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THE TAXATION OF FOREIGN INCORPORATED POCKETBOOKS WITH NONRESIDENT ALIEN SHAREHOLDERS

WILLIAM D. POPKIN*

I. INTRODUCTION

Since the Civil War Income Tax Act of 1864, individuals have sought to avoid high graduated income tax rates by organizing corporations to receive their income.1 Lower corporate income tax rates were a major incentive,2 but there have been other advantages as well. Income received at the corporate level could be realized at lower capital gains rates when the taxpayer sold his stock in the corporation.3 The taxpayer could also distribute income from the corporation to himself in a year when his income was so low that the tax effect would be minimal. And an income tax could be avoided altogether by retaining the corporation's stock until death.4 In 1934, Congress sought to counteract these advantages by imposing a heavy surtax on these "incorporated pocketbooks," otherwise known as personal holding companies.5

It was not the purpose of this tax to prevent all income from being realized at the corporate level. Genuine business income was considered appropriate for corporate receipt and could legitimately escape the graduated income tax rates imposed on individuals. However, if eighty per cent of a corporation's gross income was derived from royalties, dividends, interest, or rent and gains from the sale of stock and

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1. For a history of the avoidance of graduated income tax rates on individuals by means of incorporation, see H.R. REP. No. 1860, 75th Cong., 3d Sess. 2-3 (1938).
2. Rates on individuals have always risen much higher than corporate income tax rates. Revenue Act of 1913, ch. 16, §§ IIA (6% on individuals), IIG (a) (1% on corporations), 38 Stat. 166; Revenue Act of 1934, ch. 277, §§ 12(b) (59% on individuals), 13(a) (1331/2% on corporations), 48 Stat. 686; INT. REV. CODE OF 1954, §§ 1(a)(2) (70% on individuals), 11(c)(3) (48% on corporations).
3. The benefit of a lower capital gains tax has been available since 1921. Revenue Act of 1921, ch. 136, § 206, 42 Stat. 232 (now INT. REV. CODE OF 1954, §§ 1201-02).
4. The basis of the stock in the hands of the taxpayer's legatees is equal to its value on the taxpayer's death. Thus, no income tax would be paid on the value accruing prior to the taxpayer's death. This has been true since at least 1918. See 3a MERTENS, LAW OF FEDERAL INCOME TAXATION § 21.65 (Zimet & Weiss Rev. 1958). The present provision is INT. REV. CODE OF 1954, § 1014(a).
securities by one other than a dealer, the corporation was subject to the personal holding company status. Income from personal services of major shareholders was added to the list of personal holding company qualifying income in 1937. Once the corporation had the specified percentage of personal holding company income, its entire taxable income with certain adjustments became subject to the heavy surtax, if one further requirement were met. Five or fewer individuals had to control the corporation before the tax would apply. This latter requirement was designed to prevent penalization of a widely owned investment company, which Congress thought was appropriately carried on in corporate form.

In order to determine if five or fewer individuals controlled the corporation, certain stock attribution rules were applied. Thus, stock ownership could be attributed between members of a family or from a corporation, which is not an "individual" but a "person," to its shareholders. These rules prevented the dispersion of stock ownership among the family or the transfer of stock to a corporation for the purpose of avoiding actual ownership of the stock by five or fewer individuals without dispensing with effective control by them.

The rules concerning type of income and extent of stock ownership of a corporation insure that the personal holding company tax will fall only on an "incorporated pocketbook." Only income which, in the absence of a tax avoidance purpose, would have been received by a few individuals is reached by the penalty tax. Once these mechanical rules are satisfied, it is not open to the taxpayer to prove that the corporate

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6. Revenue Act of 1934, ch. 277, § 351(b)(1)(A), 48 Stat. 751. Under present law rents and royalties may not be personal holding company income if received under circumstances which indicate that it is business income. INT. REV. CODE OF 1954, §§ 543(a)(2)-(5). Since 1964, only 60% personal holding company income is necessary for personal holding company status to result, and the 60%, is of gross income computed without regard to capital gains income. INT. REV. CODE OF 1954, §§ 542(a)(1), 543(b)(1)(A), as amended, Pub. L. No. 88-272, §§ 225(b), (d), 78 Stat. 79 (1964).
7. Revenue Act of 1936, § 353(e), added by ch. 815, § 1, 50 Stat. 814 (1937) (now INT. REV. CODE OF 1954, § 543(a)(7)). If the person to perform the services directly or indirectly owns 25% of the corporation's stock and such individual is named in the personal service contract, or someone other than the corporation can designate the person to perform the services, the income for furnishing such services is personal holding company income.
8. Revenue Act of 1934, ch. 277, § 351(b)(3), 48 Stat. 752 (now INT. REV. CODE OF 1954, § 545). Thus, personal holding company income may be 80% of the corporation's income but income tax deductions could be such that there is no taxable income subject to the personal holding company tax.
9. The term "individuals" is used in this article to mean a natural person.
11. The term "person" includes not only natural persons, but also corporations, trusts, estates, and partnerships. See INT. REV. CODE OF 1954, § 7701(a)(30).
12. Revenue Act of 1934, ch. 277, §§ 351(b)(1)(C), (D), 48 Stat. 751 (now INT. REV. CODE OF 1954, §§ 544(a)(1), (2)). These paragraphs also provide that partners are deemed to own the stock owned by their partners and the partnership, and beneficiaries are deemed to own the stock owned by an estate or trust.
corporation is not being used to avoid the graduated income tax rates on individuals in the year in question.\textsuperscript{13}

The subject of this article is the foreign incorporated pocketbook and the problems which arise in its taxation. Particular emphasis will be placed on the problems which arise when some or all of its shareholders are nonresident aliens.\textsuperscript{14} The term foreign incorporated pocketbook is not used in any technical sense, but only signifies that the corporation is incorporated abroad.

The concern of United States tax authorities with foreign incorporated pocketbooks is based upon the desire to protect two different interests. Nonresident aliens are taxed only on their United States source income,\textsuperscript{15} while United States individuals are taxed on foreign source income as well.\textsuperscript{16} Without an appropriate tax statute, a foreign corporation with only nonresident alien shareholders could shield its shareholders from the high United States taxes which would have been imposed on United States source income had it been received directly by the shareholders. Similarly, a foreign incorporated pocketbook with only United States shareholders may shield the owners of the corporation from United States taxes on both foreign and United States source income.

Statutory rules which deal with these cases of tax avoidance have not always been rational in their application. Particular difficulty is encountered when the shareholders of a foreign incorporated pocketbook consist of both United States individuals and nonresident aliens and the income earned by the corporation consists of both United States and foreign source income. Instances of such complications have no doubt increased with the tremendous growth of international trade and commerce since World War II.

