Controlled Foreign Corporations: Determining Control under Subpart F

Andrew H. Shaw

Follow this and additional works at: http://scholarship.law.cornell.edu/cilj

Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.cornell.edu/cilj/vol11/iss2/9

This Note is brought to you for free and open access by Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell International Law Journal by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.
CONTROLLED FOREIGN CORPORATIONS: DETERMINING CONTROL UNDER SUBPART F

Subpart F of the Internal Revenue Code imposes income taxation upon United States shareholders who own a majority of the voting power of a foreign corporation. Certain income of such a “controlled foreign corporation” (CFC) is attributable to its United States shareholders for tax purposes, without regard to whether the income is distributed. Many United States shareholders, most of them American parent companies of foreign subsidiaries, seek to avoid Subpart F and the severity of its tax burden.


2. “United States shareholder” under Subpart F and as used in this Note is a term of art. I.R.C. §§ 951(b) and 958 define a United States shareholder as a United States person who owns or is considered to own at least 10 percent of the voting power of a foreign corporation's stock. United States persons are defined as United States citizens, residents, partnerships, corporations, estates, and trusts, with the exception of certain individuals who reside in United States possessions. I.R.C. §§ 7701(a)(30), 957(d). The rules of indirect and constructive stock ownership, found in I.R.C. § 318(a) as modified by I.R.C. § 958, are stringent and complex. See generally Bandy, Ways to Avoid Current Taxation of Subpart F Income, 52 TAXES 181, 182-83 (1974).

3. Subpart F provides that control of a foreign corporation hinges upon majority ownership of voting power of all classes of stock by United States shareholders. I.R.C. § 957(a); see note 28 infra and accompanying text.

4. I.R.C. § 951(a). Only certain types of income earned by a foreign corporation are taxable to its United States shareholders on their pro rata shares. These are the corporation's Subpart F income, I.R.C. § 952, see note 31 infra, its previously excluded Subpart F income withdrawn from investment in less developed countries, its previously excluded Subpart F income withdrawn from foreign base company shipping operations, and its increase in earnings invested in United States property, see note 32 infra.

5. I.R.C. § 957(a). For the full text of this subsection, see note 28 infra.


7. Wales, Tax Policy in Relation to Foreign Business Income, 40 TAXES 961, 965 (1962). This Note will concentrate on problems arising from decontrolling American-controlled foreign subsidiaries to avoid Subpart F. The problem of retention of voting control is peculiar to the decontrol situation and would not normally arise in the context of formation or acquisition of a foreign corporation by an American parent corporation.

8. The Tax Court has upheld the propriety of attempts to avoid Subpart F taxation. See Kraus v. Commissioner, 59 U.S. Tax Ct. 681, 692-93 (1973), aff'd, 490 F.2d 898 (2d Cir. 1974); note 121 infra and accompanying text.

9. The provisions of Subpart F are among the most restrictive of the Internal Revenue
One method by which United States shareholder parent corporations can escape the tax burden of Subpart F is to divest themselves of majority control over their foreign subsidiaries.11

United States shareholders who wish to avoid Subpart F by decontrolling a foreign corporate operation need to know the degree of decontrol necessary to accomplish avoidance, since they inevitably desire to retain as much voting power and economic interest in the foreign corporation as possible without falling under Subpart F. Although the statutory definition of a CFC rests on mathematical criteria, Treasury Regulation section 1.957-1(b)(2), promulgated pursuant to Subpart F, may impose taxation on United States shareholders who have transferred a significant degree of control over a foreign corporation—enough to avoid CFC classification under the statutory criteria.

This Note will examine the extent to which section 1.957-1(b)(2) is an appropriate and accurate measure of United States shareholder control over a foreign corporation. Several recent cases that apply the regulation15

---


11. The statutory provisions of Subpart F do not include the retention of economic interest as a factor to be considered in the determination of control. See notes 87-99 infra and accompanying text. However, the treasury regulation promulgated pursuant to I.R.C. § 957(a) introduces an economic interest factor for measuring control. See note 42 infra and accompanying text.

12. The statutory test is “more than 50 percent” ownership of voting power. See note 28 infra.

13. The statutory test is “more than 50 percent” ownership of voting power. See note 28 infra.


15. There are five reported cases decided under section 957(a) and its regulations. They are: Kraus v. Commissioner, 490 F.2d 898 (2d Cir. 1974), aff’d 59 U.S. Tax Ct. 681 (1973); Garlock, Inc. v. Commissioner, 489 F.2d 197 (2d Cir. 1973), aff’d 58 U.S. Tax Ct. 423 (1972), cert. denied, 417 U.S. 911 (1974); Koehring Co. v. United States, 433 F. Supp. 929 (E.D. Wis. 1977), appeal docketed, No. 77-2016 (7th Cir. Oct. 17, 1977); CCA, Inc. v. Commissioner, 64 U.S. Tax Ct. 137 (1975), aff’d 1976-2 C.B. 1; and Weiskopf v. Commissioner, 64 U.S. Tax Ct. 78 (1975), aff’d mem., 538 F.2d 317 (2d Cir. 1976).
will provide a background for the discussion. The Note will then propose an alternative approach to measuring United States shareholder control under Subpart F which is more equitable, more precise, and more easily applied.

I

SUBPART F

A. BACKGROUND AND GENERAL PURPOSE

Prior to 1962, the Internal Revenue Code did not subject United States shareholders to taxation on foreign source income realized by their foreign corporate holdings until the income was actually distributed to them as dividends. Consequently, Americans who controlled a foreign corporation could indefinitely postpone paying tax on the corporation’s income by causing it to retain the entire amount of its earnings. This method of tax deferral was widespread and produced many undesirable and inequitable consequences. For example, American parent companies with foreign subsidiaries could take advantage of this tax deferral, but wholly domestic companies could not. Tax deferral thus encouraged U.S. investment abroad and retention abroad of earnings realized by American-controlled foreign corporations. Many American companies operating abroad through foreign subsidiaries abused tax deferral by causing their subsidiaries to accumulate profits by artificial means—profits otherwise attributable to the American parent. By directing a disproportionate share of

17. I.R.C. § 61 subjects U.S. taxpayers to taxation of dividend income when it is received. Prior to 1962, earnings repatriated by liquidation or sale of stock rather than by dividend distribution were taxable at preferential capital gains rates. I.R.C. § 1248 eliminates this loophole by making certain gains from the sale of stock in a controlled foreign corporation taxable at ordinary income tax rates. See Gifford, Controlled Foreign Corporations—Section 1248, 240 Tax MNGM'T PORTFOLIO (BNA) A-I (2d ed. 1975).
19. Id.
20. Id. at 29 (statement of Secretary of the Treasury C. Douglas Dillon). United States corporations are subject to current federal income taxation on income from foreign sources. I.R.C. § 11.
21. Hearings, supra note 18, at 9-10 (message from the President).
22. Artificial arrangements such as intercompany pricing, transfer of patent licensing rights, shifting of management fees, and transfer of distribution rights tended to maximize the income attributable to the foreign subsidiary. Id. at 8; Kauder, Taxation of Domestically Controlled Foreign Corporations: A Comparative Study of Subpart F and Section 482, 14 WAYNE L. REV. 260, 261 (1969). The Internal Revenue Service found it difficult to police such artificial arrangements. Hearings, supra note 18, at 29 (statement of Secretary of the Treasury C. Douglas Dillon); Wales, supra note 7, at 972.
profits to a subsidiary located in a "tax haven" country, the parent company could shelter this income from current U.S. taxation in favor of the lower rates of the tax haven. Because of the adverse effects which tax deferral of foreign corporate income had on the U.S. balance of payments and tax revenue, Congress, in 1962, added Subpart F to the Internal Revenue Code.

