

# Controlled Foreign Corporations, 1994

by Ruth Schwartz

In 1994, the 7,500 largest active foreign corporations (CFC's) controlled by large U.S. multinational corporations held \$2.0 trillion in assets, a 26-percent increase from 1992, the last year for which statistics are available. These 7,500 largest CFC's generated \$1.3 trillion in receipts and \$98 billion in "earnings and profits" before taxes, an increase of 10 percent and 41 percent, respectively, from 1992.

For purposes of this study, a foreign corporation was controlled if a U.S. corporation owned at least 50 percent of the CFC stock (see Explanation of Selected Terms). Statistics for the study were obtained from Forms 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, filed by U.S. corporations with total assets of \$500 million or more (see Data Sources and Limitations). The statistics presented here are for the largest 7,500 CFC's ranked by asset size. For 1994, there were 801 U.S. corporations (with assets of \$500 million or more) that controlled these 7,500 largest CFC's. Because the 7,500 largest CFC's for 1994 were ranked independently from the largest 7,500 for 1992, statistics in this article comparing 1994 with 1992 may not be altogether valid (see also the Data Sources and Limitations sections in this regard) [1]. The reader should keep this in mind in evaluating the comparisons cited in the text descriptions that follow.

## CFC's by Industrial Division

Nearly 38 percent of the largest 7,500 CFC's were primarily engaged in manufacturing--more than any other industrial division (Figure A). While the percentage share of the largest 7,500 CFC's classified in manufacturing remained relatively stable, "earnings and profits" before taxes (see the Explanation of Selected Terms) grew by 54 percent, from \$32 billion for 1992 to \$50 billion for 1994 (Table 1). Receipts generated by manufacturers grew by 9 percent to \$750 billion, while assets increased by 7 percent to \$570 billion.

CFC's classified as motor vehicles and equipment manufacturers were the predominant group of manufacturers, accounting for over 21 percent of manufacturing receipts. For 1994, receipts grew by 10 percent to \$161 billion, while "current" earnings and profits before taxes rose nearly 60 percent to \$6 billion. Significant growth

was also reported for electrical and electronic equipment manufacturers, whose current earnings and profits before taxes more than doubled to \$7 billion. Receipts for electrical and electronic equipment manufacturers grew by over 32 percent to \$92 billion.

Over 30 percent of the 7,500 largest CFC's were classified in finance, insurance, and real estate. These CFC's held more than 53 percent of the total assets of the largest CFC's. Even though this percentage share remained stable for 1994, business earnings increased substantially. Current earnings and profits before taxes increased 29 percent, from \$19 billion to \$24 billion, while total assets grew from \$750 billion to \$1.1 trillion, a 42-percent increase. This growth in assets was primarily attributable to holding and other investment companies, as well as banking. Assets reported by holding and other investment companies grew from \$182 billion to \$322 billion, an increase of 77 percent. At the same time, bank assets grew from \$128 billion to \$210 billion, a 64-percent increase.

The largest 7,500 CFC's in the remaining industrial divisions were fairly consistent for 1994 compared to 1992. Over 15 percent were wholesalers or retailers, accounting for 26 percent, or \$345 billion, of receipts and 12 percent, or \$12 billion, of current earnings and profits before taxes. These amounts increased by 10 percent and 41 percent, respectively, from 1992. Over 9 percent of the largest CFC's were primarily engaged in services. However, the services division generated only 4 percent, or \$50 billion, of the group's total receipts and 3 percent, or \$3 billion, of pre-tax current earnings and profits. Both receipts and pre-tax current earnings for CFC's classified in construction and mining remained relatively constant. Accounting for only 1 percent of the largest 7,500 CFC's, earnings of construction companies showed the smallest increase of any industrial division. Construction pre-tax earnings grew by 13 percent, from \$579 million for 1992 to \$656 million for 1994.

