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International Tax Planning Offshore Style: An Update

by Paul M. Kiffner* and William D. Rohrer†

Offshore tax planning is becoming increasingly important among multinational and domestic corporations alike. While many "tax-flavored" offshore arrangements have not "settled well" with Uncle Sam, no thorough international tax planner should overlook the benefits he or she can achieve through carefully structured international tax planning—offshore style. In addition to enabling the corporate group to maximize worldwide tax benefits, offshore arrangements may also serve a variety of non-tax objectives, such as:

1. Gaining access to external sources of finance;
2. Deploying and recycling existing group funds;
3. Avoiding accumulation of funds in countries with exchange controls and/or monetary instability;
4. Avoiding ownership of fixed assets in countries that are politically unstable;
5. Managing and minimizing reinvoicing/multicurrency exchange exposure; and
6. Reducing economically exorbitant service costs.

In an effort to eliminate the congressionally unintended tax benefits generated by many offshore arrangements,† Congress enacted the Tax

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1 A multitude of cases and rulings indicates the scrutiny with which the Internal Revenue Service (IRS) has viewed many of these offshore arrangements. These cases and rulings will be discussed infra to the extent they apply to a particular offshore arrangement examined in this article.

On July 18, 1984, Congress enacted the Tax Reform Act of 1984 (1984 Act), Pub. L. No. 98-369, 98 Stat. 494 (1984), which impacted a number of these offshore arrangements. Relevant provisions will be discussed infra to the extent they apply to a particular offshore arrangement examined in this article.

2 Tax incentives intentionally created by Congress must be distinguished from congressionally unintended tax incentives created by innovative tax practitioners. Congress will frequently enact certain tax incentives, such as the investment tax credit or the foreign sales corporation provisions, to encourage a particular type of economic behavior. Conversely, tax practitioners are constantly structuring transactions to circumvent some of the less favorable provisions of the Internal Revenue
Reform Act of 1984 (Act). Offshore arrangements must now be critically evaluated, carefully structured, and closely monitored in light of the more restrictive rules of the Act. This article will discuss four of the more popular offshore arrangements prior to the Act. These were:

1. Offshore Factoring Subsidiaries;
2. Offshore Captive Insurance Companies;
3. International Leasing Companies; and
4. Reinvoicing/Multicurrency Management Centers.

While these offshore arrangements may continue to have some viability even after the Act, the degree of their effectiveness has been diminished. The primary purpose of this article with respect to each of these offshore arrangements is: first, to familiarize the reader with the particular offshore arrangement as it existed prior to the Act; second, to discuss the impact of the Act on the particular offshore arrangement; and third, to discuss some possible solutions, if any, to the tightened rules of the Act.

I. OFFSHORE FACTORING SUBSIDIARY

A. Typical Situation Prior to the Act

One of the primary, non-tax purposes of an Offshore Factoring Subsidiary Factor is to deploy and recycle existing group funds. As illustrated below, a cash-rich Controlled Foreign Corporation (CFC) will typically form a Factor in a low-tax jurisdiction by contributing cash in the form of a loan or equity capital. It may also be possible to use an existing subsidiary in a low tax jurisdiction to achieve the same result. The cash-poor U.S. Parent Corporation (Parent), or any other domestic affiliate, will then periodically sell its U.S. customer receivables to the Factor at their current fair market value. The Code, such as the Subpart F provisions, and thereby shift U.S. source income outside of U.S. taxing jurisdiction. Since these transactions do not stimulate the type of economic behavior encouraged by Congress, they become classified as "tax loopholes." As these "loopholes" gain in popularity, they become targets for tax reform. Some of the congressionally unintended tax benefits generated from these offshore arrangements are:

1) Shifting income from an otherwise wholly domestic transaction which is temporarily outside of U.S. taxing jurisdiction;
2) Recharacterizing shifted income upon repatriation as low-taxed foreign source income available to absorb otherwise unusable foreign tax credits; and
3) Allowing a U.S. parent access to its foreign subsidiary's excess cash without paying U.S. taxes on the earnings which generated the cash.

4 The debt-to-equity ratio of the Factor should be structured to withstand an IRS attack on the substance of the corporation. See Weisser v. Mursam Shoe Corp., 127 F.2d 344 (2d Cir. 1942).
5 Fair market value is typically the amount that an unrelated factor will pay for the same receivables. Arm's length terms are used in order to avoid any constructive dividend or allocation of
Factor collects them and uses the proceeds to purchase additional receivables from Parent.

**OFFSHORE FACTORING SUBSIDIARY**

(Illustration)

Diagram 1.

### B. Consequences

The preferred consequences prior to the Act were that:

1. Parent gained access to CFC's excess cash without being taxed on its receipt;\(^6\)

2. Parent recognized a loss on the difference between the face value of the receivables and the amount paid for them by the Factor;\(^7\)

3. Parent shifted some of the risk of collecting the receivable to the Factor;

4. Factor gained a steady source of revenue which was either un-

\(^6\) See Ltr. Rul. 8338043, June 17, 1983, which held that an arm's-length transfer of accounts receivable to a Factor constitutes a bona fide sale of property.

\(^7\) *Id.* However, see Higgins v. Smith, 308 U.S. 473 (1940) and subsequent cases which held that a Parent could not recognize a loss upon a sale of *securities* to a wholly owned subsidiary either because of the Parent's domination and control over the subsidiary or because there was no business purpose other than tax avoidance. Compare Crown Cork Int'l Corp. v. Comm'r, 4 T.C. 19 (1944), *aff'd*, 149 F.2d 968 (3d Cir. 1945); Bank of America National Trust and Savings Ass'n v. Comm'r, 15 T.C. 544 (1950), *aff'd*, 193 F.2d 178 (9th Cir. 1951) *with* Anderson, Clayton & Co. v. Comm'r, 7 T.C.M. (CCH) 573 (1948).

