income derived from the use of a satellite is sourced primarily by the nationality of the person deriving the income. \textit{See} I.R.C. § 863(d), (e).}

The country-of-incorporation exclusion already applies, albeit indirectly, to income falling with the sixth and seventh components of foreign base company shipping income. \textit{See} I.R.C. § 954(b). The sixth component consists of certain dividends, interest, and gain attributable to the payor's or issuer's own foreign base company shipping income. \textit{See} I.R.C. § 954(f)(1). The seventh component consists of a foreign corporation's distributive share of partnership income and income from estates and trusts that is attributable to the foreign base company shipping income of those entities. \textit{See} I.R.C. § 954(f)(2); Treas. Reg. § 1.954-6(g)(1). To the extent that the underlying income falls within the exclusion, the income is removed from the dividends, interest, gain, distributive share, or estate and trust income that would otherwise be attributable to the income.

A recommendation can now be made.

\textbf{RECOMMENDATION TWO:} First, amend Code section 954(b)(7) to read as follows:

\textbf{"(7) SPECIAL EXCLUSION FOR FOREIGN BASE COMPANY SHIPPING INCOME.--} Income derived by a foreign corporation that is foreign base company shipping income under paragraph (4) of subsection (a) shall be excluded from foreign base company income if derived by the corporation from sources within its country of residence. The corporation's country of residence and the source of its income shall be determined under regulations issued by the Secretary."

Second, add the following at the end of Treasury Regulations section 1.954-6(h):
"(6) For purposes of the country-of-residence exclusion under section 954(b)(7):

(i) A foreign corporation's country of residence shall be its country of incorporation, unless that country fails to tax, on the basis of residence, a corporation incorporated within its territory but the management and control of which are located outside its territory, in which case such corporation's country of residence shall be the country in which its management and control are located; and

(ii) The source of a foreign corporation's income shall be determined as follows:

(A) The source of gain from the sale, exchange, or other disposition of an asset described in § 1.954-6(e)(2)(i), a vessel, or an aircraft shall be the same as the source of the income derived from the use of such asset during the period described in § 1.954-6(f)(6); and

(B) The source of all other income shall be determined under U.S. tax principles."

The proposed Code provision makes no direct reference to a vessel's or aircraft's place of registration. Under the proposal, a vessel's or aircraft's place of registration would matter only to the extent that it affected the source, under U.S. tax principles, of income derived by a foreign corporation in connection with the vessel or aircraft. This avoids the confusion, discussed above in connection with directly-related services, that otherwise would arise when a foreign corporation derives foreign base company shipping income without the use of a vessel or aircraft.

Furthermore, the proposed Code provision makes no reference to the use of a vessel or aircraft between two points within the foreign corporation's country of incorporation. Under the proposal, such a fact would be relevant only to the extent that
it affected the source, under U.S. tax principles, of the income derived by the foreign corporation from such use.

The proposed exclusion speaks in terms of a foreign corporation's country of residence, rather than its country of incorporation. This change avoids the problems now arising under country-of-incorporation exclusions stemming from the fact that some countries do not tax, on the basis of residence, a corporation that is not managed and controlled from within their territory even though the corporation is incorporated there.

C. Ordering Rules

Ordering rules settle conflicts of classification between foreign base company shipping income and other categories of foreign base company income. Foreign base company shipping income generally takes priority over all other categories of foreign base company income.\textsuperscript{127} The one exception applies to interest and dividends, for which the category of foreign personal holding company generally takes precedence over foreign base company shipping income.\textsuperscript{128} In turn, an exception to that exception applies to those dividends and interest that fall within the sixth component of foreign base company shipping income. Such dividends and interest are those paid by foreign corporations in respect of which taxes are deemed paid under Code section 902, but only to the extent that such dividends and interest are attributable to foreign base company shipping income.\textsuperscript{129} For those dividends and interest, the category of foreign base company shipping income continues to take priority over the category of foreign personal holding company income.\textsuperscript{130}

In the event that a single item falls within two or more components of foreign base company shipping income itself, the taxpayer may choose the component under which to classify the item.\textsuperscript{131} The availability of the country-of-incorporation exclusion

\textsuperscript{127} See I.R.C. § 954(b)(6)(A).
\textsuperscript{128} See I.R.C. § 954(f).
\textsuperscript{129} See I.R.C. § 954(f)(1).
\textsuperscript{130} See I.R.C. § 954(f).
\textsuperscript{131} See Treas. Reg. § 1.954-6(h)(3).
may determine the taxpayer's choice. The exclusion is currently available only for income otherwise falling within the first component of foreign base company shipping income.\textsuperscript{132}

D. Exclusion for Others' Shipping Income

Code section 954(b)(6)(B) excludes a controlled foreign corporation's foreign base company shipping income from the foreign base company income of other controlled foreign corporations as the shipping income is distributed up a qualifying chain of ownership.\textsuperscript{133} But Code section 959(b), which applies to all categories of foreign base company income and not simply to foreign base company shipping income, provides that a controlled foreign corporation's foreign base company income is excluded from other controlled foreign corporations' foreign base company income when distributed up a qualifying chain of ownership once the income has been included in the gross income of a United States shareholder.\textsuperscript{134} Code section 959(b) thus helps to prevent double taxation by the United States of items of foreign base company income. The existence of Code section 959(b) raises the question of whether Code section 954(b)(6)(B) adds anything new.\textsuperscript{135}

There is a difference between the two exclusions. In order for foreign base company shipping income to be excluded from another controlled foreign corporation's income pursuant to Code section 959(b), the income must have been taxed to a United States shareholder See I.R.C. § 959(b); in order for that income to be excluded pursuant to Code section 954(b)(6)(B), the income need not have been taxed to a United States shareholder. See I.R.C. §

\textsuperscript{132} For a proposal to enlarge the scope of the country-of-incorporation exclusion, see supra Part I.B.
\textsuperscript{133} See I.R.C. § 954(b)(6)(B).
\textsuperscript{134} I.R.C. § 959(b).
\textsuperscript{135} Section 954(b)(6)(B) was added to the Code at the same time that foreign base company shipping income was added to the Code as a component of foreign base company income. See Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 58 § 602, reprinted in 1975-1 C.B. 545, 565. The foreign base company shipping provisions were added in conference committee, and the conference report is silent on the reason for including Code section 954(b)(6)(B). See H.R. CONF. REP. No. 94-120 (1975), reprinted in 1975-1 C.B. 624, 631.
959(b)(6)B). The exclusion of Code section 954(b)(6)(B) is more generous, of course, than the exclusion under Code section 959(b).

