A History of Controlled Foreign Corporations and the Foreign Tax Credit

by Melissa Redmiles and Jason Wenrich

As U.S. corporations have expanded their businesses overseas in the last several decades, the United States Tax Code has been modified to account for increasingly complex international corporate structures and transactions. Two important international tax concepts that have emerged over the years are the corporate foreign tax credit and controlled foreign corporations. The corporate foreign tax credit was created to alleviate the burden of double taxation. The income of controlled foreign corporations has become increasingly subject to U.S. tax after initially presenting a potential tax deferral advantage over foreign branches. A brief history of the foreign tax credit and controlled foreign corporations is presented below.[1]

Corporate Foreign Tax Credit

The United States generally taxes U.S. companies on their worldwide incomes. Since other countries may also impose a tax on income earned within their borders, U. S. companies with foreign-source income face potential double taxation. When the income tax was first created, Congress addressed this issue by allowing taxpayers to deduct their foreign taxes when computing taxable income. In 1918, after the cost of World War I pushed up both domestic and many foreign tax rates, Congress passed the foreign tax credit provisions to provide greater relief in cases of double taxation. These provisions permit taxpayers the option of either deducting their foreign taxes when computing their taxable incomes or taking a dollar for dollar credit for them against their U.S. tax liabilities. Corporations report the foreign income and taxes related to the credit on *Form 1118, Computation of Foreign Tax Credit—Corporations*.

Creditable Taxes

To be eligible for the credit, the tax paid had to be a foreign income tax. Although the precise definition of a foreign income tax has changed somewhat over the years, the basic idea remains today. Other taxes, such as value-added taxes, excise, property, and payroll taxes, can be deducted from foreign-source income but not credited. Income taxes paid to a local authority, such as a province, are eligible for the credit. Taxes paid for a specific right or service, like a royalty payment for the right to mine, generally cannot be credited. After the Technical Amendments Act of 1958, taxpayers could carry their unused foreign taxes forward for 5 years or back for 2. Figure A shows foreign tax credit amounts for select years between 1925 and 2004, in constant 2004 dollars.

Figure A

Corporate Foreign Tax Credit, in Constant 2004 Dollars, Selected Tax Years 1925-2002 [1]

[Money amounts are in millions of dollars]

Tax year	U.S. income tax before credits	Foreign tax credit	Percentage
	(1)	(2)	(3)
1925	12,629	216	1.7
1930	8,054	328	4.1
1940	28,929	783	2.7
1950	123,757	3,637	2.9
1960	139,544	7,811	5.6
1970	160,414	22,147	13.8
1980	238,030	57,037	24.0
1990	172,617	36,115	20.9
2000	292,106	53,210	18.2
2004	299,555	56,872	19.0

[1] For comparability, money amounts have been adjusted for inflation to 2004 constant dollars.

U.S. companies generally are not taxed on the earnings of their foreign subsidiaries until those earnings are distributed to the parent company, and thus cannot claim a direct credit for the foreign taxes paid by the subsidiary. The foreign tax credit provisions, however, allow taxpayers an indirect credit for the foreign "taxes deemed paid." Taxes deemed paid are computed as a share of the foreign taxes on the earnings out of which the distribution was made proportionate to the ratio of the distribution to the total earnings. To be eligible for the indirect credit, the U.S. company must own a certain percentage of the foreign subsidiary's voting stock. In 1962, the ownership percentage was lowered from the original 50 percent to 10 percent. Until 1976, taxpayers could claim the credit down to the second tier of ownership, as long as the second tier corporation was at least 50-percent owned by the first tier corporation.

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[1] For a more detailed description of international taxation, see Doernberg, Richard L. (1999), *International Taxation*, West Group, St. Paul, MN.

The Tax Reform Act of 1976 expanded the level of ownership to three tiers and changed the percentage requirements to 10 percent for all tiers, provided that the combined percentage ownership of all tiers is at least 5 percent. Congress gradually expanded the level of ownership down to six tiers, but the 5-percent rule remains in effect.

