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Richard J. Horwich

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THE CONSTITUTIONALITY OF SUBPART F OF THE INTERNAL REVENUE CODE

RICHARD J. HORWICH*

I. INTRODUCTION

For the more than five decades of corporate income taxation prior to 1961, corporations organized abroad were generally not subject to United States income tax on foreign income, even if they were controlled by United States residents.[1] When the administration proposed in early 1961 to reach the foreign income of many controlled foreign corporations by taxing the *stockholders* currently, a good deal of consideration was given to the question of whether or not such taxation would violate the United States Constitution. Without deciding the propriety of Congress concerning itself about constitutionality,[2] it is necessary for the tax bar to evaluate the validity of the legislation finally enacted in 1962. This discussion relates to subpart F,[3] the matter of controlled corporations; other aspects of the taxation of foreign income by The Revenue Act of 1962, although possibly raising constitutional questions, are outside the scope of this article.[4]

II. THE EVOLVING PROPOSAL

Subpart F did not reach enactment in a smooth or customary manner. There have been many changes between the first gleam in Professor Surrey's eye and the most recent regulations approved by Assistant Secretary Surrey. It is one thesis of this article that the applicability of certain rules of constitutional law has varied with these changes, so that a particularly cogent argument, pro or con, at one stage of the proposal may miss the target when addressed to a later version.

In 1956, Professor Surrey, although encouraging the study of tax deferral for domestic corporations with all income from foreign sources,

* Partner, Pallot, Marks, Lundeen, Poppell & Horwich, Miami, Florida; Lecturer in Law, University of Miami School of Law.

1. Tariff of 1909, § 38, 36 Stat. 113 (1909); INT. REV. CODE OF 1954, §§ 881(a), 882(b). Foreign personal holding companies, a limited exception, are discussed later.

2. See PAUL, TAXATION FOR PROSPERITY 211 (1947).

3. INT. REV. CODE OF 1954, §§ 951-64. Subpart G, sections 970-72, deals with export trade corporations, an exception to subpart F.

4. Some of the areas in which constitutional problems have been suggested but which are not considered in this article are these:

The grossing-up provisions of §§ 902 and 78, taxing to the domestic parent the amount of foreign taxes paid by a foreign subsidiary.

The treatment of some proceeds of a sale or exchange of stock of a controlled foreign corporation as a dividend under § 1248.

The current taxation of the income of non-electing foreign investment companies to their stockholders under §§ 1246 and 1247.

The extent to which Congress has delegated rule-making power to the Secretary of the Treasury under the various foreign income provisions of The Revenue Act of 1962.

mentioned in passing the possibility of taxing foreign subsidiaries currently; he referred to either taxation of the exercise in the United States of control and management of a foreign corporation or taxation of ownership of the stock of a foreign corporation.[5] For a few years, the trend of critical thinking was in favor of more liberal treatment of foreign income of corporations, particularly along the lines of benefits for domestic corporations.[6] But one writer concluded a discussion of the Boggs Bill, an unadopted attempt to benefit domestic corporations receiving foreign income, with these prophetic words:

> Perhaps the most significant effect it has had is to stimulate some embryonic new thinking about our taxation of foreign income—thinking which moves in the opposite direction from the liberalization which Representative Boggs intended.[7]

Indeed, despite suggestions that taxation should not be used to attempt to control foreign investment,[8] the administration proceeded in early 1961 to seek a major change in the taxation of foreign corporations. The proposal was to tax earnings of foreign corporations to United States stockholders currently unless the foreign corporations were organized in less developed countries; tax on the latter corporations would remain deferred unless they were tax haven corporations, *i.e.*, corporations deriving more than 20 per cent of their income from outside the country of organization.[9]

Now the path became irregular.[10] After extensive hearings, the Ways and Means Committee could not report a bill and asked the Treasury Department to draft one, preserving deferral except for tax haven corporations. A draft bill by the Treasury Department was released July 28, 1961 and revised thereafter. The Ways and Means Committee resumed hearings in 1962 and H.R. 10650 was reported out and passed by the House on March 29, 1962; the Committee compromised its original request by permitting deferral by non-tax haven corporations which reinvested their earnings in their businesses. After more extensive hearings before the Senate Finance Committee in April and May, that Com-

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5. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 826-27 (1956).

6. *E.g.*, Lidstone, *Double Taxation of Foreign Income? Or an Adventure in International Double Talk?* 44 VA. L. REV. 921 (1958).

7. Tillinghast, *Taxation of Foreign Investment: A Critique of the Boggs Bill*, 16 TAX L. REV. 81, 118 (1960).

8. Anthoine & Bloch, *Tax Policy and the Gold Problem: An Agenda for Inquiry*, 61 COLUM. L. REV. 322 (1961); Surrey, *The United States Taxation of Foreign Income*, 1 J. LAW. & ECON. 72 (1958).