There are two basic statutory rules which prevent the use of foreign incorporated pocketbooks to avoid United States taxes. First, there is the personal holding company tax itself, which is imposed upon foreign as well as domestic corporations.\textsuperscript{17} All of the rules under that law outlined above are applicable to both. Secondly, there is the Foreign Personal Holding Company\textsuperscript{18} law, which was passed in 1937 to prevent United States individuals from incorporating abroad in order

\textsuperscript{13} Treas. Reg. 86, art. 351-1 (1934); H.R. Rep. No. 704, 73d Cong., 2d Sess. 12 (1934).
\textsuperscript{14} The term "nonresident aliens" is defined in Treas. Reg. § 1.871-2 (1957).
\textsuperscript{15} Int. Rev. Code of 1954, § 872(a). See note 76 infra concerning a proposed modification of this rule.
\textsuperscript{16} Int. Rev. Code of 1954, § 61(a).
\textsuperscript{17} Treas. Reg. 94, arts. 351-1, 351-2 (1936). Similarly, the accumulated earnings tax, which is also a tax upon undistributed profits, is imposed on both foreign and domestic corporations. Treas. Reg. 74, art. 541 (1928); S. Rep. No. 2156, 74th Cong., 2d Sess. 17 (1936).
\textsuperscript{18} Foreign Personal Holding Company, as here capitalized, signifies a corporation complying with the Foreign Personal Holding Company law.
to avoid the detection of a personal holding company and to make the collection of a personal holding company tax more difficult. This law taxes each United States person who is a shareholder of a qualifying corporation on his percentage of the undistributed profits of the foreign incorporated pocketbook. However, the law only applies if the foreign incorporated pocketbook is controlled by five or fewer United States citizens or residents, as determined under the same attribution rules which apply in the case of personal holding companies. Under the Foreign Personal Holding Company law, undistributed profits are imputed to the actual United States shareholders of the foreign corporation who may or may not be the five or fewer United States individuals deemed to be the "controlling group" under the attribution rules. For instance, if a domestic corporation owns stock in a foreign corporation, the individual shareholders of that domestic corporation are looked upon as owning the foreign corporation's stock for purposes of determining if the foreign corporation is controlled by five or fewer United States individuals. However, the tax will fall directly on the domestic corporation which owns the stock of the foreign corporation. If the Foreign Personal Holding Company law applies, the personal holding company tax is not imposed.

The treatment of Foreign Personal Holding Companies is relevant to the problems connected with the ownership by nonresident aliens of stock in foreign incorporated pocketbooks, because of the possible implications it has for the taxation of these aliens who may be minority shareholders in such Companies. Nonresident alien shareholders may also be blood relatives of United States individuals, thereby raising the question whether to attribute their ownership of stock to the United States relative. Attribution in such cases may result in five or fewer United States individuals being deemed to own more than fifty per cent of the stock of the foreign incorporated pocketbook. The problem of attribution, therefore, raises two basic questions: (1) whether a corporation is a Foreign Personal Holding Company, and (2) what consequences will follow if that status is avoided.

The first part of this article discusses the taxation of the personal holding company incorporated abroad owned solely by nonresident aliens. New legislation offered to deal with this situation is discussed after a review and appraisal of the treatment of the problem to date.

20. Revenue Act of 1936, § 337(a), added by ch. 815, § 201, 50 Stat. 822 (1937) (now INT. REV. CODE OF 1954, § 551(a)).
22. Revenue Act of 1936, § 352(b), added by ch. 815, § 1, 50 Stat. 814 (1937) (now INT. REV. CODE OF 1954, § 542(c)(5)).
Secondly, we deal with the problem of minority ownership by nonresident aliens in Foreign Personal Holding Companies and by United States individuals in a personal holding company incorporated abroad. Lastly, we consider the case of a foreign incorporated pocketbook with a nonresident alien shareholder who has a United States relative and whose percentage of stock ownership, if attributed to his United States relative, is sufficient to cause the corporation to be a Foreign Personal Holding Company. This problem is the subject of the recent case of Estate of Nettie S. Miller. 24

II. PERSONAL HOLDING COMPANY INCORPORATED ABROAD OWNED EXCLUSIVELY BY NONRESIDENT ALIENS

When the modern income tax law was passed in 1913, the nonresident alien was taxed in much the same manner as United States individuals, with the major exception that the nonresident alien was taxed only on income which was related to some transaction in the United States, while the United States individual was taxed on income from both domestic and foreign sources. 25 The Revenue Act of 1916 used the phrase "from . . . sources within the United States" to define a nonresident alien's income subject to tax, 26 and that statutory language is with us today. 27 Thus, the nonresident alien had the same incentive to incorporate to avoid graduated surtax rates as did the United States individual, except that the former was only concerned with United States income. The personal holding company law could, therefore, be rationally applied to the foreign incorporated pocketbook owned by nonresident aliens. The personal holding company tax fell on a modified version of taxable income, which was limited, in the case of a foreign corporation, to United States source income just as in the case of the nonresident alien. 28 It was appropriate to impose a penalty tax on the United States income of a foreign incorporated pocketbook owned exclusively by nonresident aliens because the shareholders would have been subject to graduated income tax rates on this income had they received it directly.

In 1936, two years after the personal holding company tax was imposed, however, Congress completely changed the method of taxing nonresident aliens and foreign corporations on the very type of income which, if it had been received by a foreign corporation prior to the

25. Revenue Act of 1913, ch. 16, § II(A)1, 38 Stat. 166.
27. INT. REV. CODE OF 1954, § 872(a).
28. Revenue Act of 1934, ch. 277, § 231(a), 48 Stat. 737 (now INT. REV. CODE OF 1954, § 882(b)). If a foreign corporation fails to file a return, taxable income equals gross income; if a return is filed, the personal holding company tax imposed on nonresident foreign corporations falls on income after deductions, even though the income tax is imposed on a gross income figure. Treas. Reg. §§ 1.545-1(b) (1958), 1.882-3(a)(1) (1957).
change, would have resulted in personal holding company status. The imposition of graduated income tax rates on nonresident aliens and foreign corporations had been found to be an unsatisfactory means of collecting a tax on these persons. It was decided, therefore, to impose a flat tax on passive and personal service income without regard to any deductions, and to collect it by requiring the payor to withhold the tax unless the nonresident alien or the foreign corporation was engaged in a United States trade or business, or had an office or place of business in this country. In these latter cases, graduated income tax rates, after allowance for deductions, continued to apply to both business and non-business income, and the tax was not collected through the withholding system. Capital gains were completely exempted because they were too difficult to collect, unless the taxpayer would have been subject to graduated income tax rates on his other income. At the time Congress changed the method of taxing nonresident aliens, it also indicated its belief that a personal holding company tax on foreign corporations was a totally unsatisfactory means of preventing tax avoidance by nonresident aliens. The penalty tax was not repealed as to foreign corporations, however, since United States individuals might own stock in a foreign incorporated pocketbook.