There is also a possibility that once a sale which lacks substance is disregarded for tax purposes, the payment from the Factor will be treated as a dividend. See National Lead Co. v. Comm'r, 40 T.C. 282 (1963), *aff'd in part*, 336 F.2d 134 (2d Cir. 1964).
taxed or taxed at lower rates in a tax haven country;\(^8\) and

5. The corporate group maximized its worldwide tax benefits.

Unfortunately, the Act had a dramatic impact on this particular off-shore arrangement. The following comparative analysis illustrates the various tax consequences which would occur under the typical situation described above, both before and after the Act:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Before</th>
<th>After(^9)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Arm's length&quot; transfer of U.S. customer receivables by Parent to Factor</td>
<td>“Arm's length” Constitutes a bona fide sale of property.(^10)</td>
<td>Unchanged.</td>
</tr>
<tr>
<td>Parent will recognize a loss on the difference between the face value of the receivable and the amount paid by Factor.(^11)</td>
<td>Unchanged.</td>
<td></td>
</tr>
<tr>
<td>Will not represent an &quot;investment in U.S. property&quot; since the obligors are unrelated to the Factor.(^12)</td>
<td>Will represent an &quot;investment in U.S. property&quot; if acquired from a related U.S. person.(^13)</td>
<td></td>
</tr>
</tbody>
</table>

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8 "Tax Haven Country" refers to a country in which a corporation is taxed at a lower effective tax rate as compared to the U.S. tax rate.

9 The relevant provisions of the Tax Reform Act of 1984 apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984.

10 See supra note 6 and accompanying text.

11 See supra note 7 and accompanying text.

12 Prior to the Tax Reform Act of 1984, the general rule was that the term “U.S. property” included any “obligation of a U.S. person.” One of the exceptions to this general rule was that “U.S. property” did not include obligations of unrelated persons. I.R.C. § 956(b)(2)(F) (1983).

13 1984 Act section 123(b) amended I.R.C. section 956(b) by adding new paragraph (3) to read, in part, as follows:

(3) Certain Trade or Service Receivables Acquired from Related United States Persons.

(A) In General — Notwithstanding paragraph (2), the term “United States property” includes any trade or service receivable if —

(i) such trade or service receivable is acquired (directly or indirectly) from a related person who is a United States person, and

(ii) the obligor under such receivable is a United States person.

Prior to 1976, the purchase of receivables of U.S. obligors would have resulted in an “Investment in U.S. Property” taxable under I.R.C. section 956. In 1976, however, Congress believed that under the then existing law the classification of investments (in any stock or debt obligations) of U.S. corporations as the equivalent of dividends was harmful to the U.S. balance of payments. Accordingly, I.R.C. section 956 was liberalized to exclude from the definition of “U.S. property” investments in unrelated corporations. Congress thus sought to encourage investments in the United
Collection of receivables by Factor | Discount income generally is not Subpart F income.\textsuperscript{14} | Discount income will be treated as U.S. source interest income for Subpart F and foreign tax credit purposes.\textsuperscript{15} \\
| No U.S. tax should be imposed until earnings are remitted to the States, but not where the U.S. parent gains access to previously untaxed earnings. Since the purchase of U.S. customer receivables by a foreign factoring subsidiary from its U.S. parent also provides the U.S. Parent with access to the foreign subsidiary's untaxed earnings, Congress tightened I.R.C. section 956 in 1984 to include within the definition of "U.S. property" any U.S. customer trade or service receivables acquired from a related U.S. person. See H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1306 (1984).

\textsuperscript{14} Subpart F income is the U.S. tax principle that forces a U.S. parent company to include in its U.S. taxable income the earnings of certain controlled foreign subsidiaries, depending upon the character of income earned by each subsidiary and the circumstances giving rise to that income.

There are three principal kinds of Subpart F income under the U.S. tax rules: 1) Foreign Personal Holding Company Income; 2) Foreign Base Company Sales Income; 3) Foreign Base Company Services Income. Foreign Personal Holding Company Income includes, except in the case of regular dealers, gains from the sale or exchange of stock or securities (assuming discount income is not interest, as discussed infra note 17). Discount income should not be Foreign Personal Holding Company Income because: 1) it is doubtful that noninterest bearing receivables will be "securities"; 2) the collection of receivables should not be a "sale or exchange" because the receivables are not capital assets in the collection agency's hands. See Drybrough v. Comm'r, 45 T.C. 424 (1966), aff'd, 384 F.2d 715 (6th Cir. 1967); and 3) even if the collection of the receivables does equal a sale or exchange of securities, the Factor should be covered by the "dealer" exception.

Foreign Base Company Sales Income includes income derived from the sale or purchase of personal property: 1) manufactured, produced, grown, or extracted outside the controlled foreign subsidiary's country of incorporation; 2) to or from a related person; 3) for use or consumption outside of that country. Even though Factor purchased the receivables from a related person (Parent), it will not subsequently sell the receivable to another person for use or consumption outside Factor's country of incorporation. Therefore, discount income should not be Foreign Based Company Sales Income.

Foreign Base Company Services Income includes income derived from the performance of services: 1) outside the country in which the controlled foreign subsidiary is organized; and 2) for a related person. Discount income should not be Foreign Base Company Services Income because: 1) the purchase of receivables is probably not a service; 2) the collection of receivables is performed for Factor's benefit, not Parent's; and 3) even if collection is deemed to be a "service," the resulting income will only be foreign base company services income if the collection is "performed outside Factor's country of incorporation." If the purchase and collection of the receivables takes place within Factor's country of incorporation, and the receivables are extinguished there, it would be difficult to contend that the resulting income is foreign base company services income.

\textsuperscript{15} 1984 Act section 123(a) amended I.R.C. section 864 by adding subsection (d) to read, in part, as follows:

(d) Treatment of Related Person Factoring Income

(1) In General — For purposes of the provisions set forth in paragraph (2), if any person acquires (directly or indirectly) a trade or service receivable from a related person, any income of such person from the trade or service receivable so acquired shall be treated as if it were interest on a loan to the obligor under the receivable.