An example will highlight the difference between the two exclusions. Consider a controlled foreign corporation which derives foreign base company shipping income that is not taxed to a United States shareholder because of the current earnings and profits limitation.\textsuperscript{136} Suppose that the corporation has accumulated earnings and profits in excess of the amount of its foreign base company shipping income. If the corporation distributes that income to another controlled foreign corporation in its chain of ownership, the shipping income is excluded from the recipient's foreign base company income under Code section 954(b)(6)(B) even though the dividend would otherwise qualify either as foreign personal holding company income or as foreign base company shipping income in the hands of the recipient.\textsuperscript{137} In the absence of Code section 954(b)(6)(B), the distribution would generally be included in the foreign base company income of the second controlled foreign corporation and taxed to the corporation's U.S. shareholders, if the second corporation's current earnings and profits are sufficient to cover the amount.

Hence, under some circumstances, Code section 954(b)(6)(B) permits foreign base company shipping income to escape U.S. taxation altogether. The exclusion granted by section 954(b)(6)(B) should be deleted from the Code in favor of the more accurate exclusion established by Code section 959(b).

\textbf{RECOMMENDATION THREE:} Delete section 954(b)(6)(B) from the Code.

\textsuperscript{136} See I.R.C. § 952(c)(1)(A).
\textsuperscript{137} See I.R.C. § 954(c), (f)(1) (if the first corporation is high enough in the chain of ownership for its foreign income taxes to be eligible for the indirect foreign tax credit, the income in the hands of the second corporation is foreign base company shipping income; otherwise, the income is foreign personal holding company income for the second corporation).
E. Contingent Exclusion for Certain Shipping Income

Gross income derived by a foreign corporation from the international operation of ships or aircraft is excluded from the corporation's gross income for purposes of U.S. income taxation, if the corporation's country of incorporation grants a similar exclusion to U.S. corporations. 138 Controlled foreign corporations are eligible for this exclusion. 139 When applicable, this exclusion exempts income from taxation to the controlled foreign corporation under Code sections 881(a) and 882(a) and from taxation to its United States shareholders under Code section 954(f). 140

To exempt such income from taxation to U.S. shareholders undoes much of the effect of Code section 954(f). Income derived from the international operation of ships and aircraft lies at the heart of foreign base company shipping income. The treatment of such income should be analogous to the treatment of income from space or ocean activity: income from space or ocean activity generally is not taxed to the controlled foreign corporation under Part II.B of Subchapter N but is included in the controlled foreign corporation's income for purposes of taxing its U.S. shareholders under Part III.F. 141 Implementing the following recommendation would produce an analogous result:

---

138 See I.R.C. § 883(a)(1), (2).
139 See I.R.C. § 883(c)(2).
140 See I.R.C. § 883(a). Code section 883(a) provides that “the following items... shall be exempt from taxation under this subtitle” and proceeds to list income derived by a foreign corporation from the international operation of ships and aircraft. Subtitle A of the Code includes section 954 as well as sections 881 and 882. The regulation under Code section 954(f) provides that the exclusion is not available when calculating the gross income of a foreign corporation for purposes of the regulation. See Treas. Reg. § 1.954-6(h)(1). This seems to be merely a direction in connection with calculating ratios and limitations; see, for example, the calculation of interest attributable to a payor's own foreign base company shipping income supra Part I.A.6(b)(ii).
141 See I.R.C. §§ 863(d)(1)(B) (providing in effect that income derived by a controlled foreign corporation from space or ocean activity is foreign source income, and therefore unlikely to be subject to U.S. taxation under Code sections 881 or 882), 954(f).
RECOMMENDATION FOUR: Amend the first clause of Code section 883(a) by replacing the word “subtitle” at the end of the clause by the word “subpart.”

III. FOREIGN BASE COMPANY OIL-RELATED INCOME

Foreign base company oil-related income is the subject of section 954(g) of the Code. Such income consists primarily of the offshore refining income of integrated oil companies. Foreign base company oil-related income includes other income, but none is as central.

To define foreign base company oil-related income, Code section 954(g) borrows the concept of foreign oil-related income from the foreign tax credit limitation and modifies it. The borrowed concept of foreign oil-related income generally consists of the foreign-source income derived from processing, transporting, distributing, or selling hydrocarbons, together with certain other income attributable to those operations. Foreign oil-related income therefore arises only from an oil company’s downstream operations, in the terminology of the oil industry. An independent producer generally cannot have foreign oil-related income, since an independent producer by definition conducts only exploration and production activities.

The modifications made by Code section 954(g) to the concept of foreign oil-related income comprise the addition of a threshold test for the foreign corporation’s operations, three exclusions that together serve in a role analogous to a country-of-incorporation exclusion, and a fourth exclusion that provides an ordering rule. The threshold test and four exclusions act as screens on the income we are addressing; only the foreign oil-related income remaining after the screens are applied qualifies as foreign base company oil-related income. Borrowing a concept from another area of the Code is not without its problems. These are identified in the discussion that follows.

At the outset, we note that Code section 954(g) envisions entities other than controlled foreign corporations as deriving

---

142 See I.R.C. §§ 907(c)(2), (3), 954(g)(1).
143 See I.R.C. § 907(c)(2), (3).
foreign base company oil-related income. The section itself refers to foreign corporations generally, and its incorporation of Code section 907(c) causes some of the income of flow-through entities to qualify as foreign base company oil-related income in the hands of the entities' corporate owners.\textsuperscript{144} Although only the foreign base company oil-related income of a controlled foreign corporation is taxed to U.S. shareholders, that income may include dividends, interest, a distributive share of partnership income, or trust or estate income from other kinds of entities that derive foreign base company oil-related income.

A. Threshold Test: The Large Producer Requirement

To derive foreign base company oil-related income, a foreign corporation must produce at least 1000 barrels per day of crude oil (or the equivalent in natural gas) from wells outside the United States, either by itself or with the help of related persons.\textsuperscript{145} The threshold test may be met with either the current taxable year's production or the previous year's production.\textsuperscript{146} This threshold test requires, in the terminology of the oil industry, that the foreign corporation, or the group of related persons of which it is a member, have significant upstream operations outside the United States. Recall that foreign oil-related income itself is derived from downstream operations. See I.R.C. §954(g)(1). Adding the threshold test to the base concept of foreign oil-related income, we see that the foreign corporations targeted by Code section 954(g) are parts of integrated producer groups, that is, groups that

\textsuperscript{144} See I.R.C. §§ 907(c)(3)(C), 954(g)(1); see also Treas. Reg. § 1.907(c)-2(f).
\textsuperscript{145} See I.R.C. § 954(g)(2). A related person for this purpose is defined as a person who controls or is controlled by the foreign corporation or who is controlled by the same persons who control the foreign corporation. See I.R.C. § 954(d)(3); see also Treas. Reg. § 1.954-8(b)(2). Control for this purpose is the direct or indirect ownership of more than fifty percent, by value or by voting power, of the stock or beneficial interests in the relevant entities. See id.
\textsuperscript{146} See I.R.C. § 954(g)(2)(B). The Code specifies that the group's average daily production from wells outside the United States is to be determined under rules similar to those of Code section 613A, I.R.C. § 954(g)(2)(D), a specification echoed by the regulations under Code section 954(g), Treas. Reg. § 1.954-8(b)(2). See id.
explore for and produce oil and gas, refine or otherwise process the hydrocarbons, and market the resulting products.

