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UNITED STATES AND UNITED KINGDOM TAX RESTRAINTS IN FORMING, REORGANIZING AND LIQUIDATING FOREIGN CORPORATIONS

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I. INTRODUCTION

It is generally recognized that one of the more serious problems confronting the world community is providing means whereby capital importing nations may accelerate their economic development. Peace and order appear to demand that effective measures be taken to meet the "rising expectations" of the peoples of less-developed areas. It is also recognized that the elimination of barriers to the free flow of private capital across international lines can contribute significantly to such economic development.

In the post-World War II era the flow of private capital in international trade and investment is increasingly taking the form of direct investment through the legal mechanism of a foreign corporation. From a business viewpoint, the shift from pure export operations to direct investment as the principal means of developing or retaining foreign markets has been described as "one of the vital new dimensions in foreign operations."¹ But, much needs to be done to ensure a continuation of the foregoing trend. Perhaps rightfully, priority here is being given to measures designed to provide needed governmental services, education, and development of a satisfactory climate for direct investment in capital importing nations. Yet, other barriers are recognized to exist, among them the burdens of taxation in both capital-exporting and capital-importing countries. This article proposes

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¹ Williams, New Dimensions for American Foreign Operations, 14, International Management Association, Inc. Special Report No. 3, (1957).

to examine the principal tax restraints imposed by the two major capital-exporting nations²—the United States and the United Kingdom—on one of the principal legal forms employed by private capital in conducting foreign operations, the foreign corporation.³

The tax restraints here under consideration can not be examined out of the context of the basic policy of the restraining legislation of both countries, which legislation is designed to prevent tax avoidance. In other words, if the free flow of private capital is considered desirable, so is the prevention of tax avoidance. From a factual viewpoint no useful purpose would be served by deploring the existence of a demonstrated tax barrier if the barrier was simply accomplishing that which it was designed to do. The problem in such case is a re-examination of the tax-avoidance policy and a search for possible alternative preventive techniques.

The focus of attention of this article will be on Section 367 of the United States Internal Revenue Code, 1954 and Section 468 of the United Kingdom Income Tax Act, 1952. Broadly, these legislative measures vest unreviewable discretion in the tax administrators to pass on the question whether certain capital transactions undertaken in international operations are to be cleared, depending upon whether or not they involve avoidance of national taxes.

Section 367 of the Internal Revenue Code requires a United States taxpayer to secure an advance ruling from the Internal Revenue Service to qualify any foreign corporate formation, or reorganization or liquidation of a controlled subsidiary, for nonrecognition of gain. Failure to secure such clearance in advance subjects the taxpayer to the penalties of recognition of gain (ordinarily capital gain) on any appreciated property involved in an otherwise tax-free exchange. The statute requires that the Service be satisfied that the particular exchange (for example, an exchange of property for stock in a corporate formation) "is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." In addition,

² In 1957 the United States provided two-thirds and the United Kingdom one-sixth of the private long term investment in the international field. Other important contributions were made by Belgium, Luxembourg, West Germany and The Netherlands. *International Flow of Private Capital*, Yearbook of the United Nations, 1958, 142 (1959).

³ Since 1936 United Kingdom tax law has restricted asset transfers abroad by individuals. Currently embodied in § 413, Income Tax Act, 1952, the statute is designed to prevent tax avoidance by virtue of transfers of assets abroad under arrangements whereby income is payable to nonresidents but benefits (income or capital) are acquired or retained by the transferor-resident; in such cases the income is imputed to the resident taxpayer and subject to tax unless the taxpayer can establish that the transactions were not motivated by tax avoidance. 3 Simon, *Income Tax* §§ 49-63 (2d ed. 1952).

Section 1491 of the Code imposes a special excise tax on certain transfers of appreciated property to foreign corporations as capital contributions unless a similar clearance is obtained from the Service.

Section 468 of the Income Tax Act, 1952, requires the consent of the United Kingdom Treasury for the transfer of corporate residence abroad, or any part of the trade or business of a corporate resident abroad, and for the issue of shares or debentures of controlled non-resident corporations and the transfer of resident-held shares and debentures in controlled nonresident companies. The background of the foregoing provision indicates that the British Parliament vested the Treasury with such discretion to prevent avoidance of United Kingdom income and profits taxes and for the conservation of foreign exchange. Failure to secure such consent subjects both companies and individuals involved to severe penal sanctions of fine and imprisonment.

An analysis of the administration of the foregoing provisions requires as a preliminary matter an outline of the basic techniques by which both countries assert tax jurisdiction over corporations, and a description of the legislation and its background. Thereafter, the criteria of tax avoidance developed by the two administrative agencies will be examined in the context of forming, reorganizing and liquidating foreign corporations.

II. TAX JURISDICTION OVER CORPORATIONS

A. *United States*

In broad outline the Internal Revenue Code draws a basic distinction from the standpoint of tax jurisdiction between domestic (incorporated in the United States) and foreign corporations. Corporate income tax is imposed on the world-wide income of domestic corporations and on the United States source income of foreign corporations, with a distinction being drawn between resident and nonresident foreign corporations. However, from time to time Congress has granted a number of limited concessions to domestic corporations engaged in certain foreign operations. As a result, United States tax jurisdiction admits of the following categories of corporate entities, the first four of which are domestic and the last two foreign:⁴ (1) ordinary domestic

⁴ Omitted in this classification because of their limited application to the subject matter of this article are the following categories of entities for which special provision is made in the Internal Revenue Code: Personal Holding Companies, §§ 541-47; Foreign Personal Holding Companies, §§ 551-58; Insurance Companies, §§ 801-43; Regulated Investment Companies, §§ 851-55; and China Trade Act Corporations, §§ 941-43.

Unless otherwise indicated all United States references are to the Internal Revenue Code, 1954, and all United Kingdom references are to the Income Tax Act, 1952.

corporations; (2) Western Hemisphere Trade Corporations; (3) Possessions Corporations; (4) Foreign Business Corporations (proposed at this writing); (5) Resident Foreign Corporations; and (6) Non-resident Foreign Corporations.

1. *Ordinary Domestic Corporations.* United States tax jurisdiction over corporations is asserted primarily on the basis of the place of incorporation. Thus, a domestic corporation is defined as one "created or organized in the United States or under the law of the United States or of any State or Territory."⁵ All others are foreign corporations. As a general rule, the locus of management or control or place of doing business are irrelevant from the standpoint of tax jurisdiction. A domestic corporation is subject to United States tax on its world-wide income as earned.

From the viewpoint of the restraints imposed by Section 367, a United States domestic corporation is free to use all the traditional methods of international trading and investing when such methods are structured in the form of a domestic subsidiary or branch without risk of United States tax being imposed on a wide variety of "capital" transfers and adjustments. Corporate assets can be separated for devotion to export and import operations, capital in all forms can be transferred to overseas branches, and patents, trademarks, and "know-how" can be moved freely from home plant to overseas branches and between overseas branches themselves without being subject to United States tax. On the other hand, one of the principal disadvantages of operating in branch or domestic subsidiary form is that foreign source earnings are subject to United States corporate income tax as earned. Deferral of foreign source income is not possible as is the case with the use of a foreign subsidiary corporation. (Deferral, of course, has significance only where foreign rates are lower than United States rates.) However, foreign income taxes and foreign taxes paid in lieu of income taxes may be taken as a credit against United States tax. Foreign tax credit is available under the various United States tax conventions or on a unilateral basis under the Code.⁶

Notwithstanding the lack of ability to defer foreign income, and the presence of other advantages flowing from operating in foreign corporate form, business and tax reasons may indicate that a particular foreign venture be conducted in domestic subsidiary or branch form. Experience indicates that foreign petroleum extracting operations and often initial overseas producing and marketing ventures are best conducted in branch or domestic subsidiary form.

⁵ IRC § 7701(a)(4).

⁶ IRC §§ 901-05.

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2. *Western Hemisphere Trade Corporations.* A Western Hemisphere Trade Corporation is a domestic corporation that: (1) does all its business, other than the making of incidental purchases, in the Western Hemisphere; (2) derives 95 percent or more of its gross income from sources outside the United States; and (3) derives 90 percent or more of its gross income from the active conduct of a trade or business.⁷ A Western Hemisphere Trade Corporation is subject to United States corporate income tax as earned but is allowed a special "14 point" deduction from taxable income under a statutory formula.⁸ The special deduction has the effect of imposing average effective corporate rates ranging from 22 percent to 38 percent as compared to the marginal surtax rate of 52 percent on corporate income in excess of \$25,000. Foreign tax credit is available on the same terms as applicable to other domestic corporations, and dividend remissions to domestic parents make the 85 percent intercorporate dividend credit available to the parent.

A Western Hemisphere Trade Corporation may be formed, liquidated, divided or reorganized tax-free without Section 367 clearance in the same manner as an ordinary domestic corporation. However, a conversion of a Western Hemisphere Trade Corporation to foreign corporate status would require Section 367 clearance.

Experience indicates that the Western Hemisphere Trade Corporation has been used mostly for Latin American export operations, and in some measure for natural resource extraction. However, the legislative history indicates the Western Hemisphere Trade Corporation concession, originally a surtax exemption, was designed to meet the competitive disadvantages and tax problems of "several American corporations engaged in actual business operations in Latin America."⁹

The foregoing legislative history has affected the attitude of the Service in this area. There is evidence that the Service regards pure export operations, without a substantial economic penetration of Western Hemisphere countries, as violative of the policy and spirit of the tax concessions granted by Congress.¹⁰ To date, the practice of the Service has been to attack such export operations by attempts to disqualify sales to such foreign countries as constituting non-United States source income. Broadly, property purchased in the United States by a Western Hemisphere Trade Corporation and sold to a Latin

⁷ IRC § 921.

⁸ IRC § 922.

⁹ Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 Colum. L. Rev. 815, 835 (1956).

¹⁰ Professor Surrey critically examines the background and history of the present Western Hemisphere Trade Corporation concession at pages 831-38, *id.*

country, for example, title passing at the port of entry, would give rise to the required non-United States source income.¹¹ However, the Service indicates it will not recognize the title-passing test where a "sales transaction is arranged in a particular manner for the primary purpose of tax avoidance."¹² In such cases, the Service attempts to be guided by the "substance of the sale" for purposes of determining the source of income.

The Service has not been too successful in the courts in the foregoing respect. Perhaps for this reason difficulty could be anticipated in securing Section 367 clearance for a transfer of assets of a Western Hemisphere Trade Corporation export operations to a foreign corporation should business reasons make such a course desirable. Particularly might this be true if the foreign corporation is to function as a base company. On the other hand, where it is desired to reorganize foreign subsidiary operations in the form of a Western Hemisphere Trade Corporation, it is understood that Section 367 clearance can be obtained. The Service apparently regards bona fide Western Hemisphere Trade Corporation operations as being outside the scope of tax avoidance for purposes of Section 367.¹³

3. *Possessions Corporations.* Qualifying a business form as a Possessions Corporation (Section 931 corporation) affords the investor in United States possessions some of the most widespread tax advantages afforded by the Internal Revenue Code. In general, a Possessions Corporation is a domestic corporation that derives: (1) 80 percent or more of its gross income from within United States possessions; and (2) 50 percent or more of its gross income from the active conduct of a trade or business within the possessions.¹⁴

A Possessions Corporation has some of the attributes of both domestic and foreign corporations. It has the attributes of a foreign corporation insofar as its non-United States source income is not subject to United States tax (unless such income is paid in the United States); it has domestic status for purposes of Section 367. Such a corporation may be formed, reorganized or liquidated without prior clearance under Section 367. Thus, for example, where a domestic parent is carrying on business in a United States possession through an 80 percent-owned Section 931 Corporation it may bring home accumulated earnings tax-free by liquidating such corporation under

¹¹ IRC § 862(a)(6).

¹² Treas. Reg. § 1.861-7(c) (1957).

¹³ See Horne, *Foreign Tax Planning: Company Branch or Independent Organization*, N.Y.U. 17th Inst. on Fed. Tax 349 (1959).

¹⁴ IRC § 931. The benefits of § 931 are also available to direct investments by individuals, e.g., a possessions business conducted in proprietorship or partnership form.

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Section 332 of the Code without prior clearance under Section 367. However, a transfer of a Possessions Corporation's assets to a foreign corporation in formation or reorganization would require a Section 367 clearance.