Limitations and Reductions

As originally enacted, the foreign tax credit had a major drawback. Since companies could credit an unlimited amount of tax paid to countries with tax rates that exceeded the U.S. rate, they could offset some of their tax on domestic income with the credit for taxes on foreign income. To remedy this, Congress added a limitation to the foreign tax credit in the Revenue Act of 1921. The limitation essentially caps foreign taxes credited to the U.S. rate, by limiting the amount of credit to a corporation's U.S. income tax liability multiplied by the ratio of foreign-source income to worldwide income. When first enacted, taxpayers computed the limitation using total foreign-source taxable income. A limitation computed using this method later become known as an overall limitation.

One problem with the limitation was that taxpayers could still offset some domestic tax liability by combining amounts of income earned in high-tax countries with income in low-tax countries, in their computation of the credit limitation. What, if anything, should be done about this issue has been the driving force behind much subsequent foreign tax credit legislation. Beginning in 1932, Congress required taxpayers to compute the limitation on a per country basis. In addition, the sum of all allowable credits from all countries could not exceed the overall limitation. The latter requirement was removed from the Internal Revenue Code in 1954. Public Law 86-780, enacted in 1960, granted taxpayers the ability to elect either an overall limitation or a per country limitation. In 1962, Congress introduced a separate limitation for nonbusiness-related interest. This prevented taxpayers from making interest-bearing investments abroad to generate additional, low-taxed foreign income that could be combined with higher tax income.[2]

Congress placed further restrictions on the foreign tax credit in the Tax Reduction Act of 1975 and the Tax Reform Act of 1976. These laws eliminated the per country limitation option and added a new limitation category, dividends from a Domestic International Sales Corporation (DISC).[3] Income that did not fit into the interest category or DISC dividend category fell into an overall or general limitation category. This legislation also introduced a reduction in credit for taxes paid on foreign oil and gas extraction income equivalent to the amount of foreign taxes paid, accrued, or deemed paid on foreign oil and gas extraction income that exceeded a certain percentage of foreign oil and gas extraction taxable income. The percentage has changed over time and is currently set at the highest rate of corporate tax, 35 percent for Tax Year 2006. In addition, the 1976 Act included boycott legislation. Now, taxpayers who agree to participate in an unsanctioned boycott may need to reduce their foreign credits or their foreign taxes eligible for credit.

Finally, these laws added an overall foreign loss recapture. The intent of the overall loss recapture was to limit the amount of domestic tax liability that could be offset by foreign losses. Before this legislation, if a taxpayer had an overall foreign loss in one year and an overall foreign gain in a subsequent year, the taxpayer could use all of his or her foreign-source taxable income in the year with the gain in computing the foreign tax credit limit. Since 1976, in the years when taxpayers have an overall foreign gain, they must treat the smaller of all overall losses from previous years or 50 percent of their current foreign-source income as domestic source income.

In 1985, the Treasury Department recommended reinstating the per country limitation. U.S. companies with substantial foreign-source income objected, and Congress compromised by greatly expanding the categories of income requiring a separate limitation in the Tax Reform Act of 1986.[4] Beginning with Tax

[2] Andersen, Richard E. (1996), *Foreign Tax Credits*, Warren, Gorham & Lamont, Boston, MA.

[3] *Dividends from a DISC or former DISC* refer to dividends from a Domestic International Sales Corporation (DISC) that are treated as foreign-source income. A DISC is a small domestic corporations whose activities are primarily exported-related. A portion of the DISC's income was not subject to tax until it was distributed to shareholders. Tax advantages of DISCs were repealed in 1984.

[4] Gustafson, Charles H.; Robert J. Peroni; and Richard Crawford Pugh (2001), *Taxation of International Transactions, Materials, Text and Problems*, West Group, St. Paul, MN.