9. U.S. TREAS. DEP'T PRESIDENT'S TAX PROGRAM—OFFICIAL EXPLANATION 11-15 (1961), in *Hearings Before the House Ways and Means Committee on the President's 1961 Tax Recommendations*, 87th Cong., 1st Sess. 253 (1961).

10. See generally Stone, *Taxation on Private Investments Abroad—Legal Aspects (Part 1)*, 4 SW. L. FN. INST. ON PRIV. INV. ABROAD 195 (1962).

mittee also asked for a new draft by the Treasury Department, which was forthcoming May 31, 1962; this draft incorporated major changes:

(a) Foreign manufacturing subsidiaries were not reached, unless they loaned or otherwise repatriated assets to the United States; reinvestment of earnings in the business was no longer relevant.

(b) Intangible industrial rights, *e.g.*, patents, were taxed at transfer rather than classifying compensation for use of them as tax haven income.

(c) Service income was included as tax haven income.

(d) The Secretary of the Treasury was authorized to permit deferral upon finding no purpose of tax reduction.

(e) Deferral for investment increase in less developed countries was limited to investment income derived from less developed countries.

There were additional hearings, but a more regular course followed. The Finance Committee Report,[11] essentially the final act, raised the floor on significant tax haven income to 30 per cent of gross income, permitted individual United States shareholders to elect corporate rates in certain instances, and added two more escape valves (or loopholes):

(a) Exemption from the legislation if a sufficient portion of the earnings of the foreign subsidiary is distributed, depending on the foreign tax rate.

(b) Exemption for export trade corporations.

Since subpart F became law on October 16, 1962, the Treasury Department has issued proposed and final regulations of impressive length and complexity[12] and the subpart F regulations probably are now substantially complete.[13] They hold little significance for constitutional issues, except, perhaps, for the firm attitude toward indirect control of foreign corporations[14] and the rather startlingly detailed rules

11. S. REP. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 CUM. BULL. 785-86. Of major significance, the Senate also deleted the proposed additions to § 482.

12. This may fuel the fires under the last constitutional issue listed in note 4 *supra*, relating to the extent of authority delegated to the Secretary of the Treasury.

13. In September of 1964, Assistant Secretary Surrey advised that all regulations under the 1962 subpart F provisions would be published by the end of 1964. Surrey, *The United States Tax System and International Tax Relationships*, 43 TAXES 6, 26 (1965). At least one substantial exception was T.D. 6795 published January 29, 1965. 30 Fed. Reg. 933 (regulations under § 951 and amendments of other subpart F regulations).

14. Treas. Reg. § 1.957-1(b),(c) (1963). *Cf.* Treas. Reg. § 1.951-1(e)(2),(3),(4) and (g)(2) (1965) (determination of prorata share of subpart F income and of voting power, when there is more than one class of stock). The final regulations under § 957 are even stricter than the proposed regulations. Friedman & Silbert, *Final Regulations on Controlled Foreign Corporations and Less Developed Country Corporations*, N.Y.U. 22D INST. ON FED. TAX 811, 813-823 (1964); Hughes, *First Foreign Income Regulations Are Adopted; Do They Exceed the Intent of the Statute?*, 20 J. TAXATION 24 (1964).

established to determine the destination of sales, location of production, and place of performance of services.[15]

One way to measure the impact of subpart F is to review the tax avoidance proposals of tax planners:

1. Decontrol of foreign corporations.

2. Combining foreign businesses so that over 70 per cent of the gross income of the foreign corporation is non-tainted: from manufacturing, trading with unrelated parties, trading or rendering services in the country of organization.

3. Use of export trade corporations.

4. Securing Treasury approval because actual foreign taxes are at least 90 per cent of taxes avoided, showing no purpose of tax reduction.

5. Wise use of foreign tax credit.

6. Minimum adequate distributions of earnings.

7. Use of Western Hemisphere Trade Corporations and possessions corporations.

8. Investments in less developed countries by tax haven corporations.

9. Election of individual to use corporate rates.

10. Avoiding repatriation of earnings when taxation is otherwise deferred.[16]

III. The Taxing Power

The Constitution does grant the power "to lay and collect taxes,"[17] but another provision requires that "direct taxes shall be apportioned among the several States" according to their respective populations.[18] When the Supreme Court held an 1896 income tax unconstitutional because a tax on income from property was considered a direct tax on property,[19] the Constitution was modified by addition of the sixteenth amendment:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment

15. Treas. Reg. § 1.954-3, 4 (1964).

16. Hoefs & Bunge, *How to Minimize the Tax Impact on Foreign Operations under the 1962 Act*, 19 J. Taxation 346 (1963). Wender similarly discusses several of the methods and concludes that no single method is best to minimize United States tax in all cases. Wender, *Tax Planning for International Operations Under the Revenue Act of 1962—A Case Study*, 41 Taxes 835, 848-57 (1963).