B. *Other Screens: The Analogue to Country-of-Incorporation Exclusions*

Even if the foreign corporation meets the 1000 barrel-per-day threshold, only the part of its foreign oil-related income that remains after the application of four exclusions qualifies as foreign base company oil-related income. The first three exclusions serve as an analogue to the country-of-incorporation exclusions found elsewhere in Subpart F. See I.R.C. § 954(g). In general terms, Code section 954(g) targets a downstream operation that does not serve its local market: the targeted operation does not process local oil and gas production and does not sell hydrocarbons or their primary products for local use or consumption. See I.R.C. § 954(g). In more specific terms, the three exclusions exclude income derived from sources within a foreign country in connection with (i) oil or gas extracted from a well located in that country; (ii) oil, gas, or a primary product of such hydrocarbons that is sold by the foreign corporation or a related person for use or consumption in that country; or (iii) fuel that is loaded in that country onto a vessel or aircraft for use as fuel. (I will refer to these exclusions as the local-extraction, local-use, and local-fueling exclusions.) The

---

147 *See e.g.*, I.R.C. § 954(b)(7) (the country-of-incorporation exclusion for foreign base company shipping income).

148 *See* I.R.C. § 954(g)(1)(A). Rules for applying the local extraction exclusion are given in the regulations. *See* Treas. Reg. § 1.954-8(c).

149 *See* I.R.C. § 954(g)(1)(B).

150 *See id.* The drafters of Code section 954(g) may have intended that the foreign corporation or a related person sell the fuel for such loading and hence the third exclusion be an elaboration of what a local use consists of. If this is accurate, the drafters should have resisted the phrase, "is loaded," in favor of the phrase, "for loading." The regulations do not address the matter and simply refer to both the second and third exclusions as the "use or consumption exemption." Treas. Reg. § 1.954-8(a)(1)(ii). As it stands, the third exclusion does not require that the fuel have been sold by the entity that derives income in connection with its use; the entity may have refined the fuel under contract with the owner of the hydrocarbons, or the entity may have loaded the fuel onboard a vessel or aircraft under contract with the owner of the fuel.
exclusions as a group serve as the country-of-incorporation exclusion for foreign base company oil-related income in the sense that the exclusions address the policy of capital import neutrality, the same policy underlying country-of-incorporation exclusions. Capital import neutrality strives to reduce the total income tax burden on a foreign operation of a U.S. multinational business to that borne by its local competitors.\footnote{A discussion of the general features of country-of-incorporation exclusions can be found \textit{supra} Part I.B.} The exclusions differ from the other country-of-incorporation exclusions in Subpart F by not requiring the foreign corporation to be incorporated in the country in which the local market is located.

C. Ordering Rules

The fourth exclusion excludes from foreign base company oil-related income any income that constitutes foreign personal holding company income.\footnote{\textit{See} I.R.C. § 954(g)(1). Much of foreign personal holding company income is excluded anyway by the directive in Code section 907(c)(2) that the base concept of foreign oil-related income is not to include passive income, as that term is defined by Code section 904(d)(2)(A). The definition of passive income includes foreign personal holding company income, any amount included in gross income under Code section 551, and much of the amount included in gross income under Code section 1293. \textit{See} I.R.C. § 954(d)(2)(A). The exceptions in Code section 904(d)(2)(A) to the definition of passive income, which otherwise cause the excepted amounts to be thrown back into foreign oil-related income, are subject to Code section 954(g)(1), which excludes from foreign base company oil-related income any foreign personal holding company income that escapes the definition of passive income in Code section 904(D)(2)(A). Separately, we should note that foreign base company oil-related income does not include some of the amounts described in Code sections 551 and 1293. \textit{See} I.R.C. §§ 904(d)(2)(A), 907(c)(2), 954(g)(1).} Foreign base

\footnote{A controlled foreign corporation's income from oil trading and other commodities transactions may therefore fall within foreign personal holding company income rather than foreign base company oil-related income. \textit{See} I.R.C. § 954(c)(1)(C), (g)(1). For a discussion of income from commodities transactions as a category of foreign personal holding company income, see \textit{Passive Income}, \textit{supra} note 5, at 330-333.
company shipping income also takes priority over foreign base company oil-related income.\(^{154}\) Hence, income derived by a foreign corporation from the use of a vessel to ship crude oil in foreign commerce constitutes foreign base company shipping income, rather than foreign base company oil-related income.\(^{155}\) In turn, foreign base company oil-related income takes priority over foreign base company sales or services income.\(^{156}\) The complete ordering of categories of foreign base company income, from highest priority to lowest, is as follows: (i) foreign base company shipping income that consists of dividends or interest that are attributable to foreign base company shipping income;\(^{157}\) (ii) foreign personal holding company income;\(^{158}\) (iii) all other foreign base company shipping income;\(^{159}\) (iv) foreign base company oil-related income;\(^{160}\) and (v) foreign base company sales and services income.\(^{161}\)

Treasury Regulations section 1.954-1(e)(4)(i), which provides that foreign base company oil-related income takes precedence over foreign personal holding company income, is invalid in this respect since it conflicts with Code section 954(g)(1). The regulation is also invalid to the extent that it conflicts with Code section 954(f), which gives the correct priorities between foreign personal holding company income and foreign base company shipping income. See Treas. Reg. § 1.954-1(e)(4)(iii) – (iv). The regulation should be amended to reflect the addition to the Code of the final sentences of sections 954(f) and (g)(1), which establish the relative rankings of foreign personal holding company income, foreign base company shipping income, and foreign base company oil-related income.