## CFC's by Country of Incorporation

Collectively, the largest 7,500 CFC's were incorporated in 111 countries, with over 55 percent incorporated in Europe. (The country of incorporation is not necessarily the principal place where business was conducted; see "Country of incorporation" in the Explanation of Selected Terms.) This percentage remained nearly stable compared to 1992. Here, current earnings and profits before taxes grew by 33 percent to \$52 billion, while assets increased by 24 percent to \$1,232 billion, and receipts grew only

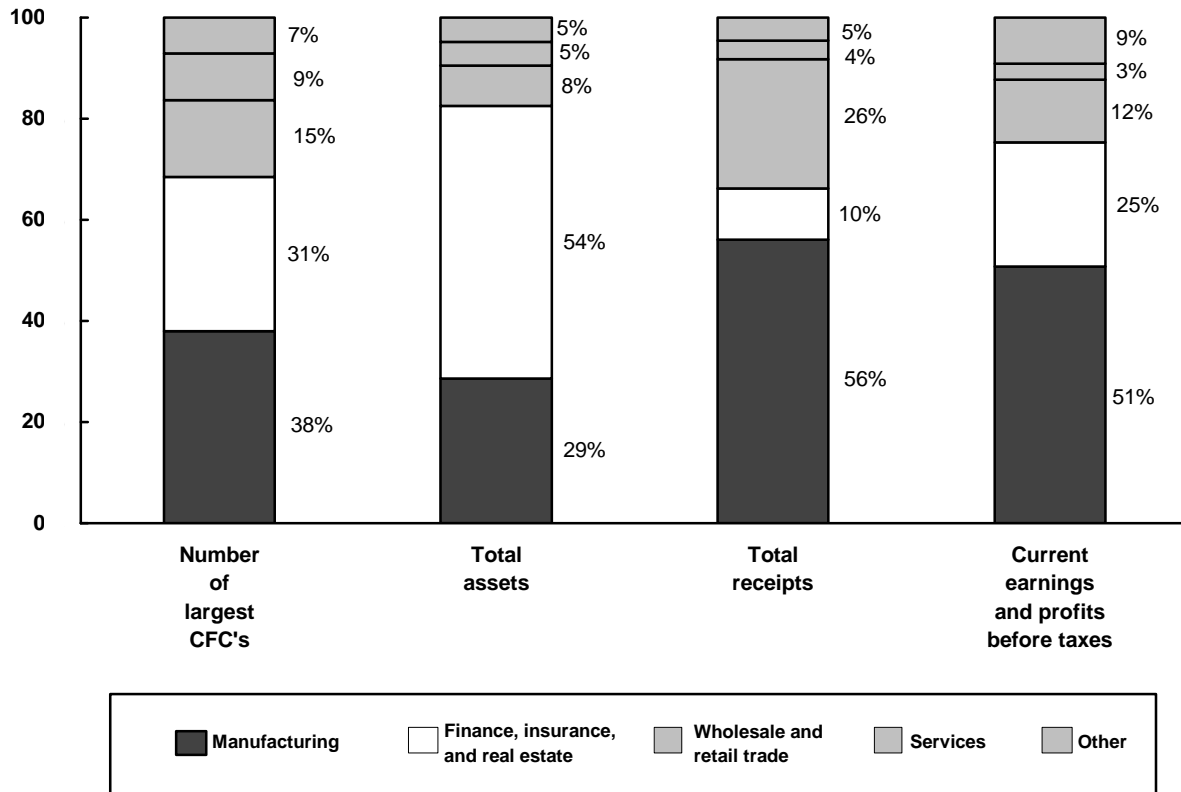
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# Controlled Foreign Corporations, 1994

Figure A

## Selected Data for the 7,500 Largest CFC's, by Industrial Division, 1994

Percentage of total



NOTES: Data are for the 7,500 largest Controlled Foreign Corporations of U.S. corporations with total assets of \$500 million or more. Data may not add to totals because of rounding.

marginally, by 6 percent, to \$777 billion. With 53 percent of current pre-tax earnings, 62 percent of assets, and 58 percent of receipts, Europe remained the primary region for investment by the 801 parent corporations (Table 2).