B. CONTROL PROVISIONS OF SUBPART F

Section 957(a) of Subpart F defines a controlled foreign corporation as any foreign corporation of which more than 50 percent of the total voting power of all classes of stock is owned directly or indirectly by United States shareholders. Subpart F requires United States shareholders to pay tax on their pro rata shares of a CFC's "Subpart F income" and certain other

---

23. The so-called "tax havens" are countries with very low domestic rates of taxation. The two most popular tax havens were Panama and Switzerland. Other frequently used tax havens were the Bahamas, Canada, Haiti, Liberia, Liechtenstein, Luxembourg, The Netherlands Antilles, Uruguay, and Venezuela. Kust, Controlled Foreign Corporations—Section 955, 109 Tax Mngmt' Portfolio (BNA) A-2 (2d ed. 1970).

24. Hearings, supra note 18, at 28 (statement of Secretary of the Treasury C. Douglas Dillon). In addition, companies could still, under I.R.C. § 901, credit income taxes paid abroad against U.S. income tax liability. Hearings, supra note 18, at 30.

25. Secretary of the Treasury Dillon estimated that elimination of tax deferral for foreign subsidiaries would improve the U.S. balance of payments by as much as $390 million per year. He also estimated that net capital outflow to Western Europe between 1957 and 1960 amounted to $400 million and that net capital outflow to Canada during the same period amounted to $200 million. Hearings, supra note 18, at 31-32 (statement of Secretary of the Treasury C. Douglas Dillon).


28. The subsection states:

   For purposes of this subpart, the term "controlled foreign corporation" means 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.

I.R.C. §§ 957(b) and 957(c) set forth certain special circumstances which may exempt a foreign corporation from CFC status. The most significant of these exceptions is that the term controlled foreign corporation does not include any corporation created or organized in the Commonwealth of Puerto Rico or a possession of the United States, provided that a certain percentage of the corporation's income is derived from sources within the Commonwealth of Puerto Rico or a possession of the United States. I.R.C. § 957(c). The purpose of this exception is to encourage investment in U.S. possessions. O'Connor, supra note 27, at 610.

29. "Foreign corporation" is defined as a corporation not organized or created in the United States under the laws of the United States or any State or Territory. Treas. Reg. § 301.7701-5 (1960).

30. For the definition of United States shareholders, see note 5 supra.

31. As defined in I.R.C. § 952(a), Subpart F income of a controlled foreign corporation is the sum of its income from the insurance of United States risks, as determined under I.R.C.
income, thereby indirectly taxing the corporate income itself.

In 1963 the Treasury Department promulgated a regulation pursuant to section 957(a), the effect of which was to broaden the mathematical statutory definition of a CFC. Section 1.957-1(b)(1) of the regulation authorizes attribution of voting power to United States shareholders where they possess actual majority control of a foreign corporation's voting power, even though they may lack a nominal majority of the voting stock. The regulation permits consideration of "all the facts and circumstances of each case" in determining whether the requisite degree of control is present. If United States shareholders have the ability to elect a majority of the board of directors or can appoint the person whose vote decides deadlocks among directors, the foreign corporation will be considered a CFC regardless of whether United States shareholders formally control the voting stock.

Under section 1.957-1(b)(2) of the regulation, any shift of voting power away from United States shareholders will not be given effect if it is not bona fide. The regulation sets forth two specific situations in which attempts to transfer control will be invalidated. First, any express or implied agreement that restricts the capacity of non-United States shareholders to § 953, and its foreign base company income, as determined under I.R.C. § 954. Insurance abroad of United States risks became popular after the passage of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, § 2(a), 73 Stat. 112 (current version at I.R.C. §§ 801-820), which created a tax on underwriting gains. American companies attempted to avoid such taxation by reinsuring their policies abroad or by placing the initial policies with American-controlled foreign insurance companies, resulting in the Subpart F requirement that United States shareholders include as income their pro rata shares of the income from premiums received by a CFC for the insurance of United States risks. S. Rep. No. 1881, supra note 9, at 81; O'Connor, supra note 27, at 610. The major part of Subpart F income, foreign base company income, has four components: (1) foreign personal holding company income, (2) foreign base company sales income, (3) foreign base company service income, and (4) foreign base company shipping income. I.R.C. § 954(a). A discussion in detail of each component is beyond the scope of this Note. Generally, foreign base company income includes items of passive income such as dividends, interest, royalties and rents as well as certain types of sales and service income. See O'Connor, supra note 27, at 611.

32. I.R.C. § 951(a) subjects United States shareholders to taxation on several other major types of income. For instance, United States shareholders are taxed on their pro rata shares of a CFC's previously excluded Subpart F income withdrawn from foreign base company shipping operations, as determined under I.R.C. §§ 951(a)(3) and 955(a)(3), and on their pro rata shares of a CFC's increased earnings from investments in United States property, as determined under I.R.C. § 956(a)(2). I.R.C. § 951(a).

33. I.R.C. § 951.
35. Id.
36. Id. § 1.957-1(b)(1)(i).
37. Id. § 1.957-1(b)(1)(ii).
38. Id. § 1.957-1(b)(2).
39. Non-United States shareholders are either foreign shareholders, or American shareholders who do not own at least 10 percent of a foreign corporation's voting power and therefore do not qualify as United States shareholders under I.R.C. § 951.
exercise their voting power independently will cause their voting stock to be disregarded in determining control.\textsuperscript{40} Second, the regulation attempts to prevent United States shareholders from retaining control by issuing multiple classes of stock and transferring to non-United States shareholders classes of stock that are subject to restrictions on voting power. To accomplish this objective, the regulation provides that the voting power held by the non-United States shareholders will be disregarded if not exercised, and if it is exercised, it will be attributed to the persons on whose behalf it is exercised.\textsuperscript{41} Application of this portion of the regulation—the "tri-test"—is dependent upon the existence of the following three conditions: (1) the percentage of voting power held by non-United States shareholders must be substantially greater than their proportionate shares of the corporation's earnings; (2) the facts must indicate that the non-United States shareholders do not exercise their voting rights independently; and (3) a principal purpose of the arrangement must be to avoid CFC classification under section 957(a).\textsuperscript{42}

II

JUDICIAL APPLICATIONS OF THE CONTROL PROVISIONS

Garlock, Inc. v. Commissioner\textsuperscript{43} and Kraus v. Commissioner,\textsuperscript{44} the two

\textsuperscript{40} Treas. Reg. § 1.957-1(b)(2) (1963). This portion of the regulation states: Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of shareholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement.