17. U.S. Const. art. I, § 8, cl. (1).

18. U.S. Const. art. I, § 2, cl. (3).

19. Pollock v. Farmers Loan & Trust Co., 157 U.S. 429, *rehearing*, 158 U.S. 601 (1895).

among the several States, and without regard to any census or enumeration.[20]

Between the inception of the amendatory process and the final certification of ratification, the Supreme Court upheld a tax on corporate income as an excise tax on doing business as a corporation.[21] Consequently, there has been a corporate income tax continuously, and the Court has not dealt with a system which does not tax corporations separately.[22] So the accurate argument that the Court generally recognizes the separate existence of corporations for tax and other purposes[23] does not indicate that the Court would object on constitutional grounds to ignoring the corporation in taxing income.[24]

However, the language of the Court in *Eisner v. Macomber*[25] goes beyond merely recognizing the separate existence of corporations. In that case the Court held that a stock dividend not changing the proportionate interests of shareholders is not taxable, neither as a valuable thing received nor as evidence of an increase in the stockholder's undistributed share of the corporate net worth. The Court addressed itself to the latter basis in these words:

> That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question; and that such interests might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require appor-

20. U.S. CONST. amend. XVI.

21. Flint v. Stone Tracy Company, 220 U.S. 107 (1911).

22. The trend among the nations of the world is to tax corporate income separately. U.N. ECOSOC. COMPARATIVE APPROACH TO NATIONAL AND INTERNATIONAL CORPORATE TAX PROBLEMS, Fiscal Comm., 3d Sess. 30-33 (E/CN 8/55) (1951).

23. *Hearings on the President's 1961 Tax Recommendations, supra* note 9, at 311-12.

24. In Helvering v. National Grocery Co., 304 U.S. 282 (1938), the Court upheld the special corporate tax on unreasonably accumulated earnings. The following passage seems worth noting on this point:

> It is said that the statute is unconstitutional because the liability imposed is not a tax upon income, but a penalty designed to force corporations to distribute earnings in order to create a basis for taxation against the stockholders. If the business had been carried on by Kohl individually all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners, although these had been retained by the partnership undistributed. . . . *Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits.* If it preferred, Congress could lay the tax upon the corporation, as was done. . . ." 304 U.S. at 288. (Emphasis supplied.)

The footnote to the emphasized dictum gives authorities which fall roughly into three groups: (1) cases upholding the taxation to parent corporations of pre-1913 earnings distributed by wholly-owned subsidiaries; (2) foreign personal holding company provisions, and (3) the various acts taxing unreasonably accumulated earnings, some levied on the stockholders and some on the corporations. In the last connection, although the pre-1920 taxes were all against shareholders and the post-1920 taxes all against the corporations, no mention is made of the 1920 decision of the Court in *Eisner v. Macomber*, discussed *infra* in the text.

25. 252 U.S. 189 (1920).

> tionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court. . . .
>
> Manifestly this argument must be rejected, since the Amendment applies to income only, and what is called *the stockholder's share in the accumulated profits of the company is capital, not income.* As we have pointed out, a stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation, prior to dividend declared.[26] (Emphasis supplied.)

Earlier in its opinion, the Court discussed at length the distinction between capital and income under the constitutional amendment and defined income as something "*proceeding from* the property, *severed from* the capital."[27] It is upon that distinction, and upon its application to the taxation of shareholders on increases in undistributed net worth, both as stated in *Eisner v. Macomber*, that most doubts of the constitutionality of subpart F are predicated.[28]

By the same token, proponents of constitutionality cast their doubts upon the decision in *Eisner v. Macomber* itself:[29] The decision was five to four, with two strong dissenting opinions by Justices Holmes and Brandeis, and the dissents went to the issues pertinent to subpart F. Later, in *Helvering v. Bruun*,[30] the Court held that the value added to land by buildings erected by a lessee could be taxed as income to the lessor in the year in which he repossesses his land; the Court indicated that *Eisner v. Macomber* retained validity only to distinguish ordinary dividends from stock dividends.[31]

On the other hand, one may rush to the aid of *Eisner v. Macomber* with mention of the refusal of the Court to overrule it in *Helvering v. Griffiths*,[32] a five to four decision rendered two years after *Helvering v. Bruun*. And much more recently the Court, in the process of rejecting *Eisner v. Macomber* as determinative of all gross income questions, nevertheless described the case as useful in "distinguishing gain from capital."[33] Even the broadest language in *Helvering v. Bruun* appears to contain some limitation on realization of income:

> *While it is true that economic gain is not always taxable as income,* it is settled that the realization of gain need not be

26. *Id.* at 217, 219.
27. *Id.* at 207.
28. *E.g., Hearings on the President's 1961 Tax Recommendations, supra* note 9, at 312-13; Dowdle, *Can Domestic Shareholders Be Taxed on Foreign Corporate Earnings Prior to Distribution?*, 40 TAXES 436 (1963).
29. *E.g., Hearings on the President's 1961 Tax Recommendations, supra* note 9, at 314-16.
30. 309 U.S. 461 (1940).
31. *Id.* at 468-9.
32. 318 U.S. 371 (1942).
33. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-31 (1955) (punitive damages recovered in antitrust suit held taxable).

> cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit *realized from the completion of a transaction.*[34] (Emphasis supplied.)

It seems fair to infer that a "transaction" is an essential ingredient of realization.[35] The distinction between completion of a transaction and passage of an annual accounting period is long-standing.[36] Recognizing these factors, as well as the possible vitality of *Eisner v. Macomber*, one must conclude that the power to tax economic gain in this situation is surprisingly uncertain for a major change in the tax law.[37]

IV. THE COMMERCE POWER

As H.R. 10650 went into Senate Finance Committee hearings, one of the main purposes of the proposal was to make the immediate balance of payments more favorable to the United States.[38] It was, therefore, argued convincingly that the power of Congress "to regulate commerce with foreign nations"[39] was applicable and could be exercised by a tax measure not subject to the constitutional limitations on pure revenue measures.[40]

At that stage, it seemed that the legislation would not run afoul of the only relevant limitation on the power to regulate foreign commerce, the need to use reasonable means substantially related to the objective.[41] Then the Finance Committee, as previously mentioned, excepted manufacturing income from the impact of the act, thus encouraging the export of manufacturing investment. Further, the admonition to Congress to make legislative findings indicating use of the commerce power[42] was not heeded in the act itself[43] or in the Finance Committee

34. 309 U.S. at 469.

35. *Cf.* Robert Lehman, 17 T.C. 652 (1951), *acq.*, 1951-1 CUM. BULL. 3, *acq. withdrawn*, T.I.R. 248, Aug. 29, 1960 (lapse of restrictions on stock received as payment held not a taxable event); Kempler, *Non-Restricted Option Plans: Kuchman and Lehman Cases*, 16 TAX L. REV. 339, 344-45 (1961).

36. Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931). The regulations under subpart F hew strictly to the concept of accounting periods. See Treas. Reg. § 1.964(b)(iv) (1964) (computing profits "without regard to equalization over more than one accounting period").

37. It is also argued that the taxing power may reach the American shareholder under the doctrine of constructive receipt, in order to prevent tax avoidance. *Hearings on 1961 Tax Recommendations*, *supra* note 9, at 314. Since this argument leans heavily on the similar provisions taxing foreign personal holding companies, it is considered in regard to that analogy, *infra* in the text. Tax avoidance problems may also affect due process limitations, discussed *infra* in the text.

38. *Hearings Before the Senate Finance Committee on H.R. 10650*, 87th Cong., 2d Sess. 173-217 (1962).

39. U.S. CONST. art. I, § 8, cl. (3).

40. *Hearings on the President's 1961 Tax Recommendations*, *supra* note 9, at 318-21. The cases there cited bear out the argument.

41. *Id.* at 321-22.

42. *Id.* at 322.

43. The title of The Revenue Act of 1962 comes no closer than "to eliminate certain defects and irregularities"; there is no declaration of legislative intent. 76 Stat. 960 (1962).

report.[44] Thus a strong legal position has been undermined, to some degree, by matters of fact and form; the evolution of the proposal has been particularly telling in this area.

V. Due Process

The Court has held that the due process clause of the fourteenth amendment prevents a state from taxing a man on his wife's income;[45] the federal government is, of course, subject to a similar due process clause.[46] In support of subpart F, it is pointed out that income may be taxed to persons having the real control or enjoyment and to persons who must be deemed to constructively receive income in order to prevent tax avoidance.[47] Applying these rules is more difficult than stating them.

Subpart F measures a United States taxpayer's income by his proportionate share of the income of a foreign corporation if he owns as little as ten per cent of its stock.[48] There is not much problem with wholly-owned subsidiaries; complexity and constitutional difficulties increase with the attribution rules, minority investors, beneficiaries of estates, and the like.[49]

But, at least at the current stage of development of the constitutional law of income tax, it is hard to distinguish the degree of tax avoidance that will justify taxing the stockholder on undistributed corporate profits from that which would justify measuring his tax by the corporate income;[50] in other words, if the power is there because of tax avoidance,

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44. The declared purpose is to end tax haven abuses and deferral, both as to all of the foreign income provisions generally, S. Rep. No. 1881, *supra* note 11, at 708, and as to subpart F particularly. *Id.* at 784-85. On the other hand, the domestic investment credit was expressly declared to be intended to aid in meeting the balance of payment problem. *Id.* at 707. At the Finance Committee hearings, Secretary of the Treasury Dillon had pointed out that tax haven corporations repatriated to the United States only about one third as much as their earnings (about 15%) as other controlled foreign corporations (about 45%). *Hearings on H.R. 10650, supra* note 38, at 4314-15.