The flat tax rate imposed by this new law was ten per cent in the case of nonresident aliens and fifteen per cent in the case of foreign corporations, except that dividends received by foreign corporations were subject to a ten per cent tax, probably as a means of diminishing "double taxation" of corporate profits, i.e., taxation in the hands of both the distributing domestic corporation and the receiving foreign

30. Revenue Act of 1936, ch. 690, §§ 211(a) (nonresident aliens), 231(a) (foreign corporations), 49 Stat. 1714 (now INT. REV. CODE OF 1954, §§ 871(a), 881(a)).
32. Revenue Act of 1936, ch. 690, §§ 143(b) (nonresident aliens), 144(a) (foreign corporations), 49 Stat. 1701 (now INT. REV. CODE OF 1954, §§ 1441(a), 1442).
33. Revenue Act of 1936, ch. 690, § 211(b), 49 Stat. 1714. In 1987, nonresident aliens who earned more than $21,600 from United States sources became subject to graduated income tax rates. Revenue Act of 1936, § 211(c), added by ch. 815, § 501(b), 50 Stat. 830 (1937). Under present law the cutoff point is $21,200. INT. REV. CODE OF 1954, § 871(b). In 1942, the possession of an office or place of business in the United States was eliminated as a basis for imposing graduated income tax rates. Revenue Act of 1939, § 211(b), as amended, ch. 619, § 160(d), 56 Stat. 861 (now INT. REV. CODE OF 1954, § 871(c)).
34. H.R. REP. No. 2475, 74th Cong., 2d Sess. 9 (1936). In 1950, the nonresident alien not engaged in a United States trade or business became subject to tax on capital gains from United States sources at the same flat rate of taxation applicable to passive income if he was present in the United States for ninety days during the tax year or if he was present at the time of the sale. Revenue Act of 1939, § 211(a)(1)(B), added by ch. 994, § 213(a), 64 Stat. 956 (1950) (now INT. REV. CODE OF 1954, § 871(a)(2)(B)).
35. See note 33 supra.
corporation. While this tax rate did not equal the highest surtax rate on individuals, it was more than twice the lowest tax rate.\(^3\)

As a result of this change in the law, the application of the personal holding company tax to foreign corporations not engaged in a United States trade or business and not having an office or place of business in the United States (i.e., a nonresident foreign corporation) became irrational where the corporation was owned exclusively by nonresident aliens not subject to graduated income tax rates. In this situation, the 1936 withholding system collected whatever tax the nonresident alien would have had to pay had he received the income directly;\(^3\) the government would collect at least ten per cent of all United States source income distributed to this foreign incorporated pocketbook. There was, therefore, no tax avoidance potential and no reason for a personal holding company tax.

In the case where a nonresident alien shareholder would have been taxed at graduated income tax rates on the income received by the foreign corporation, the personal holding company tax could be rationally applied, although Congress seemed to have little hope of its effectiveness. Furthermore, this tax could be applied in the case of a resident foreign corporation even if the nonresident alien shareholders would have been taxed at the flat ten per cent rate on the corporation's income, since a resident foreign corporation would pay a tax at a rate lower than the flat ten per cent tax rate if it could use its deductions to sufficiently reduce or eliminate its income.\(^3\) It is not completely irrational to prevent this potential tax avoidance by imposing the personal holding company tax on resident foreign corporations, although it seems odd to use the tax to prevent the avoidance of the flat tax rate rather than the graduated income tax rates.\(^4\)

37. The lowest tax rate on individuals was 4%. Revenue Act of 1936, ch. 690, § 11, 49 Stat. 1653.

38. Since a nonresident foreign corporation is not entitled to deductions (see note 31 supra), the withholding tax applies to the full amount of the dividend unreduced by the 85% deduction otherwise available. Revenue Act of 1936, ch. 690, § 26(b), 49 Stat. 1664 (now INT. REV. CODE OF 1954, § 243(a)).

39. In 1936, the corporate tax rate on resident foreign corporations was 22%, which was higher than the 10% fixed tax rate applicable to nonresident aliens. Revenue Act of 1936, ch. 690, § 231(b), 49 Stat. 1717. Therefore, only the use of deductions could have reduced the effective tax rate on such corporations below 10%. Under present law, however, actual tax rates on corporations may be lower than the flat tax rates imposed on nonresident aliens. Compare INT. REV. CODE OF 1954, § 11(b)(2) (22% on corporations), with § 871(a) (30% on nonresident aliens).

40. There is one instance where the Foreign Personal Holding Company law is used to prevent the avoidance of fixed rates of taxation rather than graduated income tax rates. The taxable income which is attributed to the United States shareholders of a Foreign Personal Holding Company includes long term capital gains. See INT. REV. CODE OF 1954, § 556. Presumably this is done since the nonresident foreign corporation pays no tax on its capital gains income (INT. REV. CODE OF 1954, § 881(a)) and the United States shareholders are, therefore, avoiding the 25% tax thereon. The personal holding company tax, on the other hand, is not applied to long term capital gains. INT. REV. CODE OF 1954, § 545(b)(5).
The above analysis, which urges an exemption from personal holding company tax in the case of a nonresident foreign corporation owned exclusively by nonresident aliens not subject to graduated income tax rates, was never accepted by the Treasury or the courts. A 1937 Treasury Memorandum\textsuperscript{41} illustrates this point: A nonresident foreign corporation received all of its income from United States sources in 1936, and all the shareholders were nonresident aliens not subject to graduated income tax rates. The income consisted of dividends, interest, and capital gains from the sale of securities, but the ruling did not deal with the dividend and interest income. The sole question was whether the capital gains income was includable in gross income for purposes of the personal holding company tax. The ruling correctly determined that capital gains were not excluded from gross income merely because a nonresident foreign corporation pays no corporate income tax on such income. The income of a foreign corporation subject to personal holding company tax was unaffected by any special corporate income tax rules applicable to nonresident foreign corporations. However, the Treasury further concluded that capital gains were included in gross income for personal holding company tax purposes, notwithstanding the fact that the shareholders would have paid no tax on this income had it been received by them directly.

An examination of the reasoning of the ruling will explain how this irrational result was reached. The Treasury drew support for its conclusion from the fact that, had the foreign corporation paid a dividend to its nonresident alien shareholders, they would have been liable for United States tax thereon. Dividends paid by a foreign corporation to nonresident alien shareholders have a United States source (and are therefore subject to taxation) if the distributing corporation earned fifty per cent of its income from United States sources in any one of the three years previous to the year of distribution, or during any year of the corporation's existence if that was less than three years.\textsuperscript{42}

However, by focusing on the tax effect of a dividend from the foreign corporation, the Treasury confused the personal holding company tax with the other penalty tax on undistributed profits, \textit{i.e.}, the accumulated earnings tax. This latter tax was designed to prevent a corporation from unreasonably accumulating earnings of \textit{all} kinds with a view towards avoiding the graduated surtax which would be paid by its shareholders if a dividend had been distributed.\textsuperscript{43}

\textsuperscript{43} Prior to 1921, the improper accumulation of earnings resulted in the corporation being taxed as a partnership. See Revenue Act of 1913, ch. 16, § II A(2), 38 Stat. 166; Revenue Act of 1916, ch. 463, § 3, 39 Stat. 758; Revenue Act of 1918, ch. 18, § 220, 40 Stat. 1072. In 1921, Eisner v. Macomber, 252 U.S. 189 (1920), dealing with an income tax on stock dividends, was thought to cast doubts on the constitutionality of such a provision.
of a dividend would, therefore, be relevant in determining the application of the accumulated earnings tax to such a corporation. The personal holding company tax, on the other hand, was designed as a substitute for the tax which would have been paid had certain types of corporate income been received directly by the shareholders. The fact that the foreign corporation's dividend would be taxable to the nonresident alien shareholders is therefore no support for the conclusion that the corporation should be a personal holding company.

In Fides v. Commissioner, the Fourth Circuit reached the same conclusion as the Treasury in a case involving dividends and interest received in 1936 by a nonresident foreign corporation owned exclusively by nonresident alien shareholders who were not subject to graduated income tax rates. United States source income was insufficient for the foreign corporation's dividends to be taxed in the hands of the shareholders, but the court correctly rejected the relevance of this fact as a basis for argument against the application of the personal holding company tax. However, it did not adopt as its criterion the tax effect on the nonresident alien shareholders upon direct receipt of the income in question. Instead the court simply pointed out that the dividend and interest income literally fit the definition of personal holding company income. Personal holding companies were considered malum in se, and the tax avoidance potential of the particular fact situation was not examined.