Where a Possessions Corporation can qualify for tax exemption under an industrial development program, such as in Puerto Rico, it may be possible both to operate tax-free and remit earnings tax-free (through liquidation). On the other hand, there are a number of limitations on the effective use of a Possessions Corporation. The remission of ordinary dividends to a United States parent subjects the latter to full tax on such income, the 85 percent dividend-received credit being unavailable. To this extent the benefit of deferral of the Possessions Corporation's income is eliminated. Also, the Service regards the use of Possessions Corporations in the same manner as it does Western Hemisphere Trade Corporations as regards economic penetration.¹⁵

4. *Foreign Business Corporations.* Since the end of World War II, economic groups in the United States have been active in proposing legislation designed to soften the tax burden on foreign operations. While minor changes in the Code have been enacted, current attention is centered on the more widespread measures of the proposed Foreign Investment Incentive Tax Act of 1960 which passed the House and is now waiting Senate action.¹⁶ In broad outline, the proposed legislation does two things that have general application. First, it grants tax deferral to a new type of domestic corporation (Foreign Business Corporation) on its business income from less developed countries, until such income is distributed. Second, it removes certain Section 367 and Section 1491 transactions from the exclusive jurisdiction of the Service, and in addition provides an express rule recognizing gain or loss upon transfers of inventory to Foreign Business Corporations and foreign corporations.

Limiting tax deferral to business income from less developed countries¹⁷ can be regarded as expressive of a policy to actively aid such nations through the mechanism of the Internal Revenue Code.

¹⁵ Rev. Rul. 58-486, 1952-2 Cum. Bull. 393.

¹⁶ H.R. 5 (Boggs Bill), 86th Cong., 1st Sess. (1959). During the short August, 1960 session of Congress no action was taken on the bill by the Senate.

¹⁷ A "less-developed" country is defined as "any foreign country (other than an area within the Sino-Soviet bloc)" or United States possession which is so designated by the President. However, certain countries are expressly excluded, notably those of Western Europe, Japan and Canada (H.R. 5, supra note 16, § 951(e)), although the legislative history of the bill indicates that an "overseas department, province or possession" of excluded countries may be designated a less developed country. 106 Cong. Rec. 9825-26 (daily ed. May 18, 1960).

Of equal importance, the proposed bill represents a detailed congressional articulation of a policy limiting an income tax concession to situations where there has been a substantial economic penetration of a foreign economy.

Tax deferral is limited to domestic corporations electing to be treated as Foreign Business Corporations and meeting certain tests. These tests require that: (1) 90 percent of the corporation's gross income be derived from sources within less developed countries; (2) 90 percent of the income be derived from some combination of four classes of income: from the active conduct of a trade or business, dividends from a "qualified payor corporation" (a domestic or foreign corporation in which a Foreign Business Corporation has a 10 percent or more stock interest and meeting tests similar to the latter), income (other than dividends) from a qualified payor corporation, compensation for management, technical or similar services rendered within a less developed country, and, income from patents, franchises and similar property used in such countries up to 25 percent of gross income; (3) not more than 10 percent of the Foreign Business Corporation's income consists of income derived from imports; (4) a Foreign Business Corporation is not classed as an ineligible corporation (tax exempt, China Trade Act Corporation, life insurance company, Section 1361 corporation, or tax option corporation); and (5) that the Foreign Business Corporation furnish the Service, as may be required by regulation, such information as is necessary to carry out the provisions of the statute.

Under Section 952, a qualifying Foreign Business Corporation is subject to United States tax on its United States source income and non-qualifying foreign source income as earned, and on its income from less developed countries when distributed. Delaying United States tax on less developed country income until actual or constructive distribution is the basic tax deferral procedure used to equate the treatment of Foreign Business Corporations with foreign subsidiary operations.

Section 953 of the bill prescribes detailed rules of accounting, including a requirement that less developed country income be recorded in a separate "reinvested foreign income account," special accounting for long-term capital gains, rules establishing the order of subtractions, and for carry-overs to a new Foreign Business Corporation in reorganization. A Foreign Business Corporation is expressly excluded from qualifying for membership in an affiliated group, precluding participation in a consolidated return.

In carrying out the policy that limits tax deferral to income from less developed countries, the bill subjects such income to United States

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tax when it enters the United States economy. Thus, such income is subject to tax upon actual distribution in the form of dividends (except stock dividends or stock rights) and in redemption of shares under Section 302 and in partial and complete liquidation. In addition, three types of transactions are characterized as constructive distributions resulting in the imposition of tax.

Section 955 of the proposed law provides that an overall limitation, rather than the standard "per country" limitation, is to be used in computing any available foreign tax credit of a Foreign Business Corporation. Thus, such a corporation will have the averaging advantages now available to a foreign base company subsidiary.

The proposed provisions pertaining to Foreign Business Corporations and to foreign corporations otherwise subject to Sections 367 and 1491 are discussed in detail below.

5. *Resident Foreign Corporations.* A resident foreign corporation is subject to corporate tax on its United States source income in the same manner as a domestic corporation on its world-wide income. A foreign corporation is resident in the United States if it is "engaged in trade or business within the United States," and generally, where a United States tax treaty is applicable a similar result obtains where such a trade or business is conducted through a "permanent establishment."

A resident foreign corporation, of course, would be subject to the requirements of Section 367; however, ordinarily, from the standpoint of tax avoidance and the flow of private capital the provision would not appear to raise any serious problems with respect to capital transactions and United States business operations.

6. *Nonresident Foreign Corporations.* A nonresident foreign corporation—a corporation not engaged in trade or business in the United States—is subject to tax on United States source income of a "fixed or determinable annual" type such as interest, dividends, rents and the like.¹⁸ Where such income exists the tax is imposed at a flat 30 percent rate without allowance for deductions and is normally subject to withholding at source.

From the viewpoint of this article it is assumed that a foreign subsidiary corporation is without United States source income—in other words, does not have United States investments—and that it is used as a vehicle for conducting foreign business operations. Income from foreign business activity, of course, is not subject to United

¹⁸ § 881. Broadly, the statute is framed to cover investment income from U.S. sources, although by its terms it is broader, including certain capital gains.

States tax as earned. Only when such income is remitted to a United States parent, resident or citizen, is the United States tax imposed.

Remission of such earnings to domestic taxpayers is governed by three basic rules: (1) when such foreign income is remitted in the form of dividends the dividends are subject to tax as ordinary income. If the recipient is a domestic corporation with a 10 percent or more interest in the foreign corporation, the United States tax thereon may be offset by a credit for foreign taxes paid by the remitting foreign corporation with respect to the amount of the dividend remitted; (2) when the remission takes the form of a liquidating dividend in a stock redemption, gain (amount received in excess of basis of shares) is subject to tax at capital gains rates (where shares are held six months or more), but a foreign tax credit is not available with respect to such gain;¹⁹ and (3) if the liquidating distribution emits from an 80-percent-owned subsidiary of a United States corporation, gain is not recognized under Section 332 provided the United States corporation had first secured the required non-tax avoidance ruling under Section 367. However, such rulings on liquidations are rarely granted. Hence in most cases rule two above is the applicable one, viz.: a capital gain tax is imposed on liquidating distributions of accumulated earnings of foreign subsidiaries.

The immunity of foreign source income from United States tax makes the foreign corporation one of the most desirable forms for conducting foreign business operations of all types. From a tax viewpoint, the foreign corporation lends itself to exporting, importing, and licensing as well as direct overseas investment. Further, since the test of taxability is based on the place of incorporation, management and control of even a 100-percent-owned foreign subsidiary can be retained in the United States while the business is conducted overseas. This advantage of home-country control and immunity from home-country corporate income tax is not available to the United Kingdom company with respect to its foreign subsidiaries, except, as indicated below, where operations are conducted in the form of an Overseas Trade Corporation.

On the other hand, the hurdles of Section 367 must be met in forming, reorganizing and liquidating such foreign subsidiaries. And the extent to which these obstacles may be overcome may determine the scope of the tax freedom with respect to the use of the foreign corporate form for overseas business operations.

¹⁹ As a general rule no tax advantage results from remitting earnings in liquidation where foreign income rates are 27% or higher. See Gibbons, *Tax Factors in Basing International Business Abroad* 11 (1957); the general trend in most foreign rate structures, even in capital importing countries, is toward rates in excess of 27%.

B. *United Kingdom*

In broad outline, United Kingdom tax law draws a basic distinction between resident and nonresident corporations. A resident corporation is subject to the United Kingdom standard tax at a rate of 38.75 percent (1960-1961) and to a profits tax at a rate of 12.5 percent on its world-wide income. A nonresident corporation is subject to the standard income tax and the profits tax only on its United Kingdom-source income. In addition to the foregoing, the Finance Act of 1957 made provision for a third category of corporate taxpayer, the Overseas Trade Corporation. An Overseas Trade Corporation must be a resident corporation which operates abroad. The foreign source business ("trading") income of such a corporation is subject to United Kingdom income tax only when distributed. Investment income from world-wide sources is subject to income and profits tax as earned.

On the basis of the foregoing, United Kingdom corporations can be classified in the following categories for tax purposes: (1) resident corporations; (2) nonresident corporations; and (3) Overseas Trade Corporations.

1. *Resident Corporations.* As a general proposition, a corporation resident in the United Kingdom is subject to United Kingdom income and profits tax on its world-wide income as earned.²⁰ The basic test of residence is determined by the locus of management and control. Ordinarily, the corporation's domicile (place of incorporation), place of registration, or place of trading activity is irrelevant.

The basic tax legislation does not define the term "residence" but the concept has been in the process of judicial development for almost one hundred years. Broadly, the House of Lords has proceeded on the basis of analogy to the residence of an individual, in other words, where the corporation "keeps house" and does business. "Business," in the foregoing respect, means the place "where the central management and control actually abides"; central management and control normally abiding where the board of directors meet.²¹ The basic inquiry is essentially factual. Thus, it has been held that where management and control was exercised in both the United Kingdom and in Sweden, the corporation was resident in both countries and subject to United Kingdom tax as a resident corporation.²²

²⁰ Generally, foreign source investment income of a United Kingdom resident company domiciled (incorporated) abroad is subject to United Kingdom tax only when "remitted" to the United Kingdom. Brudno and Bower, *Taxation in the United Kingdom* (World Tax Series) 11/2.8(a) (1957).

²¹ *De Beers Consol. Mines, Ltd. v. Howe* [1906], 5 Tax Cas. 198 (H. of L.).

²² *Swedish Central Rwy. v. Thompson* [1925], 9 Tax Cas. 342 (H. of L.).

Some of the more difficult factual problems in the foregoing respect have arisen in connection with overseas foreign subsidiaries of United Kingdom companies where parent and subsidiary have separate boards of directors. In determining the locus of management and control, the early cases seemed to regard the mere existence of the ability of a parent board to impose its will on the subsidiary as sufficient for a finding of United Kingdom residence. However, it is acknowledged that mere stock ownership does not constitute control, and the case law appears to be developing toward requiring the Treasury to make a specific showing of actual exercise of control by a parent board of directors.²³

A United Kingdom resident corporation, like a United States domestic corporation, may take either unilateral credit or treaty credit, as the case may be, for payments of foreign income or profits taxes, or foreign taxes comparable to such United Kingdom levies.

Subject to a minor exception (certain patent sales) United Kingdom income tax law does not treat gain realized upon the disposition of a capital asset as income subject to tax, and conversely capital losses are not deductible. Thus, although the wide variety of capital transactions possible in the formation, reorganization and liquidation of corporations may give rise to a host of tax problems peculiar to the United Kingdom tax system,²⁴ such transactions do not themselves generate taxes. Therefore, in the international field, the special legislation (Section 468) designed to prevent tax avoidance is directed toward preventing the migration of the taxpayer and the transfer of assets producing income subject to standard income and profit taxes.

However, like its American counterpart, the domestic corporation, a United Kingdom resident company is free to establish overseas branches and make other intra-company transfers free of the limitations of Section 468 so long as management and control is retained in the United Kingdom. On the other hand, the United Kingdom company does not have the freedom with respect to unappreciated property and securities possessed by the American corporation in the formation or reorganization of foreign corporations, which transactions may remove income producing assets from United States tax jurisdiction.

2. *Nonresident Corporations.* A nonresident corporation is subject to United Kingdom income and profits taxes only on income from United Kingdom sources. However, as far as business income is concerned, a distinction is drawn between doing business "within" the

²³ Mustoe, *Tax Residence of Subsidiaries*, 108 L.J. 758 (1958).

²⁴ See Brudno and Bower, *op. cit.* supra note 20 at 9/9, 9/10 and 14/11.