In 1994, nearly 16 percent of the largest 7,500 CFC's were incorporated in the United Kingdom, more than in any other country. Large CFC's incorporated in the United Kingdom generated more receipts (\$246 billion) and pre-tax earnings (\$14 billion) than any other country. These CFC's accounted for nearly 30 percent of assets, 18 percent of all receipts, and 14 percent of earnings and profits before taxes. Assets of CFC's classified in finance, insurance, and real estate, the dominant industrial division for United Kingdom CFC's, grew from \$300 billion to \$462 billion, a 54-percent increase in only 2 years (Table 3).

Canada and Germany ranked as the second and third

largest countries of incorporation with 9 percent and 8 percent of the total number of CFC's, respectively. Canada and Germany each accounted for 12 percent of receipts and 9 percent of pre-tax earnings of the largest 7,500 CFC's. Manufacturing, the leading industrial division for both countries, accounted for 65 percent of receipts of the largest Canadian CFC's and 63 percent of pre-tax earnings. For Germany, manufacturing accounted for 69 percent of receipts and 58 percent of pre-tax earnings.

The number of large CFC's in Eastern Europe almost doubled, from 33 to 64. Their receipts more than doubled to \$5 billion, while their assets grew by 79 percent to \$6 billion. This increase in large CFC's was mainly attributable to the former Soviet Union, Poland, and Hungary [2].

Although only 12 percent of the largest CFC's were incorporated in Asian countries, there was a significant

## Controlled Foreign Corporations, 1994

rise in their earnings. Earnings and profits before taxes for 1994 grew from \$10 billion to \$16 billion, a 66-percent increase, while assets grew from \$141 billion to \$255 billion, an 81-percent increase. Throughout Asia, these increases were primarily attributable to the growth in the finance, insurance, and real estate industrial division, where assets more than tripled in just 2 years, from \$39 billion to \$119 billion [3]. These increases were reported mainly for Hong Kong, where U.S. investments rose dramatically, as indicated by a large increase in assets: total assets grew from \$30 billion to \$99 billion. Total assets reported for the finance, insurance, and real estate division accounted for the largest share of this increase, growing over four times, from \$21 billion to \$87 billion. CFC's classified as security brokers or dealers were primarily accountable for this large increase [4].

### Data Sources and Limitations

The statistics in this article are based on data collected from corporation income tax returns with accounting periods ending July 1994 through June 1995 and attached Form(s) 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*. Because Internal Revenue Service regulations require a U.S. corporation to submit a Form 5471 for any CFC with an accounting period ending with or within the U.S. parent's accounting period, CFC accounting periods reflected in the statistics for 1994 may have ended as early as July 1993 or as late as June 1995. However, most CFC activity did occur in Calendar Year 1994.

These statistics report data for the largest (in terms of total assets) "active" 7,500 foreign corporations controlled by U.S. corporations with total assets of \$500 million or more. (See the definition of Active versus Inactive Controlled Foreign Corporation in the .) The 7,500 largest CFC's accounted for 94 percent of total assets, 92 percent of current earnings and profits before taxes, and 88 percent of total receipts reported by all active CFC's of these U.S. corporations with assets of \$500 million or more [5]. Total assets for the individual 7,500 CFC's ranged from approximately \$28 million to \$70 billion [6].

Since the 801 parent corporations with assets of \$500 million or more were selected at a 100-percent rate for the Statistics of Income sample of all corporation income tax returns, the data are not subject to sampling variability, although they may be subject to nonsampling error. It is difficult to determine the exact population of CFC's controlled by U.S. corporations having \$500 million or more in assets. For example, a related party to the U.S.

corporation, such as a partnership controlled by the corporation, can include Forms 5471 with the partnership return and satisfy the filing requirement. To the extent possible, these Forms 5471 were included in the study. However, because the study focuses on those Forms 5471 attached to U.S. corporation income tax returns, omissions like this could result.

