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COMMENTS

QUALIFIED INVESTMENTS IN LESS DEVELOPED COUNTRIES UNDER THE REVENUE ACT OF 1962

I. THE SCOPE

This paper deals with one of the major loopholes in the foreign income provisions of the Revenue Act of 1962, located primarily in subpart F of the Code. As one writer has put it:

Subpart F is a relatively obscure and highly technical part of the vastly complicated mechanism which attempts to impose an equitable tax on U.S. persons. It touches only a few taxpayers who happen to be engaged in certain bizarre financial maneuverings abroad.

This article has not been written as an explanation of the Act; there are several good explanations already in print. Instead, this article is intended to discuss the anatomy of a loophole.

II. THE LOOPHOLE

A. The Code Provisions

Before a loophole can be discussed, it must be placed in context, and for that purpose, a brief review of subpart F is provided. This review will merely serve as a background against which the subject of this paper will be presented. In large measure, this background material has been taken from the report of the Senate Finance Committee.

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1. 76 Stat. 960 [hereinafter referred to as Act].
2. INT. REV. CODE OF 1954; [hereinafter referred to as Code or else by section number alone].
The Act provides that certain types of income, even though undistributed, of controlled foreign corporations, are to be included in the income of United States shareholders in the year the income is earned by the foreign corporation. The shareholders are, however, permitted to take foreign tax credits to the same extent as if actual distributions had been made.\(^6\) Under the Act only United States shareholders are taxed on the undistributed income. A United States shareholder is one who, either actually or constructively, has at least a ten percent interest in the voting power of all classes of voting stock of a "controlled foreign corporation." A foreign corporation is a "controlled foreign corporation" for this purpose only if more than fifty percent of the combined voting power of all classes of stock is owned directly or constructively by United States shareholders.

There are two categories of undistributed income which are taxed to the United States shareholders of controlled foreign corporations. The first of these categories is referred to as income derived from insurance or reinsurance of United States risks. The second category is referred to as foreign base company income. Collectively, they are referred to in the Act as "subpart F income."

The Act requires\(^7\) that if, after December 31, 1962, a foreign corporation is a controlled foreign corporation for thirty days or more during the taxable year, then all United States shareholders must include in gross income, among other things,\(^8\) their pro rata share of the sum of the corporation's subpart F income for such year.\(^9\)

That category of subpart F income with which this paper is concerned is foreign base company income. This consists of foreign personal holding company income, foreign base company sales income, and foreign base company services income. Of these, only foreign personal holding company income is germane to this article. Generally speaking, this income is that which is passive in character, such as income from dividends, interest, most royalties, and annuities.

The Act provides that certain types of foreign base company income, however, might not be taxable to the United States shareholders of the controlled foreign corporation. These are, among others,\(^10\) dividends and interest income, and gains from the sale or exchange of in-

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6. On the subject of tax credit, see III of this article's text infra.
7. Section 951(a)(1).
8. These "other things" include the controlled foreign corporation's increase in earnings invested in United States property, as determined under § 956(a)(2), within the limits of § 959(a)(2), and previously excluded subpart F income.
9. Section 963 provides an exception to this requirement which is not properly within the scope of this paper. Briefly, it provides that subpart F income will not be taxed under § 951(a)(1) if the controlled foreign corporation makes certain minimum distributions to its United States shareholders.
10. Other exceptions can be found in §§ 954(b)(2)-(4).
vestments. However, the non-taxable status attaches only if this income or these gains arise from qualified investments in less developed countries, and only to the extent that these amounts are reinvested in qualified investments in less developed countries.\textsuperscript{11}

More specifically:

\textbf{[F]oreign base company income does not include—(A) dividends and interest received during the taxable year from investments which at the time of receipt are qualified investments in less developed countries . . . or (B) if the gains from the sale or exchange during the taxable year of investments which at the time of sale or exchange are qualified investments in less developed countries exceed the losses from the sale or exchange during the taxable year of such qualified investments, the amount by which such gains exceed such losses.}

The preceding sentence shall apply only to the extent that the sum of the dividends and interest described in subparagraph (A) and the amount described in subparagraph (B) does not exceed the increase for the taxable year in qualified investments in less developed countries of the controlled foreign corporation . . . .\textsuperscript{12}

