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Subpart F - Estate of Leonard Whitlock v. Commissioner

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SUBPART F—Estate of Leonard Whitlock v. Commissioner, 59 T.C. 490, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (1974).

INTRODUCTION

The Tenth Circuit recently confronted the rules of Subpart F of the Internal Revenue Code[1] and, in an abbreviated opinion, reversed the Tax Court's construction of section 951(d),[2] and upheld the Tax Court on the constitutionality of Subpart F, particularly section 951(a)(1) and (2) and section 956.

Estate of Leonard E. Whitlock v. Commissioner[3] gives the I.R.S. the needed precedent with which to seal two potentially large loopholes in the 1962 legislation providing for taxation of U.S. shareholders of a controlled foreign corporation on certain items of its undistributed earnings. In its opinion, the Tenth Circuit virtually dismissed the language of section 951(d), which the Tax Court had found to be decisive in the case. Basing its holding on the overall purpose of Congress,[4] the Court found that even though the statutory language clearly provides that shareholders of a controlled foreign corporation that is also a foreign personal holding company will not be subject to taxation under section 951(a), the exclusion was not intended to apply to section 951(a)(1)(B) and, therefore, the taxpayers would be obliged to include in gross income their pro rata share of the corporation's increase of earnings invested in U.S. property for its taxable years 1963-67. The other aspect of the Court's opinion that will be dealt with herein is the Court's holding that *pre-1962* earnings of the controlled foreign corporation are to be included in determining the shareholders' pro rata share of the increase in earnings invested in U.S. property.

THE FACTS

During 1963, 1964 and part of 1965, the taxpayers, Georgia M. Whitlock and her husband Leonard E. Whitlock, both citizens and residents of the United States, owned all of the stock in a Panamanian corporation, Whitlock Oil Services, Inc., which was engaged in heavy oilfield transportation in Turkey and Libya. In 1965, Leonard E. Whitlock relinquished all of his interest in Oil Services' stock and through the taxable year 1967 (the period of time in question), Georgia M. Whitlock was Oil Services' sole shareholder. On October 11,

1. According to one commentator, the provisions of Subpart F reach and never leave "a lofty plateau of complexity that the Internal Revenue Code had previously attained only in occasional subsections . . ." B. BITTKER AND L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS 339 (2d ed. 1968).

2. INT. REV. CODE OF 1954 [hereinafter cited as CODE].

3. 59 T.C. 490, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (1974).

4. 494 F.2d at 1300.

1967, Leonard died and his widow was duly appointed Executrix of the Estate of Leonard E. Whitlock by the Probate Court of Stafford County, Kansas on January 5, 1968.

From 1963-1967, Oil Services was a "controlled foreign corporation" as defined in section 957(a).[5] And except for the year 1963, it was also a "foreign personal holding company" as defined in section 552(a)[6] for the same period of time. The taxpayers did not report foreign personal holding company income for any of the years except 1967; but it was stipulated that for the years 1964-1967, certain amounts of undistributed foreign personal holding company income were includible in their gross income.

For each of the five years in question, Oil Services increased its amount of earnings invested in U.S. property, as defined in section 956(b),[7] and it was the increase for each year which the I.R.S. maintained must be included in the taxpayers' gross income under section

5. ". . . any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation."

6. ". . . any foreign corporation if

(1) GROSS INCOME REQUIREMENT.—At least 60 percent of its gross income (as defined in section 555 (a)) for the taxable year is foreign personal holding company income as defined in section 553; but if the corporation is a foreign personal holding company with respect to any taxable year ending after August 26, 1937, then, for each subsequent taxable year, the minimum percentage shall be 50 percent in lieu of 60 percent, until a taxable year during the whole of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 50 percent of the gross income is foreign personal holding company income. For purposes of this paragraph, there shall be included in the gross income the amount includable therein as a dividend by reason of the application of section 555(c)(2); and

(2) STOCK OWNERSHIP REQUIREMENT.—At any time during the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, hereinafter called 'United States group.'"

7. "For purposes of subsection (a), the term 'United States property' means any property acquired after December 31, 1962, which is

(A) tangible property located in the United States;
(B) stock of a domestic corporation;
(C) an obligation of a United States person; or
(D) any right to the use in the United States of
  (i) a patent or copyright,
  (ii) an invention, model, or design (whether or not patented),
  (iii) a secret formula or process, or
  (iv) any other similar property right, which is acquired or developed by the controlled foreign corporation for use in the United States.

951(a)(1).[8] The investments consisted of stock in domestic corporations and notes and accounts receivable from U.S. persons. The taxpayers contested the Commissioner's assessment of deficiencies for the years in question on four grounds, two of which will be dealt with herein:

(1) Section 952(d) specifically discharged them from any liability under section 951(a)(1)(B) for the years in which Oil Services was a foreign personal holding company (1964-1967);

(2) In the alternative, if there was any liability for said investments in U.S. property, it was limited to the amount of earnings accumulated *after* December 31, 1962.

The Tax Court, in a reviewed opinion, three judges dissenting, found for the taxpayers on their first contention and held that for the years 1964-1967, the amount of Oil Services' increase in earnings invested in U.S. property need not be included in the taxpayers' gross income by virtue of the provisions of section 951(d). Furthermore, the Court invalidated Treasury Regulation 1.951-3 (1965) insofar as it "requires a United States shareholder, who for his taxable year is subject to tax under Section 551(b) on income of a controlled foreign corporation, to include in gross income for such taxable year any amount under section 951(a)(1)(B) with respect to such controlled foreign corporation . . ."[9] The Tax Court did not have to consider the taxpayers' second contention because it determined that for the years 1964-67 the taxpayers were not subject to taxation under 951(a), and because for the year 1963, when the corporation was only a controlled foreign corporation and so subject to 951(a), its earnings were sufficient to account for all of the investment in U.S. property and thus, accumulations in prior years were not a factor.

The Tax Court found deficiencies for 1963 (under section 951(a)(1)(B)), since for that year only the corporation was a controlled foreign corporation and not also a foreign personal holding company and for 1965 and 1967 (due to unreported foreign personal holding company income) and an overpayment in 1964. The Commissioner appealed, and the taxpayers cross-appealed.