(2) Provisions to which paragraph (1) applies - The provisions set forth in this paragraph are as follows:
company as a foreign source dividend.\textsuperscript{16}

Discount income will not be subject to U.S. withholding.\textsuperscript{17}

(A) Part III of subchapter G of this chapter (relating to foreign personal holding companies).

(B) Section 904 (relating to limitation on foreign tax credit).

(C) Subpart F of Part III of this subchapter (relating to controlled foreign corporations).

\textsuperscript{16}The reason Congress added new subsection (g) to I.R.C. Section 904 in 1984 was to prevent corporations from converting U.S. source discount income to foreign source dividend of Subpart F income in order to absorb otherwise unusable foreign tax credits and thereby shelter that income from U.S. taxation. \textit{See infra} note 26.

\textsuperscript{17}The controlling question is whether discount income is "interest" or other "fixed or determinable" income. Case law squarely holds that discount income is not interest. \textit{See Elk Discount Corp. v. Comm'r}, 4 T.C. 196 (1944); Thompson v. Comm'r, 73 T.C. 878 (1980). In addition, discount income probably is not "other fixed or determinable" income because: 1) payments received on the account of receivables held by a factoring company lack the necessary "high content of net income" which is usually characteristic of payments subject to withholding, \textit{see} Rev. Rul. 80-222, 1980-2 C.B. 211; and 2) transactions in which the amount of income potentially subject to tax is difficult to determine have generally been held not to give rise to "fixed or determinable" income (e.g., gains from the sale or exchange of property). \textit{See Treas. Reg. §§ 1.871-7(a)(1), 1.1441-2(a)(3) (1984).}

The transaction, however, could possibly be recharacterized pursuant to I.R.C. section 482 as a secured loan generating interest. To avoid this result, all aspects of the transaction between Parent and Factor should be arm's length and without recourse against Parent. In addition, there should be a written contract of sale, purchased receivables should be identified both by obligor and amount, and Factor should be entitled to refuse to purchase any receivables which it deems uncollectable.
If properly structured
the discount income
will not represent
income effectively
connected with the
conduct of a "U.S.
trade or business."¹⁸

The following table illustrates the tax impact of the relevant antiavoidance provisions under the Act on various offshore factoring transactions depending on 1) the type of receivable (U.S. customer versus foreign customer), and 2) the seller of the receivable (U.S. parent or domestic affiliate, related CFC, or unrelated corporation). As illustrated, a U.S. parent or domestic affiliate can no longer sell its U.S. customer receivables to its offshore factoring subsidiary without triggering every one of the new antiavoidance provisions in the Act. Even a sale of foreign customer receivables will now trigger the Subpart F and foreign tax credit antiavoidance provisions, as will sales of either type of receivable by a related CFC.

One possible strategy to overcome the tightened rules of the Act would be to form an "association Factor." As illustrated in the table, the "investment in U.S. property" and Subpart F antiavoidance provisions of the Act only apply to transactions between "related persons."¹⁹ A related person includes: 1) a "U.S. shareholder" (owning at least ten

Despite these precautions, the IRS could still argue that the arrangement was "in substance" a loan by Factor since the risk of default on the receivable remains within the "economic family." The "economic family" argument was advanced by the IRS in Carnation Co. v. Comm'r, 71 T.C. 400 (1978), aff'd, 640 F.2d 1010 (9th Cir. 1981) (regarding captive insurance companies). Although the Tax Court and the Ninth Circuit decided Carnation in the Service's favor, it is not clear whether any credence was given to the "economic family" argument.

It should be noted that the withholding tax problem can be eliminated by establishing the Factor in a tax haven country with which the United States has a treaty, such as the Netherlands Antilles.

¹⁸ If a foreign corporation maintains too many U.S. "contacts," it will be considered to be conducting a "trade or business" within the United States and will be taxed at regular corporate rates on its income effectively connected with the conduct of that business. Therefore, the problem of how collection responsibilities will be handled, and by whom, must be addressed. If Factor makes use of a U.S. collection agent or allows its Parent to continue with the collection responsibilities, a U.S. trade or business may exist. In an effort to avoid this problem, Factor should possess all the attributes of a corporation: a board of directors that regularly holds meetings in its country of incorporation, a charter, a place of business, and a staff. Consideration should also be given to the fact that it may be harder for the Service to prove the existence of a "U.S. permanent establishment" under an existing tax treaty with another country than a "U.S. trade or business" in the absence of such a treaty.

<table>
<thead>
<tr>
<th>Type of Receivable</th>
<th>U. S. Parent or Domestic Affiliate</th>
<th>Related CFC</th>
<th>Unrelated Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Customer</td>
<td>§956(b) &quot;Investment in U.S. property&quot; - Parent will be taxed currently on the amount paid for the receivable (up to the amount of Factor's E&amp;P)</td>
<td>§956(b) Not applicable</td>
<td>§956(b) Not applicable</td>
</tr>
<tr>
<td></td>
<td>§864(d) Income will be classified as interest income for Subpart F purposes</td>
<td>§864(d) Income will be classified as interest income for Subpart F purposes</td>
<td>§864(d) Not applicable</td>
</tr>
<tr>
<td></td>
<td>§904(g) Interest is U.S. sourced for foreign tax credit purposes</td>
<td>§904(g) Interest is U.S. sourced for foreign tax credit purposes</td>
<td>§904(g) Discount income is U.S. sourced when remitted as a dividend to the U.S. Parent Rules before the Tax Reform Act of 1984 apply otherwise</td>
</tr>
<tr>
<td>Foreign Customer</td>
<td>§956(b) Not applicable</td>
<td>§956(b) Not applicable</td>
<td>§956(b) Not applicable</td>
</tr>
<tr>
<td></td>
<td>§864(d) Income will be classified as interest income for Subpart F purposes</td>
<td>§864(d) Income will be classified as interest income for Subpart F purposes</td>
<td>§864(d) Not applicable</td>
</tr>
<tr>
<td></td>
<td>§904(d) Interest is separate limitation interest for foreign tax credit purposes</td>
<td>§904(d) Interest is separate limitation interest for foreign tax credit purposes</td>
<td>§904(d) Not applicable</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Rules before the Tax Reform Act of 1984 continue to apply</td>
</tr>
</tbody>
</table>
percent of the voting power of a foreign corporation),\textsuperscript{20} and 2) any person who is related to such a shareholder within the meaning of section 267(b).\textsuperscript{21} Therefore, if a foreign corporation and at least ten other unrelated foreign subsidiaries form a new factoring subsidiary in which each foreign corporation owns less than a ten percent interest, the antiavoidance provisions discussed above should not apply. While the Secretary is authorized to prescribe regulations to prevent the avoidance of these new provisions,\textsuperscript{22} it is doubtful that the Secretary will expand the scope of the "related person" definition to include larger groups of unrelated U.S. companies.\textsuperscript{23}