The Code defines an increase in qualified investments as the amount by which such qualified investments at the close of the taxable year exceed the qualified investments at the close of the preceding taxable year.\textsuperscript{13}

In addition to taxing United States shareholders on their pro rata share of a controlled foreign corporation’s current subpart F income, the Act also taxes them on their pro rata share of \textit{previously} excluded subpart F income that has been withdrawn from qualified investments during the taxable year.\textsuperscript{14}

However, the United States shareholder need not necessarily include his pro rata share of \textit{all} such previously excluded income upon its withdrawal from qualified investments. For example, if the foreign corporation were a controlled foreign corporation for only \textit{half} the taxable year, then the United States shareholder need only be concerned with his share of half (or whatever the actual fraction is) of the previously excluded income upon its withdrawal.\textsuperscript{15}

The Act is quite explicit with respect to the amount withdrawn from qualified investments. It is defined as the controlled foreign cor-

\begin{itemize}
  \item[11.] For the sake of brevity, this expression will be shortened hereinafter to “qualified investments.”
  \item[12.] Section 954(b) (1).
  \item[13.] Section 954(b). Alternate methods can be used. See discussion in text accompanying note 21 infra.
  \item[14.] Section 951(a) (1)(A)(ii).
  \item[15.] Section 951(a) (3).
\end{itemize}
poration's decrease in qualified investments for the taxable year.\textsuperscript{10} This decrease is to be determined in the same way as an increase; it is the amount by which qualified investments at the close of the previous taxable year exceed such amount at the close of the present taxable year.\textsuperscript{17}

Certain limitations are placed on the amount of the decrease in qualified investments. First, it cannot exceed the sum of the exclusions from subpart F taken in the past and which have not yet been withdrawn or, in other words, the controlled foreign corporation's remaining qualified investments.\textsuperscript{18} Second, it cannot exceed the sum of all earnings and profits accumulated in taxable years since December 31, 1962.\textsuperscript{19} Also, in the event that the losses on the disposition of qualified investments exceed the gains on such dispositions, the decrease in qualified investments for the taxable year shall be reduced by the excess of such losses over such gains.\textsuperscript{20}

Alternate methods for determining the amount of increase, or the amount of decrease, in qualified investments may be provided for by regulations, and once such election is made, it must be continued for all subsequent taxable years, unless permission is granted for a change.\textsuperscript{21} At the time of this writing, no final regulations have been written in this area.

As a brief summary, the loophole for qualified investments in less developed countries is a two-way street. On the one hand, if earnings from qualified investments are properly reinvested, such earnings are excluded from foreign base company income; therefore, they do not show up as subpart F income, and consequently, need not be declared by United States shareholders. On the other hand, if such earnings, having been so excluded, are later withdrawn from qualified investments, then, within the limits previously described, such earnings become immediately taxable to the United States shareholder.

Having observed the general statutory structure, the relative position of the loophole within it, and the nature of the loophole itself, further discussion demands an understanding of exactly what is meant by the phrase, "qualified investments in less developed countries."

Less developed countries are defined\textsuperscript{22} as foreign countries (other than areas within the Sino-Soviet bloc) or possessions\textsuperscript{23} of the United

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\textsuperscript{16} Section 955(a)(1).
\textsuperscript{17} Section 955(a)(2).
\textsuperscript{18} Section 955(a)(1).
\textsuperscript{19} Section 955(a)(2)(B). It is not clear by whom these earnings and profits are to be accumulated—the controlled foreign corporation, or its subsidiary.
\textsuperscript{20} Section 955(a)(2)(B).
\textsuperscript{21} Section 955(b)(3).
\textsuperscript{22} Section 955(c)(3).
\textsuperscript{23} Oversea territories, departments, provinces, or possessions for purposes of this section can be treated as separate countries. Thus, even though the "home" country is
States which the President of the United States has designated as economically less developed.\footnote{Ibid.} However, the following countries are in no event to be considered as less developed countries:

- Australia
- Austria
- Belgium
- Canada
- Denmark
- France
- Germany (Federal Republic)
- Hong Kong
- Italy
- Japan
- Leichtenstein
- Luxembourg
- Monaco
- Netherlands
- New Zealand
- Norway
- Union of South Africa
- San Marino
- Sweden
- Switzerland
- United Kingdom

Once a country has been designated as a less developed country, the President cannot terminate that designation without giving thirty days prior notice to the Senate and House of Representatives of his intention to do so.\footnote{Ibid.} Moreover, if at the time of acquisition, property is a qualified investment in a less developed country, this property will continue to qualify even though the country ceases to be a less developed country.\footnote{Ibid.}

"Less developed country corporations"\footnote{Section 955(b)(2).} comprise two categories. The first\footnote{Section 955(c).} includes foreign corporations\footnote{Section 955(c)(1).} which are engaged in the active conduct of a trade or business, which derive eighty percent or more of their income from sources within less developed countries, and which have eighty percent or more (in value)\footnote{See discussion of Treas. Reg. § 1.955-6 (1963), concerning the source rules to be applied for this purpose in text accompanying note 77 infra.} of their assets in property generally used in a trade or business in a less developed country or in certain other specified types of associated property. The specific assets in which this eighty percent must be invested are:

1. Property used in trade or business in less developed countries;
2. Money and bank accounts;

classified as developed, the overseas area—i.e., a colony—may be considered less developed.\footnote{24. For investments to qualify, the country must have been so designated on the first day of the taxable year. Ibid.} 25. This provision was not a part of the bill as it was sent to the Senate. It seems to have been added almost as an afterthought. See the discussion of congressional policy in II(B) of this article's text infra. 26. Section 955(b)(2). 27. Section 955(c). 28. Section 955(c)(1). 29. In the House's version of the bill, such corporations had to be incorporated in a less developed country. The Senate deleted this requirement. 30. See discussion of Treas. Reg. § 1.955-6 (1963), concerning the source rules to be applied for this purpose in text accompanying note 77 infra. 31. Section 955(b)(5) requires that adjusted basis be used.
(3) Stock and obligations (having a maturity of one year or more at time of acquisition) of a less developed country corporation;

(4) An obligation of a less developed country;

(5) Investments required because of restrictions imposed by less developed countries;

(6) Certain United States property, such as United States Government bonds, money, etc., which although having a United States situs, is excluded from the definition of United States property.\(^{32}\)

The second category\(^{32}\) of less developed country corporations consists of certain shipping or aircraft companies. These must be foreign corporations (not necessarily incorporated in a less developed country) receiving eighty percent or more of their gross income from:

(1) The use (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country;

(2) The performance of services directly related to these aircraft or vessels;

(3) The sale or exchange of such vessels or aircraft;

(4) Dividends and interest received from foreign corporations which are themselves less developed country corporations and in which the corporation in question had at least a ten percent stock interest,\(^{35}\) or

(5) Gain from the sale or exchange of stock or obligations of foreign corporations which are less developed country corporations.

In addition, for these shipping or aircraft companies to qualify as less developed country corporations, they must have eighty percent or more of their assets\(^{37}\) invested in property used for the production of the income described above and in property which although having a situs in the United States is not considered as "United States property."\(^{38}\)

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32. The bill, as sent to the Senate, required a five-year maturity. The Senate lowered it to one year.

33. Section 956(c) defines what is meant by this term.

34. Section 955(c)(2).

35. More specifically, "10 percent or more of the total combined voting power of all classes of stock which are owned by the foreign corporation . . . ." Section 955(c)(2)(A)(ii).

36. The Code is silent with respect to a possible requirement of a minimum period of maturity for these obligations. The writer assumes that the same one-year requirement mentioned previously applies here also.

37. Section 955(c)(2)(B) requires that 80% or more of their assets be invested "on each day of the taxable year . . . ."

38. Such exceptions are described in § 956(b)(2).
The phrase "qualified investments" is defined best by the Act itself:

[T]he term "qualified investments in less developed countries" means property which is—

(A) stock in a less developed country corporation held by the controlled foreign corporation, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation;

(B) an obligation of a less developed country corporation held by the controlled foreign corporation, which at the time of its acquisition by the controlled foreign corporation, has a maturity of one year or more, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation; or

(C) an obligation of a less developed country.40

However, if property is disposed of within six months after it is acquired, then it cannot constitute a qualified investment.41 Also, as previously mentioned,42 property is to be valued at its adjusted basis, reduced by any liability to which such property is subject.