United Kingdom, which subjects the nonresident to tax, and doing business "with" the United Kingdom which does not. Doing business "within" the United Kingdom is not completely dissimilar in content to the concept of "engaged in business in the United States" which subjects a foreign corporation to tax on United States-source income, including business income. The nonresident corporation not doing business "within" the United Kingdom is still subject to United Kingdom tax on most items of investment income from United Kingdom sources in a manner somewhat similar to the United States tax liability of a foreign corporation not engaged in business in the United States.²⁵

As stated above, United Kingdom resident companies are limited in their use of foreign subsidiaries insofar as deferral of United Kingdom taxes is concerned. However, where a foreign subsidiary was established prior to the 1951 Revenue Act bringing Section 468 into the law, or where new foreign operations are commenced with outside capital, deferral of United Kingdom tax without Treasury consent is possible, provided the foreign subsidiary is controlled by a separate foreign board of directors with full powers as to such foreign operations.²⁶

Under United Kingdom tax law a resident corporation may recoup and retain the standard tax paid on a distribution of a dividend. Resident recipients are not subject to the standard tax on such receipts, but for surtax purposes individuals must "gross up" (in other words, restore the amount deducted) and include the full amount in their returns. For example, assuming a 40 percent standard rate, a dividend of £60 would be reported as £100 of income for surtax (over £2,000) purposes only. However, dividends paid to resident shareholders by nonresident corporations are subject to both the standard tax and surtax (individuals), but an indirect foreign tax credit is available for foreign income or profits taxes paid by the remitting company.²⁷

3. *Overseas Trade Corporations.* Qualification of a United Kingdom resident corporation as an Overseas Trade Corporation affords such company the advantages of both the United Kingdom control and management and deferral of United Kingdom tax on foreign earned business ("trading") income. An Overseas Trade Corporation is wholly exempt from the profits tax on its business income (trading must be wholly overseas), is subject to both the income and profits tax on its

²⁵ Id. at 11/3.

²⁶ *San Paulo R.R. v. Carter*, [1895] 3 Tax Cas. 407 (H. of L.).

²⁷ *Brudno and Bower*, op. cit. supra note 20 at 11/2.13.

investment income as earned, but may defer the income tax on business income until distributed.

The statute defines "trading income," as including distributions of trading income from another Overseas Trade Corporation which may be a subsidiary, parent, or subsidiary of a common parent of the recipient, all income not defined as trading income being investment income.²⁸ The foregoing definition thus permits an almost unlimited structure of Overseas Trade Corporations within which management may move funds and property free of United Kingdom tax.²⁹

The basic purpose of the Overseas Trade Corporation legislation is to provide a corporate vehicle that will permit United Kingdom companies to compete successfully, insofar as tax burdens are concerned, with local and other foreign investors in overseas markets. However, as in the case of the proposed United States Foreign Business Corporation, the usefulness of an Overseas Trade Corporation requires a comparative analysis on an individual basis. Factors such as dividend distribution policy,³⁰ exemption from profits tax, tax deferral of business income, the ease of moving surplus funds between related Overseas Trade Corporations, and control in the United Kingdom, must be considered in connection with such limitations as the restrictions on trading in the United Kingdom, exclusion of export trading, and the inability to offset trading losses against investment income.

From the viewpoint of Section 468, the Overseas Trade Corporation legislation would appear to have the effect of lessening requests for Treasury consent in making necessary capital adjustments in overseas operations. However, although relief from normal tax consequences is provided in forming, reorganizing, and liquidating Overseas Trade Corporations, the legislation expressly provides that the application of Section 468 is not to be affected.³¹ Thus, for example, any attempt to transfer part of the business of an Overseas Trade Corporation to a nonresident corporation would be subject to Section 468 and the requisite clearance from the Treasury.

III. CONTROL OF TAX AVOIDANCE: THE STATUTORY RESTRAINTS

The basic policy of both Section 367 of the Internal Revenue Code and Section 468 of the Income Tax Act, 1952, is the same:

²⁸ Finance Act of 1957, § 35.

²⁹ Ashley, *Profits Earned Abroad: Overseas Trade Corporations*, 108 L.J. 726 (1958).

³⁰ Overseas Trade Corporation status would, of course, provide no tax advantage where foreign rates exceed or equal United Kingdom rates. Weinberg, *Overseas Trading Corporation*, 21 *Modern L. Rev.* 277 (1958).

³¹ Finance Act of 1957, Sch. 4.

prevention of avoidance of national taxes on transactions that have the effect of removing assets, taxable transactions, or taxpayers from the jurisdiction of the two countries. And, although the sanctions and scope of the implementing legislation vary considerably, the statutory measures employ a common enforcement device: taxpayers of both countries must secure the unreviewable consent of the administrative agent for the applicable transaction.

This section of the article will be devoted to a descriptive analysis of the legislative history of the two sections and of the administrative agent's jurisdiction. The following section will examine the criteria established by the administrative agencies for determining whether particular transactions are to be cleared or rejected because they constitute an avoidance of taxes.

A. *United States*

In broad outline, subchapter C of the Code permits the tax-free exchange of stock and securities for property in the formation, reorganization (and division) of corporations, and the liquidation of corporate subsidiaries. However, Section 367 imposes a limitation upon the tax-free character of such exchanges where they involve a foreign corporation. In such cases gain (but not loss) will be recognized "unless, before such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."³²

Therefore, as a matter preliminary to the availability of the subchapter C tax-free exchange provisions, the taxpayer must secure a favorable ruling from the Internal Revenue Service before entering into any of the following transactions: (1) liquidation of a foreign subsidiary under Section 332; (2) transfer of property to a foreign corporation in exchange for its stock under Section 351 (normally used in non-reorganization formations); (3) exchange of stock or securities of a foreign corporation in a reorganization under Section 354; (4) exchange or distribution of stock or securities of a controlled foreign corporation in a corporate division under Section 355; (5) an exchange or distribution that would fall under Sections 354 or 355 but for the receipt of other property ("boot") under Section

³² IRC § 367 provides that a "foreign corporation shall not be considered a corporation" where the satisfaction is not first obtained. The effect of failure to secure the Commissioner's "satisfaction" is to throw the various subchapter C transactions enumerated in § 367 into the general provisions of the Code governing gain upon the disposition of property.

356; or (6) exchanges between corporate parties to a reorganization under Section 361 where one or more is a foreign corporation.

We will consider first: (1) the legislative history of Section 367; and (2) the scope of the Commissioner's jurisdiction as provided by the Section.

1. *Legislative History.* Prior to the Revenue Act of 1932 the revenue laws made no special provision for transactions involving the tax-free formation, reorganization or liquidation of foreign corporations. The foregoing transactions were required only to meet the applicable statutory provisions.³³ Where the Commissioner asserted that a foreign corporation had been formed or used for tax avoidance rather than business purposes, the courts were most often forced to rely upon such concepts as disregard of separate corporate identity and the *Gregory* doctrine, to frustrate such plans as were shown to be without substance.

The use of a nonresident foreign corporation for tax avoidance was often found inviting because United States tax jurisdiction has been traditionally limited to the fixed income of such corporations from United States sources. For example, in *Kaspare Cohn Co., Ltd.*,³⁴ a Canadian corporation, *B*, had been formed in order to effect, in Canada, a sale of assets (utility stock) of *A*, a California corporation. In the transactions which occurred in 1927, the assets sold by *B* in Canada were acquired in Canada from *A* for *B*'s capital stock in a tax-free exchange. Thereafter, *B* sold the assets in Canada for cash and bonds of the purchasing United States corporation and transferred the cash to *A* in the United States as a loan. Thereafter, *B* commenced operations in California in *A*'s former business quarters and *A*'s officers became the officers of *B*.

The Board of Tax Appeals refused to recognize *B* as a separate entity, holding it was a mere agency or instrumentality of *A*, a domestic corporation subject to capital gain tax on the cash received by *B* regardless of the source of income. *B* would not have been subject to United States tax on the gain on the sale (nor to Canadian tax for want of characterization of such gain as income, following United Kingdom law).

In *Hay v. Commissioner*,³⁵ the doctrine of disregarding the corporate entity was extended to a foreign corporation owned by a non-resident alien in a situation where the final realizable transaction was

³³ *Cosby-Wirth Sales Book Co.*, 19 B.T.A. 1074 (1930).

³⁴ 35 B.T.A. 646 (1937); accord, *John P. Curran*, P-H B.T.A. Memo. ¶ 37, 347, rev'd per curiam, 114 F.2d 1018 (2d Cir. 1940). See also *Ardbern Company, Ltd.*, 41 B.T.A. 910 (1940).

³⁵ 145 F.2d 1001 (2d Cir. 1944), affirming *William C. Hay*, 2 T.C. 460 (1943).

the liquidation of a domestic corporation by the foreign corporation. The taxpayer was the sole shareholder of *A*, a California investment and operating company holding greatly appreciated assets. Fearing large United States death duties and accumulated earnings tax, the taxpayer, a United States citizen, repatriated himself as a British subject in Canada, taking up residence in Nassau. In 1937 the taxpayer organized *B*, a Nassau corporation, and exchanged his stock in *A* for all of *B*'s stock. A few months after the foregoing exchange was effected in Nassau, the taxpayer caused *B* to liquidate *A*, and *A*'s appreciated assets were distributed to *B*. The taxpayer did not secure a Section 367 ruling with respect to either the exchange of his stock in *A* for all of *B*'s stock, or with respect to the liquidation of *A* by *B*.

The Commissioner asserted that the capital gain realized by *B* upon the liquidation of *A* was attributable to the taxpayer then a nonresident alien individual. The court: (1) rejected the taxpayer's argument that since he did not secure a Section 367 ruling, his exchange of *A* for *B* shares was a taxable transaction, but was not subject to tax because he was a nonresident alien, holding that under *Higgins v. Smith*³⁶ the Commissioner may refuse to recognize gain where the purpose of the transaction is tax avoidance; (2) held that the separate identity of *B* should be disregarded and its gain on the liquidation attributed to the taxpayer also upon the authority of *Higgins v. Smith*; and (3) rejected the taxpayer's argument that the gain on liquidation was from sources outside the United States.³⁷

The only recorded taxpayer success in this area is that of *Hazelton Corporation*,³⁸ decided shortly after the *Kaspere Cohn* case and presenting somewhat similar facts. *Hazelton* involved a merger of two domestic corporations, *A* and *B*, the latter being the buying corporation, in a series of transactions occurring in 1928. *B*, a Delaware corporation, first distributed unneeded accumulations after which its working assets were transferred to a newly-formed Nevada corporation, *C*, for all the latter's stock. The shareholders of *B* then formed

³⁶ 307 U.S. 473 (1940).

³⁷ The Code makes no express provision for determining the source of income realized through the receipt of a liquidating dividend. If the taxpayer, a nonresident alien, had sold his shares in the foreign corporation in Canada rather than caused the liquidation of the domestic corporation there would have been no basis for application of the doctrine of disregard of the separate corporate identity and no tax liability. The same result would appear to obtain if the Commissioner has asserted tax under § 367 for the exchange by the taxpayer of his domestic shares for the shares of the foreign corporation. Such an exchange, taking place outside the United States, would appear to give rise to nontaxable gain from a foreign source. See Note, 13 Fordham L. Rev. 128 (1943).

³⁸ 36 B.T.A. 908 (1937), dismissed, 100 F.2d 1012 (2nd Cir. 1939).

the taxpayer, a Panama corporation with its principal place of business in Canada. The *B* shareholders exchanged their *B* shares for all the shares of the taxpayer. *B* was then liquidated, distributing cash and all the *C* shares to the taxpayer in exchange for *B* shares in redemption. Finally, the taxpayer, in Canada, sold the *C* shares and the taxpayer continued in business in Canada as an investment company.

The Commissioner asserted a deficiency against the taxpayer without joining *B* or its shareholders, contending that in substance the sale of *C* shares had been effected in the United States. The Board found for the taxpayer on grounds the sale of *C* shares had been effected in Canada and hence was non-taxable gain of a nonresident foreign corporation from sources outside the United States. In distinguishing the *Kaspare Cohn* case, the Board simply concluded that the taxpayer was not an agent or instrumentality of the *B* corporation or its shareholders. However, it left open the question of whether the *B* corporation or its shareholders might not have been subject to tax because of the sales activities in the United States; because the Commissioner had proceeded only against the taxpayer the Board held the *Kaspare Cohn* case was not controlling.