\textsuperscript{41} Id.

\textsuperscript{42} Id. This portion of the regulation states: Moreover, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised, or, if not exercised, will be disregarded if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under Section 957.


\textsuperscript{44} 490 F.2d 898 (2d Cir. 1974), aff'd 59 U.S. Tax Ct. 681 (1973).
earliest cases to confront the issue of determining control under Subpart F, were very similar factually. In each case the foreign corporation in question was, prior to 1962, a wholly owned subsidiary of an American corporation. Upon the enactment of Subpart F, each foreign corporation issued a special class of preferred stock which ostensibly transferred exactly 50 percent of the voting power to non-United States shareholders. In both cases, however, the preferred shares held by non-United States shareholders were subject to several substantial restrictions on voting power, so that control of the board of directors of the foreign corporation remained in the hands of United States shareholders. Both Garlock and Kraus presented obvious arrangements whereby an American parent corporation attempted to avoid Subpart F taxation while retaining actual voting control over its foreign subsidiary. Thus, the Second Circuit was understandably eager to strike down these arrangements by characterizing them as sham transactions.

In each case the Second Circuit, although it upheld the tri-test's validity, was not untroubled by this portion of the regulation. The Garlock court relied solely on the tri-test, but was reluctant to speculate on the rule's applicability to facts less clearly indicative of retention of control by United States shareholders. In Kraus, the court viewed the regulation even less

45. 489 F.2d at 198; 490 F.2d at 900.
46. For example, in Kraus the preferred stock of the foreign corporation was subject to call by the board of directors on three months' notice, a power which if exercised would terminate the existence of the preferred stock. 490 F.2d at 902. In Garlock the preferred shareholders could "put" their stock under certain conditions; that is, they could demand repurchase at par by the corporation. 489 F.2d at 199. In both cases the preferred stock was transferable only upon the approval of the board of directors, while the common stock was freely transferable. 489 F.2d at 199; 490 F.2d at 900.
47. 489 F.2d at 199; 490 F.2d at 902. Retention of control of the board of directors was especially significant since neither of the foreign corporations' articles of incorporation provided an adequate means of resolving shareholder deadlocks. 489 F.2d at 202; 490 F.2d at 902. This, combined with the limitations on the voting rights of the preferred shares, see note 46 supra, effectively precluded the preferred shareholders from gaining control of the board of directors; the United States shareholders were in a position to stalemate any such attempt.
48. In each case the United States shareholders all but admitted their artifice. In Garlock, a report approved by the foreign corporation's board of directors admitted a desire to issue the preferred stock to passive investors so that Garlock would be "protected from loss of actual control." 489 F.2d at 198 (quoting the report). In Kraus the preferred stock was transferred to personal friends or business associates of the United States shareholders. 490 F.2d at 902.
49. Several articles examine the Garlock and Kraus decisions. See, e.g., Olsen, Planning to decontrol a "CFC" after the Second Circuit's Garlock and Kraus decisions, 40 J. Tax. 144 (1974); Rado, "Decontrolling" a corporation to remove the controlled-foreign-corporation taint, 39 J. Tax. 322 (1973).
50. The first sign of this reluctance surfaced in the Tax Court majority opinion in Garlock. See 58 U.S. Tax Ct. at 436. In a concurring opinion, five judges expressed skepticism about the regulation's universal validity, stating: "Given the particular fact situation involved herein and the ultimate conclusion flowing therefrom, it remains for future decisions to determine whether the totality of section 1.957-1(b)(2) of respondent's regulations is a valid implementation of the statutory provisions." Id. at 439 (concurring opinion). The Second Circuit upheld
favorably, refusing to rely squarely on the tri-test. Instead, the court based its holding on the totality of the circumstances, citing many factors which when considered together established that the United States shareholders had in fact retained voting control. 51

Other cases have struggled with the tri-test and have reached seemingly inconsistent results in applying it. In practice, the tri-test often degenerates into the *Kraus* "all the facts and circumstances" analysis. 52 This reluctance of the courts to give full force to the tri-test has produced judicial confusion and unpredictability in determining control. In *Weiskopf v. Commissioner* 53 the Tax Court held that a foreign corporation was a CFC even though the United States shareholders had transferred 50 percent of their voting stock to foreign shareholders, since the foreigners could best serve their interests by not disturbing United States shareholder control. 54 Similarly, in Revenue Ruling 70-426, 55 the Internal Revenue Service ruled that a foreign corporation was a CFC where the United States shareholder, although owning only 50 percent of the corporation's voting stock, could force a liquidation of the corporation under applicable foreign law. 56 Conversely, in *CCA, Inc. v. Commissioner*, 57 the same judge who wrote *Weiskopf* held that a 50 percent transfer of voting power by United States shareholders was a successful avoidance of CFC classification even though the court found that the

---

51. 490 F.2d at 903. The Tax Court in *Kraus* speculated on the validity of the tri-test and refused to base its holding specifically thereon: "[W]e do not pass on whether the tests further elucidated in section 1.957-1(b)(2) . . . are sufficient, in and of themselves, to find that voting power was retained." 59 U.S. Tax Ct. at 696.

52. The totality of the circumstances approach is authorized by the regulation. Treas. Reg. § 1.957-1(b)(1) (1963); see text accompanying note 35 *supra*. But the elements of the tri-test often become factors in this approach, as they did in *Kraus*.

53. 64 U.S. Tax Ct. 78 (1975), *aff'd mem.*, 538 F.2d 317 (2d Cir. 1976).

54. The court concluded that because the non-United States shareholder held only a fixed economic interest in the foreign corporation, he had no incentive to challenge United States shareholder control. Furthermore, the United States shareholders controlled the source of the foreign corporation's only product line and so could have brought business to a standstill at any time. Although the foreign corporation was set up as a deadlock corporation, with voting stock and board of directors representation evenly split between the two groups of shareholders, the court found that in reality the non-United States shareholder was powerless to alter the corporation's affairs in any meaningful way. 64 U.S. Tax Ct. at 95.


56. The foreign corporation's charter had a one year life that applicable foreign law required a 75 percent vote of the stockholders each year to renew. *Id.* The IRS's ruling ignores the fact that neither group of shareholders had an advantage over the other with respect to the power to force a liquidation. This type of true deadlock corporation, in which United States shareholders own no more than 50 percent of the voting stock, should not be classified as a CFC absent special circumstances which tilt control in their favor, as in *Weiskopf*, notes 33-34 *supra* and accompanying text. Eigner, *Tax Planning Under Subpart F*, in SIXTH ANNUAL INSTITUTE ON INTERNATIONAL TAXATION 30 (A. Kroll ed. 1975).

non-United States shareholders did not share equally in the corporation's earnings or management.\textsuperscript{58}