Several limitations apply when making comparisons to prior-year statistics for the 7,500 largest CFC's. First, changes in the composition of the 7,500 may have occurred. For example, only 75 percent of the 7,500 largest CFC's for 1994 were also included in the 7,500 largest CFC's for 1992. Many of the 7,500 largest CFC's for 1992 not included among the 7,500 for 1994 were still controlled by large U.S. corporations, but the size of their total assets for 1994 excluded them from this group. Also, some of the 7,500 for 1992 were not included for 1994 because they were no longer "controlled" by the same corporations, or because the size of the U.S. parent's total assets had dropped to less than \$500 million.

Second, the industrial mix of the 7,500 largest CFC's is not representative of the industrial mix of all CFC's controlled by U.S. corporations reporting \$500 million or more in assets. Since the largest 7,500 CFC's are defined by CFC asset size, it is reasonable to conclude that most of these CFC's are involved in business activities that historically require larger amounts of assets. Large CFC's are engaged primarily in manufacturing, or in finance, insurance, and real estate activities. While CFC's classified in manufacturing and in finance, insurance, and real estate accounted for 68 percent of the 7,500 largest CFC's for 1994, only 50 percent of the 31,383 total for active CFC's of U.S. corporations with \$500 million or more in total assets were classified in these industrial divisions [7]. By contrast, the service and the wholesale and retail trade divisions tend to be underrepresented among the largest CFC's. The services and the wholesale and retail trade divisions accounted for 18 percent and 21 percent, respectively, of all active CFC's controlled by parents with \$500 million or more in total assets, but only 9 percent and 15 percent, respectively, of the largest CFC's.

Finally, statistics previously published by *Statistics of Income* for tax years before 1986 were for all CFC's controlled by U.S. parent corporations, not just the largest CFC's. Therefore, the statistics for these years include smaller and inactive CFC's. Comparisons between statistics on the largest CFC's and statistics for years before 1986 should, therefore, be made with caution.

In addition, caution should be used when comparing data by industrial group. CFC's were classified by indus-

## Controlled Foreign Corporations, 1994

try based on their principal business activity as reported on Form 5471. However, assets, receipts, and profits may have also been related to secondary business activities. It is not possible to measure the extent of these secondary business activities, because these activities were not detailed on Form 5471.

### **Explanation of Selected Terms**

*Active versus Inactive Controlled Foreign Corporation.*--In general, a CFC was considered "active" if "earnings and profits", income taxes, receipts, expenses, or certain transactions between the CFC and its majority shareholder were reported on Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*. The filing of Form 5471 was required even if a CFC was dormant or inactive for 1994.

*Controlled Foreign Corporation.*--A foreign corporation was "controlled" if more than 50 percent of the value of its outstanding voting stock, or the value of all its outstanding stock, was owned (directly, indirectly, or constructively) by U.S. shareholders on any day during the foreign corporation's tax year. A U.S. shareholder for these purposes was defined as a "U.S. person" owning 10 percent or more of the foreign corporation's voting stock. A U.S. person could be a U.S. citizen or resident, a domestic partnership, a domestic corporation, or an estate or trust (other than a foreign estate or trust whose income from sources outside the United States was not includable in the beneficiaries' gross income). For purposes of these statistics, a foreign corporation was "controlled" only if a single U.S. corporation satisfied the ownership requirements. A CFC could be owned indirectly through a partnership if the U.S. corporation was a controlling partner. To the extent possible, these CFC's were also included in the statistics.

*Country of incorporation.*--The country of incorporation of a CFC was not necessarily the principal place of business. For 1994, there were 211 (less than 3 percent) of the 7,500 largest CFC's whose principal places of business were in countries other than their respective countries of incorporation. Tables 2 and 3 provide data by country of incorporation; data by principal place of business are not included in these statistics.