B. Policy Reasons

What makes this Act so unusual, is not that there are many purposes behind it, but because some of these purposes are in direct opposition to each other. The foreign income provisions of the Act were designed not only to cure a multitude of domestic problems, but also to augment our foreign policy. The policies embodied in the Act fall into two discordant camps. As far as is possible, each set of intentions shall be dealt with separately.

Generally there was a strong intention behind this Act to put an end to a popular form of tax dodging. Prior to the Act, tax services were giving the following advice.

By the use of a base company, the United States parent can: accumulate profits abroad without payment of United States tax on income until the foreign earnings are transferred

39. As is pointed out in McDonald 5 Institutes on Private Investments Abroad 48 (1962), if the parent loans money to its subsidiary in a less developed country and takes back bonds, the bonds represent an investment in the less developed country and the repayment on the bonds represents a decrease in qualified investments. If, on the other hand, the subsidiary borrowed the funds from an unrelated person, subsequent payment of the debt would have no effect, taxwise, on the parent.

40. Section 955(b).

41. Section 955(b) (4). The Senate added this provision to prevent sham acquisitions at the end of a year.

42. See note 31 supra.
to the United States . . .; return foreign profits and appreciation in assets via the capital gains route; transfer profits from one foreign operation to another in the process of building up capital abroad . . . .

Due to the popularity of this sort of device, the President advocated elimination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges . . . . There is no valid reason to permit their [base company's earnings] remaining untaxed regardless of the country in which they are located.

Secretary Dillon brought to the attention of the House Ways and Means Committee that the bill would further several additional objectives. They include improvement in our balance of payments position, increased tax revenue, the achievement of tax-neutrality, and an increase in domestic employment.

The problem of our balance of payments is a major subject in itself. It is mentioned here only to point out an inconsistency in one of the objectives of the Act. Speaking generally, an investment in a foreign country creates a momentary drain on our resources; the absence of such investments would eliminate these drains. Thus, at first glance, the effect of the Act seems desirable. However, testimony before the House Ways and Means Committee clearly established that United States investments abroad had generated a return flow of capital over the past fifteen years that was a major factor in preventing a serious balance of payments crisis. To explain his position, Secretary Dillon advanced a new concept by conceding that while the overall balance of payments on all United States direct investments abroad, totaling 50 billion dollars, was favorable, the return flow on new investments, 200 million dollars yearly, was insufficient in comparison with the current outflow.

Tax neutrality is a status which, when achieved, will be such that economic decisions will be made only "on the basis of economic criteria, not on tax consequences." The Act seeks to further this ideal by reducing the different tax treatments of profits earned by United States citizens whether the profits are earned in the United States or abroad. Therefore, there will be more investments at home and our employment situation will be improved.

43. 23 TAX MANAGEMENT PORTFOLIO, Foreign Operations—Base Companies 7 (1963).
44. 1 U.S. CODE CONG. & AD. NEWS 1129, 1134 (1961).
45. S. REP. No. 1881, Note 5 supra at 358.
47. S. REP. No. 1881, Note 5 supra at 360-61.
48. S. REP. No. 1881, Note 5 supra at 420.
The Act takes into consideration the realities of the marketplace, in spite of this new ideal:

Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries, nevertheless, sees no need to maintain the deferral of United States tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated.

According to the Committee's reasoning, it would be logical to expect that tax deferral would be eliminated for passive income earned anywhere in the world. However, Secretary Dillon stated before the Senate Finance Committee that "the deferral privilege should be retained for income earned in less developed countries, in line with our general foreign policy objectives." The Committee agreed with the Secretary:

This exception [to subpart F] for interest and dividend income (and certain gains) from less developed countries is intended to make it possible for a controlled foreign corporation, which is at least in part a holding company, to reinvest dividends and interest obtained from a subsidiary in a less developed country in another subsidiary in a less developed country, without its shareholders being taxed on this income.