Apparently by 1932 the use of foreign corporations in the foregoing patterns had become sufficiently widespread to prompt Congress, upon Treasury urging, to act. As a result Congress enacted what is now Section 367 of the Code as Section 112(k) of the 1932 Revenue Act.³⁹ Although both the judicial background and committee reports⁴⁰ reveal a primary concern with avoidance of capital gains tax, the terms of the statute, "Federal income taxes," indicate that Congress has cast a wider net.

In addition to the denial of tax-free status for the transactions falling under Section 367, the 1932 Revenue Act also imposed a special excise tax on certain transfers to foreign corporations and other entities. The Section 1491 excise tax is applicable to transfers of appreciated stock or securities by a United States citizen, resident, corporation, partnership or trust to a foreign corporation, as paid in surplus or capital contribution, or to a foreign trust or partnership. The tax is imposed at a rate of 27.5 percent on the unrealized gain, unless the taxpayer secures a ruling of non-tax avoidance from the

³⁹ IRC § 112(k) became § 112(i) in the 1934 Revenue Act and remained as such in the 1939 Code.

⁴⁰ H.R. Rep. No. 708, 72d Cong., 1st Sess. (1932), 1939-1 (Part 2) Cum. Bull. 457, 471; S. Rep. No. 665, id. at 515.

UNITED STATES AND UNITED KINGDOM TAX RESTRAINTS

Service.⁴¹ As in the case of the Section 367 legislation the declared purpose of the Section 1491 tax was to "check transfers of stock or securities in which there is a large appreciation in value to foreign corporations or trusts for the purpose of avoidance of taxes on capital gains."⁴²

It is worth special mention that the Section 1491 tax is limited to transfers of appreciated stock or securities and would not be applicable to capital contributions in the form of other property such as machinery or tools, or such intangibles as patents, trade-marks, or "know-how." However, as discussed below, the Service evidently takes the position that the latter type of property falls within the confines of Section 367 where made as capital contributions.

The proposed Foreign Investment Incentive Tax Act of 1960 contains three changes that pertain to Foreign Business Corporations⁴³ and to foreign corporations otherwise subject to Sections 367 and 1491. These changes cover (1) the exemption from Section 367 of transfers in the formation of Foreign Business Corporations and in the formation of foreign subsidiaries of Foreign Business Corporations; (2) the exemption from the Section 1491 excise tax of certain transfers from Foreign Business Corporations to foreign corporations; and (3) the realization of gain or loss upon transfers of inventory to a Foreign Business Corporation or to a foreign corporation.

The first of the proposed changes can be attributed to an awareness by the Ways and Means Committee of the broad interpretation that has been placed by the Service on the term "tax avoidance" in Section 367.⁴⁴ Perhaps fearing that the Service would unduly hamper both the formation of Foreign Business Corporations with foreign assets and the use of such corporations as holding companies, the proposed act amends Section 367 in two important respects. In the first place, Section 367(b) permits the transfer (whether or not in liquidation) of substantially all the property of a foreign corporation to a Foreign Business Corporation without requiring clearance from the Service. Compliance with the appropriate tax-free subchapter C provisions would be required. The foregoing provision will permit the reorientation of "less-developed" country operations around a Foreign Business Corporation using assets currently employed in foreign operations without tax cost. In the second place, proposed

⁴¹ IRC § 1492; Treas. Reg. § 1.1492-1 (1955). Transfers to charitable organizations enumerated in § 501 (other than § 401(a) trusts) are exempt from the § 1491 excise tax.

⁴² Supra note 40.

⁴³ Supra notes 16 and 17.

⁴⁴ H.R. Rep. No. 1282, 86th Cong., 2d Sess. 15 (1960).

Section 367(c) permits the formation of foreign subsidiaries of Foreign Business Corporations also without clearance from the Service. Apparently because such transfers will remove assets from United States tax jurisdiction it was believed necessary to impose a number of restrictions on Section 367(c) transactions. These restrictions are as follows: (1) the transferee foreign corporation must be controlled as defined in Section 368(c) of the Code (80 percent stock ownership) by one or more Foreign Business Corporations; (2) the transferee must be a "qualified payor corporation" with respect to each stockholding Foreign Business Corporation; and (3) the property transferred is limited to "foreign business property," which is defined as property transferred for use in the transferee's trade or business and so used within six months. The broad purpose of the latter restriction, an articulation of the economic penetration doctrine, is to restrict such transfers to property intended to be used in an active trade or business in a less-developed country. "Foreign business property" does not include inventory or stock of a domestic corporation, or stock of a foreign corporation unless the latter has been a "qualified payor corporation" for the three prior taxable years and will be such for the year following the exchange.

As a correlative amendment to Section 367(c), a proposed amendment to Section 1492 will permit the transfer of stock or securities by a Foreign Business Corporation to a foreign corporation as a capital contribution free of the Section 1491 excise tax. The only prescribed limitation is that any stock be "foreign business property," which, as indicated above, precludes a transfer of stock of a domestic corporation and imposes certain limitations with respect to stock of a foreign corporation.

Perhaps one of the most far-reaching amendments contained in the proposed Act is the addition of Section 78 to the Code. Under Section 78 a transfer by any person of inventory (Section 1221(1) property) to a Foreign Business Corporation or to a foreign corporation either in exchange for stock or as a contribution to capital constitutes a taxable event. Section 351 (tax-free transfers to controlled corporations) is expressly made inapplicable. The purpose of Section 78 is to prevent the deferral of gain on inventory during the period of time such inventory is held in the United States.⁴⁵ However, the statute would presumably apply to a transfer of foreign branch inventory of a United States domestic corporation. Although the basic purpose appears to be to reach gain on such inventory transfers the statute is broad enough to apply to the recognition of loss.

⁴⁵ *Id.* at 16.

Section 78 would not apply to inventory sales in the ordinary course of business, nor to capital transfers to noncorporate entities or persons. And transfers by a foreign corporation to a Foreign Business Corporation under Section 367(b), discussed above, would be outside the Section.

2. *The Commissioner's Jurisdiction.* Apart from the foregoing proposed changes, Section 367, in effect, vests the Commissioner with discretion to determine whether any of the enumerated exchanges are to be denied tax-free status because they involve "the avoidance of Federal income taxes." The scope of the term "Federal income taxes" was alluded to above where it was revealed that the legislative history of the Section indicates that Congress was primarily concerned with avoidance of capital gains taxes. However, in terms, the statute extends to all Federal taxes on income, including individual, corporate, accumulated earnings tax, and excess profits taxes.

Of more difficult determination is the meaning of the term "avoidance." While this term can acquire content only in the context of the actual application of the statute to specific cases, certain broad aspects of the term deserve attention here. It is understood, for example, that the Service takes the position, apparently on the strength of the broad meaning of the term "avoidance," that a capital contribution of property (other than stock and securities subject to the Section 1491 excise tax) requires clearance under Section 367.

The foregoing position of the Service has not been announced in any known ruling and its underlying rationale is not altogether clear. It is apparent that the Service would be on firm ground in asserting jurisdiction under Section 367 on the basis of the step-transaction doctrine. For example, if X, a United States parent, were to form Y, a foreign subsidiary, with a small amount of cash followed shortly thereafter with a contribution of appreciated property, there is little doubt that both transactions could be validly telescoped under Section 351 and thereby brought under Section 367. On the other hand, where appreciated property is contributed at a time and manner unassociated with an exchange of property for stock, the claimed authority of the Service becomes doubtful. It is true that the Code, in some respects, appears to regard capital contributions and Section 351 exchanges as substantially similar transactions. Thus, under Section 362 express provision is made for preserving the transferor's basis in the hands of the transferee, for property transferred under both Section 351 and as paid-in surplus or a capital contribution. However, such basis rules would appear to constitute a slender reed for asserting Section

367 jurisdiction, and it would seem that such an extension of coverage should be a matter for Congress rather than the Service.

Perhaps the most fundamental limitations on the Commissioner's power under Section 367 are to be found in the rules governing the determination of source of income.⁴⁶ If a tax is asserted against a domestic corporation, individual citizen or resident involved in an exchange, no source of income problem would arise because such taxpayers are subject to tax on their world-wide income. However, where tax is asserted against foreign corporations or nonresident aliens it may be necessary to determine whether such taxpayers are engaged in trade or business in the United States; only in such case are foreign corporations and aliens (not present in the United States during the taxable year) subject to tax on capital gains.

The foregoing rules are exemplified in *Texas-Canadian Oil Corporation, Ltd.*⁴⁷ In this case, the taxpayer, a Canadian corporation doing business in the United States, exchanged, in Canada, its United States assets, including oil and gas leases (land) in Texas, for the stock of a Bahama corporation. The Board held that gain on the exchange with respect to the United States land was subject to tax because from a United States source.⁴⁸ The Commissioner made no attempt to tax the gain on the personal property, the contract of exchange (sale) having been made outside the United States.⁴⁹ If the taxpayer had been a nonresident corporation, all the gain would have escaped tax because such would not be characterized as being of a "fixed or determinable annual" type.⁵⁰

The foregoing principles, of course, apply to individuals as well as corporations.⁵¹ However, the mere fact that a foreign corporation may be involved in an exchange does not *per se* invoke Section 367. For example, in *Revenue Ruling 55-45*,⁵² X and Y corporations were

⁴⁶ IRC §§ 861-64.

⁴⁷ 44 B.T.A. 913 (1941).

⁴⁸ IRC § 861(a)(5).

⁴⁹ IRC § 862(a)(6).

⁵⁰ IRC § 881.

⁵¹ In *Kinkel v. McGowan*, 188 F.2d 734 (2nd Cir. 1951), affirming 97 F. Supp. 43 (D.C.N.Y.), the taxpayer, a United States citizen, had received notes and bonds as security for services rendered X, a Canadian corporation. Later, the taxpayer received shares of Y, a successor Canadian corporation to X, as an X bondholder, the taxpayer along with other creditors having purchased after foreclosure. The taxpayer argued that since the reorganization involved two foreign corporations there was no need to secure clearance under § 367 since the only purpose of the prior-ruling requirement was to prevent tax avoidance transfers from domestic to foreign corporations. The court rejected the foregoing argument pointing out that the statute makes no such distinction nor does the legislative history indicate any such limited intent.

⁵² 1955-1 Cum. Bull. 34.

both wholly owned United States subsidiaries of *Z*, a Canadian corporation. A merger under state law of *X* and *Y* was proposed. Under the plan *Y* would acquire the business and assets of *X*; *X* would issue new common in exchange for *Y* shares. The Service ruled that Section 367 clearance was not required because even if *X* and *Y* shares had been held by an individual instead of a foreign corporation, the merger would have qualified as a reorganization. In other words, the reorganization had the same effect whether or not the foreign corporation was "considered as a corporation" under Sections 354, 361 and 368 of the Code.

Further, it would appear that capital transactions of the subchapter C type entered into between two or more foreign corporations would fall outside the scope of Section 367. For example, if *X* corporation were conducting its foreign operations through *Y* foreign corporation, a base company, and *Y* transferred part of its assets to *Z* corporation in still another country in exchange for *Z* shares such an exchange would not appear to be subject to the Commissioner's jurisdiction under Section 367.

Where jurisdiction does exist, it is worth special mention that clearance by the Service prior to entering into any exchange is a prerequisite to the nonrecognition benefits. In the *Texas-Canadian* case, discussed above, the taxpayer had not been aware of Section 367 and failed to request a prior ruling for the reorganization exchanges. The taxpayer argued that the Board had authority to relieve it of the hardship if it found that the plan of reorganization did not have tax avoidance as one of its principal purposes. However, not only did the Board deny its own powers in the foregoing respect, but also upheld the Commissioner in the latter's determination that he was without authority to clear the transaction after it had taken place.⁵³

Finally, although issues of whether jurisdiction exists would be subject to judicial review, once such determination is made, judicial review would be available only upon a demonstrated abuse of administrative discretion.⁵⁴

B. *United Kingdom*

Section 468 (1) of the Income Tax Act, 1952, makes it unlawful for a United Kingdom resident corporation (including an investment

⁵³ Transfers of stock and securities to foreign corporations as capital contributions subject to the § 1491 excise tax can be cleared after a transfer. § 1494(b).

⁵⁴ Long, *When Is an Exchange Not the Avoidance of Federal Income Taxes?* N.Y.U. 7th Inst. on Fed. Tax 1174 (1949).

company with respect to its share holdings) to enter into any of the following transactions without Treasury consent:

(1) to transfer management and control abroad as to cause the corporation to be nonresident;⁵⁵ (2) to transfer any part of its trade or business to a nonresident person; (3) to cause or permit a controlled nonresident corporation to issue shares or debentures; or (4) to transfer shares or debentures of a controlled nonresident corporation held by the resident corporation.