\(^{154}\) See I.R.C. § 954(b)(6)(A).
\(^{155}\) See I.R.C. §§ 907(c)(2)(B), 954(b)(6)(A), (f), (g)(1).
\(^{156}\) See I.R.C. § 954(b)(8).
\(^{157}\) See I.R.C. § 954(f).
\(^{158}\) See I.R.C. § 954(f), (g).
\(^{159}\) See I.R.C. § 954(b)(6)(A).
\(^{160}\) See I.R.C. § 954(b)(8).
\(^{161}\) See I.R.C. § 954(d). Within this pair of categories, the category of foreign base company sales income takes priority over the category of foreign base company services income for items of services income specifically described by the Code as constituting foreign base company sales income. See id. (foreign base company sales income includes certain services income derived by sales agents and purchasing agents).
One difficulty in amending the regulation lies with insurance income, a category of tax haven income separate from foreign base company income. The regulation at present gives insurance income a ranking below foreign base company shipping and oil-related income, while giving it a ranking above foreign personal holding company income. See Treas. Reg. § 1.954-(1)(e)(4). The Code appears to leave open the question of the ranking of insurance income relative to foreign base company income, so the present ordering in the regulation would have been created by the Treasury Department in its discretion. The amendments to Code sections 954(f) and (g)(1) now have raised foreign personal holding company income, a category presently ranked by the regulation below insurance income, to a place above insurance income in the regulation's present hierarchy of tax haven income. See Treas. Reg. § 1.954-1(e)(4). As we change the ranking of foreign personal holding company income in the regulation's hierarchy, what should we do with insurance income? The simple solution of promoting foreign personal holding company income in the hierarchy without changing the relative position of insurance income may be overly facile; the Treasury Department may well have had an excellent reason to rank insurance income over foreign personal holding company income when drafting the existing regulation. Since I have not yet analyzed insurance income in this series of articles, I must give the benefit of the doubt to the Treasury Department. Accordingly, I suggest that we respect the Treasury Department's basic judgment that insurance income take priority over foreign personal holding company income and move both categories of tax haven income in tandem in the regulation's hierarchy. With these comments in mind, I make the following recommendation:

RECOMMENDATION FIVE: Amend Treasury Regulations section 1.954-1(e)(4)(i) to read as follows:

(i) In general. The computations of gross foreign base company income and gross insurance income are limited by the following rules:

(A) If income is insurance income, pursuant to section 953, it shall not be considered income in any category of foreign base company income.
(B) If income consists of dividends or interest and constitutes foreign base company shipping income within the meaning of section 954(f)(1), it shall not be considered income in any other category of foreign base company income.

(C) If income is foreign personal holding company income, pursuant to section 954(c), it shall not be considered income in any other category of foreign base company income, except as provided in paragraph (e)(4)(i)(B) of this section.

(D) If income is foreign base company shipping income, pursuant to section 954(f), it shall not be considered income in any other category of foreign base company income, except as provided in paragraph (e)(4)(i)(B) or (C) of this section.

(E) If income is foreign base company oil-related income, pursuant to section 954(g), it shall not be considered income in any other category of foreign base company income, except as provided in paragraph (e)(4)(i)(B), (C), or (D).

D. Components of Foreign Base Company Oil-Related Income

Once the various screens are applied to foreign oil-related income, the remaining income constitutes foreign base company oil-related income. The components of foreign oil-related income thus are the potential components of foreign base company oil-related income. There are nine components altogether of foreign base company oil-related income: (i) foreign-source income derived from the processing of minerals extracted from oil or gas wells into their primary products;\(^\text{162}\) (ii) foreign-source income derived from the transportation of such minerals or primary products,\(^\text{163}\)

\(^{162}\) See I.R.C. §§ 907(c)(2)(A), 954(g)(1).

\(^{163}\) See I.R.C. §§ 907(c)(2)(B), 954(g)(1).
(iii) foreign-source income derived from the distribution or sale of such minerals or primary products;\textsuperscript{164} (iv) foreign-source income derived from the disposition of assets used in the trades or businesses giving rise to income in any of the first three components;\textsuperscript{165} (v) foreign-source income derived from the performance of directly related services;\textsuperscript{166} (vi) facts-and-circumstances income;\textsuperscript{167} (vii) certain dividends and interest attributable to foreign oil-related income;\textsuperscript{168} (viii) Subpart F inclusions attributable to foreign oil-related income;\textsuperscript{169} and (ix) distributive shares of partnership income and income from estates and trusts if such income is attributable to foreign oil-related income.\textsuperscript{170} The minerals involved are those hydrocarbons produced from oil and gas wells, together with their incidental impurities; the minerals do not include hydrocarbons produced from shale oil or tar sands.\textsuperscript{171}

1. \textit{Processing Income}

The first component of foreign base company oil-related income consists of foreign-source income derived from the processing of minerals extracted from oil or gas wells into their primary products.\textsuperscript{172} Processing includes the refining of crude oil into gasoline and other primary products and the removal of liquids from natural gas.\textsuperscript{173} The foreign corporation is not required to extract the minerals it processes; the minerals can be extracted by a completely unrelated person.\textsuperscript{174} The foreign corporation's group of related persons must be extracting minerals somewhere in the world in order to satisfy the large producer requirement, but

\textsuperscript{164} See I.R.C. §§ 907(c)(2)(C), 954(g)(1).
\textsuperscript{165} See I.R.C. §§ 907(c)(2)(D), 954(g)(1).
\textsuperscript{166} See I.R.C. §§ 907(c)(2)(E), 954(g)(1); see also Treas. Reg. § 1.907(c)-1(g)(1).
\textsuperscript{167} See Treas. Reg. § 1.907(c)-1(f)(6).
\textsuperscript{168} See I.R.C. §§ 907(c)(3)(A), 954(g)(1).
\textsuperscript{169} See I.R.C. §§ 907(c)(3)(B), 954(g)(1).
\textsuperscript{170} See I.R.C. §§ 907(c)(3)(C), 954(g)(1); see also Treas. Reg. § 1.907(c)-2(f).
\textsuperscript{171} See Treas. Reg. § 1.907(c)-1(f)(1).
\textsuperscript{172} See I.R.C. §§ 907(c)(2)(A), 954(g)(1).
\textsuperscript{173} See Treas. Reg. § 1.907(c)-1(d)(4).
\textsuperscript{174} See I.R.C. § 907(c)(2)(A); see also Treas. Reg. § 1.954-8(c)(1).
the foreign corporation is not required to process its own hydrocarbons in order to derive foreign base company oil-related income. Nor is the foreign corporation required to have title to the hydrocarbons it processes; the hydrocarbons might belong to another person and be processed by the foreign corporation under a service contract. 175

The local-extraction exclusion makes it unlikely that the income derived from processing natural gas will ever be included in foreign base company oil-related income. The processing of natural gas is usually performed at plants located quite close to the wells from which the natural gas is produced. The technology of such plants is such that a natural gas plant is relatively small and can easily be located close to the wells it serves. Hence, income from processing natural gas usually arises in the country in which the wells are located, and the income is excluded from foreign base company oil-related income by the local-extraction exclusion. 176

Accordingly, foreign base company oil-related income derived from processing hydrocarbons is generally limited to the income derived from refining crude oil. Oil refineries depend on economies of scale and may be located at a considerable distance from the wells producing the crude oil being refined. Not all income derived from refining crude oil qualifies, however. The local-extraction exclusion excludes refining income arising in the country in which the crude oil was produced, and the local-use exclusion excludes refining income arising in the country in which the refined products are to be used or consumed when sold by the controlled foreign corporation or a related person. 177 Thus, so far as processing operations are concerned, foreign base company oil-related income usually consists of the income derived from offshore refining. An example of such an operation is the refining of Venezuelan crude oil for the United States market in a refinery located on a Caribbean island. The refining income arises on the Caribbean island, where the oil was neither produced nor sold for local consumption.