Year 1987, the limitation categories included: general limitation income, passive income, high withholding tax interest, financial services income, shipping income, dividends from a DISC, taxable income attributable to foreign trade income, certain distributions from a Foreign Sales Corporation (FSC) or former FSC, section 901(j) income, and dividends from each noncontrolled foreign corporation.[5]

Passive income generally includes dividends, net capital gains, interest, rents, royalties (except for rents and royalties derived in an active trade or business from an unrelated person), annuities, and certain commodities transactions. Passive income subject to an effective foreign tax rate that is greater than the highest U.S. corporate rate must be "kicked out" to the general limitation category. High withholding tax interest is interest income subject to a withholding rate of 5 percent or more. (An exception exists for interest received in the conduct of financing certain export activities.) Financial services income pertains to a company whose gross income is composed of 80 percent or more of financial services income. It includes income derived from the active conduct of banking, insurance or financing, export financing interest excluded by the exception from the high withholding interest basket, and other income related to financial services income. Shipping income is income related to that industry. Taxpayers cannot claim a credit for taxes paid or accrued by a Foreign Sales Corporation (FSC) on its taxable income attributable to foreign trade, as defined by Internal Revenue Code section 923(b), and must compute a separate limitation on such income. Distributions from a FSC include distributions from the earnings and profits of the FSC's foreign trade income and interest and carrying charges from transactions that create foreign trade income. Section 901(j) countries are those considered hostile to the United States.[6] Taxpayers must calculate a separate limitation for each section 901(j) country and may not credit any taxes paid to them.

Dividends from a noncontrolled foreign corporation were defined as dividends from foreign subsidiaries of which the U.S. corporation owns at least 10 percent of the voting stock and the U.S. shareholders who own at least 10 percent of the voting stock together own 50 percent or more of either the voting stock or the value of the stock. A separate limitation had to be computed for each noncontrolled corporation. If the foreign corporation did not meet the definition of a 10/50 company, the dividends were placed into a limitation category based on the type of income that generated the dividends. These provisions are often referred to as the look-through rules. Congress has since phased out the separate limitation on each noncontrolled corporation basket. Now these dividends are categorized according to the look-through rules.

In 1988, a new category, income resourced by treaty, was added. It refers to income that would otherwise be considered domestic income that has been resourced to foreign source per tax treaty provision. Taxpayers must compute a separate limitation for each occurrence where income has been resourced.

Recent Changes

The most recent major revision of the foreign tax credit provisions was the American Jobs Creation Act of 2004. The law adjusts how taxpayers calculate the foreign tax credit for the purposes of the alternative minimum tax. It also modifies the rules that govern how companies allocate their interest expenses between foreign and domestic incomes so that multinational corporations will be able to allocate less interest to their foreign-source incomes, and thus increase their foreign tax credit limitations. The new law adds an overall domestic loss recapture that complements the rules on overall foreign loss. Now, if a taxpayer is unable to take a foreign tax credit during a year with foreign gains but an overall loss, the taxpayer will be able to resource some of the domestic income to foreign income in a subsequent year, which will increase the foreign tax credit limitation. Next, the carryback period for foreign taxes in excess of the limitation has been reduced to 1 year, while the carryforward period has been increased to 10 years. Finally, the separate limitation categories will be reduced to four: passive income, general limitation income, section 901(j) income, and income resourced by treaty. These provisions will be fully implemented by Tax Year 2009.

[5] A Foreign Sales Corporations (FSC) is a company incorporated abroad, created to promote U.S. exports and usually controlled by a U.S. person. A portion of the FSC "foreign trade income" was exempt from U.S. taxation. Congress repealed the FSC provisions in 1999 and the transition rules that permitted some FSC activity to continue in 2006.

[6] Current Section 901(j) countries include Cuba, Iran, North Korea, Sudan, and Syria.

Figure B

U.S. Corporations and Their Controlled Foreign Corporations, 1962-1980, Selected Years

(Money amounts are in thousands of dollars)

Tax year	Number of domestic corporation returns [1]	Controlled Foreign Corporations			
		Number of returns [2]	Net current earnings and profits after taxes [3]	Foreign income and profits taxes	Dividends paid to domestic corporations filing Form 2952
	(1)	(2)	(3)	(4)	(5)
1962	2,642	12,073	2,558,999	1,622,282	1,133,348
1965	3,513	17,668	3,564,260	2,168,369	1,457,561
1966	3,732	19,617	4,453,291	2,533,206	1,525,137
1980	4,799	35,471	31,181,131	16,440,451	14,172,649

[1] For 1962, both active and inactive domestic corporation returns with Form 2952, *Information Return with Respect to Controlled Foreign Corporations,* are included. For 1965, 1966, and 1980, only active domestic corporation returns are included.