It is especially difficult to understand the Fourth Circuit's failure to view the personal holding company tax as a substitute for the tax which would have been paid by the shareholders had they received the income directly. In a later decision the Fourth Circuit refused to apply the Foreign Personal Holding Company law to a United States shareholder on that portion of the foreign corporation's foreign source income earned prior to the time the shareholder became a United States resident. The court's theory was that prior to that time the income would not have been taxed had the shareholder received it directly. A similar rationale should have been used in the Fides case.

H.R. REP. No. 350, 67th Cong., 1st Sess. 12-13 (1921). This resulted in a corporate tax designed to prevent an accumulation of corporate profits to avoid the graduated surtax on dividend distributions. Revenue Act of 1921, ch. 186, § 220, 42 Stat. 247. When the personal holding company tax was passed in 1934, the accumulated earnings tax continued to apply in those cases where there was an accumulation to avoid the graduated surtax on dividends paid to individuals. Revenue Act of 1934, ch. 277, § 102(a), 48 Stat. 702 (now INT. REV. CODE of 1954, § 532(a)).

44. 137 F.2d 731 (4th Cir.), cert. denied, 320 U.S. 797 (1943).
45. See also Helvering v. Syndicate Varieties, 140 F.2d 344 (D.C. Cir. 1944) (capital gains realized by shareholder upon complete liquidation under 1936 law was unquestionably personal holding company income).
46. Marsman v. Commissioner, 205 F.2d 335 (4th Cir. 1953). The taxpayer was a nonresident alien who became a United States resident by moving to the United States late in the year. However, this liberal analysis has not been uniformly applied to Foreign Personal Holding Companies. See Alvord v. Commissioner, 277 F.2d 713 (4th Cir. 1960) in which the
One response to the argument presented here might be that the Treasury and the courts should not be burdened with the task of determining whether a nonresident alien shareholder is avoiding the graduated surtax rates. However, the Treasury accepted this burden in the case of the accumulated earnings tax which applied only if the surtax was being avoided in the year in question by the failure to distribute corporate earnings as a dividend.\textsuperscript{47} It may be further suggested, however, that the history of the personal holding company tax proves that it was to apply without regard to any proof that the shareholders were avoiding a graduated surtax. It is certainly true that the personal holding company tax was meant to apply whether or not in a given year the shareholders were avoiding the graduated surtax, a result which was intentionally at variance with the rules applicable to the accumulated earnings tax. It would have been dangerous to eliminate this defense in the case of the accumulated earnings tax since corporate profits might be accumulated for business purposes,\textsuperscript{48} an eminently desirable result. Thus, it was open to the corporation to avoid an accumulated earnings tax by proving that its shareholders had very little income in a given year and were therefore not avoiding the graduated surtax by retaining earnings at the corporate level.\textsuperscript{49} However, any attempt to apply a similar test when dealing with a personal holding company is inappropriate because a personal holding company does not carry on a business. Furthermore, even if the shareholders' income in a given year was low, it was reasonable in 1934\textsuperscript{50} to presume that retention of income at the corporate level by a personal holding company was for the purpose of avoiding the graduated surtax in some future year, if not in the particular year in question, and it was equally reasonable to deal with that unsavory purpose by imposing a penalty tax on these corporations in all cases.

In 1936,\textsuperscript{51} however, this presumption was no longer reasonable

\textsuperscript{47} Treas. Reg. 94, art. 102-1 (1936), as amended, T.D. 4791, 1938-1 CUM. BULL. 91. This result may no longer apply. The Internal Revenue Code of 1954 specifies only that the corporation must be formed or availed of to avoid "the income tax" in order for the accumulated earnings tax to apply. While the flat rate of taxation is not a surtax, it would seem to be an income tax. Treas. Reg. § 1.532-1(c) (1959).

\textsuperscript{48} Most cases involving the accumulated earnings tax turn on the question whether earnings have been accumulated for business purposes. See, e.g., Electric Regulator Corp. v. Commissioner, 336 F.2d 339 (2d Cir. 1964).

\textsuperscript{49} Seabord Security Co., 38 B.T.A. 560, 566-67 (1938).

\textsuperscript{50} The personal holding company tax was imposed in this year. See text accompanying note 5 \textit{supra}.

\textsuperscript{51} The method of taxing nonresident aliens was significantly altered in this year. See text accompanying notes 29-33 \textit{supra}.
when applied in all situations to foreign corporations owned exclusively by nonresident aliens. The rule that no avoidance of the graduated surtax need be proven with respect to the tax year in question before the personal holding company tax would apply had been adopted in 1934, when the surtax rates applied to all nonresident aliens, and avoidance of the surtax could be presumed as the purpose, if not the effect, of the foreign corporation. No policy supports this presumption after 1936 in the case of the nonresident foreign corporation owned exclusively by nonresident aliens, who under no circumstances could be said to be avoiding the graduated surtax rates on passive income since they were not subject to these rates.

It may finally be objected that the argument presented here runs counter to the plain statutory language, and that, however reasonable may be the suggested exemption from personal holding company status, the Treasury and the courts are bound by the statute—in other words, that the remedy lies with Congress. The trouble with this retort is that the Treasury thought very little of it. For tax years beginning after 1936, the Treasury decided that a foreign corporation owned exclusively by nonresident aliens was not a personal holding company if a dividend from that corporation was not taxable because an insufficient percentage of the corporation’s income had a United States source. This exemption had no statutory basis and, like the suggestion we have made, was founded solely on a conception of the purpose of the personal holding company tax.

The creation of this exemption by regulation raised a whole new set of problems. It was bad enough that the Treasury failed to exempt specific income from personal holding company income status when the nonresident alien shareholders were not subject to graduated surtax rates thereon, basing its position on a mistaken belief that the personal holding company tax was designed to prevent the corporate accumulation of all corporate profits, rather than the collection at the corporate level of certain types of income. It was worse that this mistaken belief resulted in an exemption from the personal holding company tax which opened up a loophole in the tax law applicable to foreign incorporated pocketbooks. For if a nonresident alien shareholder would have been taxed at graduated surtax rates upon the direct receipt of the income in question, he was avoiding this tax by creating a foreign incorporated pocketbook having exclusively nonresident alien shareholders, whether the foreign corporation earned forty-nine per cent or fifty-one per cent of its income from United States sources. And yet, under the exemption granted by the Treasury,

the foreign corporation earning only forty-nine per cent of its income from United States sources and owned exclusively by nonresident aliens escapes personal holding company status because its dividends are not taxable to its shareholders.53

In defense of the Treasury's action it may be suggested that, since no personal holding company tax is imposed if the corporation's undistributed profits are distributed as dividends to its shareholders,54 the purpose of the personal holding company tax is to prevent the accumulation of all corporate profits and to force a dividend distribution. It may be argued, therefore, that the personal holding company tax serves no purpose if a dividend distribution is not taxable and, further, that the existence of such a tax on dividends is support for the propriety of a personal holding company tax on the distributing corporation. However, it is one thing to say that a dividend distribution will result in the avoidance of a personal holding company tax, and quite another to say that therefore the purpose of the penalty tax is to force a dividend distribution. The avoidance of a personal holding company tax as a result of a dividend distribution should be viewed as a mitigation of the hardship which would result from both a tax on dividends and a high corporate penalty tax. Furthermore, a tax on dividend distributions, while not precisely matching the tax which would have been paid by the shareholders had they received the income directly, will not result in a significant difference in the amount of tax collected and presents little opportunity for tax avoidance planning. Thus, even though the dividend distribution would qualify for the $100 exclusion and, prior to 1964, for the four per cent dividend received credit,55 the corporate income tax on the income received at the corporate level would probably prevent the use of the dividend distribution to reduce the combined corporate and individual income tax below the tax which would have been paid had the passive and personal service income been received directly by the shareholders. Only in the unlikely case of corporate losses or loss carryovers would the corporate income tax be eliminated. However, it is very difficult to plan the existence and use of losses to result in overall economic benefit, as opposed to a limited tax benefit.