The Tenth Circuit three-judge panel reversed the Tax Court on

8. "If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year beginning after December 31, 1962, every person who is a United States shareholder . . . of such corporation and who owns . . . stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends:

(B) his pro rata share . . . of the corporation's increase in earnings invested in United States property for such year . . ."

9. 59 T.C. at 498.

the main issue, holding that section 951(a)(1)(B) was applicable to controlled foreign corporations which are also foreign personal holding companies, despite the language of section 951(d) and also held that computation of the increase in earnings invested in U.S. property is not limited to post 1962 earnings. The taxpayers' petition for writ of certiorari was denied, as was a petition for rehearing.[10]

SUBPART F

President Kennedy in his Tax Message of April 20, 1961, recommended a cessation of tax deferral with respect to earnings of U.S.-controlled foreign companies, except for earnings invested in less developed countries. The reasons given were a "desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years."[11] He proposed that U.S. corporate shareholders and individual shareholders of closely held foreign corporations be taxed on the income of the controlled foreign corporations.

The Congressional response was to focus upon tax haven corporations instead of completely eliminating the tax deferral. Section 951(a) provides for taxation of each "United States shareholder"[12] of a "controlled foreign corporation"[13] on his pro rata share of certain items relating to the earnings of the corporation, items which are generally associated with tax haven operations or with the informal repatriation of earnings to avoid taxation. The income taxed under section 951(a)(1) includes:

> (A)(i) Subpart F income, defined in section 952 as income derived from insurance abroad of U.S. risks and "foreign base company income," which includes, among other types of foreign source income, foreign personal holding company income,[14] as defined in section 553 relating to foreign personal holding companies (with certain adjustments provided in section 954(c)). Foreign personal holding company income is comprised generally of passive income—dividends, interest, royalties, annuities, gain from the sale of securities, futures transactions, etc.

10. *Cert. denied*, 419 U.S. 839 (1974), *rehearing denied*, 95 S.Ct. 529 (1974). The I.R.S. has recently nonacquiesced in the Tax Court decision. 1974 INT. REV. BULL. No. 11, at 5.

11. PRESIDENT'S TAX MESSAGE, April 20, 1961, H.R. Doc. No. 140, 87th Cong., 1st Sess. 6 (1961).

12. "United States shareholder" is defined in section 951(b)—"For purposes of this subpart, the term 'United States shareholder' means, with respect to any foreign corporation, a United States person (as defined in section 957(d)) who owns . . . or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation."

13. *See* section 957(a), cited in note 5 *supra*.

14. Also included in foreign base company income, as set forth in section 954(a), are foreign base company sales income and foreign base company services income.

In addition to Subpart F provisions, the Code also provides for taxation of foreign personal holding company income under sections 551-556. Under section 551(a), U.S. shareholders of a foreign personal holding company are taxable on their pro rata share of the corporation's "undistributed foreign personal holding company income."[15] A shareholder of a foreign personal holding company which is also a controlled foreign corporation would, therefore, be subject to taxation under both sections 551(a) and 951(a) if it were not for section 951(d), which provides that a U.S. shareholder subject to tax under section 551(b) "shall not be required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company."

(A)(ii) The corporation's previously excluded Subpart F income withdrawn from investment in less developed countries.

(B) The corporation's increase in earnings invested in U.S. property. Section 956(a) defines the amount of invested earnings as "the aggregate amount of such property held . . . to the extent such amount would have constituted a dividend . . . if it had been distributed." In order to determine the amount taxable to the shareholders under section 951(a)(1)(B), a comparison must be made between the amount of U.S. property held at the end of the taxable year to the extent of adjusted accumulated earnings and profits with the amount of such property held at the end of the previous year to the extent of adjusted accumulated earnings and profits at such time.[16] If there has been an increase in the amount of such property, it will be taxable to the shareholders as if it were a dividend.

The theory behind the latter provision, as stated in the Senate Report on the Revenue Act of 1962, is:

> Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them.[17]

This rationale fits the statute as enacted insofar as investments in related businesses, loans to shareholders, or the purchase of U.S. property to be leased to a domestic parent corporation are concerned. It is less applicable to investments in entirely unrelated businesses.

Section 959(a) provides that earnings and profits which have been included in gross income of a U.S. shareholder by virtue of section 951(a) will not again be included in the shareholder's gross income when distributed or invested in U.S. property.

Section 1248, enacted as a part of the Revenue Act of 1962, is a companion section to Subpart F. It provides that if a U.S. shareholder owns ten percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation which was a controlled foreign corporation at any time during the 5-year

15. CODE § 556.

16. Adjusted accumulated earnings and profits are obtained by subtracting any amounts previously included in income under section 951(a)(1)(B) from accumulated earnings and profits. Rev. Rul. 74-436, 1974 INT. REV. BULL. No. 36, at 12.

17. S. REP. No. 1881, 87th Cong., 2d Sess. 78 (1962).

period ending on the date of a sale or exchange of stock in that corporation, then any gain that is recognized on the sale or exchange

> shall be included in the gross income of such person as a dividend to the extent of the earnings and profits of the foreign corporation attributable . . . to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962 . . ."[18]

THE COURT'S CONSTRUCTION OF SECTION 951(D)

In order to uphold the Commissioner's assessment of deficiency against the taxpayer, the Tenth Circuit was forced into an interpretation of the statute in question which seemingly goes directly counter to the clear and specific language chosen by Congress:

> A United States shareholder who, for his taxable year, is subject to tax under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) on income of a controlled foreign corporation shall not be required to include in gross income, for such taxable year, *any* amount under subsection (a) with respect to such company [emphasis added].[19]

Whitlock Oil Services, Inc. was a foreign personal holding company during the tax years for which tax deficiencies were levied, and the plain meaning of the statute would appear to be that the corporation's shareholders are, therefore, discharged from including in gross income for tax assessment purposes *any* amount which would otherwise be includable by virtue of section 951(a). The corporation's increase of earnings invested in U.S. property, as a part of section 951(a), should, therefore, not be includable for tax purposes in the shareholder-taxpayer's income.