Since an association Factor will not be subject to the antiavoidance provisions discussed above, the discount income is not reclassified as U.S. source interest income pursuant to I.R.C. section 864(d).\textsuperscript{24} Therefore, to the extent the discount income is generated from foreign customer receivables, the separate foreign tax credit limitation in I.R.C. section 904(d) on interest income will not apply.\textsuperscript{25} However, to the extent the

\begin{itemize}
\item \textsuperscript{20}I.R.C. § 951(b) (1984).
\item \textsuperscript{21}See discussion of I.R.C. § 864(d)(4)(B), \textit{supra} note 15. The "related person" definition was expanded to prevent tax free related party factoring by several U.S. persons. By precisely defining "related person" in the Act however, no ambiguity should exist as to what does and does not constitute related party factoring.
\item \textsuperscript{22}See I.R.C. § 864(d)(7) (1984).
\item \textsuperscript{23}In fact, this cannot be done without changing the codified percentages in either: 1) the definition of "U.S. shareholder" contained in I.R.C. § 951 (1983) or 2) the relationships in I.R.C. § 267(b) (1983). Arguably, only Congress would have the authority to change these percentages.
\item \textsuperscript{24}See discussion of I.R.C. § 864(d)(1), \textit{supra} note 15.
\item \textsuperscript{25}1984 Act sections 122 and 801 amended section 904(d) to read in part as follows:
\begin{enumerate}
\item In General. The provisions of subsections (a), (b), and (c) shall be applied separately with respect to each of the following items of income:
\begin{enumerate}
\item the interest income described in paragraph (2).
\end{enumerate}
\item Interest Income to which Applicable. For purposes of this subsection, the interest income described in this paragraph is interest other than interest—
\begin{enumerate}
\item derived from any transaction which is directly related to the active conduct by the taxpayer of a trade or business in a foreign country or a possession of the United States.
\end{enumerate}
\item Certain Amounts Attributable to United States-owned Foreign Corporations, etc., Treated as Interest.
\begin{enumerate}
\item In general. For purposes of this subsection, dividends and interests—
\begin{enumerate}
\item paid or accrued by a designated payor corporation, and
\item attributable to any taxable year of such corporation, shall be treated as interest income described in paragraph (2) to the extent that the aggregate amount of such dividends and interest does not exceed the separate limitation interest of the designated payor corporation for such taxable year.
\end{enumerate}
\end{enumerate}
\end{enumerate}
Prior to the 1984 Act, U.S. taxpayers could circumvent the separate foreign tax credit limitation on interest income by having their foreign subsidiaries earn the separate limitation interest instead.
discount income is generated from U.S. customer receivables, the U.S. source character of the income is maintained under I.R.C. section 904(g) when the income is remitted by the Factor as a dividend to the U.S. parent.26

A second potential strategy to overcome the Act’s tightened rules is

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26 1984 Act section 121(a) amended I.R.C. section 904 by adding new subsection (g) to read, in part, as follows:

(g) Source Rules in Case of United States-Owned Foreign Corporations.

(1) In General. The following amounts which are derived from a United States-owned foreign corporation and which would be treated as derived from sources outside the United States without regard to this subsection shall, for purposes of this section, be treated as derived from sources within the United States to the extent provided in this subsection:

(A) Any amount included in gross income under—
(i) § 951(a) (relating to amounts included in gross income of United States shareholders), or
(ii) § 551 (relating to foreign personal holding company income taxed to United States shareholders).

(B) Interest.

(C) Dividends.

(2) Subpart F and Foreign Personal Holding Company Inclusions. Any amount described in subparagraph (A) of paragraph (1) shall be treated as derived from sources within the United States to the extent such amount is attributable to income of the United States-owned foreign corporation from sources within the United States.

(4) Dividends.

(A) In general. The United States source ratio of any dividend paid or accrued by a United States-owned foreign corporation shall be treated as derived from sources within the United States.

(B) United States source ratio. For purposes of subparagraph (A), the term “United States source ratio” means, with respect to any dividend paid out of the earnings and profits for any taxable year, a fraction—

(i) the numerator of which is the portion of the earnings and profits for such taxable year from sources within the United States, and
a "reciprocal factoring" arrangement between two unrelated U.S. parents that have independently established their own offshore factoring subsidiaries. Instead of each parent using its own subsidiary to factor receivables, each will use the other U.S. parent's subsidiary. As with the association Factor discussed above, the "investment in U.S. property" and Subpart F antiavoidance provisions of the Act will not apply to this reciprocal factoring arrangement since the transactions are not between related persons. As a result, the discount income will not be reclassified as U.S. source interest income pursuant to section 864(d). Therefore, any discount income generated from the foreign customer receivables is not subject to the separate foreign tax credit limitation on interest income.