45. Hoeper v. Tax Commissioner, 284 U.S. 206 (1931).

46. U.S. Const. amend. V. Heiner v. Donnan, 285 U.S. 312 (1932).

47. *Hearings on the President's 1961 Tax Recommendations, supra* note 9, at 318.

48. Int. Rev. Code of 1954, § 951(b). The original proposal to tax every United States shareholder if over half the stock was owned by all United States shareholders may have been modified to reduce constitutional objections. *Cf.* Glasmann, *Taxation on Private Investments Abroad—Legal Aspects (Part 2)*, 4 Sw. L. Fn. Inst. on Priv. Inv. Abroad 213, 224-25 (1962).

49. *E.g.*, Alexander, *Controlled Foreign Corporations and Constructive Ownership*, 18 Tax L. Rev. 531, 569 (1963); *Hearings on H.R. 10650, supra* note 38, at 2356.

50. In Heiner v. Donnan, 285 U.S. 312 (1932), an irrebuttable presumption that gifts made within two years of death were made in contemplation of death was held unconstitutional since it resulted in including another man's property in the estate of the deceased donor *and* including the value of that property as part of the value of the donor's estate. Corporations and income taxes, however, may lead to more complicated situations. For example, an actual distribution probably can be taxed to the shareholder without regard to whether its source was corporate profit or not. Holmes, Federal Taxes 789 (6th ed. 1925). If undistributed amounts can be deemed distributed, does Congress have similar discretion in classifying them? Can a stockholder be taxed on undistributed income no matter

the limitation is not applicable. And, if stockholders can be so taxed, there is need for broad attribution rules to prevent wholesale avoidance.[51] The question appears to be whether or not the ends of subpart F justify the means; a popular method of seeking the answer is to examine the analogy to the foreign personal holding company provisions.

VI. THE ANALOGY TO FOREIGN PERSONAL HOLDING COMPANIES

If at any time during a taxable year, United States citizens and residents own, directly or indirectly, more than 50 per cent in value of the stock of a foreign corporation, and at least 60 per cent of its gross income (or 50 per cent in subsequent years) is passive (*e.g.*, dividends, interest, rent, royalties), the corporation is a foreign personal holding company,[52] and each United States taxpayer actually[53] owning stock must include in his gross income, as a dividend, his share of the otherwise undistributed taxable income of the corporation.[54] These provisions were enacted in 1937 to stop flagrant tax avoidance which a special joint congressional committee found in the use of "incorporated pocketbooks" organized abroad.[55]

Writers who discussed taxing United States ownership of foreign subsidiaries had mentioned the foreign personal holding company provisions as a template even prior to 1961.[56] Certainly the basic pattern of subpart F follows the same lines: classify the foreign corporation according to income and stock ownership, direct and indirect, and, if it fits within the undesirable class, tax the United States stockholders currently.[57] Most important to this discussion, counsel for the Treasury

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how small his holdings? As to the latter question, see Echt, *The Constitution and the Corporation and the Congress*, 42 TAXES 775, 777 (1964).

51. See Alexander, *supra* note 49, at 570.

52. INT. REV. CODE OF 1954, § 552.

53. The corporation is classified according to indirect, as well as direct, stock ownership. INT. REV. CODE OF 1954, § 554, but only actual stockholdings attract tax on the undistributed corporate income. The difference can lead to strange results. Alexander, *Foreign Personal Holding Companies and Foreign Corporations That Are Personal Holding Companies*, 67 YALE L.J. 1173, 1179-80, 1185-86 (1958). The similar difference between the stock ownership requirements of §§ 951(a)(2) and 957(a) in subpart F can also be of great practical importance in special cases. Alexander, *supra* note 49, at 542.

54. INT. REV. CODE OF 1954, § 551(a). The taxable income of the corporation is first subject to a limited number of adjustments. INT. REV. CODE OF 1954, § 556.

55. See generally Paul, *The Background of the Revenue Act* of 1937, 5 U. CHI. L. REV. 41, 49-52 (1937).

56. *E.g.*, Tillinghast, *supra* note 7, at 117.

57. Similarly, tax avoidance by American minority interests is not affected. See Alexander, *supra* note 53, at 1203.

One of the main types of income subjected to subpart F treatment is foreign personal holding company income, defined by reference to § 533 but with modifications. INT. REV. CODE OF 1954, § 954(c). For a discussion of the relationship between subpart F and the personal holding company provisions, see Tillinghast, *Problems of the Small or Closely Held Corporation Under the Revenue Act of 1962*, N.Y.U. 22D INST. ON FED. TAX 697, 702-26 (1964).

