

Michigan Law Review

Volume 71 | Issue 1

1972

Rhoades: Income Taxation of Foreign Related Transactions

Alan G. Choate

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Legislation Commons](#), and the [Taxation-Federal Commons](#)

Recommended Citation

Alan G. Choate, *Rhoades: Income Taxation of Foreign Related Transactions*, 71 MICH. L. REV. 206 (1972).
Available at: <https://repository.law.umich.edu/mlr/vol71/iss1/7>

This Review is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS. 2 Vols. By Rufus von Thülen Rhoades. New York: Matthew Bender. 1971. Pp. xliii, xxxii, 1070. \$100.00.

Lawyers live in an age of increasing specialization. While the age of the sole practitioner has not ended—the ABA estimates that nearly half of the lawyers in the United States are in sole practice¹—law firms in large cities and, increasingly, even in smaller cities, have grown tremendously in size since the end of the Second World War. This growth has been furthered by the increasing complexity of government regulation and the necessity for a breed of lawyers willing to spend all of their time working within a relatively small area of the law. Nowhere has specialization been more evident than in the law of federal income taxation. The practice of tax law has been divided into subspecialties so that one finds specialists in deferred compensation, estate planning, corporate reorganizations, or the taxation of foreign related transactions. It is to the last area that Rufus von Thülen Rhoades has directed his new book.

The number of sections in the Internal Revenue Code dealing with the taxation of foreign related transactions is small. The complexity of these sections, however, is extremely great, and developments within the area have been so rapid in recent years that it is indeed a full time job for a practitioner to maintain his expertise. Historically, while there have been provisions in the Code that have applied to foreign transactions at least since 1913,² the interest of the government in the application and enforcement of those sections did not become acute until the great depression of the 1930's fostered a desire on the government's part to maximize its revenue and to curb certain tax avoidance uses of foreign transactions. That interest waned for some time during and after the Second World War, and as late as 1959 proposals were seriously being considered by Congress that would have exempted all foreign income of domestic taxpayers from federal taxes.³

A chronically adverse balance of payments and an atmosphere of reform that surrounded the Kennedy Administration led to a tremendous resurgence of interest beginning in the early 1960's and the enactment of more sections dealing with foreign related transactions during that decade than had previously been in the Code. This fact, coupled with vast changes in regulations under certain of the old sections dealing with foreign transactions, presents the practitioner with even greater complexity than he might otherwise expect.

1. AMERICAN BAR ASSOCIATION, CAREERS IN LAW: THE LAWYER'S ROLE IN SOCIETY 15 (1968).

2. See Act of Oct. 3, 1913, ch. 16, § II(A)(1), 38 Stat. 166.

3. See H.R. 5, 86th Cong., 1st Sess. (1959).

While most of the basic concepts of federal taxation of domestic transactions exist as a background, the foreign areas are very different in their basic approach and can be treated almost as a separate tax law. The United States taxes its citizens and residents (individual and corporate) on all of their income from all sources.⁴ It imposes tax on the income of nonresident foreign nationals and corporations that is derived from sources within the United States, and on certain types of income that are generated by the conduct of business in the United States.⁵ In addition, and this is a recent development, the United States sometimes imposes a tax on its citizens who are the owners of foreign corporations on certain "deemed distributions" from those foreign corporations.⁶ The Internal Revenue Service exercises considerable control over transactions between domestic taxpayers and related foreign taxpayers, and, when it subjects a United States taxpayer to tax on account of his foreign income, the Internal Revenue Code provides a credit for foreign taxes paid.⁷ In some instances, treaties between the United States and foreign countries vary the amount or method of taxation, sometimes even exempting certain classes of taxpayers or forms of income from all United States tax.⁸

Thus, a foreign corporation that does business in the United States is taxed in much the same way as a domestic taxpayer would be taxed. A foreign corporation that does not do business in the United States is generally not taxed at all unless it has income from United States sources (such as dividends, interest, and royalties) and then it is taxed at a flat rate on the gross amount with no deductions allowed.⁹ The domestic business that operates in branch form abroad is taxed on the income of that branch just as if it were in the United States.¹⁰ A domestic business that has a subsidiary abroad is generally not taxed at all on the income of that subsidiary until the income is distributed to it.¹¹ All of this fits in with the general scheme.

But what about investment income of the foreign corporation that does do business in the United States? What about foreign source income of a foreign corporation doing business in the United States? What about the special rules for income from less developed countries and investments in the Western Hemisphere? If a domestic

4. INT. REV. CODE OF 1954, §§ 1, 11, 1201.

5. INT. REV. CODE OF 1954, §§ 871, 882.

6. INT. REV. CODE OF 1954, §§ 551, 951.

7. INT. REV. CODE OF 1954, §§ 33, 78, 901-06.

8. *E.g.*, Treaty with Canada on Double Taxation, March 4, 1942, 56 Stat. 1399 (1942), T.S. No. 983; Treaty with the United Kingdom on Double Taxation, April 16, 1945, 60 Stat. 1377 (1946), T.I.A.S. No. 1546.