The exceptions and modifications to the foregoing prohibited transactions are discussed below in connection with the: (1) legislative history of Section 468; and (2) the Treasury's jurisdiction under the provision.

1. *Legislative History.* The legislative history of most United Kingdom tax measures can best be described as amorphous. The cabinet system of government has not developed anything comparable to the reports of the two tax-writing committees of the United States Congress. On the other hand, it is often possible to piece together from the debates in Parliament and elsewhere, the background and policy of most United Kingdom legislative measures, especially where one is labeled with the term "tax avoidance" as is the case with Section 468.

Section 468 as originally enacted in 1951 was directed at two basic facts of British commercial life that had apparently reached a new high in development after the end of World War II: (1) the removal of United Kingdom companies and their foreign subsidiaries from United Kingdom tax jurisdiction; and (2) the tax-free bailout of earnings of nonresident foreign subsidiaries "controlled" by United Kingdom companies.

As regards removal, or migration, from United Kingdom tax jurisdiction, United Kingdom law appears to have long adhered to the principle that a taxpayer is free to arrange his affairs to minimize his tax liability; in other words, tax avoidance, as distinguished from tax evasion, is a privilege of the United Kingdom taxpayer.⁵⁶ Perhaps

⁵⁵ §§ 468(1)(a), 468(7), the latter defining residence on the basis of the locus of management and control thereby codifying the body of judicial precedent on the question. Where a corporation has already been "established," as between the Crown and the corporation, as resident, the corporation then has the burden of proof of showing that a change has taken place (apparently before the coming into effect of § 468 in 1951). § 468(7).

⁵⁶ For some recent commentary on the distinction between "evasion" and "avoidance," including some suggestions that perhaps "avoidance" is less privileged than it once was see Farnsworth, *Public Policy and Legal Avoidance*, 18 Sol. 197 (1951); Wheatcroft, *The Attitude of the Legislature and Courts to Tax Avoidance*, 18 Modern L. Rev. 209 (1955); Bowman, *Tax Evasion—The Legal and Practical Consequences*,

it is for this reason that there is no suggestion, even by government counsel, in the cases pertaining to corporate residence that tax liability should be predicated upon a deliberate arrangement designed to remove or establish management and control outside the United Kingdom. And it is clear that since the end of World War I and the establishment of a relatively high rate of income tax⁵⁷ many United Kingdom companies have arranged their affairs in the foregoing manner motivated in part, at least, by tax considerations.

The attitude of the courts, especially the lawmaking House of Lords, is revealed in *Todd v. The Egyptian Delta Land and Investment Co. Ltd.*⁵⁸ This 1929 decision was the first of the House of Lords dealing with the residence of a United Kingdom company that had migrated. Although remaining incorporated and retaining a registered office in England, the Board of Directors had been removed to Egypt where the company's business activities were conducted. The government's principal argument was that English company law, with its requirement of a registered office, required a finding that the taxpayer was resident in the United Kingdom for tax purposes. However, the House of Lords reinstated the findings of the General Commissioners, overruling both the King's Bench Division and the Court of Appeal to the effect that the taxpayer was resident in Egypt and not in the United Kingdom. In forty-five pages of opinion stretching from the case stated by the General Commissioners through the intermediate courts to the House of Lords there is no suggestion by court or counsel that removal of residence should be considered even as a factor in determining tax liability. On the contrary, Viscount Sumner, delivering the principal opinion of the House of Lords, seemed concerned about the reliance of United Kingdom companies on the

1958 J. Bus. L. 158; Royal Commission on The Taxation of Profits and Income, Final Report, Cmd. 9474, Chaps. 32 and 33 (1955).

⁵⁷ On the eve of World War I standard tax was 6.25%; at the end of the war it stood at 30%. During the following two decades the rate ranged downward to 25% where it stood prior to World War II at which time it jumped to 50%. Following the close of the war the rate has edged downward to its present rate of 38.75% for 1960-61. See 1 Simon, op. cit. supra note 3 at § 93 for a table of rates for the years 1799 to 1952-53.

Profits Tax, computed in a manner similar to income tax and imposed only on corporations, had its origins in a special defense tax (National Defense Contribution—NDC) imposed as a revenue measure in 1937 upon all forms of business. In 1947 the purpose was changed to a measure to control inflation, rates on corporations being graduated up to as high as 30% on distributed profits. In 1958 the revenue purpose was restored, tax being imposed at a flat rate of 10% which was increased in 1960 to 12.5%, resulting in a combined standard tax (38.75%) and profits tax rate of 51.25% on corporations.

⁵⁸ [1929] 14 Tax Cas. 119-164 (H. of L.).

therefore established rule that the locus of management and control was decisive. He observed:⁵⁹

The matter is one of very general importance. Many companies have, at the cost of some trouble and expense, transferred their control and management abroad on the faith of decisions, or if you will, *dicta*, to the effect that by so doing they could legitimately reduce the burden of their taxation. Are they now to reconsider their position and if so in what direction?

Undoubtedly, the new higher plateau of rates established during World War II and maintained thereafter (including, at one time a 30 percent profits tax rate on distributed earnings), currency and customs restrictions in foreign countries making direct investment necessary to retain export markets, and a host of other factors all increased the pressures for company migration. Further, and perhaps of equal importance, since 1945 the United Kingdom has experienced considerable difficulty in maintaining a satisfactory balance of payments. It was believed that migration of direct investment would reduce the supply of foreign exchange produced by English export trade. Therefore, it would appear that it was primarily a combination of revenue loss and the need for foreign exchange that led to the enactment of what is now Section 468 in 1951.

However, the emergency nature of trade balances, together with the feeling that the statute constitutes a serious restriction on commercial freedom, undoubtedly accounts for the thought, in some quarters at least, that Section 468 is expressive of a temporary tax policy. The recent Royal Commission on The Taxation of Profits and Income had this to say:⁶⁰

We do not see what we can be expected to say about a section of this kind. It has no real connection with the subject of tax avoidance, and we take it that we ought to regard it as a temporary regulation to deal with an emergency, the existence of which made it imperative for the Government to take measures to maintain the yield of revenue, even at the cost of an interference as extreme as this. . . .

⁵⁹ Id. at 156.

⁶⁰ Supra note 56, Par. 1046. The Commission recommended that § 468 be removed from the permanent Income Tax Act, 1952 and enacted in the annual Finance Acts as long as Parliament deemed the emergency to exist. This has not been done. The tenacity of tax measures defies analysis. Gladstone regarded the Income Tax Act, 1853, as a temporary measure, stating he was against the permanent employment of an income tax as a national financing device. See 1 Simon, op. cit. supra note 3, § 73.

We do not suppose that we ought to regard it as a permanent feature of our tax system that a company can only decide on a matter of this kind if it is permitted to do so by the Government.

The second facet of tax avoidance under Section 468, the bailout of earnings of foreign subsidiaries, presents quite different considerations than those outlined above. Bailout, of course, has relevance only in situations where a foreign subsidiary is nonresident so that the United Kingdom tax is deferred until remitted in the form of dividends.

As a preliminary matter, it is worth noting that the terms of Section 468 contemplate situations where a foreign subsidiary would be controlled within the meaning of Section 468, but be nonresident because management and control was exercised abroad through a separate board of directors. For example, Section 468(1) (c) and (d) employed the terms "body corporate not so resident over which it [resident company] has control." Also, the term "control" as defined in Section 468(10) expressly excludes from its definition the same term found in Section 468(7) which defines residence on the basis of the judicially developed principle of the locus of management and control.

Experience in the United States has indicated a need for almost minute statutory regulation of bailout in stock redemption, partial and complete liquidation, and reorganization of corporations. On the other hand, the United Kingdom taxpayer, notwithstanding freedom from a capital gains tax, apparently has not exploited bailouts on the domestic level to the same extent as his American counterpart.⁶¹ Perhaps one reason for this is the long maintained integration of corporate and individual standard income taxes in the United Kingdom. In any event, subject to few exceptions,⁶² the rules governing, or rather permitting, bailout in the United Kingdom are primarily a product of the case law. And under United Kingdom case law neither the issuance of a stock dividend (bonus issue),⁶³ nor the subsequent

⁶¹ For a comparative analysis see Chommie, *Surtax Avoidance and Extra Taxation of Corporate Earnings in the United States, United Kingdom and Canada*, 12 *Tax. L. Rev.* 279 (1957), reprinted in 5 *Can. Tax. J.* 237 (1957).

⁶² E.g., § 233 of the Income Tax Act, 1952, expressly provides for inclusion of undistributed profits in the income of shareholders for surtax purposes upon liquidation of a § 245 company, a closely held corporation which is subject to administrative direction of deemed-paid dividends when earnings have been accumulated unreasonably. The foregoing legislation is comparable to the United States accumulated earnings tax. See Chommie, *id.*

⁶³ *Inland Revenue Commissioners v. Fisher's Executors*, [1926] A.C. 395, allowed a tax-free distribution of a six-year debenture redeemable at the company's option.

redemption of stock in a capital reduction or in a liquidation give rise to taxable income, such benefits to the shareholder being characterized as capital receipts.⁶⁴

In the international area there does appear to have been some exploitation of bailout of the earnings of foreign subsidiaries. Although the corporation laws of many countries impose limitations on the issuance of stock dividends and redemption of shares,⁶⁵ it has been possible for United Kingdom parent companies with overseas subsidiaries to cause the capitalization of earnings through issuance of stock dividends or debentures and later to cause their tax-free redemption. In this manner, foreign earnings formally remitted by a foreign subsidiary to a United Kingdom parent as ordinary dividends subject to United Kingdom tax are converted into tax-free capital receipts.⁶⁶ The foregoing transactions have now been brought under the control of the Treasury through the terms of Section 468(1) (c) and (d), paraphrased above, dealing with the transfer and issuances of shares and debentures of controlled nonresident corporations.

2. *The Treasury's Jurisdiction.* Section 468(10), defining certain terms, contains a final proviso that a corporation "shall not be deemed for the purposes of this section to cease to be resident in the United Kingdom by reason only that it ceases to exist." The purpose of the foregoing clause is not altogether clear. However, the language would appear broad enough to control a possible abuse of the first category of unlawful transactions—the transfer of management and control abroad—through liquidation of a United Kingdom resident company followed by reincorporation and location of management and control abroad.

In other respects, the terms of Section 468 impose a number of important limitations on the discretion given the Treasury. First, the statute expressly provides, as a limitation on the second category—the transfer of any part of a trade or business to a nonresident person—that "in no event shall a mere transfer of assets . . . not resulting in a substantial change in the character or extent of the trade or business

⁶⁴ *Inland Revenue Commissioners v. Burrell*, [1924] 2 K.B. 52 (C.A.). See also *Brudno and Bower*, op. cit. supra note 20, 9/10.7; Note, *Taxation of Capitalization Issues*, 99 Sol. J. 572 (1955).

⁶⁵ E.g., United Kingdom law itself restricts share redemptions. *Companies Act*, 1948, §§ 4, 54.

⁶⁶ See Note, *Tax Avoidance by Companies*, 212 L.T. 93 (1951).

It is worth noting that all dividends of nonresident companies, whether paid out of business profits or capital gains, are subject to tax in the hands of United Kingdom recipients. *Inland Revenue Commissioners v. Reid's Trustees*, [1949] 30 Tax Cas. 431 (H. of L.).

[of the resident corporation] . . . be treated . . . as a transfer of a part of the trade or business."⁶⁷ It seems clear that a determination of what would constitute a "substantial change" in the transferor's business would not be within the discretion of the Treasury, but would be subject to the fact findings of the Special Commissioners and judicial review. However, to date no British company appears to have been sufficiently willing to face the risks of the severe penal sanctions to litigate the foregoing issue.⁶⁸

A similar problem, essentially factual, could arise under the statutory definition of "control" of a nonresident corporation, which term is defined as the ability to have the nonresident company's "affairs . . . conducted in accordance with the wishes" of the United Kingdom company.⁶⁹

Jurisdiction of the Treasury is also limited with respect to investment companies. Although investment company activities are treated as trade or business under Section 468 (1)(6), this is true only when the functions of such a company "consist wholly or mainly in the holding of investments or other property."⁷⁰ Thus, casual holdings of operating companies would not appear to be within the purview of the statute.

