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Although overshadowed in the media by the sweeping domestic tax revisions in the Tax Reform Act of 1986,[1] the foreign tax provisions in title XII of the Act also make highly significant changes in the Internal Revenue Code[2] and, together with the Congressional Committee Reports, comprise about one-fifth of the Act and its legislative history.[3] Moreover, some of the same policy considerations prompted both the domestic and the foreign provisions. For instance, tax neutrality, that much ballyhooed domestic tax policy goal, is equally evident in certain foreign tax provisions such as the new branch profits tax,[4] which tends to make more tax-neutral the decision of a foreign corporation to operate in the U.S. either through a U.S. subsidiary or a branch. By contrast, the tightening up of the U.S. foreign tax credit,[5] combined with the significantly reduced domestic tax rates,[6] will provide many U.S. companies having foreign op-

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1. Pub. L. No. 99-514, 100 Stat. 2085 [hereinafter the Act].
2. The Act renames the Internal Revenue Code of 1954, together with all amendments to it, including those made by the Act, as the Internal Revenue Code of 1986 [hereinafter the Code]. Act § 2. The Internal Revenue Code of 1954, as it existed just prior to the enactment of the Act, will be referred to as the Prior Code.
3. The committee reports accompanying the Act are the reports of the House Committee on Ways and Means. H.R. REP. No. 426, 99th Cong., 2d Sess. (1986) [hereinafter House Report]; the Senate Committee on Finance, S. REP. No. 313, 99th Cong., 2d Sess. (1986) [hereinafter Senate Report]; and the Committee of Conference, CONF. REP. No. 841, 99th Cong., 2d Sess. (1986) [hereinafter Conference Report].
4. *See infra* notes 106-22.
5. *See infra* notes 7-27.
6. After the 1987 phase-in period, the top individual rate will be 28 percent (compared with 50 percent in 1986), and the top corporate rate will be 34 percent (compared with 46 percent in 1986). Act §§ 101 & 601.

erations with a tax motive for rearranging their businesses in order to decrease their foreign source income and increase their U.S. source income.

This article will survey, with some background discussion, the more significant provisions of the Act and the legislative history relating to the U.S. taxation of international transactions and operations. The main section headings used below correspond generally to the subtitle headings of title XII of the Act. While the majority of these provisions are effective beginning after December 31, 1986, many of the new rules contain different effective dates and detailed transition rules largely beyond the scope of this article.

I. Foreign Tax Credit Modifications

A. New Separate Limitations

Because the U.S. taxes the worldwide income of U.S. citizens or residents,[7] a U.S. citizen or resident may be taxed by both the U.S. and a foreign country on foreign source income arising in the foreign country. The foreign tax credit alleviates this tax burden by effecting a subtraction from U.S. tax of an amount attributable to the foreign tax paid or accrued on foreign source income.[8] The amount of foreign taxes, however, that may be credited is limited to an amount equal, in effect, to the U.S. tax on the taxpayer's foreign source income.[9] Expressed as a formula, the overall foreign tax credit limitation amount equals the following product:

$$\frac{\text{foreign source taxable income}}{\text{worldwide taxable income}} \times \text{taxpayer's U.S. tax.}$$

The foreign tax credit is allowed with respect to foreign taxes paid directly by the taxpayer. Moreover, a "deemed-paid" credit is allowed a domestic corporation with respect to dividends it receives from a foreign corporation that pays foreign taxes and that is at least ten percent owned by the domestic corporation.[10] Such domestic corporations are deemed to have paid a ratable share of the foreign taxes paid by the foreign corporation and first and second tier foreign subsidiaries of the foreign corporation.

7. Treas. Reg. § 1.871-1(a) (as amended in 1980).

8. *See* Code §§ 901-908. The foreign tax credit must be elected by the taxpayer. If the election is not made, foreign taxes paid or accrued may be deducted. *Id.* §§ 901(a), 275, & 164(a).

9. *Id.* § 904(a). To the extent that foreign taxes paid or accrued in a particular year exceed the limitation they may be carried back to the second preceding year and first preceding year and then carried forward to the first through fifth succeeding years.

10. *Id.* § 902.

In addition to the overall foreign tax credit limitation, Congress has created certain separate limitations with respect to certain types of foreign source income that can give rise to abuse of the foreign tax credit. According to the House Report, separate limitations have been applied for one of three reasons: the income's source (foreign or U.S.) can be manipulated; the income typically bears little or no foreign tax; or the income often bears a rate of foreign tax that is abnormally high or in excess of rates on other types of income.[11] Accordingly, a foreign tax credit limitation is calculated separately, for example, for passive interest income and certain dividends from domestic international sales corporations and foreign sales corporations.[12] The new law creates more such separate categories (sometimes called "baskets") of income that are subject to a separate limitation calculation. In general, these new separate limitation categories are as follows: (1) passive income; (2) financial services income; (3) certain shipping income; (4) highly taxed interest income; and (5) certain dividends from noncontrolled foreign corporations.[13]

The new passive income basket replaces the old separate limitation for passive interest income and includes, generally, dividends, interest, annuities, rents, royalties, and gains from the sales of noninventory assets.[14] Passive income does not, however, include certain foreign oil and gas extraction income, interest derived from financing certain export sales (except financial interest), and highly taxed passive income on which the effective foreign tax rate exceeds the highest U.S. rates for such income.[15]

Financial services income generally means the nonpassive investment income earned in an active banking or financing business and certain investment income earned by an insurance company.[16] The shipping income category includes any income of a kind that would be foreign base company shipping income, which generally means income from the use, hiring, or leasing of any vessel or aircraft in foreign commerce or from the performance of services directly related to such use, hiring, or leasing.[17]

The high withholding tax interest category encompasses interest income subject to a foreign withholding tax of at least five percent.[18] This category does not include export financing interest; and, if interest qualifies as high

11. H.R. Rep. at 331.
12. Prior Code § 904(d).
13. Act § 1201 (amending Code § 904(d)). If a U.S. taxpayer incurs a foreign loss in one of the separate limitation categories, it must be applied to reduce proportionately the income in the other separate limitation categories before being applied to reduce U.S. income. Act § 1203(a) (adding paragraph (5) to Code § 904(f)).
14. Code § 904(d)(2)(A)(i) & (ii).
15. *Id.* § 904(d)(2)(A)(iii).
16. *Id.* § 904(d)(2)(C).
17. *Id.* §§ 904(d)(2)(D) & 954(f).
18. *Id.* § 904(d)(2)(B).

withholding tax interest, it is not included in the passive income basket. The Secretary is to prescribe regulations providing that amounts not otherwise qualifying as high withholding tax interest are to be treated as such in order to prevent tax avoidance.[19]

Lastly, the fifth new item of income subject to a separate limitation computation is dividends paid by noncontrolled foreign corporations to domestic corporations owning at least ten percent of the voting stock of the payor foreign corporation.[20] Such domestic corporations are deemed to have paid a proportion of any income taxes paid or deemed to have been paid by the payor foreign corporation and are, accordingly, entitled to the deemed-paid foreign tax credit.[21]

B. Other Foreign Tax Credit Changes

An amendment of the rules for computing the deemed-paid credit provides that dividends paid by a foreign corporation to a ten percent or more domestic corporate shareholder are considered as paid first out of earnings and profits accumulated by the foreign corporation after December 31, 1986, rather than, as under prior law, from all undistributed accumulated earnings and profits on the books in the year the dividend is paid.[22] Furthermore, for purposes of computing the foreign tax credit of a ten percent or more U.S. corporate shareholder of a controlled foreign corporation, new "look-through" rules are provided. Under these rules dividends, interest, rents, and royalties received by the domestic corporation from the controlled foreign corporation, as well as subpart F income of the controlled foreign corporation that is included in the income of the domestic corporation, is allocated to one or more of the five new separate limitation categories to the extent the income of the controlled foreign corporation is itself attributable to one or more of these categories.[23]

For taxable years after 1986 (with certain transitional phase-in rules) the Act determines the taxable income of each member of an affiliated group of corporations by allocating and apportioning the interest expense of each member of the affiliated group as if all members of the group were a single corporation.[24] Existing Treasury Regulations provide that affiliated groups of companies must allocate interest expense between U.S.

19. *Id.* § 904(d)(2)(B)(iii).

20. *Id.* § 904(d)(1)(E).

21. *See supra* note 10 and accompanying text.

22. Act § 1202(a) (amending Code § 902). A transition rule allows a limited application of prior law with respect to dividends paid out of pre-1987 earnings and profits. Code § 902(c)(6).

23. Act § 1201(b); Code § 904(d)(3).

24. Act § 1215(a), adding new subsection (e) to Code § 864.

and foreign source income on a company-by-company basis for purposes of computing the foreign tax credit.[25] This change will apply for purposes of computing the foreign tax credit limitation and for all other taxing purposes in the Code. Furthermore, the Act provides that this new allocation method is to apply to expenses other than interest that are not directly allocable and apportioned to any specific income-producing activity.[26] Certain financial institutions are excepted from the new allocation rule, so that interest and other similar expenses are allocated to each such company on a separate basis.[27]

II. Income Source Rules

The Code rules for determining whether an item of income is U.S. source income or foreign source income are necessary in order to compute the overall limitation on the foreign tax credit available to U.S. citizens and residents.[28] On the other hand, nonresident foreign persons need these rules in order to distinguish between their U.S. source income, which the U.S. generally taxes, and their foreign source, which the U.S. does not generally tax.[29] The Act makes some important amendments to the source rules.