176 See I.R.C. § 954(g)(1)(A).
177 See I.R.C. § 954(g)(1).
Even if the foreign corporation engages in offshore refining on behalf of a related person, its processing income is foreign base company oil-related income rather than foreign base company services income. The gain realized from the disposition of assets used in refining that gives rise to foreign base company oil-related income is also included in foreign base company oil-related income.

2. Transportation Income

The second component of foreign base company oil-related income consists of foreign-source income derived from the transportation of minerals extracted from oil or gas wells or their primary products. The means of transportation include ships, pipelines, trucks, railroads, and aircraft. The income derived by transporting oil or gas by ship or aircraft, however, is not included to the extent that it constitutes foreign base company shipping income.

In the past, pipeline operations generally did not give rise to foreign base company oil-related income due to the local-extraction and local-use exclusions. Those exclusions require transportation income to arise from shipping hydrocarbons that were neither extracted in the country in which the income arises nor sold by the controlled foreign corporation or a related person for use or consumption in that country. See I.R.C. § 954(g); Treas. Reg. § 1.954-8(c)(2). Thus, a pipeline that gives rise to foreign base company oil-related income generally must pass through parts of at least three countries: the country in which the hydrocarbons were extracted, a country in which the hydrocarbons are consumed, and one or more countries in between. Until relatively recently, few pipelines met that requirement. With the advent of transcontinental pipelines, pipelines that give rise to foreign base

---

178 The classification of income as foreign base company oil-related income takes precedence over its classification as foreign base company services income. See I.R.C. § 954(b)(8).
177 See I.R.C. §§ 907(c)(2)(D), 954(g)(1).
180 See I.R.C. §§ 907(c)(2)(B), 954(g)(1).
181 See Treas. Reg. § 907(c)-1(d)(2).
company oil-related income are more common. An example of such a pipeline would carry hydrocarbons from Turkmenistan either through Iran to Turkey or beneath the Caspian Sea and through the combination of Azerbaijan and Georgia to Turkey. The transportation income derived by the carrier from sources in an intermediate country is foreign base company oil-related income.\textsuperscript{183}

The advent of common-carrier pipelines will also increase the number of pipelines that give rise to foreign base company oil-related income. If a pipeline transports hydrocarbons owned by customers, the carrier cannot take advantage of the local-use exclusion, and a simple two-country pipeline may give rise to foreign base company oil-related income for the carrier.\textsuperscript{184} An example of such a pipeline is a common carrier pipeline transporting natural gas for unrelated persons from Argentina to Chile for sale in Chile by those unrelated persons for use in a Chilean power plant. The transportation income derived by the carrier from transporting the gas through Chile is foreign base company oil-related income. The income the carrier derives from transporting the gas in Argentina is not, due to the local-extraction exclusion.\textsuperscript{185} As the deregulation of pipelines gains favor outside the United States, transportation income will become a more important component of foreign base company oil-related income. The relevant portion of the gain from disposing of either the transcontinental pipeline or the common-carrier pipeline is also included in foreign base company oil-related income.\textsuperscript{186}

In the case of both the transcontinental pipeline and the common-carrier pipeline, the classification of the income as foreign base company oil-related income is inappropriate. In neither instance can the source of the income be manipulated easily to

\textsuperscript{183} See I.R.C. §§ 907(c)(2)(B), 954(g)(1). In the case of a crude oil pipeline, the relevant income is measured by the difference between the fair market value of the crude oil as it entered the intermediate country and its fair market value as it left that country. See Treas. Reg. §§ 1.863-1(b)(1), 1.863-6, 1.954-8(a)(2).

\textsuperscript{184} The local-use exclusion requires that the hydrocarbons be sold for use or consumption by the transporter or a related person. See I.R.C. § 954(g).

\textsuperscript{185} The rules of Treasury Regulations section 1.954-8(c)(2) govern the exact determination of the income that qualifies for the extraction exclusion. See Treas. Reg. § 1.954-8(c)(3).

\textsuperscript{186} See I.R.C. §§ 907(c)(2)(D), 954(g)(1).
take advantage of tax havens. In the example of the transcontinental pipeline, the passage of the pipeline through an intermediate country is a geographical necessity; there is no other way to reach Turkish markets from Central Asia. In the example of the common-carrier pipeline, the source of the income is the country of consumption, a traditional reason not to characterize income as foreign base company income. The income from pipeline operations should be excluded from foreign base company oil-related income.

**RECOMMENDATION SIX:** Amend Code section 954(g) to exclude from foreign base company oil-related income any income arising from pipeline operations.

3. **Distribution and Sales Income**

The third component of foreign base company oil-related income consists of foreign-source income derived from the distribution or sale of minerals extracted from oil or gas wells or their primary products.\(^{187}\) There is no related-person requirement for the sales or purchases.\(^{188}\) Hence, the income from independent tax haven sales operations in hydrocarbons may fall within foreign base company oil-related income even though such income cannot qualify as foreign base company sales income.\(^{189}\) The three exclusions serving as an analogue to the usual country-of-incorporation exclusion of Subpart F -- the local-extraction exclusion, the local-use exclusion, and the local-fueling exclusion -- require that the hydrocarbons involved must not have been extracted (by anyone) in the country in which the distribution operations are located nor sold for use or consumption in that country by the foreign corporation or a related person. See I.R.C. § 954(g)(1). A transaction that would produce income within the

\(^{187}\) See I.R.C. §§ 907(c)(2)(C), 954(g)(1).

\(^{188}\) Compare I.R.C. § 954(d)(1) with I.R.C. §§ 907(c)(2)(C), 954(g)(1).

\(^{189}\) Income that falls nominally in both the category of foreign base company oil-related income and the category of foreign base company sales income is placed definitively in the category of foreign base company oil-related income. See I.R.C. § 954(b)(8).
third component of foreign base company oil-related income is the sale by a foreign corporation of a cargo of crude oil at the Turkish terminus of a Turkmenistan-to-Turkey pipeline for transport to a refinery at Catania, Italy.