This simple syllogism was the taxpayers' basic argument, and having made this argument, they relied mainly on the corroborating statements of commentators and treatises.[20] The taxpayers' brief states that the language of the statute "in sweeping terms simply pulls shareholder . . . *out from under Section 951(a) in its entirety*."[21]

In fact, had the statute itself been the extent of governmental guidance on the matter, as the Tax Court pointed out, the taxpayers'

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18. CODE § 1248(a)(2).

19. CODE § 951(d).

20. In their brief (Brief for Cross Appellants at 21-22, Estate of Whitlock v. Commissioner, 494 F.2d 1297 (10th Cir. 1974)), the taxpayers cite J. MALONE, MERTENS LAW OF FEDERAL INCOME TAXATION, Code Commentary § 951.1, at 131 (1973); 8 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 45A.01, at 11 (1970); 5 CCH 1973 STAND. FED. TAX REP. 4380 D.021, at 51,022; Hamer, *International Trade,* 30 J. TAXATION 272 (1969); and Tillinghast, *Problems of the Small or Closely Held Corporation Under the Revenue Act of 1962,* N.Y.U. 22ND INST. ON FED. TAX. 697 (1962).

21. Brief for Cross Appellants at 20, Estate of Leonard Whitlock v. Commissioner, 59 T.C. 490, 494 F.2d 1297 (10th Cir. 1974).

argument would undoubtedly have been overwhelmingly decisive.[22] The words "any amount" virtually exclude a statutory interpretation other than that argued by the taxpayers if based solely on the language of the statute. However, the Treasury Regulations go directly counter to this interpretation:

> A United States shareholder . . . who is required under section 551(b) to include in his gross income for his taxable year his share of the undistributed foreign personal holding income for the taxable year of a foreign personal holding company . . . which for that taxable year is a controlled foreign corporation . . . shall not be required to include in his gross income for his taxable year under section 951(a) . . . any amount attributable to the earnings and profits of such corporation *for that taxable year* of such corporation [emphasis added].[23]

Since the exclusion as it is described in the Regulation is limited to amounts attributable to *current* earnings and profits of the controlled foreign corporation which is simultaneously a foreign personal holding company, it may be inferred that amounts attributable to earnings and profits of prior years are *not* to be given such treatment, but, to the contrary, must be included in the gross income of the shareholders of such corporation when invested in U.S. property. Furthermore, divination of the Regulations' intent is not restricted to mere inferences. Example (5) of the Regulations actually presents a situation comparable to the principal case, and holds that a one hundred percent shareholder of a controlled foreign corporation that is also a foreign personal holding company for its taxable year must include in his gross income for that year his pro rata share of the corporation's increase in earnings invested in U.S. property during the year. In contrast to the taxation of the increase in earnings invested in U.S. property as set forth in example (5) is the treatment of Subpart F income which is not foreign personal holding company income. As is explained in example (1) of the Regulations, shareholders of a corporation which is both a foreign personal holding company and a controlled foreign corporation, and so covered by section 951(d), will not be taxed on non-foreign personal holding company income. Foreign personal holding company income will be taxed under section 551, but foreign base company sales or services income will not be taxed to the shareholder.

The Tax Court invalidated the Regulations as plainly inconsistent with the statute and accepted the taxpayers' argument that when "the provisions of a statute 'are unambiguous, and its directions spe-

22. "If we were faced only with the provisions of the statute, we would have little trouble in rejecting respondent's argument and adopting the straightforward reading of section 951(d) urged upon us by petitioners." 59 T.C. at 497.

23. Treas. Reg. § 1.951-3 (1965).

cific, there is no power to amend it by regulation' [citing *Koshland v. Helvering*]."[24] The Tenth Circuit, however, accepted the Commissioner's assertion that the Tax Court construction of section 951(a) was broad and overly literal, and termed Treasury Regulation 1.951-2 "a reasonable contemporary construction of section 951(d)."[25]

In contrast to the Tax Court opinion, the Tenth Circuit looked beyond the language of the statute to the legislative purpose as a whole and concluded that the regulation, "when read in the light of the overall purpose of the statute, and the obvious need not to permit voids or unexplained exceptions,"[26] was valid. Stressing the strong presumption in favor of the validity of Treasury Regulations the Court relied upon *Commissioner v. South Texas Lumber Co.*[27] wherein the Supreme Court "has clearly stated that such a contemporaneous construction by regulation must be followed unless 'unreasonable and plainly inconsistent with the revenue statutes.' "[28]

Legislative History

Had the intent of Congress been more clearly manifested with respect to the interrelationship of sections 951(d) and 951(a)(1)(B), the Court's decision would be more convincing than it in fact is. For as the Tax Court maintained, it is difficult to define a "statutory scheme" with respect to Subpart F:

> While we do not doubt that Congress sought to achieve the general purposes quoted above in the Senate committee report "to end tax deferral on 'tax haven' operations by U.S. controlled corporations," and to insure that foreign corporations' "earnings are not indirectly brought back to the United States in a manner which avoids the U.S. tax" (S. REP. NO. 881, 87TH CONG. (1962), C. B. 1962-3, 785-86), it appears that Subpart F, as finally enacted, embodies numerous exceptions to those general purposes.[29]

And as illustrated by an examination of the I.R.S. and taxpayer arguments, the legislative history involved may easily be applied to support either the inclusion in or exclusion from the shareholders' gross income of a foreign personal holding company's increase in earnings invested in U.S. property.

The original House bill provided for a modification of section 551(b) which would reduce the amount of foreign personal holding company income to be included in the shareholder's gross income under section 551 by the

24. 59 T.C. at 499, citing Koshland v. Helvering, 298 U.S. 441, 447 (1936).
25. 494 F.2d at 1300.
26. *Id.*
27. 333 U.S. 496 (1948).
28. 494 F.2d at 1300. Also cited by the court were Corn Products Co. v. Comm'r, 350 U.S. 46 (1955) and United States v. Correll, 389 U.S. 299 (1967).
29. 59 T.C. at 500.