A. Sales of Personal Property

New Code section 865 substantially revises the rules for determining whether income from the sale of personal property is U.S. source income or foreign source income.[30] Prior law applied a "passage of title" rule and generally sourced income from the sale of tangible or intangible personal property in the country where title to that property passed to the purchaser.[31] The new general rule makes income from the sale of personal property by a U.S. resident U.S. source income and income from such

25. Treas. Reg. § 1.861-8(a)(2) (as amended in 1984). By contrast, a case that was decided before the effective date of the Treasury Regulations states that expenses not directly attributable to the production of U.S. or foreign source income should be deducted from gross income on a consolidated group basis. International Tel. & Tel. Corp. v. United States, 79-2 U.S.T.C. ¶ 9649.

26. Code § 864(e)(6).

27. *Id.* § 864(e)(5)(C). The Internal Revenue Service has promulgated Notice 87-6, 1987-3 I.R.B. ———, which provides interim guidance (prior to the issuance of regulations) with respect to the application of several of the new foreign tax credit provisions.

28. *See supra* note 9 and accompanying text.

29. *See* Code §§ 871-883.

30. Act § 1211. These new personal property source rules generally apply to taxable years beginning after December 31, 1986. In the case of foreign persons other than controlled foreign corporations, the amendments apply to transactions entered into after March 18, 1986. *Id.* § 1211(c).

31. *See* Prior Code §§ 861(a)(6), 862(a)(6) & 863(b).

sales by nonresidents foreign source income.[32] Income from the sale of inventory property, however, continues to be sourced under the passage of title rule.[33]

With respect to income from the sale of depreciable personal property used in the taxpayer's trade or business, an exception to the general rule taxes gain attributable to the recapture of depreciation deductions[34] as U.S. gain to the extent of all prior depreciation deductions that were allowable in computing U.S. taxable income.[35] All remaining depreciation recapture income is foreign source income, and gain in excess of depreciation recapture is sourced according to the passage of title rule applicable to inventory property.[36]

The source of income from the sale of intangibles[37] is determined under the new general rule, unless payments for the sale are contingent on the productivity, use, or disposition of the intangible. In such cases, the payments are usually treated like royalties and sourced where the intangible is disposed of, produced, or used.[38]

Special rules are provided for sales, through offices or fixed places of business, of personal property which is neither inventory nor depreciable trade or business property. Income from such property, which includes stocks, bonds, and securities, is foreign source income if two conditions are met. The property must be sold by a U.S. resident who maintains an office or other fixed place of business outside the U.S. and an income tax of at least ten percent of the income from the sale must be actually paid to a foreign country with respect to the income.[39] Gain from the sale by a U.S. resident of stock in a foreign affiliated corporation is sourced outside of the U.S. if the affiliate is engaged in the active conduct of a trade or business and the sale occurs in a foreign country in which the affiliate derived more than fifty percent of its gross income for the three-year period ending with the close of the affiliate's taxable year immediately preceding the year during which the sale occurred.[40]

Regardless of any other rule, if a nonresident maintains an office or other fixed place of business in the U.S., income from any sale of personal

32. Code § 865(a).
33. *Id.* § 865(b).
34. *See Id.* § 1245. This section taxes gain from the sale of depreciable property as ordinary income to the extent the gain does not exceed prior depreciation deductions taken by the seller with respect to the property.
35. *Id.* § 865(c).
36. *Id.*
37. Intangibles are defined to include any patent, copyright, secret process or formula, goodwill, trademark, trade brand, or other like property. Code § 865(d)(2).
38. *See id.* §§ 865(d), 861(a)(4) & 862(a)(4). Income from the sale of goodwill is sourced in the country in which the goodwill was generated. *Id.* § 865(d)(3).
39. *Id.* § 865(e).
40. *Id.* § 865(f).

property (including inventory property) attributable to that office or place of business is U.S. income, except in the case of income of export trade corporations.[41] In the case, however, of sales by nonresidents of inventory for use, disposition, or consumption outside of the U.S., the source of the income is foreign if an office or other fixed place of business of the taxpayer outside of the U.S. materially participates in the sale.[42]

B. Transportation Income

As under the prior rule, transportation income[43] attributable to transportation that begins and ends in the U.S. is treated as U.S. income. Fifty percent of the income from all other transportation either beginning or ending in the U.S. is to be treated as from sources in the U.S., however. The other fifty percent is treated as foreign source income.[44]

New Code section 887 provides for the imposition of a four percent tax on the U.S. source gross transportation income of nonresident aliens and foreign corporations.[45] To the extent transportation income is subject to the four percent tax, it is not taxable as income effectively connected with a U.S. trade or business.[46]

41. *Id.* § 865(e)(2)(A). "Export trade corporation" is defined at *id.* § 971 generally as a controlled foreign corporation 90 percent of whose income is foreign source and 75 percent of which is export trade income (as defined therein).

42. *Id.* § 865(e)(2)(B). An exception is provided for amounts included in income under *id.* § 951(a)(1)(A), the section taxing U.S. shareholders on their pro rata shares of certain categories of income of a controlled foreign corporation, as defined at *id.* § 957(a). The Treasury is to conduct a study of the source rules for sales of inventory property and submit a report on such study no later than September 30, 1987, to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. Act § 1211(d). The report is to include any such recommendations as the Secretary of the Treasury deems advisable.

43. As under prior law, the definition of "transportation income" is "any income derived from, or in connection with—(A) the use (or hiring or leasing for use) of a vessel or aircraft, or (B) the performance of services directly related to the use of a vessel or aircraft." Code § 863(c)(3).

44. Act § 1212(a) (amending Code § 863(c)(2)). This rule does not apply to any transportation income that is personal services income, unless such income is attributable to transportation that begins in the U.S. and ends in a possession of the U.S., or begins in a possession of the U.S., and ends in the U.S. Code § 863(c)(2)(B).

45. Act § 1212(b). The definition of "gross transportation income" is gross income that is U.S. source transportation income described in Code § 863(c)(3). The tax does not apply to transportation income that is effectively connected with a U.S. trade or business under Code §§ 871(b) or 882. Code § 887(b)(2). For purposes of determining whether § 871(b) or § 882 applies, however, transportation income is not treated as effectively connected with a U.S. trade or business unless: (a) the taxpayer has a fixed place of business in the U.S. involved in the earning of transportation income; and (b) substantially all of the U.S. source gross transportation income (whether effectively connected or not) of the taxpayer is attributable to regularly scheduled transportation (or, in the case of income from the leasing of a vessel or aircraft, is attributable to a fixed place of business in the U.S.). Code § 887(b)(3).

46. Code § 887(c).

Under current law nonresident alien individuals and foreign corporations may exclude from their U.S. gross income all income derived from the operation of a ship or aircraft that is documented or registered under the laws of a foreign country that grants an equivalent exemption to U.S. citizens and U.S. corporations.[47] The Act modifies this rule so that it will apply only if the foreign country of residence or incorporation of the nonresident alien or foreign corporation, rather than the foreign country of documentation or registration of the ship or aircraft, grants the equivalent exemption to U.S. citizens.[48] The income subject to this exemption includes income derived from the rental on a full or bareboat basis, of a ship or ships or aircraft.[49] In addition, the exemption does not apply to foreign corporations unless fifty percent or more of the value of the stock of the corporation is owned by individuals who are residents of the foreign country of incorporation or another country that meets the reciprocal exemption requirements.[50]

C. Source Rule for Space and Ocean Activities

A new source rule under section 863 of the Code provides that, except as may otherwise be provided in regulations, any income derived by a U.S. person from a "space or ocean activity" is sourced in the U.S., and any such income derived by a person other than a U.S. person is sourced outside the U.S.[51] The term "space or ocean activity" means any activity conducted in space, and any activity conducted on or under water, not within the jurisdiction (as recognized by the U.S.) of a foreign country, possession of the U.S., or the U.S.[52] Space or ocean activities do not include those activities that give rise to transportation income (as defined in Code section 863(c)) or "international communications income" and any activity with respect to mines, oil and gas wells, or other natural deposits to the extent they are within the U.S. or any foreign country or possession of the U.S.[53]

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47. Prior Code § 872(b)(1) & (2).

48. Act § 1212(c) (amending Code § 872(b)(1) & (2) and § 883(a)(1) & (2)).

49. Code § 872(b)(5). The Act also states that the Secretary of the Treasury may provide that these exemption rules be applied separately with respect to income from different types of transportation. *Id.* § 872(b)(6).

50. *Id.* § 883(c). This rule does not apply to controlled foreign corporations (defined at *id.* § 957(a)) and publicly traded corporations. Also, attribution rules are prescribed for the attribution of stock owned directly or indirectly by or for corporations, partnerships, trusts, or estates.

51. Act § 1213(a), adding subsections (d) & (e) to Code § 863. Code § 7701(a)(3) defines a U.S. person as a citizen or resident of the U.S., a domestic partnership or corporation, and any estate or trust other than a foreign estate or trust.

52. Code § 863(d)(2)(A). The term includes any activity conducted in Antarctica.

53. *Id.* § 863(d)(2)(B).