Therefore, dividend distributions prevent the application of a personal holding company tax, not because the evil at which the statute is aimed is thereby avoided, as would be true in the case of the accumulated earnings tax, but because such a rule involves little chance for tax avoidance and a contrary rule would involve intolerable hardship.

53. See note 42 supra.
Another basis for the Treasury's mistake may have been the fact that the imposition of a tax on nonresident alien shareholders receiving dividends from a foreign corporation earning a certain percentage of its income from United States sources may serve the same function as the personal holding company tax. Thus, if a nonresident alien avoids graduated income tax rates by incorporation abroad, the imposition of a "second tax" upon a distribution of dividends from the foreign corporation may result in an approximation of the tax rate which would have been applicable had the income been received directly by the shareholder in the first place. But the fact that a "second tax" incidentally serves the same purpose as the personal holding company tax does not mean that, in the absence of the "second tax," there is no avoidance of United States taxes which the personal holding company tax was meant to prevent. An examination of the history of the taxation of dividends from foreign corporations earning a certain percentage of income from United States sources will cast doubt even on the theory that the original purpose of such taxation had anything to do with imposing a "second tax" on nonresident aliens. A strong argument can be made that prevention of tax avoidance by United States individuals prompted this taxation.

The definition of United States source income, which included dividends from foreign corporations earning a sufficient percentage of United States source income, was originally adopted in 1921. However, their United States source did not result in the taxation of such dividends when received by foreign corporations. At that time a dividend paid by a United States corporation to a foreign corporation was tax free. Nonetheless, the siphoning off of dividend income into the hands of a foreign corporation had the major disadvantage of subjecting this income to the undistributed profits tax imposed on the United States source income earned by the foreign corporation. It would have been easy, however, to redistribute the income of the first foreign corporation to a second parent foreign corporation tax free since, in 1921, dividends paid by a foreign corporation were tax free.

56. The constitutionality of this "second tax" on dividends paid by foreign corporations has been twice upheld. Frank W. Ross, 44 B.T.A. 1 (1941); Lord Forr, 25 B.T.A. 154 (1932). Since 1936 the tax has been imposed only upon a percentage of the dividend equal to the percentage which the foreign corporation's United States source income is of its total gross income from all sources. See Revenue Act of 1936, ch. 690, § 119(a)(2)(B), 49 Stat. 1693; S. Rep. No. 2156, 74th Cong., 2d Sess. 22-23 (1936).


59. Revenue Act of 1921, ch. 136, § 234(a)(6)(A), 42 Stat. 255. In 1935, the deduction for dividends received was reduced to 90% of the dividend. Revenue Act of 1934, § 23(p), as amended, ch. 329, § 102(h), 49 Stat. 1016 (1935). And in 1936 it was reduced to its present level of 85%. Revenue Act of 1936, ch. 690, § 26(b), 49 Stat. 1664.
if the corporation earned more than fifty per cent of its income from United States sources.\textsuperscript{61} Unless these dividend distributions to a second parent foreign corporation owned by a United States individual had a United States source, the undistributed profits tax would not apply, and dividend income would have been received by a foreign incorporated pocketbook without the payment of either a corporate income tax or an undistributed profits tax. It is significant that the House tried in 1936 to limit the definition of United States source income in the case of dividends paid by a foreign corporation to distributions from a resident foreign corporation earning seventy-five per cent of its income from United States sources.\textsuperscript{62} The Senate rejected this change in order to prevent tax avoidance by United States individuals.\textsuperscript{63} While this purpose goes unexplained in the Committee Reports, it may be that a tax avoidance scheme similar to the one outlined above (involving the use of a chain of foreign corporations owned ultimately by United States individuals) was what the Senate had in mind.\textsuperscript{64} Such a chain of foreign corporations was not subject to the Foreign Personal Holding Company law at the time when the Senate voiced this opinion; that result was to come a year later.

Notwithstanding the apparent anomaly of basing an exception from a law designed to prevent tax avoidance by nonresident aliens on a definition originally designed to prevent tax avoidance by United States individuals, and notwithstanding the tax avoidance potential for nonresident aliens which this exception created, it was written into the Internal Revenue Code of 1954 without explanation.\textsuperscript{65}

The Treasury’s unwillingness to adopt a more rational approach to the problem of personal holding company income in the case of foreign corporations owned exclusively by nonresident aliens becomes especially alarming when the tax rate on passive income is fixed by treaty.\textsuperscript{66} In such a case the failure to recognize that the personal hold-

\textsuperscript{61} Revenue Act of 1921, ch. 136, § 234(a)(B), 42 Stat. 255. This exemption for dividends received from foreign corporations with over 50\% United States source income was removed in 1934. Revenue Act of 1934, ch. 277, § 23(p), 48 Stat. 690; S. REP. No. 558, 73d Cong., 2d Sess. 26 (1934).


\textsuperscript{63} S. REP. No. 2156, 74th Cong., 2d Sess. 22 (1936).

\textsuperscript{64} In 1936, however, this tax avoidance scheme did not work as well as in 1921. In 1921, dividend income could be paid to two successive nonresident foreign corporations tax free, while other passive income would have been subject to only one corporate tax when received by the first foreign corporation. In 1936, two 10\% corporate taxes would have to be paid on dividend income and a 15\% and 10\% corporate tax on other passive income when received by one nonresident foreign corporation and passed on to another in the form of dividends. See notes 29-37, 59, 61 supra and accompanying text. However, such corporate taxes were still less than 75\%, the highest surtax rate. Revenue Act of 1936, ch. 690, § 12(b), 49 Stat. 1655.

\textsuperscript{65} INT. REV. CODE OF 1954, § 542(c)(7).

\textsuperscript{66} United States income tax treaties with other countries usually provide that passive income is not to be taxed in accordance with United States tax law unless the resident of
ing company tax is a substitute for a tax on the income in question had it been directly received by the shareholders deprives nonresident aliens of a bargain struck between nations. In a 1960 Revenue Ruling, however, the Treasury ruled that dividend and interest income from United States sources earned by a nonresident Netherlands corporation with five or fewer nonresident alien shareholders owning more than fifty per cent of the stock was personal holding company income. No attempt was made to analyze the problem in terms of the taxability of direct receipt of the income in question by the shareholders. Actually we do not even know whether the shareholders were eligible for an exemption from graduated income tax rates. Personal holding company status may, therefore, have been appropriate.