> shareholder's proportionate share of the undistributed personal holding company income which is included in his gross income under sec. 951(a)(1)(A) . . . for such taxable year as his pro rata share of the *subpart F* income of the company [emphasis added].[30]

The taxpayer argued that the change by the Senate, which placed the provision in section 951 instead of section 551 and eliminated the reference to Subpart F, replacing it with the reference to "any amount" (thereby covering the increase in earnings invested in U.S. property) was evidence of a Congressional intention specifically to discharge shareholders of a corporation which is both a foreign personal holding company and a controlled foreign corporation of all liability under section 951(a), and not to limit the exclusion to Subpart F income. The I.R.S. contended that the change was not significant and the Congressional purpose had been retention of the effect of the House provision, even though the language had been changed.

The taxpayers also relied on the legislative history of section 951(c), providing that qualified shareholders of a foreign investment company with respect to which an election under section 1247 is in effect need not include in gross income any amount under subsection (a) with respect to such company. The House version of 951(c) had been couched in terms very similar to the provision coordinating foreign personal holding companies and controlled foreign corporations. The Senate changed the provision for foreign investment companies to exempt completely shareholders of such companies from including any amount under section 951(a), and in so doing used language similar to that in section 951(d).[31] The Technical Explanation for section 951(c) specifically noted the change for foreign investment companies— "[t]he corresponding provision of the bill as passed by the House applied only to Subpart F income."[32] The taxpayers maintained that the similarity in language of the two provisions substantiated their claim that Congress intended the same result with respect to foreign personal holding companies as it had specifically indicated it desired for foreign investment companies. The Tax Court agreed:

> That the Senate intended, by this change, to broaden the exclusion under sec. 951(c) strongly implies that when it added sec. 951(d) with its identical words of exclusion, it intended the same result.[33]

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30. H.R. 10650, 87th Cong., 2d Sess., Sec. 13, 135-36.

31. Section 951(c) "COORDINATION WITH ELECTION OF A FOREIGN INVESTMENT COMPANY TO DISTRIBUTE INCOME,—A United States shareholder who, for his taxable year, is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247 is in effect shall not be required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company."

32. S. REP. No. 1881, *supra* note 10, at 240.

33. 59 T.C. at 503.

The I.R.S. argued that the fact that a similar notation was not made with respect to shareholders of foreign personal holding companies was more significant. However, the I.R.S. position does not fully take into account the actual wording of the Technical Explanation of section 951(d). Indeed, the language is to a large degree analogous to that explaining section 951(c) and the most obvious interpretation of the Explanation is that Congress knew that changing the reference to "subpart F income" to "any amount" under subsection (a) was a significant modification which could affect the taxable income of shareholders of controlled foreign corporations which also qualify under section 553 as foreign personal holding companies. The full Technical Explanation of section 951(d) is as follows:

> (d) *Coordination with foreign personal holding company provisions*—Subsection (d) provides that a United States shareholder who, for a taxable year, is subject to tax under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) on income of a controlled foreign corporation is not required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company. The corresponding provision of the bill as passed by the House (sec. 13(b)(1)) amended section 551(b) to provide that the amount of undistributed foreign personal holding company income otherwise required under section 551(b) to be included in gross income of a United States person is reduced by his proportionate share of undistributed foreign personal holding company income included in gross income under section 951(a) for the taxable year as his proportionate share of subpart F income of such controlled foreign corporation.[34]

Here the Explanation does not, as in the Explanation for 951(c), point out that the House version "applied only to subpart F income." However, it does do basically the same thing. For section 951(c) there was simply a change in wording, but for section 951(d) a change had to be made as well in the placing of the provision, which had originally been included in section 551. And this, the Explanation points out, while at the same time stating that the original version reduced foreign personal holding company income by the shareholder's proportionate share of *Subpart F income*, thus acknowledging the change in substance as well as in the manner of inclusion. This was the logical way of explaining the Senate modifications—by describing both changes in the same sentence. The fact that the words are different and one Explanation is more detailed and specific than the other is not significant.

Section 951 (d)—The Tenth Circuit Analysis

The Tenth Circuit avoided entanglement in the extensive, though fairly unenlightening, legislative history and elected to base

34. S. REP. No. 1881, *supra* note 10, at 240.

its decision on a construction of the statute in light of the general purposes behind it:

> . . . to prevent the postponement of the inclusion of earnings in the shareholders' gross income; to cover the repatriation of earnings, and to select provisions to prevent double taxation when the foreign corporation was both a personal holding company and a controlled foreign corporation.[35]

Congress, the Court said, was seeking to "provide an integrated coverage of the subject without voids or unexplained inconsistent treatment of essentially the same position," and since there "is no indication that shareholders of foreign personal holding companies were to receive favored treatment"[36] and no explanation why they should not be taxed under section 951(a)(1)(B) on the corporation's increase in earnings invested in U.S. property, that section should be as applicable to a controlled foreign corporation that is a foreign personal holding company as it is to one that is not.

The reason for including subsection 951(d), the Court reasoned, was purely to prevent double taxation of income which, were it not for section 951(d), would be taxed under both sections 551(a) and 951(a). Since by virtue of express provisions which exclude earnings attributable to the foreign personal holding company income of a foreign controlled corporation,[37] there is no possibility of double taxation when the increase in earnings invested in U.S. property are taxed under section 951(a)(1)(B); consequently, according to the Tenth Circuit, no reason exists for limiting the application of section 951(a)(1)(B) by an overly literal reading of section 951(d).[38]

The Court also attempted to find justification in the language of the statute for the desired conclusion. However, its "construction" of the statute basically consisted of saying that the subsection does not mean precisely what it says. In subsection 951(d), there are references to "income" of a foreign personal holding company, and this language, the Court stated, was significant as an indication that Congress was concerned solely with *income*[39] and preventing double taxa-

35. 494 F.2d at 1300.