The term "international communications income" means all income derived from the transmission of communications or data from the U.S. to any foreign country or from any foreign country to the U.S.[54] In the case of any U.S. person, fifty percent of any international communications income is sourced in the U.S., and the remaining fifty percent is sourced outside the U.S.[55] Unless otherwise provided in regulations, in the case of any person other than a U.S. person any international communications income is sourced outside the U.S.[56] In the case of any person (other than a U.S. person) who maintains an office or other fixed place of business in the U.S., however, any international communications income attributable to such office or other fixed place of business is to be sourced in the U.S.[57]

D. Limitations on Special Treatment of 80-20 Companies and Individuals

Generally, the source of dividend and interest income for tax purposes is the country of residence of the payor.[58] Prior to the Act an exception to this rule existed with respect to resident alien individuals and domestic corporations that realized more than eighty percent of their income from sources outside the U.S. for the three-year period prior to the year in which the payment of interest or dividends was made. Interest paid by such an individual or dividends and interest paid by such a corporation (sometimes referred to as an "80-20 individual" or an "80-20 company") was treated as foreign source income.[59] The Act repeals these rules with respect to 80-20 companies and individuals and replaces them with a more complex set of rules that distinguish between the source of the income and the taxation of the income by the U.S.[60]

In general, interest received from a resident alien individual or domestic corporation is foreign source income if at least eighty percent of the gross income of the individual or corporation from all sources for the prior three-year period is "active foreign business income," defined as foreign source gross income attributable to the active conduct of a trade or business in a foreign country or U.S. possession by the individual or corporation (or a subsidiary or subsidiaries of the corporation).[61] An exception

54. *Id.* § 863(e)(2).
55. *Id.* § 863(e)(1)(A).
56. *Id.* § 863(e)(1)(B)(i).
57. *Id.* § 863(e)(1)(B)(ii).
58. *See id.* §§ 861 & 862.
59. Prior Code §§ 861(a)(1)(B) & 861(a)(2)(A).
60. Act § 1214.
61. Code § 861(a)(1)(B) & (C).

to this rule is provided where interest is received by a related person[62] from a resident alien individual or domestic corporation meeting the eighty percent test described above. In such a case only a percentage of the interest is foreign source income, determined by the ratio that the foreign gross income of the individual or corporation for the prior three-year period bears to the total gross income for such period.[63]

The prior 80-20 foreign sourcing rule for dividends is repealed for all domestic corporations other than corporations with a Code section 936 election in effect.[64] Thus, with one exception, all dividends received from a domestic corporation will be U.S. source income regardless of the percentage of the corporation's income that is foreign source.

In conjunction with the amendments to the source rules relating to dividends and interest paid by 80-20 companies and individuals the Act amends the withholding tax provisions applicable to interest and dividends paid to nonresident aliens and foreign corporations.[65] Under the Act no withholding tax is imposed on interest paid to nonresident aliens or foreign corporations on most bank and savings and loan deposits, as long as the interest is not effectively connected with a U.S. trade or business.[66] Also, the withholding tax is eliminated on a percentage of dividends paid by domestic companies meeting the eighty percent active foreign business income test described above[67] equal to the percentage determined by the ratio of foreign source income to all income for the prior three-year period.[68] Withholding taxes also have been eliminated on income derived by foreign central banks of issue from bankers' acceptances.[69]

The changes to the sourcing rules for 80-20 companies and individuals and the withholding tax changes apply to payments after December 31, 1986, with some exceptions. For instance, interest paid or accrued on any obligation outstanding on December 31, 1985, is not affected by the changes.[70] This exception does not apply when the interest is paid pur-

62. The definition of "related person" is that found at Code § 954(d)(3) with specified modifications.

63. *Id.* § 861(c)(2).

64. Act § 1214(b) (amending Code § 861(a)(2)(A)). Code § 936 provides an electing domestic corporation (a so-called "possession corporation") with a U.S. tax credit against U.S. taxes attributable to income from an active trade or business (and certain related investment income) conducted in certain U.S. possessions, and the Commonwealth of Puerto Rico.

65. Except where reduced or eliminated by tax treaty, a 30% withholding tax is imposed on most U.S. source passive income (including dividends and interest) paid to nonresident aliens and foreign corporations. Code §§ 871, 881 & 1441.

66. Code § 871(i)(2)(A).

67. *See supra* note 31.

68. Code § 871(i)(2)(B).

69. *Id.* § 871(i)(2)(C).

70. Act § 1214(d)(2)(A).

suant to an extension or renewal of such an obligation that is agreed to after December 31, 1985.[71]

E. Allocation of Research Expenses to Foreign Source Income

Under Treasury Regulations U.S. taxpayers were required to allocate a portion of their research and experimental expenditures incurred in the U.S. to foreign source income from products generated by the research.[72] In 1981 and 1984 Congress suspended this rule, thereby allowing all U.S. research and experimental expenditures to be offset against U.S. source income.[73] Instead, the Act provides that fifty percent of all amounts allowable as a deduction for qualified research and experimental expenditures (defined as Code section 174 expenses that are attributable to activities conducted in the U.S.) are to be deducted from U.S. source income, and the remaining portion of these expenditures is to be apportioned on the basis of gross sales or income.[74] The Conference Report urges the House and Senate tax writing committees to continue to study whether any additional permanent tax incentives for U.S. research are appropriate.[75]

III. Foreign Currency Transactions

A. Functional Currency Concept

For the first time the Code attempts a comprehensive set of statutory rules for the tax treatment of foreign currency transactions and the use of foreign currency in foreign business operations.[76] Perhaps the most significant change is the adoption of the "functional currency" concept of new Code section 985. The general rule of that section is that, unless otherwise provided in regulations, all income tax determinations under the Code are to be made in the taxpayer's functional currency. The term "functional currency" is defined as either the dollar or "in the case of a qualified business unit, the currency of the economic environment in

71. *Id.* Also, if the payee of any interest paid or accrued on any such obligation outstanding on December 31, 1985, is related within the meaning of Code § 904(d)(2)(G) to the payor, such interest is treated for purposes of Code § 904 as if the payor were a controlled foreign corporation within the meaning of Code § 957(a). Act § 1214(d)(2)(B).

72. *See* Treas. Reg. § 1.861-8(e)(3) (as amended in 1984).

73. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 223, 95 Stat. 170, 249 (1981); Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 126, 98 Stat. 494, 775 (1984), as amended by Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, § 13216, 100 Stat. 82, 324-25 (1986).

74. Act § 1216.

75. Conf. Rep. at II-608.

76. Act § 1261, adding Code §§ 985-989.

which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records."[77] The term "qualified business unit" is defined elsewhere as "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records."[78] Where the activities of a qualified business unit are primarily conducted in dollars the functional currency of the unit is the dollar.[79] Moreover, to the extent provided in regulations to be promulgated, the taxpayer may elect to use the dollar as the functional currency for any qualified business unit (QBU).[80] The election will be available only if: (i) the unit keeps its books and records in dollars; or (ii) the taxpayer uses a method of accounting that approximates a "separate transactions" method.[81] The election to use the dollar as the functional currency is to apply to the taxable year for which it is made and all subsequent taxable years, unless revoked with the consent of the Secretary.[82] Any voluntary change in the functional currency of a QBU is to be treated as a change in the taxpayer's method of accounting under procedures to be established by the Secretary.[83] The Senate Report directs the Secretary to prescribe regulations providing for the treatment of "taxpayers whose functional currency changes."[84]

These regulations should deal with involuntary changes in the functional currency, which could arise, for instance, when most of a taxpayer's customers or clients begin paying the taxpayer in a nonfunctional currency.

77. Code § 985(b)(1).
78. *Id.* § 989(a).
79. *Id.* § 985(b)(2).
80. *Id.* § 985(b)(3).
81. According to the Conference Report, this latter exception is to be made available under the regulations where the method of currency translation into dollars used by the taxpayer approximates the results of determining exchange gain or loss on a transaction-by-transaction basis. The conferees contemplated that the Secretary would implement this exception through regulations that require the comparison of year-end balance sheets using historical exchange rates for all balance sheet items, and that the Secretary would condition the applicability of either exception on the taxpayer's making the election for all of the taxpayer's QBUs on a worldwide basis. Moreover, the "separate transactions" exception, allowing the dollar as the functional currency, was included to address the concerns of taxpayers operating in hyperinflationary economies, and this exception was not expected to be made available, through the regulations, to taxpayers who are not operating in hyperinflationary economies. In such a case, according to the Conference Report, local-currency-based accounting might not accurately reflect the income or loss of a taxpayer with substantial fixed plant and equipment since the local currency depreciation charge would otherwise become insignificant in relation to operating income. CONF. REP. at II-661 to -62.
82. Code § 985(b)(3).
83. *Id.* § 985(b)(4).
84. S. REP. at 458.

B. Currency Translation

Code section 986 provides rules for translating into U.S. dollars earnings and profits and foreign taxes paid by a foreign corporation that has a functional currency other than the dollar. These computations are necessary in order to apply other provisions of the Code that tax U.S. shareholders on actual or deemed dividends from a foreign corporation's earnings and profits or that allow U.S. corporate shareholders a foreign tax credit with respect to taxes deemed paid by a foreign corporation. Under Code section 986(a) the earnings and profits of a foreign corporation are first determined in the corporation's functional currency. In the case of a U.S. shareholder, the earnings and profits so determined shall, when distributed, deemed distributed, or otherwise taken into account for U.S. tax purposes, be translated into dollars using the appropriate exchange rate.[85] This means that for actual dividend distributions to U.S. shareholders of foreign corporations and for deemed dividends under Code section 1248,[86] no exchange gain or loss resulting from exchange rate fluctuations between the time earnings and profits arise and the time of actual or deemed distribution is separately recognized.