It was argued that a personal holding company tax on the dividend and interest income received by the corporation violated the United States-Netherlands Income Tax Treaty, which sets forth the tax treatment of such income when received by a Netherlands corporation. The Treasury countered with the argument that the personal holding company tax was a tax on undistributed profits, not a tax on corporate income as such, and that the treaty made no provision concerning an undistributed profits tax. While it is proper not to view the personal holding company tax as a tax on corporate income, it is improper to fail to characterize this tax as essentially a tax on the shareholder's percentage of the corporation's income.

The Treasury also rejected an argument that no personal holding company tax should be imposed because, under the treaty, a dividend paid by a Netherlands corporation to a nonresident alien shareholder was not taxed by the United States regardless of how much United States source income the Netherlands corporation had. While it was proper to reject this argument, no explanation is given for not following the analogy of the statutory rule which eliminates personal holding company status when the dividend is not taxable to nonresident alien shareholders under United States law. The Ruling simply cites the Fides case, which was inapplicable after 1936.

The Treasury further supported its conclusion with an argument the other treaty country has a permanent establishment in the United States. Instead, either a flat rate of taxation below the usual 30% rate is provided or complete exemption is granted. See, e.g., Convention With the Netherlands Respecting Double Taxation, April 29, 1948, art. VII, para. 1 (dividends subject to 15% rate) and art. VIII, para. 1 (interest exempt from tax), 62 Stat. 1761, T.I.A.S. No. 1855; Convention With United Kingdom Respecting Double Taxation, April 16, 1945, art. VIII, para. 1 (royalties exempt from tax), 60 Stat. 1382, T.I.A.S. No. 1546.

The Treasury supported this conclusion by citing the Fides case. Of course, Fides was not the law in this respect after 1936. See note 52 supra.

70. Fides v. Commissioner, 137 F.2d 731 (4th Cir.), cert. denied, 320 U.S. 797 (1943).
based on legislative history. The United States-Netherlands Income Tax Treaty had contained a provision exempting Netherlands corporations controlled by Netherlands residents who were not United States citizens from any undistributed profits tax, but Congress refused to accept this provision because the question of an undistributed profits tax on foreign corporations was currently under legislative study. However, this fact alone could not establish a congressional finding that the Treasury was precluded from adopting a rational approach to the determination of what should be personal holding company income in the case of income taxed in accordance with a treaty.

The Treasury also pointed to Congress's reason for rejecting an exemption from undistributed profits taxes in the United States-Ireland Income Tax Treaty as support for its conclusion in the ruling. In fact, however, Congress was afraid of giving Irish corporations doing business in the United States the advantage this exemption would have created, a reason which was relevant to the application of one of the undistributed profits taxes, i.e., the accumulated earnings tax, but which lacked force in the case of a personal holding company which does not normally carry on a business.

It has only been in the United States' Income Tax Treaties with the United Kingdom and Canada that an undistributed profits tax on corporations of the other treaty country has been eliminated, and then only if the residents of the other treaty country (other than United States citizens) own more than fifty per cent of the voting control of the corporation. It should not be thought that the failure to grant an exemption in other treaties constitutes a finding that the foreign corporation of the other treaty country is automatically subject to the personal holding company law. Undistributed profits taxes are avoided by British and Canadian corporations regardless of whether their shareholders would have been subject to United States graduated income tax rates had they received the income collected at the corporate level. Therefore, the elimination of undistributed profits taxes by treaty in these two instances must be viewed more as a concession in tax rates to the residents of the other treaty country than as an attempt to deal rationally with the general question of the taxation of personal holding companies incorporated abroad.

Despite the questionable approach over the years to the problem of personal holding companies owned exclusively by nonresident aliens, Congress may soon correct the situation. A bill presently before Congress would eliminate personal holding company status in all cases where the foreign corporation was owned exclusively by nonresident aliens.\textsuperscript{75} There is no fear that this exemption would allow nonresident aliens who are subject to graduated income tax rates to avoid United States taxes. Under the proposed law, a nonresident alien's income effectively connected with a United States trade or business would be subject to graduated income tax rates, while all other income would be subject to flat rates of taxation whether or not the taxpayer is engaged in a United States trade or business and regardless of the amount of his United States source income.\textsuperscript{76} Taxes on this other income, which consists of passive and non-business income, would be collected through the withholding system. The same flat tax would be similarly collected from foreign corporations on their passive and non-business income whether or not they were engaged in business in the United States.\textsuperscript{77} Therefore, the full tax on passive and non-business income is collected through the withholding system whether it is paid to a foreign corporation or to a nonresident alien. Since graduated income tax rates cannot be avoided through the creation of a foreign incorporated pocketbook by a nonresident alien, personal holding company status would be eliminated for foreign corporations owned exclusively by nonresident aliens.\textsuperscript{78}

There is, however, a serious loophole in the proposed elimination of personal holding company status. We have assumed that the income received by the foreign corporation instead of by the nonresident alien shareholders is passive or non-business income. But there is one category of personal holding company income which does not fit that description, \textit{i.e.}, personal service income. The rendition of personal


\textsuperscript{76} H.R. 13103, 89th Cong., 2d Sess., §§ 3(a), (b) (1966). In proposing to tax income effectively connected with a United States trade or business, the proposed law would impose a tax upon income which might be from a source \textit{without} the United States as that term is presently understood. Section 2(d) of the proposed law sets forth the criteria for determining when income is effectively connected with a United States trade or business. Cf. \textit{WORLD TAX SERIES, TAXATION IN INDIA}, ch. 11/1.2b at 292-95 (1960).

The proposed new law, H.R. 13103, 89th Cong., 2d Sess., § 9(a) (1966), would tax nonresident aliens on capital gains at a flat rate of taxation only if they were present in the United States for at least 183 days during the tax year, without regard to their presence at the time of sale. If the capital gains were effectively connected with a United States trade or business, they would be taxed in the same manner as if received by a United States individual.

\textsuperscript{77} H.R. 13103, 89th Cong., 2d Sess., §§ 4(a), (c) (1966). Withholding on passive and non-business income paid to foreign corporations may be eliminated by the Secretary or his delegate if tax collection will not thereby be jeopardized.

\textsuperscript{78} A Treasury Department Release in connection with H.R. 5916, 89th Cong., 1st Sess. (1965), the first of two predecessors to H.R. 13103, stated as follows:

With the elimination of graduated rates as suggested in recommendation 1 . . . .
services by individuals in the United States has been considered a trade or business ever since the taxation of nonresident aliens’ income at graduated rates depended upon that criterion.\textsuperscript{79} Personal service income would continue to be effectively connected with a trade or business under the proposed law and taxed at graduated income tax rates if received by nonresident aliens.\textsuperscript{80} There can be no reason to allow this income to escape the personal holding company tax because it is received by a foreign corporation.