The income from the distribution or sale of hydrocarbons does not include the income from extracting the hydrocarbons.\textsuperscript{190} Nor does the third component of foreign base company oil-related income generally include the interest income derived by selling hydrocarbons on credit. Such interest income is usually foreign personal holding company income,\textsuperscript{191} and that characterization overrides that of foreign base company oil-related income.\textsuperscript{192} If interest income falls within an exclusion to foreign personal holding company income, the income then is eligible to fall within foreign base company oil-related income.\textsuperscript{193}

4. \textit{Gain from the Disposition of Certain Assets}

The fourth component of foreign base company oil-related income consists of foreign-source income derived from the disposition of assets used in the trades or businesses giving rise to income falling within any of the first three components, \textit{i.e.}, income from processing, transporting, selling, or marketing hydrocarbons.\textsuperscript{194} Only assets used primarily in those trades or businesses are of concern here.\textsuperscript{195} If an asset is used primarily in those trades or businesses, then all of the gain or loss realized upon the disposition of the asset falls within the fourth category of foreign base company oil-related income even though the asset

\begin{itemize}
\item \textsuperscript{190} Extraction income does not fall within foreign oil-related income, \textit{compare} I.R.C. § 907(c)(1) \textit{and} I.R.C. § 907(c)(2), and thus cannot fall within foreign base company oil-related income, I.R.C. § 954(g)(1). In the example of the sale of oil at the Turkish terminus of a Turkmenistan-to-Turkey pipeline, if the foreign corporation extracted the crude oil itself, the portion of the corporation's receipts from the sale of crude oil equal to the fair market value of the oil at the wellhead in Turkmenistan is extraction income. \textit{See} Treas. Reg. § 1.907(c)-1(b)(2).
\item \textsuperscript{191} \textit{See} I.R.C. § 954(c)(1)(A).
\item \textsuperscript{192} \textit{See} I.R.C. § 954(g)(1).
\item \textsuperscript{193} \textit{See} Treas. Reg. § 1.907(c)-1(d)(3).
\item \textsuperscript{194} \textit{See} I.R.C. §§ 907(c)(2)(D), 954(g)(1).
\item \textsuperscript{195} \textit{See} Treas. Reg. § 1.907(c)-1(e)(1), (2).
\end{itemize}
might have secondarily been used in another trade or business; the gain or loss is not pro-rated to recognize the contribution the asset made to the secondary trade or business.\textsuperscript{196} The disposition of shares of stock in any corporation, whether domestic or foreign, does not give rise to income within this component of foreign base company oil-related income.\textsuperscript{197}

5. Income from Directly Related Services

The fifth component of foreign base company oil-related income consists of foreign-source income derived from the performance of services directly related to the processing, transportation, distribution, or sale of minerals produced from oil or gas wells or their primary products, \textit{i.e.,} from services directly related to operations that give rise to income within the first three components of foreign base company oil-related income.\textsuperscript{198} There is no requirement that the related services be performed for the benefit of a related person.\textsuperscript{199} Also included in the fifth component is the income derived from leasing or licensing assets used in operations giving rise to income within the first three components.

\textsuperscript{196}See Treas. Reg. § 1.907(c)-1(e)(2).
\textsuperscript{197}See Treas. Reg. §§ 1.907(c)-1(e)(3), 1.907(c)-2(b)(1).
\textsuperscript{198}See I.R.C. §§ 907(c)(2)(E), 954(g)(1); see also Treas. Reg. § 1.907(c)-1(g)(1), (g)(2)(i). The regulation restricts the definition of relevant services in two ways. First, the regulation restricts the services to only those that are directly related. See Treas. Reg. § 1.907(c)-1(g)(1). Second, the regulation restricts the related services to those that are related to the active conduct of the operations listed in Code section 907(c)(2)(A), (B), and (C), \textit{i.e.}, the operations giving rise to income within the first three components of foreign oil-related income. See Treas. Reg. § 1.907(c)-1(g)(2). The regulation also asserts that the fifth component of foreign oil-related income includes income from certain types of services described in the foreign base company shipping income regulations. See Treas. Reg. § 1.907(c)-1(g)(2)(i). In the context of foreign base company oil-related income, the reference can only be to services for the oil and gas industry that are analogous to those described in Treasury Regulations section 1.954-6(d) for the shipping industry, and not to services that are identical. If the reference was to identical services, the income derived from such services could only be foreign base company shipping income since foreign base company shipping income takes precedence over foreign base company oil-related income. See I.R.C. § 954(b)(6)(A).
\textsuperscript{199}See Treas. Reg. § 1.907(c)-1(g)(2)(iii).
of foreign base company oil-related income.\(^{200}\) Such assets can include intellectual property.\(^{201}\) Excluded from the fifth component is income arising from the performance of insurance, accounting, or managerial services, unless those services are performed by the same person who is conducting the underlying operations of processing, transporting, distributing, or selling.\(^{202}\)

The regulations effectively grant a general exclusion from the fifth category of foreign base company oil-related income. A person does not have any directly-related services income whatsoever if either of two conditions is met. First, a person has no directly-related services income if the person has neither foreign oil-related income nor foreign oil and gas extraction income.\(^{203}\) Second, a person who does have foreign oil-related income or foreign oil and gas extraction income will still have no directly-related services income if the sum of the person’s foreign oil-related income and foreign oil and gas extraction income constitutes less than half of its gross foreign source income and if less than half of its directly-related services income is derived from performing services for or on behalf of related persons or from leasing or licensing assets to related persons.\(^{204}\)

6. Facts-and-Circumstances Income

The sixth component of foreign base company oil-related income consists of income that, under the facts and circumstances of the particular case, is directly attributable to the activities giving rise to income in any of the first five components.\(^{205}\) For

\(^{200}\) See Treas. Reg. § 1.907(c)-1(g)(1), (3).

\(^{201}\) See Treas. Reg. § 1.907(c)-1(g)(3).

\(^{202}\) See Treas. Reg. § 1.907(c)-1(g)(2)(iv)(B).

\(^{203}\) See Treas. Reg. § 1.907(c)-1(g)(1)(i). Foreign oil and gas extraction income is defined in Code section 907(c)(1) and Treasury Regulations section 1.907(c)-1(b).

\(^{204}\) See Treas. Reg. § 1.907(c)-1(g)(1)(ii), (iii). A foreign corporation is treated as a domestic corporation for purposes of measuring its gross income. See Treas. Reg. § 1.907(c)-1(g)(5). A related person for this purpose is any partnership or partner described in Code section 707(b)(1) and any corporation that would be described in Code section 954(d)(3) if it were a controlled foreign corporation. See Treas. Reg. § 1.907(c)-1(g)(4).