In determining the deemed-paid foreign tax credit available to domestic corporate shareholders of foreign corporations,[87] Code section 986(b) provides that any foreign income taxes paid by a foreign corporation are to be translated into dollars using the exchange rate as of the time of payment of the tax. Also, any adjustment to the amount of foreign income taxes paid by a foreign corporation is to be translated into dollars using the exchange rate as of when the adjustment is made. In the case of any refund or credit of foreign taxes the exchange rate as of the time of the original payment of the foreign taxes is to be used. These rules have the effect of legislatively overruling the *Bon Ami* case,[88] which held that the foreign taxes of a foreign subsidiary which were deemed paid by the U.S. parent corporation were to be translated at the exchange rate on the date of the distribution of dividends to the U.S. corporation.

Finally, Code section 986(c) provides that a foreign gain or loss with respect to actual distributions of previously taxed earnings and profits,[89]

85. Code § 986(a).

86. *Id.* § 1248 taxes a shareholder selling stock of a foreign corporation on a ratable portion of the corporation's earnings and profits that have not been previously taxed to the shareholder.

87. *See* Code §§ 902 & 960.

88. Bon Ami v. Commissioner, 39 B.T.A. 825 (1939).

89. The term "previously taxed earnings and profits" means earnings and profits described in Code § 959 that previously have been taxed to a U.S. shareholder as part of a foreign corporation's subpart F income and earnings and profits described in Code § 1293(c) that previously have been taxed to a shareholder of a qualified electing fund. Code § 986(c)(1).

which is attributable to fluctuating exchange rates between the times of deemed and actual distribution of the earnings and profits, is to be recognized and treated as ordinary income or loss from the same source country as the associated distribution of income. The Secretary is to prescribe regulations with respect to the treatment of distributions of previously taxed earnings and profits through tiers of foreign corporations.[90]

Under prior law a taxpayer with a branch in a foreign country that maintained its books in a foreign currency could generally compute its U.S. taxable income attributable to the branch by using either the "profit and loss" method or the "net worth" (or "balance sheet") method. The profit and loss method allowed the U.S. taxpayer to translate into U.S. dollars any remittances of profit made by the branch during the year at the exchange rate in effect on the date of remittance.[91] Any unremitted profit was translated at the year-end exchange rate. By contrast, under the net worth method, U.S. taxable income was generally calculated as the difference between the branch's net worth at the end of the prior taxable year and at the end of the current taxable year.[92] New Code section 987 mandates the use of the profit and loss method for all QBUs.[93]

A taxpayer having one or more qualified business units with a functional currency other than the dollar determines the taxable income of the QBUs by a four-step process.[94] First the taxable income or loss is computed separately for each QBU in its functional currency. Next, these separately computed income or loss amounts are translated at the appropriate exchange rate[95] into U.S. dollars. Proper adjustments (as

90. *Id.* § 986(c)(2).

91. *See* Rev. Rul. 75-107, 1975-1 C.B. 32.

92. *See* Rev. Rul. 75-106, 1975-1 C.B. 31; Rev. Rul. 75-134, 1975-1 C.B. 33.

93. The Conference Report specifically contemplates that the Internal Revenue Service will allow groups of corporations filing on a consolidated basis to revoke prior elections under Code § 1504(d) to include, for consolidated filing purposes, wholly owned Canadian or Mexican subsidiaries as a part of the U.S. consolidated group. Since the net worth method of accounting for foreign currency gains or losses has been discarded in favor of a profit and loss method, such consolidated groups no longer will be able to recognize unrealized currency exchange gains or losses arising from the operations of the Canadian or Mexican subsidiary. The Conference Report prescribes guidelines for the Internal Revenue Service in implementing this revocation possibility. CONF. REP. at II-672 to -73.

94. Code § 987.

95. The term "appropriate exchange rate" is defined in new Code § 989 as:

(1) [I]n the case of an actual distribution of earnings and profits, the spot rate on the date such distribution is included in income;

(2) [I]n the case of an actual or deemed sale or exchange of stock in a foreign corporation treated as a dividend under section 1248, the spot rate on the date the deemed dividend is included in income;

(3) [I]n the case of any amounts included in income under section 951(a), 551(a), or 1293(a), the weighted average exchange rate for the taxable year of the foreign corporation; or

prescribed by the Secretary) are then made for transfers of property between QBUs of the taxpayer having different functional currencies.[96] Finally, the taxpayer translates foreign income taxes paid by each QBU of the taxpayer in the same manner as described above for foreign corporations.[97]

C. Foreign Currency Transactions

Code section 988 addresses issues relating to the timing of the recognition of income or loss from foreign currency exchange and the character, geographic source, and allocation of such foreign exchange gains or losses.[98] Any foreign currency exchange gain or loss attributable to what is denoted a "section 988 transaction" is to be computed separately and treated as ordinary income or loss. Section 988 transactions include four categories of transactions where the amount the taxpayer is entitled to receive (or is required to pay) by reason of the transaction is denominated in terms of a nonfunctional currency[99] or determined by reference to the value of one or more nonfunctional currencies.[100] The four categories are: (1) the acquisition of a debt instrument (including preferred stock) or becoming the obligor under a debt instrument;[101] (2) accruing (or otherwise taking into account) for income tax purposes any item of expense or gross income or receipts to be paid or received after the date on which so accrued or taken into account; (3) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument if the instrument is not marked to market at the close of the taxable year under Code section 1256; and, (4) the disposition of any nonfunctional cur-

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> (4) [I]n the case of any other qualified business unit of a taxpayer, the weighted average exchange rate for the taxable year of such qualified business unit.

Id. § 989(b).

96. All post-1986 remittances from a QBU are to be treated as made on a pro rata basis out of post-1986 accumulated earnings. Moreover, any currency exchange gain or loss on transfers of property or remittances between QBUs having different functional currencies are to be treated as ordinary income or loss and sourced the same as the source of the income giving rise to the post-1986 accumulated earnings. Code § 987(3).

97. *See supra* notes 87-88 and accompanying text.

98. Conf. Rep. at II-662.

99. Code § 988 defines the term nonfunctional currency as including coin or currency; it denominates nonfunctional currency as demand or time deposits or similar instruments issued by a bank or other financial institution. Code § 988(c)(1)(C)(ii).

100. *Id.* § 988(c)(1).

101. Under the strict wording of Code §§ 988(c)(1)(B) & (c)(1)(A)(i) only the creation of a debt instrument, not the payment or satisfaction of the debt, is a Code § 988 transaction. The Congressional Committee Reports, however, are not so restrictive. *See* H.R. Rep. at 474; S. Rep. at 459-61; Conf. Rep. at II-663. This rather important gap in the coverage of Code § 988 should be closed by regulation.

rency.[102] Foreign currency gain or loss is generally defined as a gain or loss from a section 988 transaction to the extent of the gain or loss realized by reason of changes in exchange rates on or after the booking date (the date of acquisition or accrual) and before the payment date (the date on which payment is made or received).[103]

In general, any amount treated as ordinary income or loss from a section 988 transaction is treated as interest income or expense to the extent provided in regulations.[104] Also, the source of any such ordinary income or loss from a section 988 transaction is determined by reference to the residence of the taxpayer or the QBU of the taxpayer on whose books the asset, liability, or item of income or expense is properly reflected.[105]

IV. Tax Treatment of Foreign Taxpayers

A. Branch Profits Tax

Dividends and interest paid by a U.S. subsidiary to its foreign parent corporation are subject to a thirty percent U.S. withholding tax on the gross amount paid.[106] This thirty percent rate is reduced or eliminated by an appropriate provision in an income tax treaty between the U.S. and the country of residence of the recipient parent corporation. If a foreign corporation chose to operate in the U.S. through a branch rather than a U.S. subsidiary, prior law provided no withholding tax on remittances from the U.S. branch to a foreign office of the foreign parent corporation. If fifty percent or more of the gross income of a foreign corporation operating in the U.S. was effectively connected with a U.S. trade or business, however, then the U.S. thirty percent withholding tax (or a lower treaty rate) was imposed on that portion of the dividends or interest paid by the foreign corporation allocable to the payor's U.S. effectively connected income.[107] Such a withholding tax on payments by, rather than

102. Code § 988(c)(1). Regulations are to be promulgated whereby all § 988 transactions that are part of a legitimate hedging transaction will be treated as a single transaction. Code § 988(d). The Internal Revenue Service has issued Notice 87-11, 1987-4 I.R.B. ———, which provides interim guidance to taxpayers until regulations are promulgated on the treatment of hedging transactions.

103. Code § 988(b), (c)(2) & (3).

104. Code § 988(a)(2). Provision is to be made for regulations allowing a taxpayer to elect to treat as capital gain or loss (as opposed to ordinary gain or loss) any foreign currency gain or loss attributable to a forward contract, futures contract, or option (as described in the third category of § 988 transactions set out above). In general, the regulations are to provide that the taxpayer must make such an election before the close of the day on which the transaction is entered into or at such earlier time as the Secretary may prescribe. *Id.* § 988(2)(1)(B).

105. *Id.* § 988(a)(3). Special residence rules are provided. *Id.* § 988(a)(3)(B).

106. *Id.* § 881.