The most recent decision to consider the meaning of control under section 957(a) is \textit{Koehring Co. v. United States}.\textsuperscript{59} This case involved the transfer by Koehring Company, an American corporation, of a controlling block of its voting stock in one of its foreign subsidiaries to Newton-Chambers & Co., Ltd., a British corporation.\textsuperscript{60} Following World War II, Koehring and Newton-Chambers had developed extensive business ties in the international marketing of their heavy construction equipment products.\textsuperscript{61} On several occasions prior to the enactment of Subpart F, the companies had discussed setting up a jointly owned corporation to increase their international sales.\textsuperscript{62} In 1963, Newton-Chambers acquired newly issued preferred stock constituting 55 percent of the voting stock of Koehring Overseas Corporation (KOS), originally a wholly owned foreign subsidiary of Koehring.\textsuperscript{63} Soon after the completion of the voting stock transfer, the board of directors of KOS was reconstituted. Newton-Chambers nominees filled three positions of the five member board, including the chairmanship, while Koehring nominees filled the remaining two.\textsuperscript{64}

The U.S. District Court for the Eastern District of Wisconsin held that KOS was a controlled foreign corporation despite Koehring's transfer of 55 percent of KOS's voting stock and Newton-Chambers' installation of a majority of directors. The court found that Newton-Chambers failed to exercise its voting stock actively or independently, and that an implied agreement existed between the parent companies requiring Newton-Chambers to vote its stock in accordance with the desires of Koehring. The court also found that all three of the conditions set forth in the tri-test were satisfied.\textsuperscript{65} Under section 1.957-1(b)(2), either of these findings alone would

\textsuperscript{58} For a discussion of the CCA decision see notes 100-04 & 110 infra and accompanying text.
\textsuperscript{59} 433 F. Supp. 929 (E.D. Wis. 1977), appeal docketed, No. 77-2016 (7th Cir. Oct. 17, 1977).
\textsuperscript{60} Id. at 932-33.
\textsuperscript{61} Both Koehring and Newton-Chambers conduct worldwide sales and have several marketing subsidiaries. In 1948, the two parent companies entered into a licensing agreement whereby Newton-Chambers manufactured and sold products of Koehring design, concentrating its sales in the Eastern Hemisphere. In return, Koehring concentrated its marketing efforts in the Western Hemisphere. Id. at 931.
\textsuperscript{62} Id. During this period, each company was somewhat dissatisfied with the other's performance under the 1948 licensing agreement. These problems gave rise to discussions centering on proposals to establish a cooperative sales venture. The chairman of Newton-Chambers wrote to the president of Koehring to express his concern about the problems arising under the licensing agreement and to urge that Newton-Chambers "have an equity stake in Koehring's overseas ventures." Id. at 932.
\textsuperscript{63} Id. at 933. Meanwhile, to complete a planned cross-investment between the companies, the Koehring group purchased more than 40 percent of the stock of a Newton-Chambers subsidiary. Id.
\textsuperscript{64} Id.
\textsuperscript{65} Id. at 935.
have justified the holding that KOS was a controlled foreign corporation. 66

III
ANALYSIS

The recent cases decided under section 957(a) have demonstrated that courts will closely scrutinize attempts to avoid CFC classification by decontrolling a foreign subsidiary. 67 The Koehring decision, however, is the first to apply section 1.957-1(b)(2) to a situation where United States shareholders actually held less than 50 percent—as opposed to exactly half—of the voting stock of a foreign corporation. The Koehring court provided very little reasoning in support of its determination that KOS was a controlled foreign corporation. For example, the facts of Koehring are very similar to those of CCA, but the Koehring court did not distinguish or even mention the latter case.

Apart from the difficulty of ascertaining the Koehring court’s reasoning, there are weaknesses in the regulation itself that have become more apparent by the court’s sweeping application of the regulation. Neither the regulation’s implied voting agreement test nor its tri-test is a particularly accurate measure of actual voting control. Furthermore, the tri-test is not completely consistent with the congressional intent of section 957(a). These two tests, each of which the Koehring court cited to justify its decision, will be examined to determine their propriety, both on their face and as applied in the section 957(a) cases.

A. IMPLIED AGREEMENT TEST

The first three sentences of section 1.957-1(b)(2)68 deal with the elevation of substance—actual voting control—over the nominal ownership of voting stock. 69 If a transfer of voting stock is merely an artifice or sham to escape the quantitative definition of a CFC under section 957(a), a court may disregard the transfer in determining control. This portion of the regulation permits scrutiny of voting stock for express or implied agreements not to

66. See Treas. Reg. § 1.957-1(b)(2) (1963); notes 34-42 supra and accompanying text. 67. Pehrson & Terr., supra note 11, at 542. 68. Treas. Reg. § 1.957-1(b)(2) (1963). For the text of this portion of the regulation, see note 40 supra. 69. The regulation implements an important principle of taxation—that the substance of a transaction will be elevated over its form if the statute was intended to encompass the substance. See Gregory v. Helvering, 293 U.S. 465 (1934) (corporate reorganization effected solely to minimize taxable gain on the sale of property was a mere contrivance and was outside the intent of the statute). Courts have often applied this principle to void fictitious transfers of stock. See, e.g., Atkins v. Commissioner, 76 F.2d 387 (5th Cir. 1935) (artificial stock transaction held not a bona fide sale establishing a deductible loss); Hook v. Commissioner, 58 U.S. Tax Ct. 267 (1972) (stock transfer must be bona fide and have economic reality).
exercise voting power independently. A court may also consider similar devices that could significantly affect ostensible voting power, such as restrictions on the stock itself or a close relationship between United States and non-United States shareholders.

Section 957(a) authorizes an examination of voting stock for possible infirmities: the statutory measure of control is actual or constructive ownership of voting power, not merely a numerical count of voting stock. Nonetheless, disregard of non-United States shareholder voting power on the basis of an implied agreement should occur only where the weight of the evidence shows that the voting stock is subject to voting restrictions or qualifications. Reliance on factors that only vaguely indicate a voting agreement or restrictions on voting power imparts too much discretion to the judiciary.

Koehring is the first decision under section 957(a) to rely on a finding of an implied agreement, although the test was undoubtedly a factor in earlier

---

70. See, e.g., Kraus v. Commissioner, 490 F.2d 898 (2d Cir. 1974); Garlock, Inc. v. Commissioner, 489 F.2d 197 (2d Cir. 1973).

71. See Treas. Reg. § 1.957-1(c)(5) (1963); note 72 infra.

72. As a general rule, an agreement should not be implied unless there is a meeting of the minds of the parties indicated by some intelligible conduct. In Baltimore and Ohio R.R. Co. v. United States, 261 U.S. 592 (1922), the Supreme Court stated that an implied agreement should be “founded upon a meeting of minds, which, although not embodied in an express contract, is inferred, as a fact, from conduct of the parties showing, in light of the surrounding circumstances, their tacit understanding.” Id. at 598. See also Braun v. United States, 46 F. Supp. 993 (Ct. Cl. 1942) (statement of account by the IRS was not under the circumstances sufficient to give rise to an implied agreement to repay an overpayment of estate taxes); Kirk v. United States, 451 F.2d 690 (10th Cir. 1971) (implied agreement inferred from the acts of the parties or other circumstances showing an intent to contract).