Department has argued that the analogy clearly tends to establish the constitutionality of subpart F.[58] Is the analogy sound? Is it significant?

It is sound if the same principles of constitutional law are applicable. Certainly, *Eisner v. Macomber* and the issues raised by that decision seem similarly relevant. However, even assuming that prevention of tax avoidance gives rise to an extension of the taxing power, probably under the doctrine of constructive receipt, so that stockholders of foreign personal holding companies may be taxed on the corporate income without severance from capital or realization by completed transaction, there is some question as to whether subpart F lies within the same extension.

In particular, there is the contention that the situations reached by subpart F are in no way comparable to the glaring loopholes found and stopped by Congress in 1937.[59] A leading authority had characterized deferral of tax for foreign subsidiaries as "a sensible accommodation of our world-wide income rule to the fact that our foreign investments are subject to taxation at the source."[60] If incorporating an individual's pocketbook abroad was tax immorality, there had been no such taint associated with foreign corporations engaged in active business or with foreign subsidiaries of widely held American corporations.[61] The earning and reinvestment of profits abroad without taxation, it was argued, could not be evil per se if such operations in less developed countries were granted the tax deferral.[62]

Yet the determination of what is avoidance and whom should be permitted to continue it are surely within the province of Congress, no matter whose ox may be Gore-d; this is evidenced throughout the entire Internal Revenue Code. It must simply be clear that Congress was moving against tax avoidance.[63] Here, again, it was in the evolution of the proposal that fact and form developed to prove congressional intent. As described more fully before, although the original proposal of the Treasury Department barred tax deferral indiscriminately except in less developed countries, congressional modifications increasingly channeled the impact of the legislation against tax haven operations.[64] Subpart F became essentially a tax avoidance remedy,[65] as predicted,[66] and both

58. *Hearings on the President's 1961 Tax Recommendations*, *supra* note 9, at 314.

59. *Hearings on the President's 1961 Tax Recommendations*, *supra* note 9, at 312; *Hearings on H.R. 10650*, *supra* note 38, at 3041.

60. Surrey, *supra* note 8, at 76.

61. *Cf.* Tillinghast, *supra* note 7, at 84-85; H.R. REP. No. 1546, 75th Cong., 1st Sess. (1937), 1939-1 CUM. BULL. (Pt. 2) 722.

62. *Hearings on H.R. 10650*, *supra* note 38, at 3013-14.

63. There was testimony that existing § 482 was adequate. *E.g.*, *Hearings on H.R. 10650*, *supra* note 38, at 4816, 4867. Certainly Congress could weigh it and believe otherwise.

64. *E.g.*, Glasmann, *supra* note 48, at 215-17 (May 31, 1962 draft considered stricter on tax havens).

65. Wales, *Tax Policy in Relation to Foreign Business Income*, 40 TAXES 961, 971-73 (1962).

66. See Anthoine & Bloch, *supra* note 8, at 351.

chambers so declared it.[67] With evidence of tax avoidance in the record,[68] the intent was justified,[69] and the analogy to the foreign personal holding company provisions appears sound.[70]

While the analogy may be sound, it is only as significant as the degree of certainty about the constitutionality of the foreign personal holding company provisions. One federal circuit court has twice indicated the validity of taxing *minority* stockholders when a small American *group* holds control.[71] Another has specifically upheld the constitutionality, but the precise issue was whether the law could be applied when the currency of the foreign country involved was blocked, and the explanation of the holding is unsatisfactorily brief considering the novelty of disregarding the corporate entity.[72] The Supreme Court has cited the 1937 legislation, but only in a footnote to a dictum (possibly a relevant dictum, however).[73] The matter has not progressed much beyond the original evaluation by Randolph Paul:

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67. H.R. REP. No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 CUM. BULL. 461-62; S. REP. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 CUM. BULL. 784-85.

68. *E.g., Hearings on H.R. 10650, supra* note 38, at 173-217.

69. A small but prickly issue is whether or not Congress may legislate against avoidance of taxes levied by other nations. Section 954(b)(4) permits the exclusion of income from the tainted category if the Internal Revenue Service is satisfied that the choice of country for organizing the recipient "does not have the effect of substantial reduction of income, war profits or excess profits taxes or similar taxes." The proposed regulations provided that the Internal Revenue Service generally would be satisfied if the *foreign* taxes paid on the income equal or exceed 90% of the *foreign* taxes that would have been paid if the corporation had been organized in the country in which the goods were sold or services performed. Proposed Treas. Reg. § 1.954-1(b)(3)(i), 27 Fed. Reg. 12760 (1962).

The final regulations do not refer to reduction of *foreign* taxes, but describe a comparison of taxes actually paid "to a country or countries" with the taxes that would have been paid to the country of destination or production or where the services are performed, as the case may be. Treas. Reg. § 1.954-1(b)(3)(i),(iii) (1964). *Cf.* Treas. Reg. § 1.954-3(b)(1)(i)(b),(ii)(b) (1964) (whether a branch has substantially the same effect as a wholly-owned subsidiary).