36. *Id.*

37. According to Treasury Regulation 1.956-1(b)(2)(ii)(1964), amounts which are included in the gross income of a U.S. shareholder under section 551(b), or would be so included but for the fact that such amounts are distributed to the shareholder, are not included in the earnings and profits of the controlled foreign corporation. Thus, such earnings would not be taken into account when determining whether the corporation has an increase in earnings invested in U.S. property under section 951(a)(1)(B).

38. 494 F.2d at 1299-1300.

39. The increase in invested earnings is sought to be taxed to the shareholders, however, because *it is considered as income to them,* in the form of dividends. *See* S. REP. No. 1881, at 78, cited at note 20 *supra.*

tion of it. The increase in earnings invested in U.S. property, on the other hand, is not income, but a corporate financial transaction, an event which Congress chose to tax and which is not susceptible to double taxation. Therefore, the Court concluded, section 951(d) is not meant to apply to this kind of taxable transaction. However, the references to "income" in the subsection are not as important as the reference to "any amount under subsection (a)," which, as the Court recognized,[40] includes the "event" of investment in U.S. property as surely as it does Subpart F income.

In point of fact, there was no real basis in the statutory language upon which the Court could "construe" the subsection to mean what it thought it should mean. The wording is not ambiguous at all. It plainly gives foreign personal holding companies preferred treatment. This fact was sufficient for the Tax Court:

> . . . there is no more persuasive evidence of the statute's purpose than the words by which Congress undertook to give expression to its wishes, and here examination of the legislative history does not require a different interpretation of those words. . . . [I]f for any reason the language of the statute should be changed, it is the responsibility of Congress, and not the prerogative of this Court, to effect such change.[41]

Additionally, the legislative history, although very meager, does seem to favor slightly the taxpayers' argument.

Furthermore, the Tax Court was correct when it said that a statutory scheme is difficult to find for Subpart F. At every turn, the supposed purpose of the statute is diluted by exceptions, escape valves, and relief provisons. The final bill was less comprehensive than the House bill had been and much less so than President Kennedy had requested. The desire not to put U.S. business at a competitive disadvantage combined with a heavy lobby from American corporations doing business abroad were substantial considerations which influenced Congress in coming to the final product.[42] The result was the minimun distribution[43] and export trade corporation[44] relief provisions, the concentration on tax haven corporations combined with the exemption for certain manufacturing and processing activities from tax haven treatment,[45] and the de minimis 30% rule,[46] all of

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40. 494 F.2d at 1300.

41. 59 T.C. at 509-55.

42. *See* S. REP. No. 1881, *supra* note 16, at 72, and 59 T.C. at 501, n. 10.

43. CODE § 963. This section was repealed by the Tax Reduction Act of 1975 § 602(a)(1) (March 29, 1975).

44. CODE § 970.

45. CODE § 954(d).

46. CODE 954(b)(3)(A). This section was modified by the Tax Reduction Act of 1975 § 602(e) (March 19, 1975). The minimum income requirement was reduced from 30 percent to 10 percent.

which serve to weaken the impact of Subpart F on the operations of controlled foreign corporations. In this regard, the Tax Court said:

> . . . the existence of these many exceptions make it hard to glean from subpart F the precise "statutory scheme" to which respondent alludes. In summary, we are not prepared to say that the purposes and goals of subpart F have been so obviously revealed as to preclude the possibility that Congress intended in certain cases that section 951(d) would provide favorable treatment for the taxpayer.[47]

Despite the Tax Court's intimation that there may be a reason for giving foreign personal holding companies preferred treatment, no logical explanation is apparent. But other considerations, not a part of the history of this particular provision, could have prompted the Congress ultimately to settle for measures less inclusive than had originally been sought.

By its decision, the Tenth Circuit was clearly extending the coverage of the statute. Had it done so based solely on a less than manifest legislative intent and its own concept of the purposes of Subpart F and section 951(a)(1)(B), one would have to conclude that the Tenth Circuit had simply set out to improve the Congressional job and by applying its own interpretation of what the statute should achieve, had changed the law, a risky thing at best, considering the reliance which taxpayers must place in the Internal Revenue Code and the obvious dangers if it is interpreted to mean something other than what it very obviously says.

Fortunately, however, the Court had the considerable force of the Treasury Regulations upon which to rely. It is well settled that the Regulations can flesh out the provisions of the Code, as well as limit and place restrictions where none appear in the statute. Of course, it is equally well settled that a Regulation which goes clearly contrary to both the meaning and the overall purpose of a statute will be invalidated by the courts. However, as noted above, the legislative purpose here is unclear, and while we cannot say with certainty that Congress meant that shareholders in a corporation which is both a foreign personal holding company and a controlled foreign corporation should be covered by the provisions of section 951(a)(1)(B), neither can it be said that Congress clearly intended the opposite result.

The Regulations' position in holding with the former view is a justifiable one. And because of Treas. Reg. 1.951-3, there is less danger that taxpayers will be misled than with a court decision after the fact. Hopefully, the Regulations serve the function of interpreting Congressional purpose before taxpayers have to make decisions.

In the case of this particular statute, however, is is safe to say

47. 59 T.C. at 501.

that some taxpayers and lawyers were misled. Prior to *Whitlock,* the provisions of Subpart F, including the sections here in question, had been discussed by several commentators and tax services; and very few of them stated that a foreign personal holding company would have a tax liability under section 952(a)(1)(B) if it qualified as a controlled foreign corporation.[48] One commentator, in fact, pointed to the Regulations and stated that he felt they would not be upheld.[49] Nevertheless, the Regulations were there as a warning of the I.R.S. position and, of themselves, a formidable declaration of the meaning of the law.

Finally, however, and from a practical point of view most important, as is pointed out by the Tenth Circuit, there is no reason why a controlled foreign corporation which also happens to be a foreign personal holding company should have preferential treatment over other controlled foreign corporations which also have foreign personal holding company income, but do not qualify for that status under the terms of section 551. Section 551 was aimed at the individual or family using a foreign personal holding company to protect current income of income producing properties from U.S. taxes. Section 951(a)(1)(A) (i) and section 954(c) have basically the same purpose, and, in fact, the provisions for taxation of foreign personal holding company income are so similar in design that section 954(c) simply adopts the definition in section 553, making only minor adjustments which limit in some ways the statute's application and broaden it in others. A statutory rationale which is directed at taxing U.S. investments of earnings not previously taxed under section 551 or section 951 is no stronger or weaker simply because the corporation qualifies under both sections.