107. *Id.* §§ 861(a)(1)(C) & 861(a)(2)(B).

to, a foreign corporation is sometimes referred to as the "second-level withholding tax." Of course, aside from withholding taxes on dividends and interest, U.S. branches of foreign corporations pay U.S. tax by the U.S. on their income that is effectively connected with a U.S. trade or business.[108]

In an effort to make more tax neutral the decision of a foreign corporation to operate in the U.S. through a U.S. subsidiary or branch, the Act adds Code section 884, which imposes, in addition to the regular U.S. tax on the income of U.S. branches, a tax equal to thirty percent of the "dividend equivalent amount" of a foreign corporation for the taxable year.[109] The term "dividend equivalent amount" is generally defined as the foreign corporation's earnings and profits for the taxable year that are effectively connected with the conduct of a U.S. trade or business.[110] The dividend equivalent amount is generally decreased for increases in U.S. net equity and is increased for decreases in U.S. net equity of the foreign corporation.[111] Thus, in keeping with the purpose of the branch tax, earnings of the U.S. branch that are reinvested in U.S. operations, rather than remitted abroad, are free from the branch profits tax, just as earnings of a U.S. subsidiary would be free from the withholding tax on dividends if the earnings were not distributed to a foreign parent.[112]

No provision in an income tax treaty between the U.S. and a foreign country will exempt a foreign corporation from the branch profits tax (or reduce the amount of the tax) unless the foreign corporation is a "qualified resident" of the foreign country or, if not, the income tax treaty permits a second-level withholding tax on dividends paid by the foreign corporation.[113] A qualified resident of a foreign country is any foreign corpo-

108. *Id.* § 882.

109. Act § 241, adding Code § 884. *See* CONF. REP. at II-647 to -650. The foreign tax credit is not allowed against the branch profits tax. Act § 1241(c); Code § 906(b)(6).

110. Code § 884(b).

111. *Id.* § 884(b)(1) & (2). U.S. net equity is, in short, the net worth, determined on a tax basis, of the U.S. operations of the foreign corporation, i.e., money, and the aggregate adjusted bases of property less liabilities. Code § 884(c).

112. Subtracted from the dividend equivalent amount subject to tax are certain shipping and aviation income currently exempt under other Code provisions, gain from the sale of a U.S. real property holding corporation (defined at Code § 897(c)(1)(A)(ii)) and certain other income. *Id.* § 884(d)(2). In addition, the Internal Revenue Service has issued Notice 86-17, 1986-52 I.R.B. 19, which states that the branch profits tax will generally not be imposed on (1) the complete termination of a foreign corporation's U.S. trade or business, (2) certain liquidations or reorganizations of a foreign corporation with a U.S. trade or business, or (3) the incorporation of a foreign corporation's U.S. trade or business.

113. Code § 884(e)(1). The Senate Report states that the branch profits tax is not intended to apply when it would be contrary to an existing income tax treaty to which the U.S. is a party. The Senate Report also expresses agreement with the Treasury Department view that if a corporation is organized in a country with which the U.S. has a treaty that contains a nondiscrimination article similar to the article contained in the U.S. 1981 Model Income

ration that is a resident of the foreign country, unless more than fifty percent of the value of the stock of the foreign corporation is owned directly or indirectly by individuals who are not residents of the foreign country and who are not U.S. citizens or resident aliens, or unless fifty percent or more of its income is used, directly or indirectly, to meet liabilities to persons who are not residents of the foreign country or the U.S.[114] This definition of qualified resident is designed to prevent "treaty shopping" in order to avoid the branch profits tax.[115] Publicly traded foreign corporations, however, fall within the definition of qualified resident regardless of their stock ownership.[116] Furthermore, the Secretary has authority to prescribe regulations treating other corporations as qualified residents where requirements insuring against treaty shopping are met.[117] In general, if a foreign corporation is a qualified resident of a foreign country with which the U.S. has an income tax treaty, the branch profits tax rate is the rate of tax specified in the treaty on branch profits if so specified, or if not, the rate of tax on dividends paid by a U.S. corporation to a corporation resident in the foreign country that wholly owns the U.S. corporation. Also, any other limitations under the treaty on the branch profits tax will apply.[118]

If no treaty exemption exists and the branch profits tax applies to a foreign corporation, then the corporation is not liable for any second-level withholding tax on any dividends paid by the corporation during the taxable year.[119] Moreover, no foreign corporation that is not a qualified resident of a foreign country is entitled to claim any tax elimination or rate reduction under any income tax treaty between the U.S. and that foreign country with respect to dividends paid by the foreign corporation (and on which it is liable to withhold U.S. tax) or that are received by the foreign corporation from another foreign corporation and are subject to the second-level withholding tax on dividends.[120]

The Act eliminates the prior law second-level withholding tax on interest paid by a foreign corporation fifty percent of whose income was effectively connected with a U.S. trade or business. Instead, new Code section 884(f) treats the greater of the interest paid or deducted by a U.S. branch of a

Tax Treaty, such article prevents the imposition of the branch profits tax. S. REP. at II-404. Current treaties containing such a clause include the U.S. income tax treaties with the United Kingdom, Japan, The Netherlands, Belgium, Denmark, Finland, Hungary, Italy, Norway, the Philippines, Iceland, Egypt, Cypress, and Jamaica.

114. Code § 884(e)(4).

115. *See* CONF. REP. at II-649.

116. Code § 884(c)(4)(B).

117. *Id.* § 884(e)(4)(C).

118. *Id.*, § 884(e)(2).

119. *Id.* § 884(e)(3)(A).

120. *Id.* § 884(e)(3)(B).

foreign corporation as if it were paid by a domestic corporation.[121] Consequently, interest paid or deducted by a U.S. branch is subject to virtually the same withholding tax to which payments of interest by U.S. subsidiaries of foreign corporations are subject.

Where a treaty exemption exists and the branch profits tax is prohibited, the second-level withholding tax on dividends continues to apply. The Act, however, reduces the threshold for the imposition of the second-level withholding tax on dividends. Under the new law withholding is required on dividends paid by a foreign corporation where twenty-five percent (rather than fifty percent) or more of the foreign corporation's gross income for the three preceding taxable years was effectively connected with the conduct of a U.S. trade or business.[122]

B. Extension of Effectively Connected Characterization

Section 1242 of the Act adds a provision to Code section 864(c) which declares that income or gain of a nonresident alien individual or foreign corporation is treated as effectively connected with a U.S. trade or business if it is attributable to another taxable year and would have been so treated if it had been taken into account in that other year.[123] In addition, a foreign person's sale of U.S. assets that were formerly used in a U.S. trade or business is taxable as effectively connected income if the assets are sold within ten years after being used in the U.S. business.[124] Under prior law foreign persons could avoid U.S. tax on income from a U.S. trade or business by structuring sales of property or services such that payments were deferred (through installment sales or otherwise) until a year in which the U.S. trade or business has ceased or by actually disposing of U.S. business property at a gain in a year after the business has ceased.[125]

C. Tax-Free Exchanges by Expatriates

Present Code section 877 provides that individuals who give up U.S. citizenship for the principal purpose of avoiding U.S. tax continue to be taxed by the U.S. for ten years on U.S. source income, including gains

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121. Under Treas. Reg. § 1.882-5 (1986), interest in excess of the interest actually paid by a U.S. branch of a foreign corporation may be allocated to the branch for U.S. tax purposes. The Conference Report states that any such interest in excess of that actually paid is to be treated as interest paid by a U.S. subsidiary to the foreign corporate taxpayer on a national loan from the taxpayer. CONF. REP. at II-648.

122. Act § 1241(b) (amending Code § 861(a)(2)(B)).

123. Code § 864(c)(6).

124. *Id.* § 864(c)(7).

125. *See* CONF. REP. at II-651.

from the sale or exchange of U.S. property. One method that expatriates have employed to avoid tax is to make a tax-free exchange of the U.S. property for foreign property followed by a sale of the foreign property free of U.S. tax.[126] The Act closes this loophole by providing that gain on the sale or exchange of property that has a tax basis determined in whole or in part by reference to U.S. property is treated as U.S. source income.[127] This amendment applies to dispositions of property acquired in tax-free exchanges after September 25, 1985.[128]

D. Foreign Partners

The U.S. withholding tax on payments of U.S. source investment income to foreign persons does not extend to partnership distributions to foreign partners where the partnership conducts a U.S. trade or business.[129] The Act imposes a new withholding tax of twenty percent of any amount distributed to a foreign partner by a partnership (whether domestic or foreign) having income, gain, or loss that is effectively connected or treated as effectively connected with the conduct of a trade or business within the U.S.[130] If the partnership's gross income for the three preceding taxable years, however, is less than eighty percent attributable to such effectively connected U.S. income, then only the actual effectively connected percentage of any distribution to a foreign partner is taken into account for purposes of applying the twenty percent withholding tax.[131] An exception from the withholding rule applies to that portion of a distribution attributable to passive investment income on which a withholding tax is required to be deducted and withheld under other Code provisions.[132] Also, the withholding obligation does not apply where, under the partnership agreement, substantially all U.S. income is properly allocated to U.S. persons.[133] Finally, the Secretary is to prescribe regulations providing for an adjustment in the twenty percent withholding tax to account for amounts required to be deducted and witheld on partnership

126. *See id.* at II-651 to -652.

127. Act § 1234(a) (amending Code § 877(c)). In a tax-free exchange pursuant to Code § 1031, for example, the basis the taxpayer takes in the property he receives in the exchange is generally the same as that of the property he exchanged. Code § 1031(d).

128. Act § 1234(b).

129. *See* Code §§ 1441 and 1442.