9. INT. REV. CODE OF 1954, § 881(a).

10. Treas. Reg. § 1.111-1(a) (1956).

11. INT. REV. CODE OF 1954, §§ 11(e), 882.

corporation does business abroad through a branch, how does it account for the income of that branch when foreign currency is involved? And what about the special rules that will result in tax on the United States shareholder of a foreign corporation if the corporation has certain types of "tainted" income? These are the questions that must be answered by a practitioner when he is approached by a foreign taxpayer with a question about United States taxation, or, more likely, by a domestic client that proposes to start or already has a foreign operation.

Each of these questions involves different sections of the Code and different concepts of taxation. There is no short answer to any of the questions, and, because of the complexity of the Code and regulations, there is no quick way to find out what the answer is. At this point, the tax practitioner with no prior experience in this area is no better off than a general practitioner with no specific tax training at all. The rules are all different and not always logical: the time has come to call a specialist.

The Rhoades book, in two long volumes, is a book for the specialist. Properly, it makes no attempt to summarize in a single section all of the areas that affect the income taxation of foreign related transactions. Instead, it covers each of the areas, one at a time, in an exhaustive analysis of the Code, regulations, rulings, and cases. It deals with these areas systematically, thoroughly, and, with some exceptions, well. In addition, the book is published in loose-leaf form, which will enable the author to replace pages and supplement the work as developments take place in the field.

Because of the Code's systematic organization and the small number of Code sections dealing with the foreign area, it was easy for the author to organize the book, and it is also easy for the reader to follow. The first volume deals with the taxation of Americans abroad, the taxation of foreigners in the United States, the special rules concerning foreign corporations that are controlled by United States persons, and the special rules dealing with certain tax-oriented domestic and foreign corporations that are involved in international business. The second volume deals with the Foreign Tax Credit, the network of United States tax treaties, and the rules under which federal taxing authorities can control transactions between domestic and foreign taxpayers, and contains a very helpful outline of the organization and operation of the Internal Revenue Service's Office of International Operations. The text is followed by an Appendix containing most of the Internal Revenue Service forms that are utilized in the foreign area.

The author's approach, in each chapter, is to begin with a relatively short summary of the rules concerning the subject discussed. This is followed by a more detailed analysis of the Code,

regulations, rulings, and cases, with a great many examples of the application of the principles involved. The introductory summaries are of some interest, but of questionable utility. They are of little use to the specialist, who, it is hoped, will already understand the general thrust of the law in the particular area. They will be useful to a nonspecialist only if he is utilizing the book as a text and intends to read the entire chapter or the entire book; if the nonspecialist uses the book to answer a specific narrow question, there is considerable danger that he will be misled by the introductory summary in light of his lack of familiarity with the particularized Code sections. And yet, the work is too long to be used as a text for learning the field unless practicing lawyers today are less busy than this reviewer thinks.

The detailed analysis is generally quite good. The author and his collaborators obviously have wide experience in the field and understand the intricate workings of the Code sections with which they deal. The examples are very helpful in placing complex subjects into practical hypothetical situations.

Virtually every area of the Code that deals with foreign transactions is covered adequately, with the exceptions of the Interest Equalization Tax¹² and the recently enacted Domestic International Sales Corporation rules,¹³ which receive less than full treatment. The former is an excise rather than an income tax, and the latter will no doubt receive expanded coverage in the future. These are not, therefore, substantial drawbacks.

The sections of the book that deal with the Foreign Investors Tax Act of 1966¹⁴ and the Foreign Tax Credit¹⁵ deserve special mention. They are both excellent. The Foreign Investors Tax Act of 1966 changed the rules by which foreign corporations are taxed on income from sources within and sources without the United States, introducing the concept of "effectively connected" foreign source income. The chapter deals with the questions raised by the Act efficiently and clearly, and sheds considerable light on what may otherwise be very confusing concepts. The Foreign Tax Credit section also covers, in relatively short space, the complexities of calculating that credit in a very understandable fashion. It should be noted that the latter chapter was reviewed by Professor Owens at Harvard, who must be considered the expert on the United States Foreign Tax Credit.

12. See INT. REV. CODE OF 1954, §§ 4911-31.

13. See INT. REV. CODE OF 1954, §§ 991-97.

14. Pub. L. 89-809, 80 Stat. 1541 (codified in scattered sections of INT. REV. CODE OF 1954).

15. See INT. REV. CODE OF 1954, §§ 33, 901-06.

The chapter on Controlled Foreign Corporations,¹⁶ which deals with the rules of the Revenue Act of 1962¹⁷ treating certain amounts of "tainted" income as distributed to United States shareholders of Controlled Foreign Corporations, is somewhat less praiseworthy. First of all, it follows the sequence of sections in the Code almost without exception. The reviewer would have preferred an arrangement dealing with the dangers of subpart F followed by a discussion of the statutory and other means for avoiding the application of subpart F. Second, the subject of minimum distributions,¹⁸ which is perhaps the most complex area in the entire Code, is dismissed in the space of about ten pages, while the Code's treatment of Export Trade Corporations¹⁹—provisions that were never of any practical use and have now been virtually repealed²⁰—receives an equal amount of coverage.