[2] For 1962, domestic corporations were required to report for only two tiers of foreign ownership. For 1965, 1966, and 1980, the reporting requirement was for at least three tiers of foreign ownership.

[3] For 1962, this was reported as "Net profit before taxes" on Form 2952. For 1965, 1966, and 1980, "current earnings and profits after foreign income and profits taxes" were required to be reported on Form 2952.

Controlled Foreign Corporations

The history of controlled foreign corporations in United States tax law is characterized by reduction of the tax deferral advantages of United States corporations operating businesses overseas through foreign corporations. Four major pieces of legislation have defined and extended the concept of a controlled foreign corporation and the mechanism by which foreign corporation earnings are includable in the U.S. shareholder's taxable income.

In the aftermath of World War II, political and economic developments, such as the Marshall Plan, encouraged international expansion by U.S. businesses. Congress enacted Public Law 86-780 in 1960 in part to obtain information on the overseas activities of U.S. corporations. This law required each U.S. corporation to provide, as a part of its tax return, information on all foreign corporations directly-controlled by the U.S. corporation ("first-tier" subsidiaries) and any foreign corporations controlled by a directly-controlled foreign corporation ("second-tier" subsidiaries). A controlled foreign corporation (CFC) was defined as any foreign corporation in which more than 50 percent of the voting stock was directly owned by one or more U.S. corporations on any day of the taxable year of the foreign corporation. A controlled "second tier" subsidiary was defined as a foreign corporation in which more than 50 percent of the voting stock was owned by a directly-controlled foreign corporation. Information on first- and second-tier CFCs was reported on Form 2952, *Information Return by a Domestic Corporation with Respect to Controlled Foreign Corporations*. The penalty for failing to timely file a Form 2952 for each CFC was a 10-percent reduction of foreign tax credits attributable to all foreign corporations or their foreign subsidiaries.

Initially, foreign income earned by CFCs was not taxable to the U.S. shareholder until it was repatriated to the United States in the form of a dividend. This is in contrast to foreign operations conducted through a foreign branch whose income was taxable to the U.S. corporation when it was earned. U.S. corporations could maximize the tax deferral opportunity of foreign corporations by organizing their international structures and transactions with foreign subsidiaries in such a way as to accumulate profits in foreign corporations organized in low-tax countries and repatriate the earnings in years when the U.S. parent corporation had losses or excess foreign tax credits. Additionally, when U.S. corporations disposed of their stock in CFCs the tax-deferred accumulated earnings and profits of the foreign corporation could be repatriated to the United States at the lower capital gains tax rate.

The Revenue Act of 1962 reduced the tax deferral advantages of CFCs by refining the concept of a "controlled" foreign corporation and by adding Subpart F to the Internal Revenue Code. The 1962 Act redefined a foreign corporation as controlled if more than 50 percent of the voting stock of the foreign corporation was owned by U.S. shareholders for an uninterrupted period of 30 days or more during the foreign corporation's tax year. For purposes of determining control, the voting stock of only those U.S. shareholders owning at least 10 percent of the voting stock

Figure C

U.S. Corporations with Total Assets of $250 Million or More and Their Controlled Foreign Corporations, 1976-1984, Selected Years

(Money amounts are in thousands of dollars)

Tax year	Number of U.S. corporation returns	Controlled Foreign Corporations				
		Number of returns	Current earnings and profits (less deficit) before taxes	Foreign income taxes (net)	Total distributions	Total Subpart F income
	(1)	(2)	(3)	(4)	(5)	(6)
1976	757	21,071	23,478,736	8,814,825	6,569,018	822,674
1982	1,034	26,993	36,696,077	14,077,332	14,650,375	4,466,139
1984	1,103	27,008	48,591,785	19,663,431	17,429,494	4,420,024

of the foreign corporation was included. Attribution rules were introduced in the 1962 Act to account for various ownership structures that would otherwise avoid the requirements for declaring a foreign corporation a controlled foreign corporation. For example, if 6 individuals each wholly owned a separate U.S. corporation, and, in turn, the individuals and their respective corporations each owned an equal amount of voting stock of a foreign corporation, in the absence of attribution rules, the foreign corporation would not be a CFC. By attributing the voting stock of the foreign corporation owned by each U.S. corporation to its individual owner, the 10-percent voting stock ownership threshold would be met for each U.S. shareholder, and, collectively, all U.S. shareholders would own more than 50 percent of the voting stock of the foreign corporation. The foreign corporation in this example would be a "controlled" foreign corporation and would be required to file Form 2952.