The Committee gave a stronger reason for the exception for less developed country corporations involved in shipping or aircraft operations. Here, the exception is "primarily in the interests of national defense. In this regard, it was believed desirable to encourage a U.S.-owned maritime fleet and U.S.-owned airlines operating abroad."

Stanley S. Surrey, Assistant Secretary of the United States Treasury Department, seems to have different reasons for encouraging investments in less developed countries. He feels that the investment incentive would induce large outflows of capital for investment and

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49. For this reason, the Act permits deferral to go on with respect to "operating" businesses.
50. S. REP. No. 1881, Note 5 supra at 83.
51. Senators Douglas and Gore seem to agree with this speculation. Id. at 417.
52. Needless to say, words like "privilege" should not always be accepted at face value. The mere fact that Congress, up to this point, had not taxed this income, does not necessarily mean that Congress had been granting a "privilege."
54. S REP. No. 1881, note 5 supra at 85.
55. Ibid.
encourage reinvestment of earnings in these countries. He also believed that the investment incentive would discourage the repatriation of earnings. "In brief, it should encourage funds to move to these countries and then stay at work there as long as possible."

This may indeed be the way to develop the less developed parts of the world, but it seems strange that an Act, the avowed purpose of which is the elimination of tax deferral, should provide for this result.

Thus, it is seen that throughout the Act, there are conflicting concepts and purposes. It soon became apparent that it was impossible to apply these concepts consistently to all provisions. For example, the less developed country provision discouraging the repatriation of United States dollars conflicts with the concept of tax neutrality. Consequently, the Act suffers from the pulling and hauling that grew out of these controversies and inconsistencies. It may be that as a result of its conflicting policies, the Act will fail to live up to any of its objectives.

C. Evolution

Having been fed by new streams of thought and strong cross currents of purpose, one might expect a great degree of turbulence in the journey of this legislation, as it dashed itself against one committee and another, until it emptied itself into the murky pool known as subpart F. There have indeed been several changes. However, only one major change will be treated at length here since the others are either beyond the scope of this paper, or have been mentioned earlier. Generally stated, the House bill provided for a much broader exclusion with respect to qualified investments than that which ultimately became law.

The House sent a bill to the Senate that described two types of income: business income, earned actively; and subpart F income, earned

56. SURREY, TAX POLICY ON U.S. INVESTMENTS IN LATIN AMERICA 243 (1962).
57. See MCDONALD, 5 INSTITUTE ON PRIVATE INVESTMENTS ABROAD 29 (1962).
58. SUMMERWELL, TAX POLICY, op. cit. supra note 56, at 257:
After the war, there was such a great demand for U.S. investment dollars that our usual resources could not meet the demand. A fresh concept, the base company, was developed for furnishing badly needed investment capital for underdeveloped countries. The base company was used to accumulate at low tax rates, large amounts of investment capital abroad, and to make it available throughout the free world, in areas of high risks, where the use of any other funds, more dearly acquired [i.e., aftertax funds], might have seemed unwise.
I believe . . . [the Act] will destroy for many industries and businesses the ability to invest in less developed countries, to aid those countries in developing a higher standard of living, and to develop new foreign markets for products because this legislation will destroy much of the opportunity to accumulate high risk capital for making such investments.
If we shut off this means of generating capital, we will sharply reduce United States private investment in these areas.
59. E.g., changes in the definition of a controlled foreign corporation; additional exceptions for blocked earnings, banking, financing, etc.; and the exception where there is no substantial tax savings.
passively. All business income could escape taxation by being invested in “qualified property,” which, besides what are now known as qualified investments, included investments in property which was ordinary and necessary for the business of the controlled foreign corporation and also included certain property within the United States. Under this bill, none of the passive, subpart F income could escape taxation. Also, a less developed country corporation was defined as one in which the taxpayer, and no more than four other Americans, owned more than fifty percent.

In effect, this bill allowed for a great, tax-free, pour-over of profits, earned actively in the developed countries, to the less developed countries.