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48. J. WILCOX, CONTROLLED FOREIGN CORPORATIONS—§ 956, Tax Management Portfolio No. 232 (1970) states that there would be no tax on the increase in earnings invested in U.S. property for shareholders of a corporation covered by section 551. Hamer, *supra* note 20, states that the shareholder of a controlled foreign corporation which is a foreign personal holding company will not also be subject to taxation under Subpart F (Hamer defines Subpart F to include the increase in earnings invested in the United States provision). And in FOREIGN PERSONAL HOLDING COMPANIES, Tax Management Portfolio No. 103, A-46 (1965), the tax planner is told that section 951(d) "makes the application of the foreign personal holding company and controlled foreign corporation provisions mutually exclusive."

David R. Tillinghast, *Problems of the Small or Closely Held Corporation Under the Revenue Act of 1962,* N.Y.U. 22ND INST. ON FED. TAX. 697, 721 (1962), states that a corporation qualifying under section 551 would be excluded from treatment under section 951; however, after the Treasury Regulations were promulgated, he reversed his position—*United States Income Taxation of Foreign Source Income: A Survey of the Provisions and Problems,* N.Y.U. 29TH INST. ON FED. TAX. 1, 35, n. 53 (1971).

49. 1 R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS 3.03(3)(a)(iii) (1974).

In fact, foreign personal holding companies were singled out for unfavorable tax treatment long before the Revenue Act of 1962[50] and were considered to be "one of the most flagrant loopholes for tax avoidance."[51] Whereas certain types of income were excluded from treatment under section 951 or were given more lenient treatment than in the House version of the bill, the passive type of investment income earned by the controlled foreign corporation-foreign personal holding company does not present the kind of problems of foreign competition which may be a factor when the corporation is actually actively engaged in foreign business. According to the Senate report,

> Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries, nevertheless sees no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated.[52]

As was stressed by the Tenth Circuit, the purpose of section 951(d) was to prevent double taxation under both sections 951 and 551. There is, however, no danger of double tax with respect to the increase in earnings invested in U.S. property, and consequently, no danger of contravening the aim of the subsection by taxing the corporation's increase in earnings invested in U.S. property to the shareholders of a foreign controlled corporation which is also a foreign personal holding company.

DETERMINATION OF THE AMOUNT OF INCREASE IN EARNINGS INVESTED IN U.S. PROPERTY

In ruling on the taxpayers' alternative contention—that the measure of the amount of increase in earnings invested in U.S. property must be limited to *post*-1962 accumulated earnings and profits—the Tenth Circuit looked to the plain meaning of the statute. It held that, section 951 not being limited "by its terms to accumulations of earnings after 1962," there was no basis for a limiting construction in the statute or in its legislative history. And, the "earnings and profits accumulated between 1913 and December 31, 1962, are thus sought to be included."[53] Section 956(a)(1) defines the term "amount of earnings invested in U.S. property" as "the aggregate amount of such property held . . . by the controlled foreign corporation at the close of the taxable year, to the extent such amount would have constituted a dividend . . . if it had been distributed." Since no special

50. The foreign personal holding company sections were part of the Revenue Act of 1937, sections 331-341.

51. H. R. REP. No. 1546, 7th Cong., 1st Sess. 13-14.

52. S. REP. No. 1881, *supra* note 20, at 72.

53. 494 F.2d at 1301.

definition is given for "dividend," section 316 should apply, the I.R.S. had argued, and earnings and profits accumulated since February 28, 1913 are, therefore, includable in the computation under section 951(a)(1)(B) and section 956.[54] Since a substantial percentage of Oil Services' investment in U.S. property in 1964, 1965, and 1967 was made with earnings accumulated prior to 1963, this holding made a significant difference in the taxable investment to the shareholders for those years.

The taxpayers argued that even though the statute on its face is broad enough to cover earnings and profits prior to December 31, 1962, such an interpretation was contrary to Congressional intent as manifested in the legislative history of the Revenue Act and in the history of the companion section 1248. Thus, the Government and taxpayers essentially exchanged their lines of argument on this alternative issue, with the I.R.S. now maintaining that the statute means what it says and the taxpayer declaring that the overriding statutory purpose should prevail.

The taxpayers relied upon the House Ways and Means Committee Report, which had specifically limited the application of the House version of section 951(a)(1)(B) to earnings and profits *after* 1962.[55] They contended that the intention to limit had been retained, even though the Senate report did not specifically so state. That there was such an intent, they maintained, was given further credence by the fact that companion section 1248, enacted also as a part of the Revenue Act of 1962, was by its terms expressly limited in application to post-1962 earnings and profits, thus presenting a general statutory pattern to be followed throughout the sections relating to controlled foreign corporations.

As the I.R.S. pointed out, however, the House version was "completely reworked" before enactment of the statute, and the "increase in earnings invested in U.S. property" was significantly different from the "nonqualified property" provision of the House.[56] The Government argued that the inclusion by Congress of a limitation in

54. The Treasury Regulations also state that section 316 is applicable. Treas. Reg. § 1.956-1(b) (1964).

55. "Since the concept here is merely to tax to the U.S. shareholder the earnings and profits of the corporation since the end of 1962, the investments in nonqualified property taken into account are only those which are in excess of earnings and profits accumulated *in taxable years beginning after December 31, 1962.*

"Since *it is not intended that this provision in any sense be retroactive,* only nonqualified property acquired after December 31, 1962, is taken into account" (emphasis added). H. R. REP. No. 1447, 87th Cong., 2d Sess. 63-64 (1961).