The 1962 legislation also increased the Form 2952 filing requirement by extending the definition of a controlled foreign corporation to include any foreign corporation within a chain of control. A U.S. shareholder was "deemed" to control an unlimited number of lower-tier foreign corporations when it owned more than 50 percent of the voting stock of a first-tier corporation which owned more than 50 percent of the voting stock of a second-tier corporation, and so forth. Additionally, the Form 2952 filing requirement was extended to include not only U.S. corporations but U.S. citizens and residents, domestic partnerships, estates, and trusts, as well. The penalty for failing to timely file Form 2952 was amended to a reduction of the foreign tax credit in the amount of the greater of $10,000 or the income of the foreign corporation with respect to which the reporting failure occurred.

The most significant effect of the Revenue Act of 1962 for controlled foreign corporations was the introduction of Subpart F to the Internal Revenue Code. The Subpart F inclusion rules restricted U.S. shareholders' ability to defer taxes on certain types of income by requiring the income to be included in the U.S. shareholders' current-year taxable incomes regardless of their repatriation to the United States. The pro rata share of foreign income includable in the U.S. shareholder's income consisted of Subpart F income, previously excluded Subpart F income withdrawn from investments in less-developed countries, increases in investment of earnings of CFCs in United States property, and previously excluded Subpart F income withdrawn from export trade corporation assets (these categories are collectively referred to as "Subpart F income"). The majority of Subpart F income is made up of "passive" income like dividends, interest, royalties, and rents and income derived from insurance of United States risks. U.S. shareholders were not required to include their pro rata shares of Subpart F incomes in their taxable income if the Subpart F income accounted for 30 percent or less of the CFCs gross income or if distributions of the CFCs income were made so that the combined payment of foreign and U.S. taxes were 90 percent or more of the U.S. rate. Since Subpart F income is generally includable in the U.S. shareholder's taxable income when it is earned, no additional U.S. tax is imposed when it is repatriated to the United States. Finally, the 1962 Act restricted the conversion of tax-deferred earnings into capital gains for purposes of repatriating the income at the lower capital-gain tax rate.

The Tax Reduction Act of 1975 expanded what constituted Subpart F income and increased the likelihood that such income would be included in a U.S. shareholder's taxable income. Some types of

Figure D

U.S. Corporations with Total Assets of $500 Million or More and Their 7,500 Largest Controlled Foreign Corporations, 1986-2002, Selected Years

(Money amounts are in thousands of dollars)

Tax year	Number of U.S. corporation returns	Controlled Foreign Corporations [1]			
		Current earnings and profits (less deficit) before taxes	Foreign income taxes (net)	Distributions from earnings and profits	Subpart F income
	(1)	(2)	(3)	(4)	(5)
1986	714	56,590,619	19,229,025	21,730,762	4,223,316
1988	744	79,811,427	23,929,652	45,524,746	12,101,074
1990	731	88,688,406	23,936,971	46,429,916	17,841,936
1992	749	69,613,140	18,471,643	42,971,551	13,217,040
1994	801	98,427,640	23,267,744	50,383,707	16,317,803
1996	890	141,010,411	32,394,527	68,813,441	22,943,983
1998	996	143,840,451	34,744,726	74,188,419	20,238,440
2000	1,087	207,576,012	43,143,111	94,882,197	29,372,318
2002	1,079	200,670,364	38,610,284	97,011,345	31,420,940

[1] This figure presents data for the largest 7,500 Controlled Foreign Corporations (CFCs) ranked by assets owned by U.S. corporations with $500 million or more in total assets. The largest CFCs are selected independently for each tax year study.

shipping income received by CFCs were added to the definition of Subpart F income. The 1975 Act also lowered the Subpart F percentage of a CFCs gross income necessary for Subpart F income to be taxable to the U.S. shareholder from 30 percent to 10 percent. Minor amendments to the definition of Subpart F income have occurred since 1975.