130. Act § 1246, adding new Code § 1446.

131. Code § 1446(b).

132. *Id.* § 1446(c)(1), referring to the 30% withholding tax obligation under *id.*, §§ 1441 & 1442. The Senate contemplated that, for withholding purposes, partnership distributions are deemed to come first out of such passive investment income. S. Rep. at 414.

133. *Id.* § 1446(c)(2).

distributions pursuant to Code section 1445 pertaining to withholding on distributions of gain from the sale or exchange of U.S. real estate.[134]

E. U.S. Income of Foreign Governments

Under prior law foreign governments were not subject to any U.S. tax on income from U.S. investments.[135] Under Treasury Regulations, however, income from commercial activities was ruled not to be investment income and was, accordingly, subject to U.S. tax.[136] The Act retains the prior law exemption from U.S. tax of income of foreign governments received from investments and interest on deposits in U.S. banks, but it extends this exemption to investment income on financial instruments held in the execution of governmental financial or monetary policy.[137] Furthermore, the Act effectively codifies the regulations on income from commercial activities. Income received directly or indirectly by a foreign government that is derived from the conduct of any commercial activity or received from or by a controlled entity is subject to U.S. income tax law, to the extent applicable.[138] The term "controlled commercial entity" is defined to mean any entity engaged in commercial activities (whether within or outside the U.S.) if the foreign government holds directly or indirectly either fifty percent or more interest (by value or voting interest) or any other interest in the entity that gives the foreign government effective control.[139] Finally, the income of "international organizations" from investments in the U.S. is exempt from U.S. tax.[140]

134. *Id.* § 1446(c)(3). The new partnership distribution withholding rule is applicable to distributions after December 31, 1987 (or, if earlier, the effective date, which is not to be deemed earlier than January 1, 1987, of the initial regulations issued under Code § 1446). Act § 1246(d).

135. Prior Code § 892.

136. Treas. Reg. § 1.892-1(a)(3)(1986).

137. Code § 892(a)(1).

138. *Id.* § 892(a)(2). The Internal Revenue Service has issued Rev. Rul. 87-6, 1987-3 I.R.B. ———, which applies Code § 892 to various fact situations involving income of a controlled entity and a foreign government ministry.

139. Code § 892(a)(2)(B). A central bank of issue is to be treated as a controlled commercial entity only if it is engaged in commercial activities within the U.S. *Id.*

140. *Id.* § 892(b). The Conference Report defines international organizations as those described in Code § 7701(a)(18). Conf. Rep. at II-655. Thus, the term includes public international organizations entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act, 22 U.S.C. §§ 288-288f(1982).

F. Transfer Prices for Imports

New Code section 1059A provides that importers of property into the U.S. in transactions between related persons cannot claim a cost of the property for tax purposes greater than the value they claim for customs purposes.[141] This new rule applies to transactions entered into after March 18, 1986.[142]

G. Dual Resident Companies

The consolidated tax return rules of the Code are amended by the addition of a rule that prohibits a dual consolidated loss of a domestic corporation from reducing the taxable income of any other member of the affiliated group for any taxable year.[143] The term "dual consolidated loss" means any net operating loss of a domestic corporation that is subject to an income tax of a foreign country on its income without regard to the source of the income, or is subject to such a tax solely because it is resident in the foreign country.[144] No dual consolidated loss arises, however, if such loss does not offset the income of any foreign corporation for foreign tax purposes.[145] This amendment is thought to be primarily applicable to dual resident companies incorporated in the U.S. and managed and controlled in the United Kingdom or Australia. It is supposed that the United Kingdom will enact reciprocal restrictions.

V. Tax Treatment of U.S. Possessions

The Act contains several changes to the taxing authority of U.S. possessions, namely, the U.S. Virgin Islands, Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa.[146] All of these possessions generally use a "mirror system" of taxation in which the possession uses the Internal Revenue Code as its own and inserts its own name for the U.S. in the Code.[147] Under this system the U.S. and the possession treat each other, in some cases, as foreign countries.

141. Act § 1248.

142. *Id.* § 1248(c). For an example of the possible inconsistency between transfer price for customs purposes and income tax purposes under prior law, see Brittingham v. Commissioner, 66 T.C. 373 (1976).

143. Act § 1249, adding subsection (d) to Code § 1503.

144. Code § 1503(d)(2)(A).

145. *Id.* § 1503(d)(2)(B).

146. *See* Act §§ 1271-1277. Elsewhere, the Act makes changes in the tax credit allowed U.S. corporations conducting business in a U.S. possession (possessions corporations). *Id.* § 1231.

147. *See* Conf. Rep. at II-679.

Among the more noteworthy of the changes in this area is the provision granting Guam and the Commonwealth of the Northern Mariana Islands the same authority that American Samoa currently has to enact its own income tax laws in lieu of the mirror system.[148] This enacting authority applies only if, and so long as, an implementing agreement is in effect between the U.S. and each possession with respect to the elimination of double taxation, the establishment of rules to prevent avoidance of U.S. tax, and other concerns generally addressed in income tax treaties between the U.S. and foreign countries.[149] Also, the total amount of revenues raised by a possession under a tax system enacted under this authority may not be less than the revenue that was received by the possession under its tax laws prior to the implementation of the new tax system.[150] A nondiscrimination rule is imposed that prevents the tax laws of the affected possessions from discriminating against any U.S. person or resident of any other possession.[151] The legislation provides a procedure under which the mirror system of taxation can be reinstated in a possession if the Secretary of the Treasury determines that the possession has failed to comply with the revenue condition and the nondiscrimination condition described above.[152]

Prior law excluded from the thirty percent U.S. withholding tax on passive investment income a Guam or Virgin Islands corporation if less than twenty-five percent of the corporation's stock was owned directly or indirectly by foreign persons and if at least twenty percent of the gross income of the corporation was derived from sources within Guam or the Virgin Islands, respectively.[153] This exclusion has been modified and extended to corporations created or organized in American Samoa and the Northern Mariana Islands, as well as Guam and the Virgin Islands, if a three-part test is met.[154] The twenty-five percent stock ownership test remains the same; the twenty percent gross income requirement, however, has been replaced with a requirement that at least sixty-five percent of the gross income of the corporation must be effectively connected with the conduct of a trade or business in the possession or the U.S. In addition, no substantial part of the income of the corporation may be used directly or indirectly to satisfy obligations to persons who are not bona fide residents of the possession or the U.S.[155]

148. Act § 1271.
149. *Id.* § 1271(b).
150. *Id.* § 1271(c).
151. *Id.* § 1271(d).
152. *Id.* § 1271(e).
153. Prior Code § 881(b).
154. Act § 1273(b), (amending Code § 881(b)(1)).
155. A conforming amendment is made to Code § 1442, the provision imposing the 30 percent withholding obligation on U.S. payors. Act § 1273(b)(2).

The mirror system of taxation in effect in the Virgin Islands underwent substantial reformation in the Act in order to curb abuses.[156] New Code section 932 contains rules for coordinating the U.S. and Virgin Islands income taxes. Among other requirements, Code section 932 provides that if an individual is a citizen or resident of the U.S. (other than the Virgin Islands) and has Virgin Islands income, then that individual is to file income tax returns with both the U.S. and the Virgin Islands. The tax liability of such an individual is ratably allocated between the U.S. and the Virgin Islands according to his or her adjusted gross income derived from sources within the two taxing jurisdictions.[157]

Elsewhere, the Act repeals the so-called "inhabitant rule," under which individual and corporate inhabitants of the Virgin Islands satisfy their U.S. income tax obligation by paying tax to the Virgin Islands on his or its worldwide income.[158] This rule, in combination with the Virgin Islands tax code provision taxing foreign corporations only on income derived in the Virgin Islands, had created a gaping loophole under which U.S. corporations organized in the fifty states, which were also Virgin Islands inhabitants because of their financial and business contacts with the islands, could completely avoid both U.S. and Virgin Islands tax on their investment income derived from mainland sources.[159]

VI. U.S. Taxation of Income Earned through Foreign Corporations

A. Subpart F in General

As a general rule the U.S. does not tax the foreign source income of a foreign corporation until and unless that income is repatriated to a U.S. resident in the form of dividends, interest, royalties, or other such payments. An important exception exists for certain categories of foreign source income, called "subpart F income," earned by a "controlled foreign corporation." Pro rata portions of subpart F income are taxed cur-

156. Act § 1274.

157. Code § 932(b).

158. Act § 1275(b). The inhabitant rule is found at § 28(a) of the Revised Organic Act of the Virgin Islands, 48 U.S.C. § 1642 (Supp. 1985). Section 1275(b) repeals this rule by providing that the rule will be treated as if it were enacted before the enactment of the Code and that it will have no effect on the amount of income tax required to be paid to the U.S. By a related amendment domestic corporations conducting a trade or business in the Virgin Islands now qualify for the Code § 936 possession tax credit. Act § 1275(a).

159. *See* Danbury, Inc. v. Oliver, 627 F. Supp. 513 (D.V.I. 1986). The court in *Danbury* had no choice but to hold that the taxpayer, a Nevada corporation, owed no U.S. or Virgin Islands taxes on its U.S. source investment income. The judge called the gap created by the inhabitant rule the "ultimate tax shelter" and noted that under it income from hundreds of millions of dollars of U.S. corporate assets had been sheltered. *Id.* at 519.

rently (i.e., in the year earned by the controlled foreign corporation) to U.S. shareholders holding at least ten percent of the corporation stock.[160] A controlled foreign corporation is generally defined as a foreign corporation that is owned fifty percent or more by U.S. shareholders.[161] The subpart F rules cause a ten percent or more U.S. shareholder to be taxed currently on its pro rata share of the subpart F income of the controlled foreign corporation in the year the corporation earned such income and without regard to whether it is distributed to the shareholder.[162] The general purpose of the subpart F rules is to prevent U.S. taxpayers from using tax haven jurisdictions with low tax rates in order to defer or eliminate U.S. tax indefinitely.