However, to the extent the discount income is generated from U.S. customer receivables, section 904(g) will treat the discount income, when remitted as a dividend to the U.S. parent, as U.S. source income. The amount of U.S. source dividend income is determined according to a fraction, the numerator of which is earnings and profits (E&P) from U.S. sources for the year and the denominator of which is total E&P for the year. If, however, less than ten percent of the factoring subsidiary's E&P is from U.S. sources, none of the income will be U.S. sourced upon remission to the U.S. parent. With this in mind, it will not be possible to avoid the sourcing rules by staggering the receipt of discount income.

(ii) the denominator of which is the total amount of earnings and profits for such taxable year.

(5) Exception Where United States-owned Foreign Corporation has Small Amount of United States Source Income. Paragraph (3) shall not apply to interest paid or accrued during any taxable year (and paragraph (4) shall not apply to any dividends paid out of the earnings and profits for such taxable year) if—

(A) the United States owned foreign corporation has earnings and profits for such taxable year, and

(B) less than 10 percent of such earnings and profits is attributable to sources within the United States.

Prior to the 1984 Act, a U.S. corporation could convert the source of some of its U.S. source income by deducting interest, insurance premiums, or other amounts paid to a foreign subsidiary. When the foreign subsidiary distributed dividends or paid interest to its U.S. parent, generally the dividends or interest were treated as foreign source income. Since the foreign subsidiary could be located in a tax haven, the foreign source income would be available to absorb otherwise unusable foreign tax credits. The same conversion of U.S. source income to foreign source income could occur when a CFC earned tax haven-type income taxed to the U.S. shareholders under Subpart F. Congress sought to curb this abuse by providing that U.S. source income derived by a foreign corporation will be treated as derived from U.S. sources when includable in the income of its U.S. shareholder. See H.R. Rep. No. 861, 98th Cong., 2d Sess. 918 (1984).


28 See I.R.C. § 904(d), supra note 25.


in one year and the remittance of dividends in another year. The conference report specifically addresses this matter by providing that the numerator and denominator in the above fraction are from the taxable year out of whose E&P the dividend was paid or accrued. However, if the factoring subsidiary concentrates primarily on purchasing foreign customer receivables, as opposed to U.S. customer receivables, the ten percent exception referred to above may be helpful.

**RE bât t\()AL RECEIVABLE FACTORING**

(Illustration)

Once the decision has been made by the U.S. parent to pursue this "reciprocal factoring" arrangement, several non-tax concerns must subsequently be addressed. For instance, a legitimate Factor should bear the risk of collectability of the receivable. Unfortunately, however, each industry has a different rate of uncollectability for its receivables. Therefore, it would seem that both parents should be engaged in the same or similar industries, although this may raise a problem regarding the confidentiality of customer lists. These problems and others indicate that, once one Parent decides to pursue a "reciprocal factoring" arrangement, it may be difficult to find an appropriate factoring partner.

In an effort to aid U.S. companies in their reciprocal factoring efforts, commercial banks have been forming "receivable pools." U.S. corporations wishing to gain access to their foreign subsidiary's excess cash, without being taxed on the receipt of that cash, can sell their U.S. receivables to a receivable pool. Each of these U.S. corporations will, in turn,

direct their foreign subsidiaries to purchase an equal amount of receivables from the pool, either directly or indirectly through a newly created factoring subsidiary. As an added precaution, the bank will ensure that the foreign purchaser never acquires accounts originating with its U.S. parent.

While a reciprocal factoring arrangement can be carefully structured to avoid the new provisions of the Act, it is imperative to note that the Secretary is empowered to prescribe regulations in order to prevent transactions which are designed to circumvent the spirit and intent of the Act. Since the tax benefits available through a reciprocal factoring arrangement are identical to the benefits Congress meant to eliminate through the Act, these arrangements will be closely scrutinized. The legislative history, however, fails to provide the Secretary with any guidance on this matter. It may be possible that the factoring agreements made between each U.S. Parent and the other U.S. Parent's Factor will be treated as interdependent. Alternatively, regulations could provide that the factoring income from unrelated party transactions is taxable to the U.S. Parent under the Subpart F provisions to the extent the U.S. Parent Factors any of its own receivables with another U.S. Parent’s Factor. In any event, until regulations are issued, reciprocal factoring arrangements should be approached with extreme caution.

II. OFFSHORE CAPTIVE INSURANCE COMPANY

A. Typical Situation Prior to Carnation and the 1984 Tax Reform Act

The purpose of an Offshore Captive Insurance Company (CIC) is to enable an entity to insure itself rather than pay the economically exorbitant service costs charged by independent insurers. When a U.S. Parent is unable to obtain insurance coverage at reasonable rates, it may incorporate a CIC under the laws of country A (preferably a low tax jurisdiction). Typically, the Parent will purchase a blanket insurance policy from an unrelated insurer, and contemporaneously the CIC will contract to reinsure X% of the unrelated insurer’s liability with respect to the Parent’s insurance policy. As a result of this arrangement, the unrelated insurer will forward X% of the premiums received from the Parent, and the CIC will pay the unrelated insurer a small commission and agree to reimburse the unrelated insurer for losses incurred on the Parent’s policy.

B. Consequences

The preferred consequences prior to Carnation and the Tax Reform Act of 1984 were that:
1. The Parent obtained insurance at reasonable rates.
2. The Parent received a deduction for the insurance premium paid to the unrelated insurer.
3. The CIC avoided current U.S. taxation on its insurance income. This could only be achieved if the ownership and income mix of the CIC was carefully structured. If current U.S. taxation of the CIC's insurance income could not be avoided (as was usually the case), the CIC's income was characterized as foreign source under the Subpart F rules so as to increase the foreign tax credit limitation. In addition, the imputed Sub-

33 Carnation Co. v. Comm'r, 71 T.C. 400 (1978), aff'd, 640 F.2d 1010 (9th Cir. 1981), discussed supra note 17.
34 The income derived from the insurance of U.S. risks by a CIC is currently taxable to its U.S. shareholders if the premiums or other consideration received during the year with respect to the U.S. risks exceed five percent of the total premiums with respect to all risks. I.R.C. §§ 952(a)(1), 953 (1984). Prior to the 1984 Act, income derived by a CFC from the insurance of non-U.S. risks was not currently taxable.
part F income would be offset by deducting the insurance premium payment made to the insurer.\[35\]

4. While no withholding taxes were imposed on the premiums paid to the CIC, an excise tax under section 4371 was levied on the premium to the CIC.