The statute excludes from the third category of unlawful transactions—the issuance of shares or debentures of a controlled nonresident corporation—transfers of such shares or debentures to banks or insurance companies as security in the ordinary course of the latter's lending activities.⁷¹

Finally, the fourth category—restricting transfers of resident company held shares and debentures in controlled nonresident companies—does not apply to transfers made to qualify a transferee as a company director.⁷²

IV. THE CRITERIA OF TAX AVOIDANCE

It is clear that Sections 367 and 468 impose restrictions on the movement of capital in international operations. However, by any

⁶⁷ § 468(9).

⁶⁸ The Penal sanctions for any person involved in any of prohibited transactions are severe. A director of a United Kingdom company is presumed to be a party to an offending transaction unless he can establish that the act was done without his consent or connivance; and a director is presumed to know that an act was wrongful. Penalties are fines up to £ 10,000 or imprisonment up to two years or both. A United Kingdom corporation may be fined up to three times the total income and profits tax paid or payable for the three years of assessment preceding the offence. § 468(5) and (6).

⁶⁹ § 468(10).

⁷⁰ § 468(8).

⁷¹ § 468(2) and (3).

⁷² § 468(i)(d).

pragmatic test, the scope of such restraints would depend upon the manner in which the granted discretion is exercised by the administrative agent. This section will examine those factors considered by the United States Internal Revenue Service and the United Kingdom Treasury in granting or refusing clearance to proposed transactions.

A. *United States*

Under the Internal Revenue Code, insofar as a particular objective can be reached other than through the tax-free exchange provisions, Section 367 can be regarded as being but a nuisance factor in making the capital adjustments constantly required in international trade and investment. If a foreign corporation can be formed with cash, unappreciated or leased property, Section 367 does not present a serious obstacle, and may be only an irritant because it would prevent the transfer of particular appreciated assets that would otherwise be used in a Section 351 exchange. On the other hand, Section 367 can present more serious problems. A domestic taxpayer may find himself "locked-in" with appreciated assets located abroad and with no alternative to the payment of a capital gains tax as the price of making a needed formal change in asset ownership.⁷³

⁷³ Ordinarily nonrecognition of gain would be the most desirable consequence of forming, reorganizing, or liquidating a foreign corporation. However, recognition may also result in some advantages. For example, recognition of gain upon a transfer of depreciable assets to a foreign corporation would insure that the latter would have the benefits of a depreciation deduction based on the value of the property in computing tax for both United States and foreign tax purposes. Further, even if the foreign tax system would allow a foreign subsidiary, for example, to use the value of transferred property in computing depreciation whether or not a transferor-parent had been subject to United States tax on the transfer, non-recognition could have an adverse effect in computing the parent's foreign tax credit. The foregoing can be illustrated by example: assume *X*, United States parent corporation, transfers machinery, under § 351, having a zero basis and a value of \$100,000 to *Y*, its controlled foreign subsidiary. Assume further that *Y*'s gross profit for the year is \$10,000 and it is allowed a \$9,000 (9%) depreciation deduction on the machinery, yielding a taxable profit of \$1,000. Assume further a foreign tax rate of 30% resulting in a foreign tax of \$300, and that *Y* remits the \$700 balance of profits to *X* as a dividend.

Under *American Chicle Co. v. United States*, 316 U.S. 450 (1942), the formula for the computation of *X*'s credit can be expressed as follows:

A—Dividend paid to parent

B—Accumulated profits of foreign subsidiary

C—Total profits of subsidiary for year of dividend

D—Amount of foreign tax paid on C

$$\frac{A}{B} \times \frac{B}{C} \times D = \text{Amount of Credit}$$

If gain were recognized on the transfer of the machinery to *Y*, *X* would be allowed a foreign tax credit of \$210 computed as follows:

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In the latter cases, the taxpayer ordinarily must be able to convince the Service that a proposed exchange is motivated by business reasons and that such reasons outweigh any tax avoidance factors. And strong, cogent, nontax business reasons can often be advanced for forming, reorganizing or liquidating foreign corporations. For example, it is arguable that the following reasons ought to be persuasive that business motives rather than tax avoidance motives are dominant in the formation of a foreign corporation:⁷⁴ (1) insulation of the assets of a domestic parent from foreign risks and tax burdens; (2) availability of the advantages of foreign status and laws, including laws pertaining to the forms of business organization, trading with other countries, tax treaties, exchange controls, and government concessions and contracts; and (3) establishment of a business unit more capable of developing foreign markets and dealing with the multitude of special problems arising out of foreign trade and investment.

However, it is believed that the Service is less impressed with

$$\frac{700}{700} \times \frac{700}{1000} \times \$300 = \$210$$

On the other hand, if gain were not recognized under § 351, it would seem that the depreciation deduction and stepped-up basis would not be recognized under United States standards; the result would be that X's foreign tax credit would be limited to \$21.00, computed as follows:

$$\frac{700}{9700} \times \frac{9700}{10,000} \times \$300 = \$21.00$$

The foregoing computations are based on the assumption that the Service and the courts would apply United States standards in computing accumulated profits and net profits of Y, a foreign corporation. However, one international accountant reports that "as a practical matter, the common practice is to determine both the total profits of the foreign affiliate and its accumulated profits by reference to the income reflected in the accounts of the foreign affiliate rather than in the tax returns of the foreign affiliate or by reference to the technical provisions for determining earnings and profits for United States income tax purposes." Cohen, *Tax Accounting Problems in International Operations*, N.Y.U. 18th Inst. on Fed. Tax 293, 312-13 (1960). Cf., *United Fruit Co. v. Hassett*, 61 F. Supp. 1013 (D. Mass. 1945), generally cited for the proposition that United States standards are to be used in determining profits and accumulated profits. This case involved the inclusion of a casual capital gain, not subject to tax under United Kingdom law, the court holding that such gain should be used in applying the formula for computing the foreign tax credit.

⁷⁴ For an excellent discussion of business purpose see Baker, *Selection of Foreign or Domestic Corporations for Foreign Business Operations*, 1958 Tul. Tax Inst. 416 (1959). Thus, in Rev. Rul. 57-465, 1957-2 Cum. Bull. 250, a proposed merger of a foreign holding company into a foreign operating company was cleared, the Service perhaps being influenced in large measure by the corporate business purposes of avoiding the necessity of transferring patents, trade marks, labor agreements, and foreign land concessions held by the operating company. Also, in a special ruling of December 17, 1954, the Service cleared a proposed amalgamation of two Canadian banks, indicating that the business reasons of economy and more efficient service justified the action taken.

business reasons than it is with the effect of a proposed exchange. If the principal result of a proposed plan is to leave the foreign corporation in the position of an insulator from United States tax, Section 367 clearance can hardly be expected. In the other extreme, if the factor of tax avoidance or deferral plays no role at all, such as may be the case in converting a foreign corporation into a domestic form, or removing a foreign operating company to another country, the business purposes for such changes should be sufficient to warrant the issuance of a favorable Section 367 ruling.

Against the foregoing background the attitude and action of the Service may be considered under the following headings: (1) base company operations; (2) foreign law and policy inimical to United States investment; (3) economic penetration of foreign countries by operating companies; (4) promotion of United States foreign economic or political policy; and (5) the effect of the character of the assets transferred.

1. *Base Company Operations.* Technically, the Code does not distinguish between a directly owned foreign operating corporation and the well known base company that often functions as a holding company.⁷⁵ However, from the viewpoint of the Service and tax avoidance under Section 367, it appears that a sharp distinction between operating and base companies must be made. The distinction arises out of the more wide-spread tax advantages often available where a base company is used as the guiding vehicle in multi-country operations.

In broad outline, where a United States domestic parent organizes a subsidiary in a base country (tax haven or tax sanctuary) selected because it does not tax corporate income or because it subjects only its own domestic source income to tax, the following tax advantages may exist:⁷⁶ (1) freedom in transferring accumulated profits earned abroad between business units without subjecting them to United States tax; (2) averaging or "homogenization"⁷⁷ of foreign tax rates

⁷⁵ Generally, the foreign personal holding company restrictions of the Code, §§ 551-558, present no serious problems with respect to § 367. However, base company operations would be difficult for a closely held United States corporation or a small group (where 50% or more of the holding company's stock is owned directly or indirectly by not more than five individual citizens or residents) unless the holding company itself engaged in a trade or business yielding more than 40% of its gross income.

⁷⁶ For a detailed discussion see Gibbons, *op. cit. supra* note 19.

⁷⁷ This term is attributable to Brudno, *Tax Considerations in Selecting a Form of Foreign Business Organization*, 13 Vand. L. Rev. 151, 161 (1959). Averaging is available in direct foreign operations on an elective basis under an "overall" limitation on the foreign tax credit for post-1960 tax years. § 904(a)(1) as amended by PL 86-780 (1960).

for purposes of the United States foreign tax credit, on the basis that foreign income taxes paid by a foreign holding company's subsidiaries are deemed paid by the holding company;⁷⁸ and (3) freedom in structuring holding company operations to the tax burdens and laws of foreign countries.

Therefore, in the discussion that follows, the distinction drawn by the Service should be constantly kept in mind. For example, a favorable ruling for establishing an operating company can not be regarded as Service acquiescence, to a similar situation involving a base company.

2. *Foreign Law and Policies.* The Service appears to have exhibited considerable sympathy in considering Section 367 ruling requests where action is threatened by foreign governments or where conditions exist that represent a threat to the security or well-being of foreign investments. For example, in *Revenue Ruling 54-499*,⁷⁹ a domestic corporation, engaged in petroleum refining and marketing, owned the controlling interest in a Canadian corporation. It was believed that the business advantage of both companies would be best served by putting the Canadian company under the control of another Canadian company; among the reasons advanced was Canadian resentment toward American control. The Service cleared the tax-free formation of another Canadian holding company in a reorganization and the tax-free distribution of the new company's shares to the shareholders of the domestic corporation. It is worth mentioning, that if the relatively mild resentment of Canadians as regards controlling United States interests can play a part in moving the Service, it would appear that ruling requests involving more volatile foreign countries could make out even better cases.

Situations involving direct action by foreign governments have quite often moved the Service to grant Section 367 clearance. For example, it is understood that in one case, after the nationalization of the Suez Canal, the Egyptian government put pressure on certain United States interests to incorporate their holdings under Egyptian law. Accordingly, Section 367 clearance was obtained for a transfer to an Egyptian corporation. And one writer records an even more far-reaching ruling. A United States corporation owned an operating utility subsidiary in a foreign country, the latter being forced to sell under threat of expropriation. The Service thereafter cleared a Section 332 tax-free liquidation of the subsidiary on the grounds that the sale and liquidation were beyond the control of the foreign

⁷⁸ I.T. 4089, 1952 Cum. Bull. 142.

⁷⁹ 1954-2 Cum. Bull. 150.

corporation.⁸⁰ Another writer relates that the Service has granted Section 367 clearance for the liquidation of a subsidiary when it was shown that foreign exchange control laws prevented a remission of profits via the ordinary dividend route.⁸¹ A similar result could be expected where corporate life was coming to a close and charter renewal could not be secured.

It is also understood that the Service has cleared the formation of foreign subsidiaries pursuant to Section 351 where it has been shown that foreign corporation laws prevented such formations solely with property. For example, under the Argentine and Brazilian law 10 percent of corporate subscribed capital must be paid in cash, and similar requirements prevail under Mexican law.⁸² To meet the foregoing foreign law provisions where it is not desired to use cash in forming a foreign subsidiary, the Service has allowed a tax-free "purchase" of the property by the subsidiary with cash previously contributed by the parent.⁸³

The foregoing favorable rulings do not permit the inference that the Service regards as sufficient the suggestion often made that foreign incorporation eliminates the risks to domestic assets. Perhaps such a suggestion rings a bit hollow in the Service ruling section for no other reason than that it can be met with the observation that separate domestic incorporation would have the same risk elimination effect. However, such an observation in turn would have less validity where it could be shown that foreign law or courts would regard a domestic parent and its domestic subsidiary as a single entity. In any event, it is clear that a general risk argument can not be regarded as effective, especially where economic and political conditions in a foreign country are stable.

3. *Economic Penetration by Operating Companies.* The term "economic penetration," which perhaps can be regarded as synonymous with foreign business activity, has been most often associated with pure export operations of Western Hemisphere Trade Corporations and Possessions Corporations, the Service regarding such method of producing foreign income as not being entitled to the statutory concessions granted such business forms. There is also some evidence that the foregoing attitude permeates the process of considering ruling requests under Section 367. It is possible that the Service regards economic penetration as a proper showing of business purpose,

⁸⁰ Whitehill, *Foreign Corporate Exchanges*, 36 *Taxes* 622, 627 (1958).