The exemption of personal service income from the personal holding company tax is especially serious in view of the fact that the income from the furnishing of personal services by a corporation may constitute “industrial or commercial” profits under many of our income tax treaties with other countries and may, therefore, be exempt also from the United States corporate income tax.\textsuperscript{81} The Treasury’s obvious concern with this problem is demonstrated by a provision in a recently ratified protocol to the United States-Japan Income Tax Treaty, in which industrial or commercial profits are defined in most cases to exclude income earned by a corporation as a result of furnishing the services of a major shareholder.\textsuperscript{82} The exemption from personal hold-
ing company status should therefore be inapplicable when the foreign corporation is used to lend out the services of a major shareholder. The denial of this exemption, however, should be accomplished in a manner consistent with the proposition that, if the personal service income received by the corporation would have escaped United States taxation if received by the nonresident alien shareholders, personal holding company income status should be avoided for such income. Indeed, the protocol to the United States-Japan Income Tax Treaty mentioned above does not remove income derived from the furnishing of personal services by a corporation from the definition of industrial or commercial profits if the personal service income would not have been subject to United States taxes had the Japanese shareholders received the income directly.83

But for this major problem,84 the approach of the proposed legislation is a welcome recognition that the personal holding company tax is a substitute for a graduated income tax on individuals. This rationalization of our tax structure will both ease the minds of those who object to this country's "extraterritorial" taxation of foreign corporations85 and encourage investment in this country, thereby improving our balance of payments.

days in the tax year and the income earned by the corporation for such services is no more than $3000. Convention With Japan Respecting Double Taxation, arts. II(1)(i)(ii)(E), IX, CCH Tax Treaty Rep. ¶¶ 4405, 4412, at 4407, 4409-2, -3. But see the proposed Treaty with the Philippines, signed October 5, 1964, which provides that income from the furnishing of personal services is industrial or commercial profits, but income from the performance of personal services is not. Convention With Republic of Philippines Respecting Double Taxation, art. 7(3), CCH Tax Treaty Rep. ¶ 6610, at 6610.

The Treasury is also likely to attack one man personal service corporations as shams. Johanson v. United States, 336 F.2d 809, 813-14 (5th Cir. 1964).

83. See note 82 supra. Other examples of the tax free receipt of personal service income under United States income tax treaties are Convention With Switzerland Respecting Double Taxation, May 24, 1951, art. X, para. (1)(b), [1951] 2 U.S.T. & O.I.A. 1758, T.I.A.S. No. 2316 (no more than $10,000 per year received for rendering personal services in the United States); Convention With Pakistan Respecting Double Taxation, July 1, 1957, art. XII, [1959] 1 U.S.T. & O.I.A. 991, T.I.A.S. No. 4232 (professors or teachers temporarily visiting United States for not more than two years); and Convention and Protocol With France Respecting Double Taxation, July 25, 1939, art. 10, 59 Stat. 899, T.S. No. 988 (income from the exercise of a liberal profession not taxed by United States unless the professional activity has a fixed center there).

84. One minor problem could develop in applying the proposed exemption from the personal holding company tax. Since the proposed law accomplishes the same result as many income tax treaties in establishing flat rates of taxation on passive income, the United States may be at a bargaining disadvantage in negotiating treaties. The President is, therefore, empowered to withhold these privileges if similar concessions are not granted by another country. H.R. 13103, 89th Cong., 2d Sess., § 5(b) (1966). However, the exemption from personal holding company status is not one of the privileges which the President can withhold. This is certainly an oversight, since otherwise the privileges withheld can be obtained merely by incorporating—without fear of a personal holding company tax.

III. MINORITY OWNERSHIP IN A FOREIGN INCORPORATED POCKETBOOK

A. Minority Ownership by Nonresident Aliens in a Foreign Personal Holding Company

As we have noted earlier, the Foreign Personal Holding Company law is meant to prevent the formation of foreign incorporated pocketbooks controlled by United States individuals. It seeks to accomplish this purpose by means of a direct tax on United States shareholders, rather than a less effective tax on the foreign corporation. Since the United States shareholders are avoiding tax on income from both United States and foreign sources, the income of a Foreign Personal Holding Company is defined to include income from all sources, not just United States source income, as is the case with the personal holding company incorporated abroad.\(^8\)

A problem arises when a Foreign Personal Holding Company has nonresident alien shareholders owning a minority of the corporation's stock. In taxing the United States shareholders' percentage of both United States and foreign source income, the Foreign Personal Holding Company law exempts the corporation from a personal holding company tax in order to avoid taxing the United States source income twice, once in the hands of the United States shareholders and again at the corporate level. But the nonresident alien shareholders may be avoiding graduated income tax rates on their percentage of the United States source income earned by the Foreign Personal Holding Company, which income is free from a personal holding company tax.

The fact that a nonresident alien can accomplish this is symptomatic of the fact that collaboration between United States individuals and nonresident aliens seemed unlikely in 1937.\(^8\) It further indicates the low regard for the personal holding company tax as a tool for preventing tax avoidance by nonresident aliens. Once an effective means of preventing tax avoidance by United States shareholders of a foreign corporation exists, the personal holding company tax receives little attention. However, it is not necessary to give up completely the opportunity to tax the corporation in the situation outlined above. That percentage of the corporation's United States source income which equals the nonresident alien's percentage of stock ownership could be subject to the personal holding company tax. While it is true that United States shareholders share the burden of this tax in addition to paying tax on their percentage of the corporation's undistributed profits, the above proposal prevents the double tax burden which would result if all of the foreign corporation's United States

86. Revenue Act of 1936, § 334(a), added by ch. 815, § 201, 50 Stat. 820 (1937) (now INT. REV. CODE OF 1954, § 555(a)).
87. This is the year the Foreign Personal Holding Company law was enacted.
source income were taxed at personal holding company rates. If even this unfairness is of concern, the personal holding company tax could be used as a tax credit by the United States shareholders. Certainly, this approach would provide an effective means of preventing a nonresident alien from having access to a ready-made tax avoidance scheme.

B. Minority Ownership by United States Individuals in a Personal Holding Company Incorporated Abroad

When United States shareholders own a minority of the stock in a foreign incorporated pocketbook, that corporation cannot be exempt from the personal holding company tax under both present law and the proposed legislation. This is true even if the corporation's United States source income is less than fifty per cent of its total income, so that it would not be subject to the personal holding company tax if owned exclusively by nonresident aliens. It is certainly true that a United States shareholder would be avoiding United States graduated income tax rates if personal holding company status were avoided. However, it is also true that the imposition of a personal holding company tax is a clumsy means of preventing this tax avoidance possibility. The nonresident alien shareholders may not be avoiding United States graduated income tax rates at all and, under the proposed law, very likely would not be, in view of the flat rates of taxation collected through withholding. Their share of the penalty tax on United States source income would then be completely unwarranted. The effect of this tax on the United States shareholder is also irrational because it falls only on the foreign corporation's United States source income, whereas the United States shareholder is avoiding taxes on income from all sources. The personal holding company tax would, therefore, bear no necessary relationship to the tax avoided.

This is not to say that Congress is without power to penalize nonresident aliens when they collaborate with a United States shareholder who is avoiding United States tax rates. In fact, this conclusion was implicit in our earlier discussion of a personal holding company owned exclusively by nonresident aliens when we assumed that if one nonresident alien shareholder were avoiding United States graduated income tax rates, a personal holding company tax would be appropriate. But there is no positive reason to penalize the nonresident alien shareholders who may very well have taken in the United States individual as a "partner" to help them in their investment decisions.