The Senate made drastic changes in this part of the bill, so that, as previously explained, the exclusion is now only for interest, dividends and gains from already existing qualified investments, provided that they are reinvested. Thus, the tax-free pour-over of business profits, envisioned by the House, was reduced to a mere tax-free trickle-back for certain limited types of income.

It should be particularly noted that in the House’s version, only income that was actively earned could be deferred through qualified investments, while under the Senate’s version, the deferral is only for passive income.

D. Regulations

As of this writing, the only final regulation in this area is section 1.955-6 which describes the types of income that will be considered as being from less developed country sources. It provides that the usual source rules found in sections 861-64 will be followed, except in the case of interest, dividends, and income derived from the sale of tangible personal property.

Interest income is from a less developed country source when paid by an individual who is a resident of a less developed country. This is a change from the proposed regulation, which required the paying individual to be a resident of the same country wherein the receiver was incorporated. Interest paid by a corporation will be considered as being from a less developed country source if the paying corporation for the last three years (or less, if it is younger) derived eighty percent of its income from a less developed country source.

61. In order for the investment to qualify, the taxpayer must have been engaged in the business of the controlled foreign corporation for at least five years.
64. Treas. Reg. § 1.955-6(b)(1)(ii) (1963). With regard to “unrelated” paying corporations, reasonable belief on the part of the receiving corporation that the 80% income test has been met will be sufficient.
interest paid by a less developed country will be treated as having its source in such country. There is a special rule which permits interest on United States obligations to be considered as being from a less developed country source.

Dividend income is considered as coming from less developed countries if the paying corporation meets the eighty percent income test described above. This test is presumed met when the paying corporation is unrelated to the recipient.

Income from the sale of tangible personal property is from a less developed country source only if such property is produced in a less developed country or, even if produced elsewhere, if it is sold for use in a less developed country, and the selling corporation is engaged in continuous operational activities which are in substantial relation to the sales within less developed countries. These activities may consist of storage, handling, transportation, assembly, packaging or servicing operations within the less developed countries.

Thus, without too much difficulty, a foreign corporation engaged in exporting United States made goods for use in less developed countries can qualify as a less developed country corporation. In effect, this regulation allows for the continued use of base companies, but their locus of activity is somewhat restricted. This is a great departure from the proposed regulation which treated such income as derived from less developed country sources only when the property was produced there, which required at least twenty percent of the conversion costs to take place there, and would "in no event" include the cost of packaging, labeling, or other related items.

Proposed regulation section 1.954-2 contains a rather interesting provision:

For the purposes of section 954 [foreign base company income] items of income shall be classified in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount received as "interest" which actually constitutes rent, shall not be classified as "interest" but shall be classified as rent . . . . Local law shall not be controlling in classifying an item of income. (Emphasis added.)

66. Treas. Reg. § 1.955-6(b)(2) (1963). It would seem wise, therefore, for every one owning United States obligations to transfer them to corporations in less developed countries so that the interest can be reinvested in more obligations of the United States and at the same time enjoy tax deferral.
This provision seems designed to keep the loophole for income from qualified investments as small as possible. The one final regulation in this area, described earlier, seems to adopt a much more lenient attitude.

III. SECTION 902 AND 1248

A. Section 902—The Gross-Up

The gross-up and the reasons leading to its adoption by Congress are well known, and have been treated at length in several articles. Briefly, a tax abuse occurred whenever a foreign subsidiary was located in a country having lower tax rates than those of the United States. In such cases, when dividends were paid to United States shareholders, the amount that had been paid in foreign taxes was allowed not only as a United States tax credit, but also as a deduction, since the dividends were only paid on after-tax earnings. Because of this credit-and-deduction treatment of foreign taxes, some United States shareholders were enjoying close to a twelve percent tax saving.

Section 902 provides that if a domestic corporation elects to take a foreign tax credit, with respect to dividend income from a foreign subsidiary, it must add to its gross income the taxes paid by the foreign subsidiary. For this provision to apply, ten percent ownership of the foreign subsidiary is required.