Treasury Regulation § 1.957-1(c)(5) reveals the Treasury Department’s view of what facts are necessary to constitute an implied agreement. In the example given, a United States shareholder owns 50 percent of the voting stock of a foreign corporation and a foreign shareholder, the United States shareholder’s lawyer, owns 2 percent. The other 48 percent is owned by a foreign corporation. The foreigner places his stock certificates in a depository to which the United States shareholder has access. The United States shareholder has frequently taken the shares from the depository, and on one occasion used the shares as collateral. Although dividends are paid directly to the foreigner, his charges to the United States shareholder for legal services are reduced by the amount of dividends paid to him. These facts, according to the regulation, indicate an implied agreement that the United States shareholder was to retain dominion over the foreigner’s voting stock. Treas. Reg. § 1.957-1(c)(5) (1963). This example, however, differs significantly from the Koehring fact situation where the non-United States shareholder (Newton-Chambers) owned not 2 but 55 percent of the voting stock, and the United States shareholder (Koehring) had no control over that stock or its dividends.

73. In Handy & Harman v. Burnet, 284 U.S. 136 (1931), the Supreme Court suggested that, in determining ownership of stock possessing voting rights, courts should look primarily to the actual present percentage of voting rights as established by a corporation’s articles of incorporation and only secondarily, if at all, to contingent voting rights, contractual arrangements or other factors bearing on how voting power was actually exercised.

74. One commentator has suggested that since there is no statutory foundation for the inclusion of an implied agreement test, only clear evidence that non-United States shareholders have actually surrendered their voting power should suffice to trigger the application of § 957(a). Wars, supra note 9, at 988 & n.23.
decisions. But the *Koehring* court failed to give specific reasons for its finding that Newton-Chambers agreed not to exercise its voting power independently. The court appears to have based this finding on its closely related determination that, under the tri-test, Newton-Chambers in actuality failed to vote its stock independently. Not only do the facts provide little support for this conclusion, but even if it were valid it would not necessarily prove the existence of an implied agreement. As a business reality, stock possessing voting rights is often not actually voted; when it is voted, the interests of each group of shareholders are often best served by voting similarly.

Unless specific facts—other than a mere similarity of voting records among shareholders—indicate that the parties truly reached some understanding affecting the capability of non-United States shareholders to exercise their voting power, a court should not disregard nominal voting power on the tenuous ground of an implied agreement. The implied agreement test, which permits the examination of facts and circumstances indicating actual weaknesses in ostensible voting power, should not be construed as permitting a court to read restrictions into voting power where their existence is merely speculative.

B. THE TRI-TEST

The tri-test, which appears in the fourth and final sentence of section 1.957-1(b)(2), addresses transfers of a separate class of voting stock to

---

75. For example, in *Kraus* the non-United States shareholders were friends, relatives, or business associates who were not disposed to question corporate policy. 490 F.2d at 902. But the case was decided on all the facts and circumstances. See text accompanying note 51 supra.

76. Cf. *Gilbert v. Commissioner*, 248 F.2d 399, 407-08 (2d Cir. 1957) (the appellate court found it impossible to determine whether appropriate standards had been employed by the trial court in reaching its conclusion since the trial court opinion stated only a conclusion without specifying its reasoning).

77. For a more extensive discussion of the concept of lack of independent exercise of voting power, see notes 106-09 infra and accompanying text.

78. Contrary to the court's finding, the facts indicate that Newton-Chambers did participate actively and independently in the management of KOS. See notes 112-13 infra and accompanying text.

79. One problem with the regulation is that it does not discuss in any detail what constitutes failure to exercise voting rights. See *Waris*, supra note 9, at 987 n.20. In the case of a corporation such as KOS, with shareholders who are located on different continents and who each own several other companies, it would be unrealistic to insist on a perfect voting record to demonstrate voting independence.

80. See note 108 infra and accompanying text. Cf. *Boycott Provisions of the Internal Revenue Code*, 42 Fed. Reg. 41,504, 41,511 (1977) (the existence of an agreement to participate in a boycott will not be inferred merely from the fact that a person's actions are apparently consistent with the boycott requirements of a certain country).

non-United States shareholders. This portion of the regulation has not won universal endorsement in the courts and has produced seemingly inconsistent results. A comparison of the two most recent cases to consider the regulation, CCA and Koehring, presents a striking example of the inconsistent applications of the tri-test.

The present judicial confusion over measuring voting power under the tri-test results at least in part from a failure to focus on the specific legislative history of section 957(a). In Garlock and Kraus, for example, the stock transfers to non-United States shareholders were so obviously artificial that the Second Circuit considered only general congressional statements revealing an intent to eliminate tax havens. Weiskopf and CCA adopted the Garlock and Kraus principles without making independent examinations of congressional intent.

In examining legislative history, however, courts should not ignore specific provisions in favor of more broadly worded congressional statements. Especially in dealing with Subpart F, a statute riddled with special provisions and exceptions, a court should first look to the specific legislative history of a particular section to determine its scope. In fact, the legislative history of Subpart F pertaining specifically to section 957(a) demonstrates that Congress did not approve any of the conditions incorporated in the tri-test. The following discussion examines both the foundation of these conditions in section 957(a) and their soundness as determinants of control, as illustrated by the divergent results reached in the CCA and Koehring cases.

---

82. See notes 50-58 supra and accompanying text.
83. See, e.g., text accompanying note 105 infra.
84. Neither the Garlock nor the Kraus opinion mentioned the specific legislative history of § 957 (except for one brief footnote in Garlock), although the Second Circuit did extensively discuss Subpart F's general goal of eliminating tax deferral. 489 F.2d at 200-01; 490 F.2d at 900. But by concentrating on broad statements of policy the court begged the critical question of what Congress intended should constitute control within the meaning of § 957(a).
85. See Whitlock v. Commissioner, 59 U.S. Tax Ct. 490 (1972), aff'd in part and rev'd in part, 494 F.2d 1297 (10th Cir. 1974). The Tax Court in Whitlock was faced with determining the relationship between the foreign personal holding company provisions, see note 92 infra, and Subpart F. The court, rather than rely on the general purposes of Congress, narrowed the scope of its inquiry to focus on the specific legislative history of the sections in question. 59 U.S. Tax Ct. at 501.
86. Subpart F underwent intensive legislative scrutiny and many revisions between its proposal by President Kennedy and its final enactment. The revisions of the statute created many exceptions to its general purposes. See Dougherty v. Commissioner, 60 U.S. Tax Ct. 917, 927 (1973); H. R. REP. No. 1447, supra note 26, at 57-58; S. REP. No. 1881, supra note 9, at 79-80. Courts should therefore exercise restraint to avoid destroying the carefully formulated statutory arrangement of Subpart F by looking only to the statute's general purposes.
I. Disparity Between Economic Interest and Voting Power

The first concurrent condition set forth in the tri-test is whether a disparity exists between the percentage of voting stock and the economic interest, as indicated by the share of a corporation's earnings, held by non-United States shareholders.\footnote{87} The statute, however, does not mention economic interest, but bases control solely on majority ownership of voting power.\footnote{88} Significantly, the legislative history of section 957(a) demonstrates that the House Ways and Means Committee considered and rejected a test of control that would have included an economic value factor.\footnote{89} The Treasury Department submitted a proposed draft bill which would have made greater than 50 percent ownership of either voting power \textit{or} stock value conclusive proof of United States shareholder control,\footnote{90} but the committee's first draft of the bill employed the voting power test as the sole determinant of control.\footnote{91}