\(^{205}\) See Treas. Reg. § 1.907(c)-1(f)(6).
example, if a refinery located outside the United States is expropriated by a foreign government, the compensation paid to the former owner falls within this component of income.\(^{206}\) The expropriation may also be said to be a disposition of the refinery within the meaning of the fourth component of foreign base company oil-related income.\(^{207}\)

7. **Certain Dividends and Interest**

The seventh component of foreign base company oil-related income consists of certain dividends and interest to the extent that they are attributable to foreign oil-related income.\(^{208}\) The qualifying dividends and interest are those paid by a foreign corporation “in respect of which taxes are deemed paid by the taxpayer under section 902....”\(^{209}\) This requirement entails a minimum ownership interest by a domestic corporate shareholder in the paying corporation.\(^{210}\) In the context of foreign base company income, this requirement also entails that the payor and recipient of the dividend or interest be related, in the sense that a U.S. shareholder of a recipient controlled foreign corporation must own, directly or indirectly, sufficient stock in the paying corporation to qualify for the indirect foreign tax credit of Code section 902 with regard to distributions made by the payor. Thus, the payor and any recipient controlled foreign corporation must have a common corporate U.S. shareholder, which must qualify as

\(^{206}\) See id. But any interest paid on the claim that fails within the definition of foreign personal holding company income is not foreign base company oil-related income, despite the regulation. See I.R.C. § 954(g)(1). The same is true of the regulations’ example of advance deposits paid for oil. See Treas. Reg. §1.907(c)-1(c)(6). If the corresponding discount on the price reflects the time value of money, the discount may be foreign personal holding income rather than foreign base company oil-related income. See I.R.C. § 95(g)(1). Note that the regulations under Code section 907 become subject to the provisions of Code sections 951-964 when we incorporate those regulations into the jurisprudence of Subpart F.

\(^{207}\) See Treas. Reg. § 1.907(c)-1(f)(6).

\(^{208}\) See I.R.C. §§ 907(c)(3)(A), 954(g)(1).

\(^{209}\) See I.R.C. §§ 907(c)(3)(A). This requirement is similar to one used to define certain dividends and interest as foreign base company shipping income. See I.R.C. § 954(f)(1).

\(^{210}\) See Treas. Reg. § 1.907(c)-2(c)(1).
a United States shareholder with reference to the controlled foreign corporation. Although the dividends and interest must be paid by a foreign corporation, they may be of either foreign source or U.S. source.

There are few dividends and little interest that fall within this component of foreign base company oil-related income, primarily due to the fact that the category of foreign personal holding company income takes priority over foreign base company oil-related income in the classification of foreign base company income. Foreign personal holding company income generally includes all dividends and interest, and thus dividends and interest generally cannot be included in foreign base company oil-related income. To be sure, there are exclusions from foreign personal holding company income for certain dividends and interest; thus, dividends or interest attributable to foreign oil-related income and excluded from foreign personal holding company income by one of those exclusions are eligible for inclusion within the category of foreign base company oil-related income. There are four exclusions from foreign personal holding company income for dividends or interest: the exclusion for export-related interest, the related-person exclusion, and the pair of

\[211\] A U.S. shareholder is defined by Code section 951(b). Only U.S. shareholders have Subpart F inclusions. See I.R.C. § 951(a)(1).

\[212\] Compare I.R.C. § 907(c)(2) (income restricted to foreign-source income) with I.R.C. § 907(c)(3) (no such restriction). Dividends and interest paid by a possessions corporation are also eligible for inclusion in foreign base company oil-related income. See Treas. Reg. § 1.907(c)-2(e).

\[213\] See I.R.C. § 954(g)(1). Furthermore, interest and dividends that constitute foreign personal holding company income are excluded from the base category of foreign oil-related income and thus cannot be included within the derivative category of foreign base company oil-related income. See I.R.C. §§ 904(d)(2)(A), 907(c)(2).

\[214\] See I.R.C. § 954(c)(1)(A), (g)(1). This problem does not arise with dividends and interest attributable to foreign base company shipping income, since the Code provides that such shipping income takes priority over foreign personal holding company income. See I.R.C. § 954(b)(6)(A).

\[215\] See I.R.C. § 954(c)(2)(B). The exclusion for export-related interest is unlikely to produce interest falling within foreign base company oil-related income. In general terms, export-related interest consists of interest derived in the conduct of a banking business from financing the sale of goods manufactured in the United States for use outside the United States. See id. Hence, to qualify for this
exclusions available for income derived in the active conduct of a banking or insurance business. As the notes indicate, few dividends and little interest excluded from foreign personal holding company income will qualify as foreign base company oil-related income.

exclusion, the recipient of the interest must be engaged in the banking business and the payor must be engaged in the sale, for use outside the United States, of goods manufactured in the United States. Interest paid for the financing of such sales is unlikely to be attributable to foreign oil-related income. For a discussion and a more extensive description of the exclusion for export-related interest, see Passive Income, supra note 5, at 299-305.

See I.R.C. § 954(c)(3). The related-person exclusion applies to dividends and interest received from a related person who is incorporated in the same country as the recipient and who has a substantial part of its business assets located in that country. See I.R.C. § 954(c)(3)(A)(i). For a discussion and a more extensive description of the related-person exclusion, see Passive Income, supra note 5, at 306-318. The related-person exclusion is not available for interest attributable to foreign base company oil-related income, since such interest generally reduces the payor's Subpart F income and is therefore subject to a throw-back rule. See I.R.C. §§ 952(a)(2), 954(a)(5), (c)(3)(B); see also Treas. Reg. § 1.907(c)-2(d)(2).

Hence, the related person exclusion is useful, with regard to interest, only for interest attributable to foreign oil-related income that is not also foreign base company oil-related income. Furthermore, the related-person exclusion is not useful with regard to dividends paid by controlled foreign corporations and attributable to their foreign base company oil-related income. Such dividends are excluded from the gross income of the recipient controlled foreign corporation by Code section 959(b) with regard to a common U.S. shareholder. See I.R.C. § 959(b).

See I.R.C. § 954(h), (i). Interest or dividends received by a bank or insurance company may well be attributable to foreign oil-related income, but the definition of foreign base company oil-related income requires the financial institution to be related to the payor generally by means of a common U.S. shareholder. See I.R.C. §§ 907(c)(3)(A), 954(g)(1). Moreover, the financial institution must meet the large producer requirement. See I.R.C. § 954(g)(2). Few banks and insurance companies will meet these requirements.