Form 2952 was replaced in 1983 by Form 5471, *Information Return with Respect to Certain Foreign Corporations*.[7] Form 5471 significantly increased the amount of information required to be reported for each controlled foreign corporation, although not all filers were required to complete all schedules. Form 5471 included an expanded income statement schedule, a cost of goods sold schedule, a foreign taxes paid schedule, a balance sheet schedule, and earnings and profit analysis schedules.

The Tax Reform Act of 1986 again refined the controlled foreign corporation concept in part to address the issue of U.S. shareholders transferring 50 percent of the voting stock of a foreign corporation to "friendly" foreign shareholders and avoiding the "controlled foreign corporation" designation while still maintaining 50-percent voting stock of the corporation and most of the value. The 1986 legislation expanded the definition of a CFC to include foreign corporations for which 50 percent or more of the voting power of all classes of stock entitled to vote or the total value of all shares of stock is owned by one or more U.S. persons (including U.S. corporations, partnerships, trusts, and estates). Only the voting stock of those U.S. persons directly, indirectly, or constructively owning at least 10 percent of either the voting stock or value of the voting stock of the foreign corporation is considered for purposes of determining if the 50-percent threshold is met.

The American Job Creation Act of 2004 is the most recent piece of legislation affecting controlled foreign corporations. This act, in an effort to encourage U.S. corporations to repatriate their accumulated foreign earnings and reinvest them in U.S. projects, allowed for a one-time 85-percent dividends received deduction for cash dividends received from controlled foreign corporations. To receive this deduction, the U.S. corporation must have had a qualified reinvestment plan and receive the cash dividends in the U.S. corporation's last tax year beginning before October 22, 2004, or the first tax year beginning in the 1-year period after that date.

Statistics of Income (SOI) has collected data on Forms 2952 and 5471 every other tax year since 1962. In Tax Year 1962, there were 12,073 Forms 2952 filed by 2,642 United States corporations.[8] In Tax Year 2002, there were 75,579 Forms 5471 filed by 2,119 U.S. parent corporations with $500 million or more in assets.[9] Figures B, C, and D include

[7] In addition to Form 2952, Form 5471 replaced Form 957, *U.S. Information Return by an Officer, Director, or U.S. Shareholder of a Foreign Personal Holding Company*, Form 958, *U.S. Annual Information Return by an Officer or Director of a Foreign Personal Holding Company*, Form 959, *Return by an Officer, Director, or Shareholder With Respect to the Organization or Reorganization of a Foreign Corporation and Acquisition of Its Stock*, and Form 3646, *Income from Controlled Foreign Corporation*.

[8] *Foreign Income and Taxes, Corporation Income Tax Returns* (Publication 479), Statistics of Income, April 1973.

[9] Based on unpublished data.

additional information from SOI studies covering this period.

Data Sources and Limitations

Two of the largest studies of international income and taxes conducted by Statistics of Income are the Corporate Foreign Tax Credit and Controlled Foreign Corporation studies. The foreign tax credit studies are derived from returns in the corporation Statistics of Income sample. The foreign tax credit is understated to the extent that it does not include foreign taxes carried back.

The Controlled Foreign Corporation study, usually conducted every other tax year, has changed since the first study conducted for Tax Year 1962. Initially, population estimates were tabulated using data collected from all Forms 2952 filed by U.S. parent corporations in the Statistics of Income corporate sample. For Tax Years 1974, 1976, 1982, and 1984, data were collected from Forms 2952 filed by U.S. parent corporations with greater than $250 million in total assets. Population estimates were again tabulated for Tax Year 1980. For Tax Years 1986 through 2002, data were collected for all Forms 5471 filed by U.S. parent corporations with greater than $500 million in total assets. During these years, data were published for the largest 7,500 controlled foreign corporations ranked by assets.

Data for both studies do not include adjustments made during audit. Data for recent study years can be found on the Statistics of Income Web site (www.irs.gov/taxstats).