The committee feared that taxation of Americans on income of a foreign corporation that was not American-controlled would be unconstitutional.\footnote{92}

\footnote{87. Treas. Reg. § 1.957-1(b)(2) (1963). For the text of this portion of the regulation, see note 42 \textit{supra}.}


\footnote{89. See \textit{generally} \textit{Hearings, supra} note 18, at 309-22.}


\footnote{92. The committee was uncertain whether United States shareholders would have received income under the sixteenth amendment, U.S. CONST. amend. XVI. Committee members Boggs and Byrne both questioned Secretary of the Treasury Dillon concerning the legal basis for the Treasury's proposed method of taxation. Secretary Dillon responded that Subpart F taxation would be based on the same principle as was used in the Revenue Act of 1937, see note 6 \textit{supra}, to justify taxation of foreign personal holding companies. \textit{Hearings, supra} note 18, at 309-10, 342. The committee members refused to accept this analogy, since the foreign personal holding company provisions had been enacted specifically to curtail flagrant tax avoidance by the use of "incorporated pocketbooks" abroad. \textit{Id.} at 342. Furthermore, even if the analogy is valid, there is some uncertainty as to the constitutionality of the foreign personal holding company provisions. \textit{See Horwich, The Constitutionality of Subpart F of the Internal Revenue Code}, 19 U. MIAMI L. REV. 400, 410 (1965). The Supreme Court has never addressed the constitutionality of the 1937 Act's taxation of undistributed profits, although the Court cited the Act with approval in Helvering v. National Grocery Co., 304 U.S. 282, 288 n.4 (1938). \textit{But cf.} Eisner v. Macomber, 252 U.S. 189, 219 (1920) (stock dividend not taxable to shareholder as income since it did not give to shareholder any part of the company's assets). \textit{See Horwich, supra} at 404-05.}
The committee's concern led it to request memorandums\(^93\) on the legality of the Treasury's proposed measure of control. The memorandum submitted by the staff of the Joint Committee on Internal Revenue Taxation\(^94\) concluded that income does not arise out of the mere possibility of a future claim for dividends.\(^95\) Rather, realization of income occurs only when the corporation distributes earnings to the taxpayer.\(^96\) The committee settled upon the voting power test of control because of its concern that no basis would exist for taxing American shareholders unless those shareholders, by themselves, held enough voting power to cause the declaration of dividends.\(^97\) Congress thus made a deliberate decision to limit the test of control to voting power.\(^98\) The Treasury Department's introduction of an economic value element into the regulation does not reflect this congressional intent.\(^99\)

Moreover, the presence of a greater percentage of voting power than economic interest is not a reliable indicator of United States shareholder control of a foreign corporation, where the United States shareholders own less than a majority of the corporation's actual voting power. \textit{CCA, Inc. v. Commissioner}\(^100\) recognized this principle. In \textit{CCA}, United States shareholders of a foreign corporation transferred 50 percent of their voting stock to foreign investors by issuing a new class of preferred stock for less than 50 percent of the corporation's net worth.\(^101\) The board of directors was evenly split between representatives of the common and preferred shareholders.

---

\(^93\) \textit{Hearings, supra} note 18, at 311, 313. The committee asked both the Treasury Department and the staff of the Joint Committee on Internal Revenue Taxation to submit memorandums which were incorporated into the record.

\(^94\) Pursuant to I.R.C. \S\S\ 8001-8023, the staff of the Joint Committee on Internal Revenue Taxation assists the House Ways and Means Committee and the Senate Finance Committee in investigating and reporting on the operation of the federal tax laws.

\(^95\) \textit{Hearings, supra} note 18, at 313.

\(^96\) This underlying principle of Subpart \textit{F} taxation is analogous to constructive receipt of a dividend. For the regulations governing constructive receipt, see Treas. Reg. \S 1.451-2 (1960).

\(^97\) Only then would Americans collectively have the power to appropriate the earnings of a foreign corporation for themselves. Two cases which upheld the constitutionality of Subpart \textit{F} stressed the importance of this underlying principle. \textit{See Dougherty v. Commissioner}, 60 U.S. Tax Ct. 917, 928 (1973); \textit{Whitlock v. Commissioner}, 59 U.S. Tax Ct. 490, 509 (1972).

\(^98\) Congress has utilized the value test where it felt the test appropriate. Value of stock is the \textit{only} test of control in I.R.C. \S\S 382(b), 542(a)(2) and 1239(a). Voting power \textit{and} a value test of some kind are used in I.R.C. \S\S 332(b)(1), 334(b)(2)(B), 368(c), 1033(a)(2) and 1504(a). Voting power \textit{or} value is the test in I.R.C. \S\S 269(a), 304(c)(1), 503(b), 856(d)(2), 1246(b)(2), 1551(b), 1563(a), 1563(c)(2), 4915(b), and 6038(d)(l).

\(^99\) I.R.C. \S 7805(a) grants to the Secretary of the Treasury the power to "prescribe all needful rules and regulations for the enforcement of this title . . . ." Although a treasury regulation is presumptively valid, a regulation that is inconsistent with the intent of Congress is void and will not be upheld. \textit{See, e.g., Commissioner v. Acker}, 361 U.S. 87 (1959).


\(^101\) \textit{Id.} at 153. The Tax Court stated: "We recognize that, as in the \textit{Kraus} case, the amount paid by the preferred shareholders for their stock was less than 50 percent of the net worth of AG." \textit{Id.}
with neither group having the power to break deadlocks. According to the CCA court, the fact that the non-United States shareholders held a limited economic interest did not make the corporation a CFC, absent a showing of actual restrictions on their voting power. Although the preferred shareholders "had a more limited interest to protect than the common shareholders" and their directors participated with less vigor in corporate management, the court found that they were willing to use the powers they had to protect their interests. Therefore the foreign corporation did not meet the conditions of the tri-test and was not a CFC.

None of the other section 957(a) cases have adopted the CCA interpretation of the economic disparity doctrine. Koehring presented an ideal fact situation for applying the CCA analysis, since there the non-United States shareholders held not just half but an outright majority of the voting power. Yet the Koehring court failed to follow or even distinguish CCA, finding that the corporation satisfied the economic disparity test as well as the other conditions of the tri-test.

2. Lack of Independent Exercise of Voting Power

The second concurrent condition set forth in the tri-test is whether non-United States shareholders have failed to exercise their voting rights independently or at all. This element overlooks the fact that groups of shareholders may better serve their mutual interests by voting similarly rather than in opposition. Ironically, the Treasury Department recognized this principle in its original proposed version of section 1.957-1(b)(2), which stated in part: "The mere fact that any shareholder, in exercise of reasonable business prudence, votes his stock in a manner consistent with the interests of a United States shareholder will not in itself be deemed to establish an understanding as to the voting of his stock." Furthermore, the difficulty of proving independent exercise of voting power where shareholder voting records are similar in effect creates a presumption of shareholder collusion. Neither the statute nor the realities of the exercise of

102. Id. at 151.
103. Id.
104. Id.
105. 433 F. Supp. at 935.
107. Waris, supra note 9, at 987.
109. Friedman and Silbert expressed fear that the Treasury Department would attempt to read such a presumption into the regulation, although its language does not mandate the pre-
voting power justify such a presumption, and it should not be a factor in determining whether voting control exists.