It is true that the use of a foreign corporation to earn foreign income would generally avoid United States tax. Fisher, *Proposed Regulations on Subpart F Income Reflect Cautious Treasury Approach*, 18 J. TAXATION 372, 374 (1963). Yet payment of foreign taxes higher than American rates certainly tends to show no tax avoidance. Saltzman, *Undistributed Income Subject to "Taint" of Subpart F is Spelled Out by Final Regulations*, 21 J. TAXATION 110, 114 (1964). Nevertheless, the statutory language probably is intended to include savings of foreign taxes. This brought objections during the hearings. *E.g., Hearings on H.R. 10650, supra* note 38, at 2613, 4703, 4756-57. It is believed that Congress may properly consider avoidance of foreign taxes for the reasons discussed in the conclusion of this paper with respect to foreign relations.

70. Wales, *supra* note 65, 961-64. *But cf.* Sloan, *Taxation of American-Controlled Foreign Earnings Under the Internal Revenue Act Amendments of 1962*, 9 WAYNE L. REV. 308, 308-11 (1963). Sloan believes that the legislation can only be explained by a variety of problems involving three factors: foreign taxpayers, foreign transactions and passive income.

71. American Package Corp. v. Commissioner, 125 F.2d 413 (4th Cir. 1942); Alvord v. Commissioner, 277 F.2d 713, 718-19 (4th Cir. 1960) (dictum).

72. Eder v. Commissioner, 138 F.2d 27 (2d Cir. 1943). No doubt constitutional limitations on taxation are difficult to establish in the midst of a major war.

73. See note 24, *supra*.

> This method of taxation will no doubt be attacked on constitutional grounds. The broad necessity of saving the revenue will probably repel any such attack.[74]

Thus, though the analogy be sound, the significance is no more than a probability.

VII. THE SUPREMACY CLAUSE

> [A]ll treaties made . . . under the authority of the United States, shall be the supreme law of the land. . . .[75]

In line with the quoted provision, the tax law specifically provides for the exemption of income in any case required by treaty[76] and for the non-applicability of any income tax provision wherever contrary to any treaty obligation.[77]

Income tax treaties to which the United States is a party generally provide that corporations organized under the laws of the other nation shall not be subject to United States income tax unless the corporations have permanent establishments in the United States.[78] The Treasury Department chose to tax the stockholders in order to avoid conflict with the "permanent establishment" treaty provisions.[79] Although almost all treaties also contain a reservation to each nation of the right to tax its own citizens in any manner,[80] critics argue that subpart F is a tax on the foreign corporation in substance[81] and that some treaties have no reservation and some exempt the *income* of the foreign corporation rather than the entity itself.[82]

Some confusion is added to the debate by section 31 of The Revenue Act of 1962: it states that the amendments made by the Act are not subject to the provision of the Internal Revenue Code expressing the supremacy of treaty obligations, but no reference is made to the provision excluding gross income exempted by treaty.[83] The House clearly intended that the 1962 legislation prevail,[84] but, in conference, the Senate receded from its contrary position upon advice of the Treasury Department that there were no conflicts except with one clause of one treaty and that

74. Paul, *supra* note 55, at 53.

75. U.S. CONST. art. VI, cl. (2).

76. INT. REV. CODE OF 1954, § 894.

77. INT. REV. CODE OF 1954, § 7852(d).

78. *See Hearings on H.R. 10650*, *supra* note 38, at 2631-36; Anthoine & Bloch, *supra* note 8, at 350.

79. U.S. TREAS. DEP'T, *supra* note 9, at 12. Another reason was to avoid burdening foreign minority interests with United States income tax.

80. See authorities cited note 78 *supra*.

81. *Hearings on H.R. 10650*, *supra* note 38, at 3462.

82. *Id.* at 2391-93. See also the reference to the Convention of the OECD, barring a tax on the undistributed profits of a company resident in another contracting state, in the separate views of the Republicans on H.R. 10650. H.R. REP. No. 1447, *supra* note 67, at 692-93.

83. 76 Stat. 1069 (1962).

84. H.R. REP. No. 1447, *supra* note 67, at 500.

prompt renegotiation of the exception would be sought.[85] Whatever conflict with existing treaty provisions, if any, is finally found, it would not apparently result in the invalidity of subpart F as internal law but rather in a breach of international law.[86]

VIII. Conclusion

It does seem, from a review of the matter of treaties, that the Treasury Department rejected the alternative of taxing the foreign corporation directly in order to minimize international legal complications. In doing so, its proposal has run head-on into *Eisner v. Macomber*, and it is not certain, although it is probable, that this decision can be overturned, that an exception can be carved in it for tax avoidance remedies, or that subpart F can be related to the commerce power and thus freed of the requirement of apportionment.