56. The House version, for example, would have taxed shareholders on some corporate investments outside of the United States, as well as on investments in U.S. property.

section 1248 highlighted the absence of a similar limitation in section 951(a)(1)(B) and evidenced an express intention not to provide such a limitation.[57]

Since the Tax Court decided for the taxpayers on their first contention that the language of section 951(d) necessitated excluding foreign personal holding company shareholders from the ambit of Subpart F, and since for the year 1963 when Oil Services was only a controlled foreign corporation its earnings were sufficient to account for all of its U.S. investments, the Tax Court did not reach the taxpayers' alternative argument. The Tenth Circuit relied upon the statutory language in which there is no limitation to earnings accumulated after 1962. Further, the Court agreed with the I.R.S. that the absence of a specific limitation in section 951(a), in contrast to the express limitation in section 1248, was "significant."[58]

While the Court somewhat summarily dispensed with this alternative contention, a careful reading of the statutes in question will prove this argument to be more troublesome than the taxpayers' other contentions. For, in contrast to the Court's decision to deny favored treatment to controlled foreign corporations that are also foreign personal holding companies, which can be defended on the basis of the Regulations' interpretation and the practical effect of that interpretation, this second decision finds less support when its effect on the taxpayers and the revenue are considered. And in the absence of any substantial indication in the statutes as to what Congress intended, a look at the overall provisions of Subpart F and some legislative history can be enlightening.

One of the fundamental purposes of this legislation, as stated by President Kennedy in his tax message of 1961, was to discourage the accumulation of funds abroad and, thereby, to improve the U.S. balance of payments posture.[59] And, yet, section 951(a)(1)(B) as interpreted by the Court can easily serve the opposite function, since by taxing the shareholders as if the U.S. investment were a dividend, it acts as a deterrent to U.S. investment. By investing abroad, the controlled foreign corporation can avoid U.S. taxation, and thus the

57. *See also* the discussion of this issue in Dougherty v. Commissioner, 60 T.C. 917, 926-27 (1973). Further, although statements during Congressional debate are not a very reliable indicator of Congressional intent, the I.R.S. might have pointed to the fact that during the Senate debate in the Finance Committee, Senator Miller did state that section 956 "would tax an increase in investment in U.S. property even though attributable to earnings and profits accumulated before January 1, 1963." *Hearings before Senate Finance Committee on the Revenue Act of 1962*, 87th Cong. 2d Sess. 4765 (1962).

58. 494 F.2d at 1301.

59. PRESIDENT'S TAX MESSAGE, April 20, 1961, H.R. Doc. No. 140, 87th Cong., 1st Sess. 6.

statute may serve as an encouragement to the retention of foreign income outside the United States.

In *Dougherty v. Commissioner*[60] the Tax Court did consider this line of argument, but the Court said that the "search for a unified legislative purpose in Subpart F" was too illusive to allow for an argument based on a presumed purpose. The Court conceded that the effect of section 951(a)(1)(B) as construed "may discourage the repatriation of funds accumulated abroad by controlled foreign corporations." However, it added, the same could be said for post-1962 earnings and profits.[61] But the Court failed to acknowledge that U.S. shareholders in control of a foreign corporation are in a position to reduce the outward flow of funds into foreign corporate ventures now and in the future, and to make allowances for the fact that earnings invested in the United States may be taxed immediately (if there is an increase in earnings so invested), rather than upon distribution. However, pre-1962 earnings and profits are basically a *fait accompli*, for which the taxpayer's only recourse is to remain outside the United States when making investments of accumulated earnings and profits, which result could not by any stretch of the imagination be considered as a fulfillment of legislative intention.

In keeping with the argument of a statutory pattern showing a Congressional intent to include only *post*-1962 earnings in the computations in question is the language of section 956(b)(2)(F), which provides that for purposes of section 956(a), "United States property" does *not* include "an amount of assets of the controlled foreign corporation equal to the earnings and profits accumulated after December 31, 1962, and excluded from Subpart F income under section 952(b)." Section 952(b) refers to income from sources within the United States which is effectively connected with the conduct by such corporation of a trade or business within the United States. This exception to the term "United States property" would prevent a second taxation, this time on the shareholder level, of the controlled foreign corporation's income that is effectively connected with U.S. business, even when invested in U.S. property.[62] However, the limitation is made to apply only to *post*-1962 earnings and profits. Therefore, if the definition in Section 956(a) of the "amount of earnings of a controlled foreign corporation invested in United States property" is interpreted as covering earnings since 1913, when *pre*-1962 earnings and profits which are effectively connected with a U.S. business and,

60. 60 T.C. 917 (1973).

61. 60 T.C. 917, 927 (1973).

62. Under section 882(a), a foreign corporation engaged in trade or business within the United States is subject to taxation on its taxable income which is "effectively connected with the conduct of a trade or business within the United States."

therefore, taxed at the corporate level, are invested in U.S. property, they may be subject to taxation at the shareholder level, if the other requirements of section 956(a) are met. This result is so contradictory as to justify an argument that Congress limited the exclusion in section 956(b)(2)(F) to post-1962 earnings and profits because it did not intend for *any* pre-1962 earnings and profits to be taxed when invested in the United States. Otherwise, the earnings accumulated prior to enactment of the statute receive harsher treatment than those accumulated after the statute was enacted, when the shareholders of a controlled foreign corporation would have notice of the possibility of taxation. It is doubtful that Congress anticipated such a result. Rather, it is more likely that it assumed that the invested earnings taxed under section 951(a)(1)(B) were already limited to those accrued after 1962.

The Tax Court did look at this section in *Dougherty* but merely concluded that section 956(b)(2)(F) is concerned only with whether the foreign corporation, and not its shareholders, has been subject to U.S. tax on its income, while the objective of section 951(a)(1)(B) is to treat the increase in earnings invested in U.S. property as if it were a dividend.[63] However, though taxation of the corporation under section 882 is the test under section 956(b)(2)(F),[64] the purpose of the test and the exclusion provided if the test be met, give the shareholders, and not the corporation, a tax deferral by excluding earnings already taxed under section 882 from dividend treatment.