The *CCA* decision recognized that the lack of independent exercise of voting power is a questionable criterion for measuring control. The court, rejecting the mere infrequent exercise of voting power as dispositive in determining voting control, applied a test based on the opportunity to exercise voting power. The *Koehring* court, again ignoring principles elucidated in *CCA*, found that Newton-Chambers failed to exercise its voting power consistently and independently. The facts, however, indicate that Newton-Chambers did exercise its voting power independently in governing KOS. For example, Newton-Chambers installed a majority of directors to represent its interest, and subsequently the Newton-Chambers directors defeated a proposal by the Koehring directors to declare a dividend on the common stock. The ability of the Newton-Chambers directors to defeat a proposal to declare a dividend is especially important in light of congressional concern that American shareholders should become subject to taxation under Subpart F only if they could cause the declaration of dividends.

The *Koehring* court brushed off the exercises of control by the Newton-Chambers directors, stating that their “real interest lay in protecting the Newton-Chambers stake in KOS.” But this simply confirms that Newton-Chambers did exercise its voting power in its own behalf. The court, in support of its conclusion that Newton-Chambers exercised its voting power in accordance with the desires of Koehring, stressed the irregular participation of the Newton-Chambers directors at shareholders and directors meetings. But it did not reconcile this finding with the several instances in which Newton-Chambers exercised its power to control KOS.

---

1. Friedman & Silbert, supra note 108, at 817. Waris expressed similar apprehension that the regulation might create an automatic assumption of an implied agreement wherever groups of shareholders cast their votes in harmony. Waris, supra note 9, at 987-88.

2. 64 U.S. Tax Ct. at 152. By looking to the opportunity to control, the *CCA* court was able to distinguish *Garlock*, *Kraus*, and *Weiskopf*, each of which had applied the regulation against the taxpayer. In those cases, the voting stock held by non-United States shareholders was subject to several substantial restrictions which negated any real opportunity for those shareholders to exercise their voting rights. *Id* at 151. In contrast, the stock transferred to non-United States shareholders in *CCA* had no substantial restrictions.

3. 433 F. Supp. at 935.

4. The court overlooked this extremely important demonstration of control by Newton-Chambers. Both the statute and the regulation speak of voting power of stock as the measure of determining control. And according to H. Henn, *Law of Corporations* 95 (2d ed. 1970), the primary function of shareholder voting, along with approving extraordinary corporate actions, is to elect directors.

5. 433 F. Supp. at 933.

6. See notes 92-97 supra and accompanying text.

7. *Id*.
nor did it point to a single corporate decision in which Newton-Chambers did not participate.

3. The Principal Purpose Test

The third concurrent condition set forth in the tri-test is whether a principal purpose of a voting stock transfer is to avoid CFC classification.\textsuperscript{117} The inclusion of this purpose element in measuring control infringes on the right of taxpayers to arrange their transactions so as to minimize their tax liability.\textsuperscript{118} Although some sections of the Internal Revenue Code specifically provide for the inclusion of a purpose test,\textsuperscript{119} Subpart F does not. Courts have consistently interpreted sections of the Code that incorporate a stock ownership test but not a purpose test as allowing a taxpayer to increase or decrease his stock ownership to avoid taxation.\textsuperscript{120} Moreover, the Tax Court has recognized the legitimacy of deliberate attempts to avoid Subpart F taxation.\textsuperscript{121} Therefore, a purpose test should not serve as a factor in determining whether to recognize a transfer of voting stock to non-United States shareholders.

IV

A PROPOSED ALTERNATIVE MEASURE OF CONTROL

Whatever the method of determining CFC classification under Subpart F, it should both comport with congressional intent and accurately reflect the realities of voting control. Because the tests of control in section 1.957-1(b)(2) do not fulfill these objectives, administrative or legislative action is

\textsuperscript{117} Treas. Reg. § 1.957-1(b)(2) (1963). For the text of this portion of the regulation, see note 42 supra.

\textsuperscript{118} See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935).

\textsuperscript{119} See, e.g., I.R.C. §§ 269(a), 367(a), 1492.

\textsuperscript{120} The line of cases under I.R.C. § 332 (originally enacted as Int. Rev. Code of 1939, ch. 1, § 112, 53 Stat. 37) illustrates this point well. For example, in Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945), the court held that a taxpayer's deliberate, bona fide transfer of shares of stock in a subsidiary, enabling him to realize a loss on liquidation of the subsidiary, was perfectly legitimate. See also Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956); Avco Mfg. Co., 25 U.S. Tax Ct. 975 (1956).

\textsuperscript{121} The Tax Court in Kraus v. Commissioner, 59 U.S. Tax Ct. 681 (1973), aff'd, 490 F.2d 898 (2d Cir. 1974), stated:

It is apparent that the petitioners have attempted to . . . avoid the effect of the literal language of section 957(a). . . .

We have no doubt that the effects of being classified as a controlled foreign corporation have caused many U.S. shareholders to divest themselves of enough voting power to avoid section 957(a). There is clearly nothing improper about such a purpose for the divestiture.

necessary to formulate an alternative approach to the determination of actual voting control. 122

The spectrum of possible alternative measures of control is broad. On the one hand, the replacement provision for the current regulation could embody a strict, highly quantitative analysis of voting power, focusing only on the percentages of voting stock commanded by United States and non-United States shareholders. 123 This type of test affords the advantage of providing relative certainty as to tax status. But such a test is inflexible in its application, producing an absolute determination in any case where its formal requirements are met, 124 even where formal voting power does not approximate actual voting power.

At the other extreme, the determination of control could depend heavily on the facts and circumstances of each case. 125 Although this approach has the advantage of flexibility of application, it lacks any guiding principles indicating the factors that are relevant to discerning control or how those factors should be weighted. As a result, this approach would spawn judicial confusion and inconsistent results, 126 preventing taxpayers from knowing their tax status with certainty without a judicial determination.

A. A Safe Harbor

The proposed new measure of control should draw upon the advantages of each of the above approaches—certainty and flexibility—to facilitate both tax planning and tax administration. To provide an element of certainty, the replacement provision should include a safe harbor 127—a definitive rule which, if satisfied, would predetermine that a foreign corporation

125. For example, I.R.C. § 385 sets forth several factors that are to be taken into account in determining whether an interest in a corporation is stock or indebtedness.
127. A safe harbor is a "nonexclusive, arbitrarily defined area" where non-litigious taxpayers can plan their affairs in confidence that certain tax consequences will result. Note, supra note 126, at 1705. The Note further states: "For the adventurous taxpayer the law may leave the possibility of litigation in the fringe areas . . ., but tax law should not compel taxpayers to be adventurous." Id.
is not a CFC.\textsuperscript{128} The safe harbor should utilize easily quantifiable measures of voting power to create a nonexclusive, well-defined area where a taxpayer willing to meet the requirements could rest assured that his interest in a foreign corporation was effectively immunized from IRS scrutiny.\textsuperscript{129} Such a safe harbor might include the following requirements: (1) non-United States shareholders must own more than 50 percent of a foreign corporation's total voting stock; (2) the voting stock held by non-United States shareholders must not be subject to any legal limitations on its free exercise that are not also present on the stock held by United States shareholders; and (3) the non-United States shareholders must in fact have elected a majority of the foreign corporation's board of directors.\textsuperscript{130} The inclusion of this quantitative test in the regulation would clarify for tax planners the scope of section 957(a)'s application. United States shareholders would know with relative certainty the extent to which they must decontrol to ensure that their foreign corporate interests are not classified as CFC's.