B. Subpart F Foreign Personal Holding Company Income

One of the main categories of subpart F income is foreign personal holding company income, which includes dividends, interests, royalties, annuities, rents, gains from the sale or exchange of stock or securities (except in the case of dealers), gains from futures transactions and commodities (excluding bona fide business hedging transactions), and income from personal service contracts.[163] The Act adds new items of passive income to foreign personal holding company income for subpart F purposes.[164] These include gains from sales of noninventory property that is either nonincome producing or that is held for the production of passive income (i.e., dividends, interest, royalties, rents, and annuities).[165] Also, the excess of gains over losses from transactions (including futures, forward, and similar transactions) in any commodities are included.[166] Net foreign currency gains attributable to any section 988 transaction[167] are included in foreign personal holding company income, except in the case

160. Code § 951.

161. *Id.* § 957. Under prior law the test was whether U.S. shareholders owned more than 50 percent of the voting power of the foreign corporation. Section 1222 of the Act amends the definition of controlled foreign corporation to mean any foreign corporation if more than 50 percent of the voting power or the value of the stock of the corporation is owned by U.S. shareholders.

162. Code §§ 951-964.

163. *See* Code §§ 952(a)(1) & 953.

164. The Act, however, also excludes from foreign personal holding company income any interest derived in the conduct of a banking business that is export financing interest (as defined at Code § 904(d)(2)(G)). *Id.* § 954(c)(2)(B).

165. Act § 1221; Code § 954(c)(1)(B). The legislative history also clarifies that passive leasing income is intended to be included in subpart F foreign personal holding company income. H.R. Rep. at 394.

166. Code § 954(c)(1)(C). Exceptions are provided for bona fide hedging transactions (as under the prior law) and active business gains or losses from the sale of commodities.

167. *See supra* notes 98-105, discussing § 988 transactions.

of a transaction directly related to the business needs of the controlled foreign corporation.[168]

A further addition to foreign personal holding company income for subpart F income purposes is "any income equivalent to interest, including income from commitment fees (or similar amounts) for loans actually made."[169] According to the Conference Report, this item of income was added to subpart F foreign personal holding company income to prevent U.S. taxpayers from continuing to shelter passive interest-type income from current U.S. tax under subpart F by rearranging the form of offshore passive investments so that the income generated is not traditional interest income.[170]

Under prior law, subpart F income did not include dividends and interest received by a controlled foreign corporation from a related entity created or organized under the laws of the same foreign country as the payee and that had a substantial part of its assets used in its trade or business in that foreign country.[171] Also excepted under the old law were rents and royalties received by a controlled foreign corporation from a related person for the use of, or the privilege of using, property within the country under the laws of which the payee is created or organized.[172] The Act makes both of these exceptions from subpart F income inapplicable to the extent that the dividends, interest, rent, or royalty reduces the payor's subpart F income.[173]

C. Subpart F Insurance Income

Important changes in the taxation of insurance income as subpart F income were made to curtail perceived abuses.[174] The definition of insurance income for subpart F purposes has been expanded to include all income from the insuring or reinsuring of the risks of unrelated persons outside of the insuring company's country of incorporation, rather than only income from the insurance or reinsurance of U.S. risks.[175] Moreover, the Act repeals the prior law de minimis rule whereby no insurance income was included in subpart F income if it amounted to five percent or less of the total of premiums and other consideration received during the

168. Code § 954(c)(1)(D).
169. *Id.* § 954(c)(1)(E).
170. Conf. Rep. at II-615.
171. Prior Code § 954(c)(4)(A).
172. *Id.* § 954(c)(4)(C).
173. Act § 1221(a); Code § 954(c)(3)(B).
174. One of the subpart F income components has been income from the insurance or reinsurance of certain U.S. insurance risks. Code §§ 952(a)(1) & 953.
175. Act § 1221(b) (amending Code § 953(a)).

taxable year.[176] Furthermore, the Act repeals the prior law exemption from subpart F income for certain investment income attributable to unearned premiums and reserves.[177]

New provisions were added to the subpart F rules in order to curb the abuse of offshore "captive" insurance companies. These companies are insurance companies owned by one or more U.S. shareholders and organized in a tax-haven jurisdiction with little or no taxation of premium income.[178] One practical reason for the growth in the number of captive insurance companies is the increasing unavailability of insurance coverage for certain types of risks in the U.S. The captive company insures primarily or exclusively the risks of its U.S. shareholders or persons or entities related to them.

Under prior law a special provision broadened the definition of controlled foreign corporation which was applicable to the taxation of subpart F insurance income.[179] Nevertheless, as the Conference Report notes, the widely dispersed ownership of some captive companies allowed many shareholder-insureds to escape current taxation under subpart F because they owned less than ten percent of the company's stock.[180] In addition to exemption from current taxation, two other tax benefits were of concern to the conferees.[181] The first is the exemption from the U.S. excise tax[182] on insurance premiums paid to foreign insurers and reinsurers under some U.S. income tax treaties, such as the treaty with Barbados, which became effective in 1984,[183] and the proposed U.S. income tax treaty with Bermuda. Secondly, the conferees were concerned with certain Internal Revenue Service rulings and court cases that allow the deductibility for U.S.

176. *See* Code § 953(a); CONF. REP. at II-616.

177. Prior Code § 953(c)(3)(C).

178. *See* CONF. REP. at II-616 to -618.

179. Prior Code § 954(b), defining controlled foreign corporation with respect to insurance income, provided generally that, in addition to the regular definition of controlled foreign corporation, the term included a foreign corporation of which more than 25 percent (rather than 50 percent) of the total voting power was owned directly or indirectly by U.S. shareholders on any day during the taxable year, if the income from the insurance of U.S. risks exceeded 75 percent of the income from the insurance of all risks.

180. CONF. REP. at II-617.

181. *Id.*

182. Code §§ 4371-4374.

183. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 21, 1984, U.S.—Barbados, arts. 7 & 21. In addition, the House Report expresses concern over possible abuse of similar exemptions found in U.S. tax treaties with nontax haven countries such as France and the United Kingdom. H.R. REP. at 439-43. The Act requires the Treasury Department to submit to Congress before January 1, 1988, a study determining whether existing treaties place U.S. reinsurance corporations at a significant competitive disadvantage with foreign reinsurance corporations. Act § 1244.

tax purposes of premiums paid by U.S. taxpayers to offshore captive insurance companies with relatively large numbers of owners.[184]

In order to prevent premium income paid to an offshore captive company from being both deductible and free from all U.S. income and excise taxes, the conferees added subsection (c) to Code section 953, which generally provides that subpart F insurance income constituting "related person insurance income" is taxed currently as subpart F income to any U.S. person (rather than merely a ten percent shareholder) who owns, directly or indirectly, any stock of the controlled foreign insurance company. This provision will also apply to mutual insurance companies under regulations to be promulgated that will treat the mutual company policyholders as if they were shareholders of a stock company.[185] "Related person insurance income" is defined generally as any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is a U.S. shareholder in the controlled foreign insurer or a person related[186] to such a shareholder.[187]

Three exceptions to the new related person insurance income inclusion rule are allowed.[188] The income is not included if at all times during the taxable year less than twenty percent of the value and voting power of the stock of the foreign insurer is owned, directly or indirectly, by persons who are the primary insured parties under any policy of insurance or reinsurance issued by the company or who are persons related[189] to any such primary insured parties.[190] A second exception applies where the related person insurance income for the taxable year is less than twenty percent of the total gross insurance income for the year.[191] Under a third

184. *See* CONF. REP. at II-617; Rev. Rul. 78-338, 1978-2 C.B. 107; Crawford Fitting Co. v. United States, 606 F. Supp. 136 (N.D. Ohio 1985). In this ruling and this case true risk-shifting arrangements were found because of the widespread ownership of the captive insurance company in question. *Cf.* Humana, Inc. & Subsidiaries v. Commission, 50 T.C.M. (CCH) 784 (1985); Mobil Oil Corp. v. United States, 8 Ct. Cl. 555 (1985); Rev. Rul. 77-316, 1977-2 C.B. 53 (in which no deduction was allowed).

185. Code § 953(c)(4).

186. "Related person" now means either an individual corporation, partnership, trust, or estate that controls or is controlled by the controlled foreign corporation, or a corporation partnership, trust, or estate that is controlled by the same person or persons who control the controlled foreign corporation. "Control" generally means the direct or indirect ownership of 50 percent or more of the voting power or beneficial interest. Act § 1221(e) (amending Code § 954(d)(3)).

187. Code § 953(c)(2). Like the new general definition of controlled foreign corporation (*see supra* note 161), the definition as it relates to the inclusion of insurance income and "related person insurance income" has been amended to require ownership of 25 percent or more of the voting power *or* stock value in addition to the 75 percent U.S. income requirement (*see supra* note 179). Code § 957(b).