*Current earnings and profits.*--Current "earnings and profits" represents the difference between the total earnings and profits of the foreign corporation at the end of the current year (before reduction by any dividends paid during the year) and the accumulated earnings and profits of the corporation at the beginning of the year. Although current earnings and profits is an after-tax measure of

profits, it is shown in this article both before and after taxes. Earnings and profits is a tax concept, but it is not otherwise specifically defined in the Internal Revenue Code. In those instances where current earnings and profits were not reported for the foreign corporation, net income per books was used in place of the missing earnings and profits data.

*Distributions from earnings and profits.*--A distribution comes first from current earnings and profits and then from accumulated earnings and profits.

*Income taxes.*--These were income, war profits, and excess profits taxes paid or accrued to the United States and to any foreign country or U.S. possession, following U.S. generally-accepted accounting principles.

*OPEC countries.*--The members of the Organization of Petroleum Exporting Countries (OPEC) for 1994 were: Algeria, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.

*Return on assets.*--For purposes of this analysis, a CFC's return on assets is the ratio of current earnings and profits (less deficit) after taxes to total "average assets" for corporations with positive earnings and profits. (For an explanation of "average assets," see the definition of "total assets.")

*Subpart F income.*--The Internal Revenue Code stipulates specific cases in which earnings and profits are "deemed to have been paid" by a CFC to the U.S. shareholder. These "deemed" distributions are taxable, even though the income may not have been repatriated to the United States in the form of an actual dividend. Subpart F income tends to be income that is easily movable from a high-tax region to a low-tax region [8].

*Tax haven.*--Tax havens, as recognized by the U.S. Department of the Treasury, are jurisdictions that allow transactions to take place in conditions of secrecy that may allow taxpayers to avoid taxation. They are generally characterized by income tax rates that are lower than U.S. rates. For purposes of these statistics, tax havens for 1994 include the following countries: Anguilla, Antigua and Barbuda, Aruba, Austria, Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Caymen Islands, Costa Rica, Dominica, Gibraltar, Grenada, Hong Kong, Liberia, Liechtenstein, Luxembourg, Monaco, Montserrat, Netherland Antilles, Panama, Singapore, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines, Switzerland, and the Turks and Caicos Islands.

*Total assets.*--Three types of total assets are shown in the statistics: beginning-of-year, end-of-year, and the average of the two. For time series comparisons, end-of-year total assets are used. For ratio calculations, total

## Controlled Foreign Corporations, 1994

average assets are used. Total average assets are calculated by using the sum of beginning and ending assets divided by two. However, not all of the 7,500 largest CFC's reported both beginning and end-of-year assets: 252 CFC's reported beginning-of-year assets only (probably because they were liquidated or had merged with another CFC during the year), and 65 CFC's reported end-of-year assets only (possibly because these CFC's were newly-incorporated). For these cases, average assets equals the single reported amount.

*Total receipts.*--Total receipts equals business receipts (gross receipts from sales and operations), plus income from investments. In tabulations of data prior to 1990, business receipts was used to describe the larger of gross receipts from sales and operations and "total income." The latter is a tax return concept used to describe the sum of business receipts less cost of sales and operations (i.e., "gross profit"), plus income (less loss) from investments.

### Notes and References

- [1] Statistics of Income studies of Controlled Foreign Corporations have historically been conducted for even-number tax years. Therefore, in this article, all comparisons are made to 1992 data. See, also, Green, Kathryn A., "Controlled Foreign Corporations, 1992," *Statistics of Income Bulletin*, Winter 1995-1996, Volume 15, Number 3).
- [2] Based on unpublished data.
- [3] Based on unpublished data.
- [4] Based on unpublished data.
- [5] Based on unpublished data.
- [6] Based on unpublished data.
- [7] Based on unpublished data.
- [8] Doernberg, Richard L., *International Taxation*, West Publishing Company, 1993.

Source: IRS, *Statistics of Income Bulletin*, Publication 1136, Summer 1998.