Since United States shareholders would find it very difficult to meet the requirements of the safe harbor while at the same time retaining actual voting control, it is unlikely that the proposed test could be used for tax abuse purposes. The problems surrounding the determination of control in a deadlock corporation would not arise, since the test requires that United States shareholders own less than 50 percent of the voting power. Nor could the test be circumvented by dispersal of a majority of shares among many non-United States shareholders leaving United States interests with effective control, since non-United States shareholders must actually elect a majority of the board of directors. Even if the United States shareholders were initially able to maintain control, their position of dominance would be a perilous one, since they could not even elect 50 percent of the board of directors. In sum, United States shareholders whose purpose is to avoid sacrificing actual control could not meet the requirements of the safe harbor.

\textsuperscript{128} At a minimum, the safe harbor should place the burden of proof on the Treasury. For examples of other provisions that reverse the burden of proof, see I.R.C. §§ 534, 162(c)(1), and 7454.

\textsuperscript{129} Examples of other safe harbors appear throughout the Internal Revenue Code. \textit{See}, \textit{e.g.}, Treas. Reg. § 1.483-1(d)(2) (1966) (providing that, for the purposes of I.R.C. § 483, no part of any payment on account of the sale of property will be considered as unstated interest if the contract provides for interest at a rate of at least six percent per annum).

\textsuperscript{130} In situations analogous to Subpart F the voting power of a class of stock has been measured according to the percentage of directors the class could elect. Rev. Rul. 69-126, 1969-1 C.B. 218. The question in that ruling was whether the voting power necessary to achieve affiliation status within the meaning of I.R.C. § 1504(a) had been met when the voting stock was divided among common and preferred shareholders. The IRS ruled that "participation in the management of the subsidiary through election of the board of directors is the criterion of the voting power in this case . . . ." \textit{Id.}
The classification of foreign corporations falling in the middle ground between the safe harbor and the statutory definition of a CFC should depend on whether or not the non-United States shareholders have the real opportunity to prevent United States shareholder domination of corporate management. A court should focus its inquiry on factors indicating the ability of non-United States shareholders to participate at least on equal terms with United States shareholders in corporate affairs. The critical issue is whether non-United States shareholders have the potential to exercise voting control, not whether they have frequently demonstrated the equality or supremacy of their voting power in the past.

In applying the real opportunity test, a court should first inquire whether non-United States shareholders have the ability to elect at least half of a foreign corporation’s board of directors. While section 1.957-1(b)(1) currently recognizes control of the board of directors as an important indicator of voting power, the past section 957(a) cases have not relied on this factor in situations involving multiple classes of stock, but instead have depended on other parts of the regulation. A greater emphasis on the ability to elect directors would better serve the policies underlying Subpart F. Congress intended that American shareholders should only be taxed on a foreign corporation’s earnings if they have the ability to declare a dividend prior to distribution. Since corporation laws generally grant the board of directors the power to declare dividends, the ability to elect directors should indicate very accurately the ability to command distribution of earnings.

The real opportunity test would also authorize the examination of the voting power of non-United States shareholders for legal restrictions that


The Tax Court also mentioned the real opportunity test in Kraus v. Commissioner, 59 U.S. Tax Ct. 681 (1973), aff’d, 490 F.2d 898 (2d Cir. 1974). The court stated that “what is not present in the instant case is any opportunity for the preferred shareholders to alter the course of events, even if they suddenly became so inclined.” Id. at 694.


133. Voting control will be attributed to United States shareholders “if they have the power to elect, appoint, or replace a majority of that body of persons exercising, with respect to such corporation, the powers ordinarily exercised by the board of directors of a domestic corporation.” Treas. Reg. § 1.957-1(b)(1)(i) (1963).

134. See notes 92-97 supra and accompanying text.

135. H. Henn, supra note 112, at 665.

136. See note 130 supra.
could operate to impair their ability to prevent United States shareholder
domination. Restrictions on the voting stock itself, such as call provi-
sions,137 express shareholder agreements,138 or limitations imposed by the
corporation laws of a particular jurisdiction,139 could significantly dilute
the nominal voting power of non-United States shareholders. Implied
agreements should contribute to determining real opportunity, but only
where the weight of the evidence indicates that the shareholders have
reached some understanding actually impairing non-United States share-
holder voting power, and that the United States shareholders have an effec-
tive means of enforcing the understanding.140 This might occur where the
facts indicate that the United States shareholders possess economic strangu-
lation power over the foreign corporation because they control suppliers
upon which the corporation depends for survival.141
The real opportunity test of control would supply the tools for uncovering transactions that meet the section 957(a) requirements in substance but not in form, and would eliminate many of the problems which plague the current regulation. For instance, the test would not require the actual exercise of voting power in every corporate action taken, nor would it require dissimilar voting records between groups of shareholders. The economic interest of non-United States shareholders and the principal purpose of a voting stock transfer—factors which do not significantly affect the actual ability of non-United States shareholders to exercise their voting power—would no longer contribute to the determination of control. Eliminat-
ing from consideration those factors that are not directly related to voting control would significantly alleviate the problems of current taxation of United States shareholders on income not yet available, inconsistent judi-
cial applications of section 957(a), and uncertainty in tax planning.

CONCLUSION

Treasury Regulation section 1.957-1(b)(2) is an inappropriate measure of voting power for the purposes of Subpart F. The regulation is not entirely consistent with Subpart F’s statutory provisions or its legislative intent. Furthermore, application of the regulation often fails accurately to determine actual voting control, causing courts to apply it inconsistently. In or-
der to impose Subpart F taxation in accordance with legislative intent and to facilitate tax planning, the current regulation should be revised to in-

137. See, e.g., Kraus v. Commissioner, 490 F.2d 898, 902 (2d Cir. 1974).
138. See, e.g., Weiskopf v. Commissioner, 64 U.S. Tax Ct. 78, 95 (1975).
139. See Rev. Rul. 70-426, 1970-2 C.B. 157 (although in that case the law of the country of incorporation gave neither group of shareholders a voting power advantage). For a brief discussion of this Revenue Ruling, see note 55 supra and accompanying text.
140. See notes 72-74 supra and accompanying text.
141. See, e.g., Weiskopf v. Commissioner, 64 U.S. Tax Ct. 78, 95 (1975); note 54 supra.
clude a safe harbor. The residuum of cases involving a control issue should undergo an analysis based on the real opportunity of non-United States shareholders to participate at least equally with United States shareholders in corporate management.

Andrew H. Shaw