Unfortunately, in *Carnation Company* the court ruled that the typical situation described above did not result in a true "shifting" or "distribution" of risks. Since the overall integrated plan did not constitute a true insurance contract, X% of the Parent's premium deductions were disallowed.\[36\]

In *Carnation* the CIC was wholly owned by Carnation Company and only Carnation and its subsidiaries were the insureds. In addition, the CIC was potentially undercapitalized, thus requiring Carnation to supplement the CIC's claims reserve. Even though bona fide insurance contracts existed with an unrelated insurer, the court held that they were interdependent with the reinsurance contracts with the CIC. The premium payments were held to be contributions to capital to the extent of the reinsurance because they lacked the essential insurance element of risk shifting.

In contrast, the IRS has held\[37\] that premiums paid by a domestic corporation to a sufficiently capitalized CIC were deductible where the CIC provided insurance to its thirty-one economically unrelated shareholders (none of which owned a controlling interest) and the CIC could accept only five percent of its total risks from any one shareholder. Since the risks were "shifted" from each shareholder to the CIC, and since the risks were sufficiently spread ("distributed") among an adequate number of insureds, the premium payments were held to be deductible as ordinary and necessary business expenses. As a result, groups of companies have been forming "multi-captives," or "association CIC's."

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\[35\] If the CIC's earnings are taxed under Subpart F, special insurance taxation rules exist which serve to mitigate the adverse effect of current U.S. taxation, including the exclusion of unearned premiums from the gross income of the insurer and deductibility of incurred losses and expenses in excess of actual payments for such losses from current income.

\[36\] See also Rev. Rul. 77-316, 1977-2 C.B. 53, where the Service ruled that when a wholly-owned CIC accepts risks only from its parent, or the parent's other wholly-owned subsidiaries, there is no insurance because risk had not been shifted or distributed outside of a group of "economically related corporations." The economic family argument was used by the IRS in *Carnation*, 71 T.C. 400 (1978), affd, 640 F.2d 1010 (9th Cir. 1981). See also Stearns-Roger Corp. v. United States, 83-2 U.S. Tax Cas. (CCH) ¶ 9731 (D. Colo. 1983), where the court applied the economic family argument to a U.S. captive insurance arrangement, citing *Carnation* as authority.

Unfortunately, a large gray area still exists between what clearly is insurance, as in Revenue Ruling 78-338, and what clearly is not insurance, as in Carnation. If the insurance risks are not adequately shifted or distributed outside the group of economically related corporations, the premium deductions will be denied as contributions to capital or as non-deductible payments to a self-insurance reserve.³⁸

Originally, the crucial factor appeared to be “risk distribution.”³⁹ Therefore, one company could own 100% of the CIC, provided the CIC was insuring a large number of unrelated parties outside the corporate group. However, the Act added a new provision to the Code which increases the importance of “risk shifting.”⁴⁰ When the primary insured is

³⁸ Definitions: Risk Shifting, which is analyzed from the insured’s point of view, requires that another risk-bearer (the CIC) replace the insured. See O'Brien & Tung, Captive Off-Shore Insurance Companies, 31 N.Y. INST. ON FED TAX’N 665, 679 (1973). Risk Distribution, on the other hand focuses on the insurer and requires risks to be “pooled” among an adequate number of insureds which are “separate and distinct.” Id. at 680.

³⁹ According to General Counsel Memoranda 38136, “if risks have been distributed, then it follows that they have been shifted.” Therefore, ownership by unrelated parties is not as important as insurance of unrelated parties.

⁴⁰ The 1984 Act section 137(a) amended I.R.C. section 954(e) by adding the last sentence which reads as follows:
a related person, the Act changes the situs of the insurance service to the country in which the insured risk is located, thereby triggering foreign base company services income. To avoid taxation as a "U.S. Shareholder" under the Subpart F provisions, no U.S. company, together with its affiliates, can own ten percent or more of the CIC. Therefore, at least eleven unrelated corporate shareholders, each having less than ten percent ownership, would be required to avoid this new provision. The association CIC in Revenue Ruling 78-338, for example, would provide the necessary diversity to avoid the Subpart F provisions. Therefore, the best advice for any U.S. companies considering an offshore captive insurance company would be to structure the arrangement within the confines established by Congress in the new Act and by the IRS in Revenue Ruling 78-338.

While insurance services are treated as being performed in the country where the insured risks are located for purposes of Subpart F taxation, it is not clear whether the same income sourcing rules will apply for purposes of the foreign tax credit. Prior to the Act, the insurance of U.S. risks created foreign sourced income, either taxable currently under the Subpart F rules or upon remittance as a dividend. Since the apparent purpose of the amendment to I.R.C. section 954 was to tax the income from the insurance of related parties which are non-U.S. risks, it does not appear that the sourcing of U.S. risks for foreign tax credit purposes was a concern. In fact, it does not appear that Congress even considered

For purposes of paragraph (2), any services performed with respect to any policy of insurance or reinsurance with respect to which the primary insured is a related person (within the meaning of Section 864(d)(4)) shall be treated as having been performed in the country within which the insured hazards, risks, losses, or liabilities occur, and except as provided in regulations prescribed by the Secretary, rules similar to the rules of Section 953(b) shall be applied in determining the income from such services.