188. Act § 1221(b)(2); Code § 954(c)(3).

189. The definition of "related person" at Code § 954(d)(3) applies.

190. Code § 953(c)(3)(A).

191. *Id.* § 953(c)(3)(B).

exception, a foreign insurer may elect, in lieu of inclusion of related person insurance income under subpart F, to treat its related party insurance income for the year as income effectively connected with the conduct of a trade or business in the U.S. that is taxable by the U.S. without regard to any treaty exemption or benefit.[192]

D. Other Subpart F Changes

The former exemption from supbart F income for foreign base company shipping income[193] which was reinvested in foreign base company shipping operations has been repealed by the Act.[194] Accordingly, foreign base company shipping income will be taxed currently under subpart F in its entirety. In addition, the Act now includes within foreign base company shipping income any income derived from a space or ocean activity.[195]

Before the Act the law contained an exception to the current inclusion of foreign base company income (which includes foreign personal holding company income and foreign base company sales, services, and shipping income) when the shareholder could establish that the controlled foreign corporation earning the income was not formed or availed of to avoid tax.[196] The Act replaces this subjective test with an objective test under which foreign base company income and insurance income will not include any item of income received by the controlled foreign corporation if it is established that such income was subject to an effective rate of tax imposed by a foreign country greater than ninety percent of the maximum corporate tax rate in effect in the U.S.[197] When the new thirty-four percent top corporate rate is fully implemented in 1988,[198] the income will have to be taxed at an effective rate greater than thirty and six tenths percent (ninety percent of thirty-four percent) in order to establish the right to the exclusion.

The prior law was rather liberal in allowing deficits in earnings and profits from prior years or from foreign subsidiaries to reduce the con-

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192. *Id.* § 953(c)(3)(C). The election is to apply to the taxable year and all future years, unless revoked with the consent of the Secretary. It also exempts the related party insurance income from the excise tax on premiums received by an offshore insurer. *See supra* note 182.

193. Foreign base company shipping income generally means income from the use, hiring, or leasing for use of any aircraft or vessel in foreign commerce or income from the performance of services directly related to the use or disposition of any such aircraft or vessel. *Id.* § 954(f).

194. *See* Prior Code § 954(b)(2); Act § 1221(c).

195. Space or ocean activity is defined at Code § 863(d)(2), as amended by the Act.

196. *See* Prior Code § 954(b)(4).

197. Act § 1221(d) (amending Code § 954(b)(4)).

198. *See* Act § 601(a) (amending Code § 11(b)).

trolled foreign corporation's subpart F income.[199] Under the new law, however, the use of earnings and profits deficits to reduce this income is severely curtailed.[200] Negative earnings and profits from the foreign subsidiaries of a controlled foreign corporation may no longer be used to reduce subpart F income of the controlled foreign corporation. Prior year deficits of the controlled foreign corporation itself may be used only to the extent that they were incurred in a taxable year beginning after December 31, 1986, and only to the extent that they were attributable to the same activity giving rise to the income being offset.[201] Moreover, only earnings and profits from a "qualified activity" may be reduced by deficits from such activities. "Qualified activity" generally means activities giving rise to foreign base company shipping income, foreign base company oil-related income, certain insurance income and foreign personal holding company income of a financial institution.[202]

Under prior law, no foreign base company income (including personal holding company income) was included in the subpart F income of a controlled foreign corporation unless the foreign base company income was greater than ten percent of the gross income of the controlled foreign corporation.[203] This ten percent threshold has been reduced to the lesser of five percent of gross income or one million dollars.[204]

E. Transfers of Intangibles to Related Foreign Corporations

The transfer or license of valuable intangibles such as a patent, copyright, or formula by a U.S. taxpayer to a foreign affiliate can result in significant deferral or avoidance of U.S. taxes on the income earned by the foreign affiliate from the license or sale of the right to use the intangible. In an effort to curb this deferral or avoidance, Code sections 482,[205] 367(d),[206] and the regulations under these sections attempt to establish

199. *See* Prior Code § 952(c) & (d).
200. *See* Act § 1221(f); Code § 952(c).
201. Code § 952(c)(1)(B).
202. Prior Code § 954(c)(1)(B).
203. *Id.* § 954(b)(3).
204. Act § 1223 (amending Code § 954(b)(3)(A)). The Act also repeals the exemption from taxation under subpart F which was formerly available to corporations created or organized in the Commonwealth of Puerto Rico or in a U.S. possession. Act § 1224 (repealing Code § 957(c)).
205. Code § 482 gives the Internal Revenue Service the right to reallocate income, deductions, or credits among related entities or businesses in order to prevent evasion of taxes or to reflect more clearly the income of the respective entities or businesses.
206. Code § 367 generally taxes U.S. persons transferring intangible property to a foreign corporation on the hypothetical income the U.S. transferor would have received if it had sold the property in exchange for payments based on the productivity, use, or disposition of the property by the foreign transferee.

an arm's length price standard for determining what income should be imputed to the U.S. transferor.[207] The committee reports express concern over the difficulty of determining an arm's length price standard with respect to intangibles whose profit potential is not evident at the time of the transfer to the foreign affiliate.[208]

The Act attempts to alleviate the problems of applying the arm's length price standard by amending sections 482 and 367(d) to provide that in the case of a transfer or license of intangible property[209] the amounts deemed paid to the transferor with respect to the transfer of the property "shall be commensurate with the income attributable to the intangible."[210] The Conference Report makes it clear that the changes to Code sections 367 and 482 are intended to apply to U.S. transferors in out-bound transactions, as well as to in-bound transactions such as those in which a foreign corporation transfers intangibles to its U.S. subsidiary.[211] The conferees admitted that these changes do not totally eliminate the problems under Code section 482 generated by the transfer of intangibles. Consequently, it was suggested that a comprehensive study of intercompany pricing rules shoud be conducted by the Internal Revenue Service in an effort to decide whether the existing regulations under Code section 482 should be modified.[212]

F. Foreign Investment Companies

Under prior law the U.S. shareholders of a foreign investment company that did not qualify as a controlled foreign corporation or a foreign personal holding company paid no current U.S. tax on the foreign source passive income of the foreign investment company. When a U.S. shareholder sold or exchanged his stock in the foreign investment company, however, the shareholder's gain on the sale was taxed under the old law as ordinary

207. *See* H.R. Rep. at 420-24. Code § 936(h) also attempts to properly allocate the income from intangibles in U.S. possessions corporations which qualify for the possessions corporation tax credit.

208. *See* H.R. Rep. at 423-25; Conf. Rep. II-637 to -638; United States Steel Corp. v. Commissioner, 617 F.2d 942 (2d Cir. 1980).

209. Intangible property is comprehensively defined at Code § 936(h)(3)(B).

210. Act § 1231(e) (amending §§ 482 & 367(d)(2)). The changes in §§ 482 and 367 generally apply to taxable years beginning after 1986 with respect to transfers after November 16, 1985, or licenses granted after such date. With respect to § 936 payments, the new provisions apply to taxable years after 1986, without regard to when any transfer (or license) was made. *Id.* § 1231(g). Also, the cost sharing method of allocating income from intangibles in computing the possessions tax credit (Code § 936(h)(5)(C)(i)(I)) was similarly amended by Act § 1231(a).

211. Conf. Rep. at II-637.

212. *Id.* at II-638.

income, rather than capital gain, to the extent of the shareholder's share of the earnings and profits of the foreign investment company.[213]

Because passive income is easily shifted to tax haven jurisdictions where it is subject to very low rates of tax, Congress has substantially revised the old rules to provide that a U.S. shareholder in a passive foreign investment company[214] will, at the time of the disposition of the shares or on receipt of an "excess" distribution, pay both U.S. tax and an interest charge based on the value of the U.S. tax deferral of the passive income earned in the foreign investment company.[215] The interest charge is calculated by applying the Code rate for underpayments of tax to the shareholder's tax at the highest applicable tax rate on the income of the passive foreign investment company allocated (under rules set out in Code section 1291) to the tax years during the U.S. shareholder's holding period with respect to his stock in the company.[216] "Excess" distributions are defined generally as distributions in respect of the U.S. shareholder's stock to the extent that they exceed an amount that has historically been paid by the company.[217]

If a passive foreign investment company elects to be a "qualified electing fund," its U.S. shareholders must currently include in gross income their respective shares of the corporation's earnings and profits and thus pay current tax on such earnings.[218] A passive foreign investment company becomes a qualified electing fund if it makes an election with the Secretary under conditions (yet to be prescribed) whereby the current income of the corporation and the ownership of its stock is disclosed to the Secretary for each taxable year.[219] Once made, the election applies to all subsequent taxable years unless revoked with the consent of the Secretary. Lastly, a U.S. shareholder of a passive foreign investment company that has elected to be a qualified electing fund can elect to defer U.S. tax on undistributed earnings of the qualified electing fund otherwise includible in his income. This election comes at the cost of an interest charge on the deferred taxes.[220]

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213. *See* Code § 1246, applying generally to foreign investment corporations (whether registered under the Investment Company Act of 1940 or not) of which 50 percent or more of the voting power or value of the stock is held by U.S. persons.

214. The term "passive foreign investment company" is defined as any foreign corporation if 75 percent or more of its gross income is passive income (generally, foreign personal holding company income) or if the average percentage of assets (by value) held by the corporation which produce passive income or which are held for the production of passive income is at least 50 percent of its total assets. Code § 1296. Banks and insurance companies are generally excluded from the definition of passive foreign investment company. *Id.* § 1296(b)(2).

215. Act § 1235, adding Code §§ 1291-1297.

216. Code § 1291(c).

217. *Id.*

218. *Id.* § 1293.

219. *Id.* § 1295.

220. *Id.* § 1294.