In this section, as in subpart F, there is a big loophole—qualified investments in less developed countries. In justifying this loophole, the Senate Finance Committee said:

In the case of corporations deriving most of their income from less developed countries, however, your committee concluded that it would be inappropriate at this time to raise the effective rate of combined American-foreign tax since this would discourage new investments in such countries. Your committee believes that to discourage such investments at this time would be contrary to our national policy.

In the words of Rep. Thomas B. Curtis:

The principal tax impact of the gross-up in terms of increased tax burdens on American economic endeavors would be with respect to activity in the so-called developing or emerging nations, including the Latin American countries. Thus, the

69a. See note 62 supra and accompanying text.
70. Sections 902 and 78.
72. S. REP. No. 1881, Note 5 supra at 67.
73. S. REP. No. 1881, note 5 supra at 68.
74. This position is completely contrary to the police of “tax neutrality.”
gross-up would be inconsistent with our announced foreign policy objectives and would markedly encumber the contribution of private enterprise to the realization of the goals outlined in the Alliance for Progress.\textsuperscript{75}

To broaden this loophole in the gross-up requirement, the Code adds, for purposes of section 902, a third category of less developed country corporations,\textsuperscript{76} in addition to the two categories described in sections 955(c)(1) and 955(c)(2). This new category consists of foreign corporations (wherever incorporated) having at least a ten percent stock interest in a less developed country corporation, within the meaning of section 955(c)(1). Also, the foreign corporation must derive eighty percent of its gross income from less developed country sources and have eighty percent of its assets in property described in section 955(c)(1)(B).\textsuperscript{77} In other words, this new category consists of foreign holding companies that have invested in less developed country corporations.

\textbf{B. Section 1248}

Prior to the Revenue Act of 1962, it was common practice for the earnings of foreign subsidiaries to be kept abroad where they incurred no United States tax. When the subsidiary was liquidated, the earnings could be brought back to this country as capital gains.

Section 1248 is designed to eliminate this practice. It provides that if there is a gain on the sale, exchange or redemption of stock of a foreign corporation, there is included in the gross income of the person surrendering the stock, as a dividend, that portion of the gain attributable to the earnings and profits of the foreign corporation allocable to the stock surrendered, and accumulated while the shareholder held the stock. This holding period must be one during which the corporation was a controlled foreign corporation. The provision applies to taxable years after December 31, 1962.\textsuperscript{78}

Section 1248 applies to any shareholder who owned ten percent or more of the total combined voting power of the stock of a foreign

\textsuperscript{75} H.R. No. 1447, 87th Cong., 2d Sess., B32 (1962). It has been suggested that this exclusion did not result entirely because of congressional generosity: It [the gross-up] does not apply to Latin American countries. Why? . . . Because two or three very influential southern Democratic Senators were not about to let that happen to the area that their constituents were interested in, and they insisted that the amendment be accepted by the Senate Finance Committee to exempt the underdeveloped countries from the gross-up provision. Simple political answer. \textsc{Luter, Tax Policy, op. cit. supra} note 56, at 262.

\textsuperscript{76} Section 902(d) (2).

\textsuperscript{77} \textit{Ibid.}

\textsuperscript{78} It should be noted that as originally passed by the House, § 1248 would have caused all earnings and profits accumulated since February 28, 1913 to be taxed as ordinary income. The Senate changed this to apply only to earnings and profits accumulated after January 1, 1963, and that they shall be taxed as dividends. S. Rep. No. 1881, Note 3 \textit{supra} at 108.
corporation at any time during the five-year period ending on the date of exchange, but only if the corporation was a controlled foreign corporation at any time during the period the stock was owned by the shareholder.79 The Senate Finance Committee explained:

The bill has as one of its objectives in the foreign income area the imposition of the full United States tax when income earned abroad is repatriated.80 Full taxation will occur in the case of the ordinary taxable liquidations or sales or exchanges only if the earnings and profits are in effect taxed as dividends (to the extent of any gain) at the time the funds are brought back to the United States. This objective is accomplished by this section of the bill.81

However, the Senate amended the House bill so that it does not apply to earnings and profits accumulated by a foreign corporation while it was a less developed country corporation,82 provided that the stock sold or exchanged was owned for at least ten years by the United States shareholder before the date of the sale or exchange. A transfer of stock by death does not interrupt the ten year period.83 Furthermore, the three categories of less developed country corporations which are excluded from the gross-up are excluded from this section as well.84 Therefore, the loophole for investments in less developed countries is also found here and continues to encourage American capital to leave the country.