The treatment of section 482 is also somewhat unsatisfactory. There is a lengthy discussion of the 1968 regulations,²¹ and while that is helpful, it is also true as a practical matter that none of the methods of pricing intercompany sales described in the regulations have ever, to the knowledge of the reviewer, been utilized by the Internal Revenue Service in making a section 482 adjustment. A longer discussion of the cases with a more thorough analysis of the attitude of the courts toward the powers of the Internal Revenue Service under section 482 would be more useful, and some consideration should also be given to adding textual material on how to handle the section 482 audit.

In general, the book is excellent and should be a welcome addition to the library of every tax lawyer. It has the added inducement of being the only work of its kind. There are books dealing with some of the individual areas discussed,²² but most of them are too long and technical for use as easy reference. The loose-leaf format of the book, its liberal use of examples, and its clear explanations of the legal rules involved make it highly desirable.

What the book does not discuss, and properly so because it is a

16. See INT. REV. CODE OF 1954, §§ 951-64, 970-72.

17. Pub. L. 87-834, § 12(a), 76 Stat. 1006. The Act added subparts F and G to part III of chapter 1N.

18. See INT. REV. CODE OF 1954, § 963.

19. See INT. REV. CODE OF 1954, §§ 970-72.

20. INT. REV. CODE OF 1954, § 971(a)(3), added by the Revenue Act of 1971, Pub. L. 92-178, § 505(c), 85 Stat. 553, precludes Controlled Foreign Corporations from qualifying as Export Trade Corporations after Oct. 31, 1971. Section 505(b) of the Act, 85 Stat. 551, allows presently qualified Export Trade Corporations to transfer their assets to a Domestic International Sales Corporation without incurring tax disadvantages for either subsidiary or for their domestic parent.

21. Treas. Reg. §§ 1.482-1(d), 1.482-2.

22. *E.g.*, E. OWENS, *THE FOREIGN TAX CREDIT* (1961); S. ROBERTS & W. WARREN, *UNITED STATES INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS* (1967).

text, is the lamentable state in which the law in this area is found today. Those rules concerning income taxation of foreign transactions that have been in the Code since the very early years, many of which have not been changed since they were originally enacted, combine with new Code sections—enacted particularly within the last ten years—to make the area a hodgepodge of various approaches that reflect the differing attitudes of the Congress over the years. There is no unified policy for our taxation of foreign transactions, and the rules are incredibly liberal in some areas and incredibly restrictive in others, giving rise to seeming inconsistencies.

At the risk of completely outdating Mr. Rhoades' book before it has been long in use, the reviewer would suggest that Congress review the entire area, make a conscious decision to adopt a particular policy, and try to implement that policy in a rational manner. The Treasury has not conducted such a review, and the *Report* of the President's Task Force on Business Taxation of September 1970, which considered some of the problems involved, was not broad enough in scope to serve as a basis for reform, and seems generally to have been ignored in any case.

Perhaps the most distressing phenomenon that has been witnessed in the area is the unbelievable complexity of the legislative rules and administratively developed regulations adopted within the past ten years. The rules on Controlled Foreign Corporations, created by the Revenue Act of 1962, comprise one of the least comprehensible portions of the Internal Revenue Code. Government statistics show that these rules produce no revenue for the government;²³ all they have done is to generate millions of dollars in legal and accounting fees that cannot be justified on any basis. The rules are so complex that the practicing lawyer finds it impossible to explain them to his clients, and there are areas, particularly minimum distributions, where regulations cannot be made comprehensible. Similarly, the 1968 regulations under section 482 provide a marvelously well structured means of making determinations that have proved to have no practical applicability at all.

No one questions the power of the United States to impose an income tax. No one questions that the United States has jurisdiction to tax the foreign income of its citizens and the domestic income of foreigners. In a world, however, where a bevy of specialists within a given specialty is necessary in order to understand successfully the law, complexities and absurdities like these have no place. Life is complex enough because of nonlegal factors, and Congress should not continue to ignore its responsibilities in the area of

23. Address by B. Kenneth Sanders, member of the President's Task Force on Business Taxation, at the Public Briefing Conference, Institute on United States Taxation of Foreign Income, January 21-22, 1970.

taxation. There are probably not more than a dozen men in the entire Congress who have any understanding of the tax law. Conscientious efforts on the part of the specialists in the Internal Revenue Service, the Treasury Department, and in the legal and accounting professions are called for to correct these gross inadequacies. In the meantime, we must rely on people such as Mr. Rhoades and his collaborators, who will be supplementing this valuable work as it becomes necessary with the increasing complexity of the field, to explain to us what is going on so that we can try to cope with the situation.

*Alan G. Choate,
Member of the Pennsylvania and
District of Columbia Bars*