See supra notes 213 to 217. For those dividends and interest payments that are eligible to be included within foreign base company oil-related income by virtue of an exclusion from foreign personal holding company income and by virtue of the large producer requirement being satisfied, the regulations under Code section 954(g) need to address the following matters: (i) the identity of the requisite payor; (ii) the identity of the requisite recipient; (iii) the attribution of the payment to the payor's foreign oil-related income; (iv) limiting the dividends and interest that constitute foreign base company oil-related income to those received by a controlled foreign corporation; and (v) limiting those dividends to those attributable to foreign base company oil-related income, rather than to
8. **Subpart F Inclusions**

The eighth component of foreign base company oil-related income consists of Subpart F inclusions attributable to foreign oil-related income. Foreign entities, however, cannot have Subpart F inclusions; only U.S. shareholders have Subpart F inclusions. Hence, no foreign entity will ever have income falling within this component of foreign base company oil-related income. The drafting technique of incorporating one Code provision into another -- in this case, incorporating Code section 907(c)(3) into the definition of foreign base company oil-related income -- has produced a nonsensical result.

9. **Income from Partnerships, Trusts, and Estates**

The ninth component of foreign base company oil-related income consists of distributive shares of partnership income and income from estates and trusts to the extent that such income is attributable to foreign oil-related income. The Code specifies only the foreign entity's distributive share of partnership income for this component of foreign base company oil-related income; the regulations add trust and estate income on their own authority. The holder of a small interest in a partnership may find that its distributive share of partnership income is excluded from foreign oil-related income. A limited partner or a corporate general partner holding less than a ten percent interest generally

---

those attributable to foreign oil-related income. The treatment of the first four items could draw upon the regulation dealing with dividends and interest attributable to foreign base company shipping income. See Treas. Reg. § 1.954-6(f). The fifth item would preserve the value of the threshold screens that serve as an analogue to a country-of-incorporation exclusion and thus serve the policy of capital import neutrality. Without the suggested limitation, income of local derivation would lose its exclusion once it is distributed as a dividend.

220 See I.R.C. § 951(a)(1).
221 See I.R.C. §§ 907(c)(3)(C), 954(g)(1); see also Treas. Reg. § 1.907(c)-2(f).
222 See I.R.C. §§ 907(c)(3)(C), 954(g)(1).
223 See Treas. Reg. § 1.907(c)-2(f).
will have its distributive share of income characterized as passive income rather than as foreign oil-related income.\textsuperscript{224}

IV. CONCLUDING OBSERVATIONS AND SUMMARY OF RECOMMENDATIONS

Foreign base company shipping income and foreign base company oil-related income share a similar statutory structure. Neither category of income has a general requirement that a related person participate in the controlled foreign corporation's transactions that give rise to the income. In addition, the Code establishes that entities other than controlled foreign corporations may derive either kind of income and traces that income into the hands of controlled foreign corporations when the income is paid out in the form of interest or dividends or appears in distributive shares of partnership income.

The Code's treatment of foreign base company oil-related income illustrates one of the problems of drafting by reference. That drafting technique frequently permits the drafter to achieve economy and consistency. By incorporating a pre-existing Code concept into a new provision, the drafter takes advantage of the efforts of past drafters and may concentrate on what is essentially different in the new provision. In addition, the drafter reduces the possibility of inconsistent or incomplete amendments to the Code in the future. The future drafter needs only to amend one provision of the Code, and the related statutory sections that incorporate that provision are updated simultaneously and in an identical manner. The incorporation of Code sections 907(c)(2) and (3) by the drafters of section 954(g) shows one of the drawbacks of the drafting method, however. Wholesale incorporation can result in excess baggage being imported into the new provision. The excess verbiage creates unnecessary complexity as well as the potential for misunderstanding. In the case of Code section 954(g), there are categories of income described in section 907(c)(3) that cannot exist or very rarely exist when transported into the confines of section 954(g).\textsuperscript{225} One of this Article's contributions to the literature of

\textsuperscript{224} See Treas. Reg. §§ 1.904-5(h)(2)(i), 1.907(c)-2(f).
\textsuperscript{225} See supra Parts II.D.6 and 7.
controlled foreign corporations is its sorting out of the relationship between section 907(c) and 954(g) and suggesting a coherent reading for section 954(g).

This Article has made six recommendations. The first four deal with foreign base company shipping income. Recommendation One takes advantage of the statutory parallels between foreign base company shipping income and foreign base company oil-related income. The recommendation would amend the regulations under Code section 954(f) to provide that the necessary relation between payor (or issuer) and controlled foreign corporation with regard to certain dividends, interest, and gains be that described by Code section 902 for the indirect tax credit. The recommendation would also confine the regulation within the bounds of its statutory authority. Recommendation Two would amend the country-of-incorporation exclusion so that it was available for all components of foreign base company shipping income. The recommendation would also narrow the exclusion to take into account the occasional difference between a corporation's place of incorporation and its place of management and control, and the effect of that difference on residence-based taxation.

Recommendation Three would eliminate the specialized exclusion for dividends paid out of foreign base company shipping income and rely on the more general exclusion provided by Code section 959 for dividends paid out of any component of foreign base company income. The general exclusion is more effective in preventing foreign base company shipping income from avoiding United States taxation altogether. Recommendation Four would adjust the relationship between Code sections 883(a) and 954(f) to prevent the thwarting of much of the purpose of section 954(f) by the overly broad exemption in Code section 883(a) of income derived from the international operation of ships and aircraft from U.S. income taxation generally.

---

226 See supra Part I.A.6(a) for the specific text and a discussion of Recommendation One.
227 See supra Part I.B. for the specific text and a discussion of Recommendation Two.
228 See supra Part I.D. for the specific text and a discussion of Recommendation Three.
229 See supra Part I.E. for the specific text and a discussion of Recommendation
The last two recommendations address foreign base company oil-related income. Recommendation Five would correct the regulations to reflect amendments to the Code with regard to the priorities among the categories of foreign base company income (and other Subpart F income) in cases in which income falls within more than one category of tax haven income. In particular, the relationships between foreign base company shipping income that consists of dividends and interest, foreign personal holding company income, foreign base company shipping income that does not consist of dividends and interest, and foreign base company oil-related income need to be reflected in revised regulations.\(^{230}\)

Recommendation Six would exclude income from pipeline operations from foreign base company oil-related income. Such income traditionally was excluded by the operation of several screens that together serve as a country-of-incorporation exclusion for foreign base company oil-related income. With the advent of transcontinental pipelines and the possibility of international common-carrier pipelines, those screens can no longer be relied upon to serve that purpose and a formal exclusion for income from pipeline operations has become necessary.\(^{231}\)

\(^{230}\) See supra Part II.C. for the specific text and a discussion of Recommendation Five.

\(^{231}\) See supra Part II.D.2. for the specific text and a discussion of Recommendation Six.