IV. Observations and Suggestions

If it has not already become apparent, the Revenue Act of 1962 has no effect at all on the United States shareholders of businesses in Latin America, most of Africa, and most of non-communist Asia, provided, of course, that the enterprises take the form of less developed country corporations.

Thus, by simply reinvesting the earnings of these businesses, the United States tax can still be deferred indefinitely. If any dividends are paid to United States shareholders, they need not be grossed-up, and when the corporation is liquidated, the earnings may still be returned to this country at capital gains rates. The regulations, through liberal source rules, permit a limited form of base company operation to be

79. Ibid. For purposes of the 10% stock ownership requirement, the rules in § 958(a) for constructive ownership shall apply.
80. This statement refers to "tax neutrality."
82. If, during a part of such period, the foreign corporation was not a less developed country corporation, then the earnings and profits allocable to such period are not excluded from the affect of § 1248.
83. Section 1248(d) (3).
84. Ibid.
carried on, although this is now limited to the less developed parts of the world. Through the use of a foreign holding company, earnings can be transferred from one less developed country to another without the imposition of United States taxes. Therefore, the Act still leaves most of the free world\textsuperscript{85} open to the same happy practices that have been going on for years.\textsuperscript{88}

It should also have become apparent that this is not a perfect piece of legislation. Some of its more obvious defects might be eliminated in the following ways:

(1) Tax policy should be made clear. If “tax neutrality” is really a goal of Congress, it should be applied uniformly, not selectively as is done at present. If Congress has no intentions of doing this, then the concept should be abandoned.

(2) If it is really unnecessary to have tax deferral for passively earned income, then all such income should be taxed, even though it comes from less developed countries.

(3) If it is the intent of Congress to develop the poorer areas of the world, then stronger incentives should be offered. As the act now reads, the investment incentive is limited to the total of interest, dividends and gains from already existing qualified investments. A taxpayer gets no present tax benefit from investments in excess of that amount. Congress could improve upon this by:

a) increasing the types of income from qualified investments that can be excluded from foreign base company income by reinvestment—at present, the exclusion is only for interest, dividends, and gains on the sale of qualified investments, which can be broadened to include rents, royalties, commissions, etc.; or

b) using the “pour-over” provision contained in the House bill thereby inducing all actively earned income in the developed countries to flow to the less developed parts of the world; or

\textsuperscript{85} In Exec. Order No. 11071, 27 Fed. Reg. 12875 (1962), the President designated all countries in the world, in existence on or after December 31, 1962, as less developed countries. Thus, the only parts of the world where the reinvestment of earnings from qualified investments will not defer United States taxes are the countries of the Sino-Soviet bloc, the specific countries enumerated in the Act, and Spain.

In the dissent to the report of the Senate Finance Committee, written by Senators Carlson, Bennett, Butler, Curtis and Morton, there appears the following: [Certain provisions of the Act] represent an abdication of Congressional authority over taxation. By their terms, . . . [the provisions of the Act] warn business that the tax burden is subject to change by administrative decree. This fact alone inhibits orderly planning and makes the risks of capital investment abroad very uncertain. S. REP. No. 1881, Note 5 supra at 357.

\textsuperscript{86} The Act also leaves untouched all earnings abroad, even in the developed countries, accumulated before 1963, thus putting to rest the fears of businessmen who have always wondered what the Treasury was going to do about those earnings. Those who piled up foreign earnings early in the game have been given a reward for their swift action—a continued tax moratorium.
c) providing for a tax credit, to the extent that investments in less developed countries exceed the income which is available for the exclusion. Thus, if a controlled foreign corporation’s dividend income from qualified investments were $X$ dollars, and it made new qualified investments of $X + Y$ dollars, there would be available to it a credit of $Y$ dollars which could be used to offset future income from qualified investments, in case the reinvestment in such future year were not sufficient to use completely the potential exclusion available to it in such year.

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