With these additional arguments in hand, the taxpayers' theory of a statutory pattern in Subpart F that is exemplified by the limitation on earnings and profits in section 1248 becomes more plausible. The House provision did limit the earnings to be included in determining the investment in non-qualified property to those accumulated after 1962. In reworking the provision, Congress could easily have failed to restate specifically that limitation, while at the same time presuming its retention, particularly since section 1248 which had originally included all earnings since 1913, was limited to earnings after 1962. It seems unlikely that Congress wanted to expand one section to pre-1962 earnings and profits at the same time it was limiting the other to post-1962 earnings and profits.

CONCLUSION

With the decision in *Whitlock,* a way of avoiding one of the

63. 60 T.C. 917, 926-27 (1973).

64. Thus, even if the income is from sources within the United States and effectively connected with conduct by the corporation of a trade or business within the United States, if the item is "exempt from taxation . . . pursuant to a treaty obligation of the United States" (section 952(b)), it is not excluded from the term "United States property."

taxable categories in section 951 is probably closed to taxpayers. If another court had occasion to hear a similar case, it is likely that it would follow the Tenth Circuit and hold that a foreign personal holding company which invests in U.S. property is not to be protected from taxation under section 951(a)(1)(B) if it otherwise qualifies as a controlled foreign corporation. Although the decision goes against the Tax Court's carefully reasoned opinion, and the earlier statements of most commentators on the subject, it is a supportable decision and has the force of reasonableness behind it even though it is not in accord with the plain meaning of the statute.

And, since the Tax Court in *Dougherty* and the Tenth Circuit in *Whitlock* are in agreement, the I.R.S. would almost certainly be successful in the future when attempting to include all earnings invested in U.S. property under the definition of section 956 to the extent they were accumulated after 1913. It is unfortunate that the decision was such, for in this case the better result would be to limit "earnings invested" to post-1962 earnings; but the Regulations do not support such a conclusion, and so the courts have in this situation followed the plain meaning of the statute, and avoided attempting to determine the intention of Congress. Now, at least, taxpayers have the advantage of knowing how they stand, although with respect to those earnings accumulated prior to 1962, this knowledge in retrospect may not be of much assistance.

As we have seen, the Tenth Circuit's holding with respect to the taxpayers' second contention goes counter to one of the primary reasons for enacting the statute—improvement of the U.S. balance of payments position. In fact, as the Tax Court pointed out in *Dougherty*, the impact of section 951(a)(1)(B) under either interpretation does approximately the same thing. However, the fact that in either case a statutory purpose may be thwarted does not require that the contradiction be magnified by taxing the increase of all invested earnings accumulated after 1913. The statute may partially serve its purpose by limiting the initial transfer of funds to a foreign corporation since taxpayers know they will not be able to repatriate earnings without being taxed. This possible deterrent factor is, however, in no way applicable to those earnings already accumulated abroad.

In any case, it may be true that the section as a whole has little to recommend it. Its rationale was to cause constructive dividends, paid in the form of loans to parent corporations or shareholders, to be taxed immediately, as dividends.[65] However, the statute taxes

65. The facts in this particular case illustrate well the way in which 951(a)(1)(B) was designed to work, for many of the investments which had been made in the United States by Oil Services were loans to related parties (*e.g.*, Whitlock & Associates, Leonard Whitlock, L.E. Whitlock Trust Services, Inc., B.I. Whitlock), and so transac-

U.S. investments without regard to whether the investment is in a related party or not. As a result, repatriation of earnings accumulated abroad is discouraged, rather than encouraged. It has been recommended that sections 951(a)(1)(B) and 956 be repealed, and the proposed "Energy and Individual Relief Act of 1974" introduced by Congressman Mills last year would have limited "United States property" to stock in or obligations of U.S. shareholders of the controlled foreign corporation and tangible property leased to or used by such U.S. shareholders.[66] According to T. E. Jenks, the provision in question is

> . . . unnecessary, in the sense that judicial decisions have adequately spelled out the concept of constructive dividends, where loans are made by a foreign corporation to a United States parent. Moreover, it is unjust, and a trap for the unwary, since it applies to many transactions between a foreign corporation and wholly unrelated United States persons in which no constructive dividend reasonably should be implied. The computations under the section with respect to the dividend limitation are unbelievably complex, erratic and irrational.[67] The section should be repealed or at least limited to funds invested in or loaned to the United States parent of the foreign-controlled corporation or to an affiliated domestic corporation.[68]

Whether section 951(a)(1)(B) is a defensible taxing provision or not, however, the courts thus far have shown a tendency to accept the Government's interpretation of it and related sections and, thus, to interpret the statute strictly against the taxpayer. It is likely that other courts will continue this trend in accepting the Government's contentions,[69] and leave the interpretation of Subpart F to the I.R.S. and the Treasury Regulations as long as they can establish that the result is in keeping with "general purposes" of Subpart F and/or that the plain meaning of the statute is being followed. This formula, as a general rule, would not be a valid one, since courts do not usually prefer to substitute their own or an agency opinion for the plain meaning of the statute. However, Subpart F contains extremely complex and difficult provisions, and for this reason it seems likely that the courts will allow the Treasury Regulations to take a prominent

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tions which in actual effect were little different from dividends paid by the company to the Whitlocks or their other businesses.

66. H.R. 17488, 93d Cong., 2d Sess. § 326 (1974).

67. For a good discussion of the irrationality of these computations and an explanation by the Government of how the computation is to be done, *see* J. WILCOX, CONTROLLED FOREIGN CORPORATIONS— § 956, Tax Management Portfolio (1970), and Rev. Rul. 74-436, I.R.B. 1974-36, 12.

68. Jenks, *Taxation of Foreign Income*, 42 GEO. WASH. L. REV. 537, 539 (1974).

69. Two other recent cases which illustrate this attitude by the courts are Kraus v. Commissioner, 59 T.C. 681 (1973), 490 F.2d 898 (2d Cir. 1974), and Greenfield v. Commissioner, 60 T.C. 425 (1973).

place in developing the full meaning of the provisions. It is doubtful that Congress would take issue with the main holding in *Whitlock* and probable that another court, dealing with the same matter, would rest upon the strength of the Regulations, pass over the language of section 951(d), and follow the Tenth Circuit's holding in *Whitlock*.

Myra D. Rainey