⁸¹ Gibbons, *op. cit.* supra note 19, at 13.

⁸² See Gomez, *A Survey of the Law of Latin American Business Associations*, 337, 384-86, *Proceedings 1959 Inst. on Private Investments Abroad* (1960).

⁸³ Whitehill, *supra* note 80.

tax avoidance not otherwise being present. In any event, it is understood, for example, that where export operations have reached the point of actually doing business in a foreign country Section 367 clearance will be granted for a transfer of such business to a foreign corporation organized in the same country for purposes of carrying on the business. The foregoing rationale is also consistent with *Revenue Ruling 57-465*.⁸⁴ This ruling cleared the downstairs merger of an existing foreign holding company into a foreign operating company of the same country.

On the other hand, if the plan contemplates that the operating entity is to function through a holding company in a tax haven, the Service appears to regard the tax advantages of such base company operations as tax avoidance within the meaning of Section 367.

The principle difficulties lie with the in-between areas. For example, what effect is to be given to the situation where a holding company plans to engage in substantial trade or business on its own account? What effect is to be given to a holding company formed in a country that could not be characterized as a tax haven? Or assume that an existing holding company plans a spin-off of an existing trade or business qualifying under Section 355; will Section 367 clearance depend on the ratio of business income to investment income, or will the business aspects be tarred with the holding company brush? There are no ready answers to these and similar questions.

Finally, where there has been a successful economic penetration of a foreign economy and it is desired to return the accumulated profits tax-free under Section 332 the Service has been most adamant with respect to clearance. Except in the limited area discussed above pertaining to foreign expropriation or similar action of foreign states, where a foreign subsidiary possesses accumulated earnings or appreciated assets it would appear to border on the impossible to convince the Service that a tax-free liquidation is justified by corporate business purposes rather than tax avoidance. This task would appear equally as great with a foreign operating company as with a base company. The price of liquidation, whether the shareholder be a United States corporate parent or an individual is ordinarily a capital gains tax (unless the shares have acquired a stepped-up basis in the hands of an individual because of the death of a previous owner).⁸⁵

⁸⁴ 1957-2 Cum. Bull. 250. In this ruling the merger could not qualify as an "A" (§ 368(a)(A)) reorganization because by definition such a merger must be pursuant to the laws of a state or United States territory. However, the merger was held to qualify as a "D" reorganization, though not decisive in character; the distribution of the surviving corporation's stock qualified as tax-free under § 354.

⁸⁵ A liquidation of a foreign subsidiary for purposes of bailing out earnings at

4. *United States Foreign Policies.* On occasion the Service has cleared Section 367 exchanges where such transactions could be said to be attributable primarily to a foreign economic or political policy of the United States. For example, special rulings were issued granting clearance where certain German corporations were ordered split-up by the Allied occupation authorities in order to eliminate industrial concentration.⁸⁶ Also, in *Revenue Ruling 58-397*⁸⁷ a recapitalization of a German corporation was cleared having been made pursuant to the London Agreement on the German External Debt of 1953.⁸⁸ One writer also relates that during the closing of the Suez Canal it was United States policy to frustrate the blockade. Consequently, the Service contemplated issuing favorable Section 367 rulings for transferring Liberty ships to foreign corporations in order to secure foreign registry which was needed for profitable operations. Later it was learned that foreign registry could be made by United States owners, but before action was taken the Canal was reopened and the issue became moot.⁸⁹

Broadly, it is arguable that the Service attitude concerning economic penetration or active business in a foreign country is also a response to the general United States policy to encourage international trade and development of foreign economies. Such attitude, and the rulings outlined above, may indicate a limited willingness on the part of the Service to take non-tax or non-business matters into account in considering ruling requests. On the other hand, it can not be said that such an approach constitutes a new liberal attitude toward tax avoidance under Section 367. The evidence is too meager on the question of whether the Service consciously pursues a practice of attempting to correlate Section 367 ruling requests to national foreign policies. To suggest that the Service should do so is to point up the difficult administrative task that would be involved with respect to such matters as vague, uncertain, and often conflicting foreign policies. Undoubtedly, the ruling request that establishes a close correlation with an articulate and precise United States foreign policy is better off. But, the general argument that a proposed exchange is

capital gains rates, followed by reincorporation (where basis would equal value of shares received) would run the risk of the application of the step-transaction doctrine and treatment of any liquid assets retained as boot.

⁸⁶ Letter Ruling of November 2, 1953 (Farben Company), P-H Fed. Tax Serv. 1953 ¶ 76, 720; Letter Ruling of November 10, 1953 (Stahlwerke Company), P-H Fed. Tax Serv. 1953 ¶ 76, 740; Letter Ruling of January 19, 1954 (Kloekner Werke A. G. Company), P-H Fed. Tax Serv. 1954 ¶ 76, 529.

⁸⁷ 1958-2 Cum. Bull. 412.

⁸⁸ See Rev. Rul. 54-501, 1954-2 Cum. Bull. 197.

⁸⁹ Whitehill, *supra* note 80 at 628.

pursuant to a United States policy to encourage foreign investment can not, of itself, be expected to carry much weight in any realistic appraisal by the Service ruling section. It should be kept in mind that it is also United States policy, as expressed in Section 367 and its history, to prevent tax avoidance in forming, reorganizing, and liquidating foreign corporations.

5. *Character of the Assets.* The character of the assets and property exchanged under the subchapter C transactions enumerated in Section 367 may greatly affect the imposition of tax and the taxpayer's freedom in making needed capital adjustments. For example, the formation of a foreign corporation with cash or a contribution of cash to its capital would not ordinarily require a Section 367 ruling. If the cash were used to purchase appreciated assets from the transferor, the tax consequences would be identical to a Section 351 exchange without a prior ruling. Gain would be recognized and the transferee would acquire the transferor's basis. However, it will be recalled that the Service has cleared the latter type transaction under Section 367 where foreign law required certain percentages of initial capital to be paid-in in cash.⁹⁰ In such cases, presumably the effect is that of a simple transfer of assets, the nonrecognition of gain and a transfer of basis.

It is understood that where clearance is requested, for example, in converting a branch operation into a foreign operating company, the nature and proposed uses of the assets to be transferred will be examined closely by the Service. Generally, property intended to be used in the business, such as machinery, will be cleared, but not if the property is intended to be sold. The same rule has been applied to inventory. However, it will be recalled that the proposed Foreign Investment Incentive Tax Act of 1960 adds Section 78 to the Code. Section 78 would remove all transfers of inventory to foreign corporations from the purview of Section 367 and provide an express rule of recognition of gain or loss upon such transactions.

The handling of patent, trademarks, know-how, and other industrial properties presents some of the more difficult problems involved in international operations. And even from the limited viewpoint of Section 367 troublesome problems of valuation, drafting, and the Service attitude may present themselves. For business reasons it may be considered undesirable to make an outright assignment of transfer of patent or similar rights to a foreign corporation even where wholly owned. In such a case, a licensing agreement may avoid the need for a Section 367 ruling, although creating a multitude of other problems

⁹⁰ Ibid.

such as the proper allocation of royalties between a United States parent-owner and any holding company used to service the patent or other property.⁹¹

It is understood that for some period the Service did not approve the use of a base company to hold patents and other industrial property of United States parents. However, it has been related that more recently the Service may be now willing to clear Section 351 exchanges transferring such rights to a base company, "especially where the subsidiary is or will be actually engaged in business in the base country."⁹² Such a clearance, however, may well depend upon whether the exchange would have the effect of reducing or terminating income of the parent that has been subject to United States tax.

Transfers of stock and securities in effecting capital adjustments in international operations raise not only the application of Section 367 but also that of Section 1491. Section 1491 imposes a 27.5 percent excise tax on the amount of the appreciation in value of stock and securities transferred as a contribution to capital. Thus, both a capital gains tax and an excise tax would not be levied on the same transaction. For example, a transfer of operating company shares to a base company under a Section 351 exchange would not be treated as a contribution to capital and would generate only a capital gains tax unless cleared under Section 367.

Ordinarily, if a choice between a transfer of securities and property is available, the latter is to be preferred. Not only is gain limited to 25 percent, but any property transferred would acquire a stepped-up basis in the hands of the foreign corporation transferee. The foregoing choice may exist where, for example, the objective is to bring an operating company under a base company. Instead of transferring shares to the base company under Section 351, the operating company could be liquidated and capital gains tax paid resulting in a new basis for the assets received. Thereafter the assets could be exchanged under Section 351 for shares of the base company without taxable gain because basis would equal the value of the shares received. However, the foregoing reincorporation of assets would run the risk of the application of the step-transaction doctrine and treatment of the liquidation and formation as a reorganization.

⁹¹ See Wender, *Use of "Tax Haven" Corporations and Western Hemisphere Trade Corporations*, 1959 So. Cal. Tax. Inst. 253 (1959).

For a summary of the legal and business problems pertaining to foreign licensing see Eckstrom, *Proceedings of the 1959 Inst. on Private Investments Abroad* 483-558 (1959).

⁹² Slowinski and Creed, *Current Tax Developments in Domestic and Foreign Licensing Agreements*, 11 Tax Exec. 270, 284-85 (1959).

In such cases, any cash or property retained by the parent would be treated as boot.

Where Section 367 clearance is desired for a conversion of a foreign branch to a foreign operating corporation the holdings of the branch will be examined closely by the Service for pre-incorporation build up. If there is any evidence that branch assets including securities, have been built up, the Service will not clear the transfer of such securities to a newly formed corporation.

B. *United Kingdom*

From a purely statistical viewpoint, there is some evidence that the British Treasury has imposed substantial limitations on its own powers under Section 468. For example, after four years of administration under the provision it was revealed that out of 1100 applications for consent under the provision only fifteen had been refused.⁹³ On the foregoing basis it would appear that Section 468 has not had the effect of interfering seriously with the freedom of United Kingdom companies in making needed capital adjustments in international operations. However, statistics do not account for any *in terrorem* effect and mere numbers cannot provide the real test of the restraints; for this it is necessary to examine the standards actually applied by the Treasury in making decisions in particular cases.

As an initial matter, the wider scope of Section 468 does not give the United Kingdom resident company the freedom possessed by its American counterpart under Section 367 of the United States Code. However, under the terms of Section 468,⁹⁴ the Treasury has issued a number of general consents that may be considered as self-imposed limitations on the Treasury's power so long as such consents remain unrevoked. It appears that only general consents require publication, and research has failed to indicate any source of information with respect to special consents, which may be regarded as analogous to letter rulings of the Internal Revenue Service.

While specific application under an outstanding general consent would not appear to be required, it is not clear whether taxpayers in fact continue to file in such instances. The penal sanctions would seem to make such a filing desirable where there would be any question as to the application of a general consent.

Lacking published special consents, the policy of the Treasury in administering Section 468 can be deduced only from the terms of the published general consents, and from announcements of a broad

⁹³ Proceedings, House of Commons, April 28, 1955, 105 L.J. 285 (1955).

⁹⁴ § 468(4).

general nature. In the latter regard, the Treasury has stated that in considering applications it will, in effect, balance the business reasons advanced against the prospective loss of revenue or of foreign exchange.⁹⁵ Thus, the basic task of the United Kingdom company seeking consent under Section 468 would appear essentially the same as that of the United States taxpayer seeking clearance under Section 367, with the added burden in the United Kingdom of dealing with the factor of loss of foreign exchange.

The results of the decision making process of the United Kingdom Treasury do not lend themselves to the same classification used above with respect to the administration of Section 367 by the Internal Revenue Service, although, as will be noted, there are certain facets of similarity. The attitude and action of the United Kingdom Treasury may be best considered under headings corresponding to the four categories of prohibited transactions: (1) change of residence; (2) transfer of trade or business abroad; (3) issuance of shares or debentures by controlled nonresident corporations; and (4) transfer of shares or debentures of a controlled nonresident corporation.

1. *Change of Residence.* In an early report on consents granted under Section 468, the Financial Secretary to the Treasury revealed that of 400 applications twenty-eight fell under Section 468(1)(a) pertaining to change of corporate residence, and of the twenty-eight only one had been refused.⁹⁶ However, these figures provide little or no indication of the measure of freedom available; more revealing is the only general consent that has been published in this area.