This sentence was added because Congress was concerned that related party insurance allowed CICs to improperly shift income from the insurance of foreign affiliates to tax havens, deferring any meaningful U.S. or foreign tax on that income currently and, either through dividends or Subpart F inclusions, generating low taxed foreign source income available to absorb otherwise unusable foreign tax credits. The conference report specifically states that the committee did not intend the new provision to be construed as affecting any determination as to whether a payment made to a related insurer constitutes self-insurance. The new provision, however, does affect the ownership mix of the CIC if the Subpart F provisions are to be avoided. The ownership mix of the CIC (risk shifting) is one of the factors used in determining premium payment deductibility. See S. REP. NO. 169, 98th Cong., 2d Sess. 383 (1984).

41 See supra note 14 for a definition of the limits of Foreign Base Company Services Income.

42 I.R.C. § 951(a)-(b) 1984. Subpart F taxation of the income from the insurance of U.S. risks under I.R.C. section 953 could also be avoided.

43 See supra note 37.

44 See supra note 40. Since income from the insurance of U.S. risks was already taxable under section 953 (generally), the apparent purpose of the amendment discussed, supra note 40, must have been to extend U.S. taxing jurisdiction to the insurance of non-U.S. risks.
this problem. Therefore, at least until regulations are issued to the contrary, the position can be taken that the insurance of U.S. risks by a foreign subsidiary still creates foreign source dividend or Subpart F income to the U.S. shareholder.

III. INTERNATIONAL LEASING COMPANY

A. Typical Situation

One of the primary non-tax motivations behind an International Leasing Company is the avoidance of fixed asset ownership in countries that are politically unstable. Typically, Corporation A of Country A would lease property from a Captive Leasing Company (CLC), or another unrelated corporation, of Country B.

B. Consequences

As a result of disparate leasing rules in the lessor’s and lessee’s countries, both parties are typically treated as the owner of the leased equipment for tax purposes. Thus, both parties are entitled to capital allowances (depreciation) and, hence, the plan is termed “double dip leasing.” This benefit to the lessor can be passed to the lessee in the form of lower rentals. Double dip leasing is most easily achieved if lessees are in countries that make the economic ownership distinction and lessors are in countries that rarely, if ever, make such a distinction. Readily recognizable finance leases permit capital allowances for the lessee, while

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45 Id.
46 The language of the 1984 Act itself appears to limit the application of the new provision with the introductory phrase, “For purposes of paragraph (2).” Paragraph (2) is one of the tests for determining when foreign base company services income exists. See supra note 40.
47 "Economic Ownership" countries (which use various criteria to determine if title has passed):
   a. United States - generally.
   b. Japan.
   c. Germany.
   d. Netherlands.
   e. United Kingdom (if the lessee has a purchase option).
   f. Canada.
   g. Belgium.
48 Operating Lease Countries (i.e., lessor is treated as the owner regardless of economic consequences):
   b. Switzerland — always.
   c. United Kingdom (unless the lessee has a purchase option, i.e., "hire purchase contract").
   d. Sweden (unless the lessor has a "put" on the lessee to acquire the asset at the end of the lease term).
   e. United States (only if the "finance" lease provisions, effective January 1, 1988, are elected).
   f. Denmark (provided the lessee has no bargain purchase option).
the lessor is granted its domestic allowances as legal owner. An additional "triple" dip can sometimes be achieved through subleasing. With respect to leveraged leasing, generally both the lender and the lessor can be treated as the owner and use the double dip.

A location for a leasing company should also be evaluated in light of the availability of the following attributes:

1. Low or no taxes on lease income;
2. Wide tax treaty network to avoid "permanent establishment" status in the lessee's country and to mitigate or eliminate withholding taxes on the rental payments (or interest payments if treated as a financing lease) to the lessor and dividends from the lessor to the parent company;
3. No exchange control restrictions;
4. No capital taxes; and
5. Political stability.49

Since rental income earned by the CLC was taxable currently to the U.S. shareholders under the foreign personal holding company or Subpart F provisions, companies began to develop ways to circumvent the Subpart F rules. One scheme, particularly common with CLC's, was a "stock pairing" arrangement. Under this arrangement, shares of the CLC were distributed by the Parent to its shareholders as a dividend. By the terms of the distribution, the shares of the Parent and the CLC had to be traded as a unit. If enough shareholders existed and the stock was held widely enough, the Subpart F rules could be avoided. In addition, any dividend from the CLC could be paid directly to the shareholders (thus avoiding tax at the Parent corporation level).

Unfortunately, the Tax Reform Act of 1984 rendered this stock pairing scheme null and void. The anti-stock pairing legislation of the Act will treat the "paired" CLC of a U.S. Corporation as a domestic corporation, thereby subjecting it to U.S. taxes on its worldwide income.50 In addition, where the stock of a CLC is held by the U.S. Parent

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49 A non-tax impetus for international leasing would be to keep ownership of assets outside politically unstable countries.

50 1984 Act section 136(a) added I.R.C. section 269B to read, in part, as follows:
(a) General Rules. Except as otherwise provided by regulations, for purposes of this title—
   (1) If a domestic corporation and a foreign corporation are stapled entities, the foreign corporation shall be treated as a domestic corporation.
   (2) in applying section 1563, stock in a second corporation which constitutes a stapled interest with respect to stock of a first corporation shall be treated as owned by such first corporation, and
   (3) in applying subchapter M for purposes of determining whether any stapled entity is a regulated investment company or a real estate investment trust, all entities which are stapled entities with respect to each other shall be treated as one entity.