More surely, it would be incongruous for the Court to hold that Congress must apportion taxes reaching the international activities of American taxpayers. The taxation of foreign corporations controlled by Americans is intimately related to the general foreign relations of the United States,[87] an area in which the federal government traditionally has plenary power. No doubt the case of some "innocent" minority investor could accentuate the undesirable, even oppressive, complexity[88] of subpart F, but these are the errors to which Congress is entitled (and even prone). In this day and age, the responsibilities of the federal government abroad have exceeded its domestic duties, no matter how swollen some may believe the latter; reality requires that constitutional taxing power abroad match those national responsibilities.

The "Innocent" Minority Investor—An Addendum

On March 12, 1965, the Tax Court decided *Estate of Nettie S. Miller*.[89] Each of the two taxpayers was a United States citizen with

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85. H.R. Rep. No. 2508, 87th Cong., 2d Sess. (1962), 1962-3 Cum. Bull. 1176.

86. The applicable rule is that the later congressional action prevails. Beemer, *Revenue Act of 1962 and United States Treaty Obligations*, 20 Tax L. Rev. 125, 126-31 (1964); *Hearings on H.R. 10650*, *supra* note 38, at 2360. There is some irrationality in this, since it requires a two-thirds vote of the Senate to ratify a treaty, but only a majority of each house to enact a tax law. See Sloan, *supra* note 70, at 348-49. As a hypothetical problem, what if the tax bill were made law over a presidential veto?

87. *Cf.* Norr, *Jurisdiction to Tax and International Income*, 17 Tax L. Rev. 431, 453-61 (1962).

88. It was long ago pointed out that taxing stockholders as partners, when the number of stockholders can be great, is undesirably complex. See Simons, Federal Tax Reform 75-78 (1950). Add to this the other complexities of subpart F and one may appreciate, if not join in, the conclusion of Messrs. McDonald, Brudno and Stone that subpart F is so complex that it will fall of its own weight. Seminar, 5 Sw. L. Fn. Inst. on Priv. Inv. Abroad 163-64 (1963).

89. 43 T.C. No. 62. This case exemplifies the complexity caused by minority holdings and attribution rules in this area. See note 49 *supra* and accompanying text.

less than five per cent of the outstanding stock of a Canadian holding company, computed by including in outstanding stock a large block of warrants held to be the equivalent of stock and owned by two sisters who were residents and citizens of Canada. If ownership of the warrants would have been attributed to the brother of the two sisters, a resident and citizen of the United States,[90] fifty per cent of the stock of the Canadian corporation would have been owned by five or less citizens or residents of the United States and it would have been a foreign personal holding company. The United States brother had been the broker in the sale to the taxpayers of their stock in the Canadian corporation.

Judge Mulroney, speaking for the court, reasoned that the foreign personal holding company provisions are designed to coerce the declaration of dividends and would be ineffective and inequitable if applied to tax only people who were not part of the actual controlling group.[91] It was held that the family attribution rule was intended merely to reduce the number of United States "actual" owners to five or less, as when more than five exist because of gifts to children.[92]

However, as pointed out by Judge Fay in his concurring opinion (Judges Dawson and Hoyt agreeing), family members could live abroad. He agreed with the result because the United States brother lacked "any real economic interest in the holding company" and therefore was never intended by Congress as the object of the attribution rule. A separate concurring opinion of Judge Hoyt (Judges Bruce and Train agreeing) would have also enforced attribution if the United States brother had actually owned stock himself since there would then be a United States group to which stock could be attributed.

Of the two dissenting opinions, that of Judge Scott (Judge Atkins agreeing) was more predictable. He referred to legislative history supporting a literal construction of the attribution rule because minority stockholders in personal holding companies were unlikely to be strangers, and he noted that there had been no showing that the particular taxpayers were unaware of the situation in this case.

Judge Withey's separate dissenting opinion was more relevant to the constitutional issue. It held that the attribution rule only establishes a rebuttable presumption of control because "unless this presumption is a rebuttable one, it would be in some instances in violation of the due process clause of the United States Constitution." The government

90. The statute in question was § 333(a)(2) of the INT. REV. CODE OF 1939, now § 554 (a)(2) of the INT. REV. CODE OF 1954:

> An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family. . . . [T]he family of an individual includes . . . his brothers and sisters. . . .

91. See note 53 *supra*.

92. Compare the authorities cited in note 71 *supra*.

was deemed to prevail because the taxpayers had failed to overcome the presumption.

These five opinions in one case confirm the difficulties raised by the "innocent" minority investor.[93] Judge Withey's opinion shows that these difficulties may well lead straight to a constitutional problem and a far-from-unanimous solution.

93. See note 88 *supra* and accompanying text.