Under the terms of the foregoing general consent, a nonresident corporation may be formed in order to engage in carrying "on a new trade or business not theretofore carried on by any person," provided more than 50 percent of the beneficial share ownership is vested in "persons not ordinarily resident in the United Kingdom."⁹⁷ This

⁹⁵ In establishing an advisory committee to aid in administering § 468, the terms of reference of such committee were that they would take into account "any new factors or circumstances which were represented to require the proposed transaction or other reasons for it, based on the efficiency and development of the applicant's operations, and, on the other hand, the prospective loss of revenue or of foreign exchange to this country involved in the transactions." See Note, *Tax Avoidance by Companies*, 212 L.T. 93 (1951); *Proceedings, House of Commons*, June 29, 1954, (Reply of Chancellor of Exchequer), 104 L.J. 445 (1954).

In practice it appears that the Advisory Committee is called upon only in the most difficult cases where consent is not ordinarily given outright by the Treasury. In such cases the Committee appears to have acted in accord with the final decision maker. E.g., in the foregoing report by the Chancellor it is stated that the Committee's recommendations had coincided with the final decision to refuse 14 applications.

⁹⁶ *Proceedings, House of Commons*, July 16, 1952, 102 L.J. 412 (1952).

⁹⁷ Statement of Chancellor of Exchequer in House of Commons, August 2, 1951, cited in 3 Simon, *op. cit.* supra note 3, § 64.

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consent is also made applicable to the second category of unlawful transactions pertaining to transfers of any part of a trade or business to nonresidents.

The foregoing consent is apparently designed to permit United Kingdom investors to take advantage of the tax incentive measures of many capital importing countries, which legislation is most often limited to relief with respect to new industry,⁹⁸ provided such investment is on a "joint-venture" basis with local capital possessing the majority interest. Subject to the "new trade or business" and foreign majority ownership limitations, a United Kingdom company could form a new company managed and controlled abroad employing assets currently used in a business or a trade or business itself, producing income subject to United Kingdom tax. Thereafter, such a nonresident corporation would be subject to Section 468 if "controlled" (for example, through a licensing agreement) by the United Kingdom corporate resident, notwithstanding majority ownership by the foreign interests.

The general consent above does not define the terms "new trade or business." While not free of doubt, the term apparently has reference to foreign economies. If such term had a fixed meaning under foreign law, as for example, in a tax incentive statute, such meaning would presumably govern.

It seems fairly clear that the foregoing general consent is not broad enough to permit the formation of a base company in a tax haven country to be used as a holding company. However, base company operations have not been exploited to any considerable extent by United Kingdom companies. In general, such operations do not provide either the business or tax advantages to United Kingdom parents that they do to United States domestic corporations.⁹⁹ Exchange restrictions in the sterling area have limited the availability of many haven countries used by American corporations. Also, there appears to be no advantage and some decided disadvantages with respect to credit for foreign taxes and treaty provisions. And, since 1951, Section 468 appears to have presented a practical obstacle to base company operations. On the other hand, since 1957, the Overseas Trade Corporation legislation probably provides, within the limitations of overseas trading profits, a higher degree of freedom to move surplus funds within an intracorporate network of Overseas Trade

⁹⁸ See e.g., Ross and Christensen, *Tax Incentives for Industry in Mexico* (1959), 15 *Tax L. Rev.* 411 (1960); Taylor, *Industrial Tax Exemption in Puerto Rico* (1957); Ross, *Foreign Governments' Tax Incentives for Investment*, 1959 *Inst. on Private Investments Abroad* 285 (1960).

⁹⁹ See Nortcliffe, *Base Company Operations*, 1957 *Br. Tax Rev.* 303.

Corporations, than is available to a United States corporation engaged in base country operations.¹⁰⁰

Section 468 does not prevent new overseas growth operations. So long as an existing company's residence is not transferred or a transfer of assets made that amounts to a substantial change in the character or extent of the business, new nonresident companies can be formed with cash or assets currently employed in producing income subject to United Kingdom tax.

2. *Transfer of Trade or Business Abroad.* The restriction on transferring any part of a trade or business to a nonresident undoubtedly is intended as a complementary control measure to that imposed on a change of residence. There would be little point in prohibiting a change of corporate residence if the corporation's trade or business could be moved leaving the corporation a resident "shell."

The use of the term "transfer," in Section 468(1)(b), of course, embraces a sale of a business, or a part thereof, to a nonresident. Thus, for example, if foreign political or economic conditions made it desirable that a United Kingdom parent liquidate a foreign branch by sale, consent would ordinarily be required. However, the Treasury has published a further general consent that provides a measure of freedom in the foregoing respect. Thus, specific consent is not required for a sale for full consideration not in excess of £50,000 paid in cash, provided the buyer is not a corporation controlled by United Kingdom residents and is not associated with the seller, and provided there is no arrangement by which the seller, or any person with an interest in the seller's business, may be revested in any part of the business.¹⁰¹

The £50,000 limitation is probably explainable on the basis that such a transfer would result in a minimum revenue loss. The reason for the cash requirement is not altogether clear unless it is to provide a possible source of foreign exchange and to guard against giving of creditor interests as consideration which could be used as a basis of reacquiring the business sold. The remaining limitations seem designed to prevent an abuse of the change of residence prohibition, and perhaps to limit the consent to forced sales or hardship situations.

How much freedom the £50,000 limitation provides is another question. The general consent would appear to be available only to taxpayers whose business, or part thereof, had a net worth not in excess of this amount. Of course, independent sales of parts of a

¹⁰⁰ Ibid.

¹⁰¹ Treasury Press Notice of August 27, 1952, cited 3 Simon, op. cit. supra note 97.

business may be attempted or perhaps pre-sale transfers followed by dividend distributions might be arranged to reduce any excess net worth. The statute, it will be recalled, expressly permits an asset transfer that does not amount to a substantial change in the character or extent of the business. However, some risk may exist in the foregoing respect; perhaps the Treasury would regard such transactions as part of a scheme which as a whole would exceed the authority granted in the general consent.

The stock held by a United Kingdom operating company in a nonresident corporation not controlled by the United Kingdom company is not subject to the regulations of Section 468. However, an investment or holding company is regarded as being in business with respect to investments or property held and would therefore be subject to Section 468 in case of a transfer of such holdings to a nonresident. On the other hand, a sale of such holdings for an amount not in excess of £50,000 could presumably qualify under the "sale" exception outlined above.¹⁰²

3. *Issue of Shares or Debentures by Controlled Nonresident Corporations.* The prohibition of Section 468(1)(c), preventing a controlled nonresident company from issuing its shares (or debentures) except as security for loans, could be a serious hindrance to the corporate growth of such a company. It is therefore understandable that the Treasury has issued a general consent permitting a controlled nonresident company to issue shares (but not debentures) for cash or in payment "for any business, undertaking or property acquired for full consideration."¹⁰³

The foregoing general consent, together with the loan exception of the statute, should provide a nonresident controlled subsidiary of a United Kingdom parent sufficient freedom from the restrictions of Section 468 in most instances. However, as stated in an earlier part of this paper, one of the apparent purposes of bringing the issuance of shares and debentures of nonresident subsidiaries under control was to prevent the bailout of foreign subsidiary earnings as tax-free capital receipts. Thus, the foregoing general consent is not available where the issued shares are redeemable preference shares.

A second limitation on the above general consent applies where the shares are issued to or for a nonresident company controlled by the parent United Kingdom company (or to or for individuals con-

¹⁰² One writer has also stated that § 468 does not apply to an investment company's "sale through a stock exchange, whether here or abroad, to someone other than a nonresident company controlled by the investment company." Note, Finance Bill, 1951, 95 Sol. J. 326 (1951).

¹⁰³ 3 Simon, op. cit. supra note 97.

trolling the United Kingdom resident parent). This limitation is apparently designed to prevent more refined forms of bailout. A third limitation on the availability of the general consent denies its application where the effect of issuances of shares is to terminate the control of the United Kingdom resident over the nonresident company; this restriction appears to aim at potential tax avoidance in that terminating control could possibly result in loss of controlling the remission of dividends subject to United Kingdom tax.

A second general consent under Section 468(1)(c) applies only to Commonwealth investments. This consent permits the incorporation of a nonresident company to carry on a "new industrial activity in any Commonwealth territory," provided the company is a resident in such Commonwealth territory.¹⁰⁴ The term "industrial activity" is defined as "any productive, extractive or manufacturing industry, any public utility, fisheries or any form of husbandry."¹⁰⁵ The foregoing definition appears sufficiently inclusive to embrace all normal international operations except insurance, banking, and export-import operations.

4. *Transfer of Shares or Debentures of Controlled Nonresident Corporations.* The final category of prohibited transactions, which denies a United Kingdom company the right to transfer the shares or debentures it holds in nonresident controlled companies, has an extremely broad scope. The prohibition against transfer without consent extends to a transfer to any person. From a revenue point of view, the prohibition can have meaning only insofar as dividends from overseas subsidiaries are subject to tax as declared, a matter ostensibly within the control of the foreign company's board, but perhaps practically within the control of the United Kingdom parent.

But perhaps the dominant purpose of both Section 468(1)(c) and (d) is control of bailout. And no general consent has been issued which could serve as a bailout device. In fact, the only published general consent under Section 468(1)(d) permits a transfer of shares to another United Kingdom resident company and then only if the transfer does not have the effect of terminating the transferor's control over the nonresident company.¹⁰⁶ It would seem that there would be no danger to the United Kingdom revenue if the foregoing limitation had embraced both transferor and transferee. Perhaps where

¹⁰⁴ Ibid. Apparently the general consent includes both Commonwealth countries and Crown colonies. See Note, 102 L.J. 441 (1952), pertaining to statement of the Secretary of State for the Colonies.

¹⁰⁵ 3 Simon, op. cit. supra note 97.

¹⁰⁶ Ibid.

control is to be transferred to another United Kingdom corporate transferee a special consent could be obtained.

V. CONCLUSIONS

On the basis of the available data, it is difficult to conclude that either Section 367 or 468 imposes serious restraints on the movement of private capital in international investment. However, there is some uncertainty in the foregoing respect under Section 468, primarily because of the wider scope of the United Kingdom legislation and the lack of available data on the possible *in terrorem* effect of the law.

On the other hand, even if the administration of the two measures be regarded as mild, as long as administrative discretion remains unreviewable doubts will probably always exist as to whether the restraints of the legislation comport with accepted notions of freedom to move capital in international investment. And even if unreviewable administrative discretion be regarded as necessary and the two legislative measures as constituting a workable balance between freedom and order, a serious problem remains. This is the problem of having sufficient available knowledge of the standards by which the administrative agents guide themselves in curtailing the mobility of capital in international investment. The record in the foregoing respect on both sides of the Atlantic is not very impressive.

Although on a broad basis, Section 367 may be regarded as a nuisance factor in carrying out needed capital transactions, it can not be said that reasonable expectations as regards knowledge of tax costs have been met by the Internal Revenue Service. In almost thirty years of administering Section 367 the Service has not seen fit to provide in regulation or ruling the guides that are used in making decisions in this area. The few rulings extant on Section 367 render impossible the formulation of a synthesis of any recognizable body of administrative law on the subject. The operating rules, such as they are, must be pieced together from scraps of information and considerable conjecture. The few rulings issued do not provide an adequate foundation for prediction. We lack sound insights, for example, as to the relationship of tax avoidance to tax deferral, as well as to the use of base companies when business reasons dictate their need. If the Service is not going to provide the needed criteria, it would seem desirable for Congress to repeal Section 367 substituting therefor statutory standards governing the formation, reorganization, and liquidation of foreign corporations. Perhaps the removal of certain Section 367 transactions from the jurisdiction of the Service in the proposed Foreign Investment Incentive Act may be regarded as a harbinger in this respect.

British experience would not appear to provide much aid at the legislative level. However, the general consents granted by the Treasury could well be emulated by the Internal Revenue Service in the form of more detailed regulations under Section 367, regulations which would at least provide exemplified basic principles of tax avoidance.

Although the general consents issued by the United Kingdom Treasury under Section 468 probably go a long way toward softening the impact of a severe legislative measure, there remain many areas where needed knowledge is lacking. As long as the severe penal sanctions remain, it is not likely that even factual reviewable questions, such as those pertaining to what constitutes control and when a transfer of assets amounts to a substantial change in the business, will actually be reviewed. And, as in the case of Section 367, one can always question the desirability of a grant of unreviewable administrative discretion as against formulated statutory standards.