(c) Definitions. For purposes of this section—
instead of the U.S. Parent’s shareholders, the new sourcing rules of I.R.C. section 904(g) will cause any U.S. source rental payments received by the CLC to be treated as U.S. source income for foreign tax credit purposes to the extent they are taxed to the U.S. Parent under Subpart F of the Code. As a result, U.S. involvement in captive leasing arrangements has been severely curtailed when U.S. Parent companies are concerned. While an Offshore Leasing Company could be structured to avoid the Subpart F provisions of the Code by recruiting at least ten other unrelated U.S. companies with each company holding less than a ten percent interest in the CLC, such an arrangement becomes impractical when leased property is involved. In any event, the new sourcing rules of section 904(g), which are not dependent upon any degree of ownership, would still be unavoidable. As a result, any rental income earned by the CFC from U.S. sources would retain its U.S. source character when remitted to the U.S. shareholders as a dividend.

Even though U.S. involvement in captive leasing arrangements has been curtailed when U.S. companies are the lessees, leasing arrangements between two or more foreign subsidiaries should not be overlooked. While the Subpart F provisions of the Code would still be a threat if the lessor is a CFC, the income would maintain its foreign source character upon remittance to the U.S. shareholders since it was not originally derived from U.S. sources. Therefore, every multinational company should continue to explore double dip leasing opportunities between its foreign subsidiaries to enhance its overall worldwide tax strategy.

IV. REINVOCING/MULTICURRENCY MANAGEMENT CENTER

A. Typical Situation

Typically, a foreign subsidiary acts as the middleman in all intercompany/intercountry sales and purchases, so that each affiliate in the group is dealing only in its home country’s currency. For instance, if Affiliate A in Country A wants to sell products to Affiliate B in Country B, the Reinvoicing Center (Center) will buy products from A with Country A currency and resell the products to B with Country B currency. As a result, the Center has an account payable in Country A currency and an account receivable in Country B currency, and the local affiliates maintain receivables and payables in their own currency.

(2) Stapled Entities—The term “stapled entities” means any group of 2 or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of stapled interests.

51 See supra note 26.
52 Id.
OFFSHORE COORDINATION SUBSIDIARY FOR REINVOICING/MULTICURRENCY MANAGEMENT

(Illustration)

PARENT

Affiliate A (Country A)---Product X---Affiliate B (Country B)

Payable (A Currency)  COORDINATION CENTER  Payable (B Currency)
Prior to the Tax Reform Act of 1984, the Center would probably generate foreign base company sales income subject to taxation in the United States as Subpart F income. The income, however, would have been foreign sourced. Therefore, by setting the Center up in a low tax jurisdiction (e.g., Belgium or Switzerland), this foreign source income would generate additional foreign tax credits otherwise subject to an overall foreign tax credit limitation.

Without proper planning, the resourcing provision of section 904(g) of the Act alters the above consequences. To the extent any of the Center's foreign base company sales income has been derived from U.S. sources, it will be recharacterized as U.S. source income for foreign tax credit purposes. Therefore, it has become extremely important to ensure that title passes overseas for all U.S. property sold to the Center or by the Center. This will prevent the sales income from being recharacterized as U.S. source income and maintain the ability of the Center to absorb additional foreign tax credits which would otherwise be subject to an overall foreign tax credit limitation. To the extent that the Center earns foreign source interest income, and can qualify the income under one of the exceptions of section 904(d)(2), such as deriving the income directly from the active conduct of a trade or business, the separate foreign tax credit limitation of section 904(d) should not apply.

While there are ancillary tax benefits behind establishing such a Center, potential tax savings should not be the motivating factor. On the contrary, the prime objective should be to provide a centralized, and thus more efficient, technique to deal with foreign currency exposure management. The Center will coordinate the group's exchange response with the following objectives in mind:

1. To pool exchange risks in one location (through normal Center techniques or through currency and interest rate swaps);
2. To reduce foreign exchange risks by: a) matching incoming and outgoing payments in the same currency; b) leading and lagging of payments; and c) hedging operations (e.g. forward contracts, borrowing, depositing in domestic and/or European money markets);
3. To execute foreign exchange transactions at the lowest cost;
4. To channel funds to those companies which need them most, or where borrowing costs are the highest;
5. To decrease overall borrowing costs through use of Eurocurrency markets; and

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53 Id.
54 See supra note 25.
6. To house medium and long-term Eurocurrency or intercompany loans.

Even though exchange gains or losses resulting from collections or payment of receivables or payables do not fall strictly within the definition of foreign base company sales income (or any other form of Subpart F income for that matter), "all of the income derived . . . from the performance of an integrated business transaction shall . . . be classified in accordance with the predominant characteristic of the transaction [for purposes of section 954 and Treasury Regulations 1.954-1 to 1.954-5], even though a part of such income could incidentally be imputed to another class of income." For example, the above regulation provides that interest charged on an account receivable arising from the sale of goods shall be classified as sales income rather than interest income. Accordingly, the exchange gains or losses resulting from collection or payment of receivables or payables denominated in foreign currencies should be considered as part of an integrated sales transaction which resulted in the establishment of such receivables or payables. Any exchange gains or losses should, therefore, be allocated to Subpart F income or non-Subpart F income based upon whether the income or expense from the underlying transaction is included or excluded from Subpart F income.

However, gains or losses from foreign exchange contracts which are entered into for purposes of protecting a subsidiary's balance sheet are not an integral part of everyday operations. Unless the hedge is undertaken to achieve a balanced market position with respect to a commodity that produces ordinary operating income in the taxpayer's everyday business, the futures contract will be associated with the stock of the subsidiary (a capital asset) and will result in capital gains or losses. Accordingly, hedging activity for purposes of protecting the balance sheets of the Center and other corporations in the group from losses arising from the translation process should not result in Subpart F income or loss.

V. Conclusion

The antiavoidance provisions of the Tax Reform Act of 1984 have severely curtailed or completely eliminated many of the offshore tax planning benefits previously available. Although the impact of these provisions make some offshore arrangements less promising from a tax standpoint, several non-tax benefits continue to exist. Accordingly, in order to maximize the potential benefits of offshore tax planning, these

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56 Id.
arrangements must be carefully structured in light of the new anti-avoidance provisions of the Act.