Furthermore, another more rational method of preventing the

89. Another example of "guilt by association" under the 1954 Code is §§ 341(e)(5)(A)(i), (iii), which provide that a corporation may be a collapsible corporation if one shareholder is a dealer in real property even though the corporation would otherwise escape collapsible corporation status.
United States shareholder from avoiding graduated income tax rates exists without also penalizing the nonresident alien shareholders. Under the foreign investment company provisions of the Code, stock is not treated as a capital asset upon its sale or exchange to the extent of the United States shareholders' percentage of the corporation's earnings and profits, which include income from all sources, received while the taxpayer was a shareholder. The purpose of this law was to prevent the foreign incorporation of investment companies by United States individuals. Utilization of a similar percentage approach in taxing minority United States shareholders in a personal holding company incorporated abroad would have the effect of taxing both United States and foreign source income, and would avoid penalizing nonresident aliens if they were not avoiding graduated income taxes. In fact, even if the nonresident alien shareholders were avoiding United States graduated income tax rates, the suggested method of taxing the United States shareholder owning a minority of the stock could still be used, while a personal holding company tax on the nonresident aliens' percentage of the corporation's United States source income could be imposed.

The imposition of this tax on the minority United States shareholder should not be vulnerable on the grounds that control of the foreign corporation by United States shareholders is lacking. Control might be a prerequisite to the direct imputation of corporate profits to a shareholder under the Foreign Personal Holding Company law, but it should not be a prerequisite to the removal of capital gains treatment upon the sale of stock in a foreign corporation. The foreign investment company provisions themselves may apply even though an individual shareholder or his family is not in control; and control by United States individuals, whatever their number, is completely irrelevant where the company is registered under the Investment Company Act of 1940.

The fashioning of more effective tools to tax the minority United States shareholder in a foreign incorporated pocketbook is especially important under the proposed law, since a penalty tax on nonresident alien shareholders who are not avoiding United States graduated income taxes may defeat the bill's purpose of encouraging investment in this country.


91. The requirements are that United States persons of whatever number must directly or indirectly own more than either 50% of the voting control or value of the stock of a foreign corporation engaged or holding itself out to be engaged primarily in the investment company business, or that the company be registered under the Investment Company Act of 1940 as a management company or a unit investment trust. Int. Rev. Code of 1954, § 1246(b).
IV. FOREIGN PERSONAL HOLDING COMPANY STATUS?—THE NON-RESIDENT ALIEN SHAREHOLDER WITH A UNITED STATES RELATIVE

We now turn to the broader question of whether a foreign corporation is a Foreign Personal Holding Company, a personal holding company incorporated abroad, or neither. If the foreign corporation’s income is such that its percentage of either personal holding company income or Foreign Personal Holding Company income is great enough to call into play either the personal holding company or the Foreign Personal Holding Company law, the corporation’s status will depend solely upon whether United States individuals are in control. Doubt as to the existence of control may arise when United States individuals do not actually own more than fifty per cent of the foreign corporation’s stock, but whose ownership exceeds fifty per cent when their holdings are combined with the stock of a nonresident alien who has a United States individual for a relative. The nonresident alien’s stock may or may not be attributed to the United States relative.

If it is attributed, five or fewer United States individuals may be deemed to control the foreign corporation, in which case Foreign Personal Holding Company status results and actual United States shareholders would be taxed on their share of the corporation’s undistributed profits. On the other hand, if the nonresident alien’s stock were not so attributed, a personal holding company tax is imposed at the corporate level. However, if the income of the foreign corporation is such that, with control by United States individuals, Foreign Personal Holding Company status results, but without control personal holding company status will not result, then the decision of whether or not to attribute from a nonresident alien shareholder to a United States relative will determine whether a tax avoidance device will be subject to any tax at all.

In some instances personal holding company status may be avoided even though Foreign Personal Holding Company status would result, because of the different rules applicable to personal holding company income and Foreign Personal Holding Company income. We have already seen that in the former case only United States source income is considered if the corporation is incorporated abroad, whereas income from all sources is considered in determining the amount of Foreign Personal Holding Company income. 92 Thus, a foreign corporation may have $100 in foreign income from interest and dividends and $50 in United States source business income (other than from personal services). The corporation has no personal holding company income,

92. See text accompanying note 86 supra; Porto Rico Coal Co. v. Commissioner, 126 F.2d 212 (2d Cir. 1942), holding that only United States source income is considered in determining whether a foreign corporation is a personal holding company. There, although foreign activity caused the corporation an overall loss, the fact that it had personal holding company income from a United States source was determinative.
since its United States source income is all business income, but the Foreign Personal Holding Company income is two-thirds of total gross income.

There are other differences between the rules applicable to personal holding company income and those applicable to Foreign Personal Holding Company income. Whereas the percentage of income which must be personal holding company income for a corporation to have personal holding company status was eighty per cent and is now sixty per cent, this percentage was always sixty per cent in the case of a Foreign Personal Holding Company and even this figure is reduced to fifty per cent once Foreign Personal Holding Company status is achieved in one year. Thus, if all of a foreign corporation's income consists of $100 United States source income, $55 of which is from interest and $45 of which is from business sources (other than from personal services), personal holding company status could not result, but Foreign Personal Holding Company status might result if the corporation had sixty per cent Foreign Personal Holding Company income in a prior year.

Finally, it is easier for certain types of income to qualify as Foreign Personal Holding Company income than is the case under the rules applicable to personal holding company income. The exemptions for certain royalties and the treatment of certain interest as subject to the more lenient rules applicable to rent under the personal holding company law are not available in determining whether royalties and interest are Foreign Personal Holding Company income. If a foreign corporation's income consisted solely of $100 in royalties from United States sources, Foreign Personal Holding Company status would result, but personal holding company status might be avoided if the corporation's expenses in producing the royalty income were sufficient. It can be seen, therefore, that the failure to achieve Foreign Personal Holding Company status as a result of a failure to attribute stock ownership from a nonresident alien shareholder to his United States relative will not always result in the imposition of a personal holding company tax.

The problem of attribution from a nonresident alien shareholder to his United States relative was presented by the recent case of Estate

93. See note 6 supra.

94. Revenue Act of 1936, § 331(a)(1), added by ch. 815, § 201, 50 Stat. 818 (1937) (now INT. REV. CODE OF 1954, § 552(a)(1)).

95. Revenue Act of 1936, § 332(a), added by ch. 815, § 201, 50 Stat. 818 (1937) (now INT. REV. CODE OF 1954, § 553(a)(1)); Treas. Reg. §§ 1.553-1(a), (b) (1958). Under the personal holding company rules, interest received on debts resulting from the sale of realty by a real estate dealer is subject to the more liberal rules applicable to rents. INT. REV. CODE OF 1954, §§ 543(a)(1)(A), 543(a)(2), 543(b)(3). And royalties are exempt if they are a sufficient percentage of total income, expenses in connection therewith are substantial, and other personal holding company income is not substantial. INT. REV. CODE OF 1954, §§ 543(a)(3), (4).
of Nettie S. Miller, which involved the following fact situation in a more complicated form. (Simplification has not altered the essential problem.) A United States individual owned thirty per cent of the stock in a foreign incorporated pocketbook. One nonresident alien owned ten per cent of the stock and another nonresident alien, whose brother was a United States individual, owned the remaining sixty per cent. The ultimate legal question was whether the corporation was a Foreign Personal Holding Company. The specific legal question was whether or not to attribute the stock owned by the nonresident alien amounting to sixty per cent of the shares outstanding to his United States relative, even though the United States relative owned no stock in the corporation. Without attribution, United States individuals could not be deemed to own more than thirty per cent of the corporation's stock. The taxpayer in the case was the estate of the deceased United States shareholder who had owned thirty per cent of the stock. Of course, if Foreign Personal Holding Company status resulted, the estate was liable to pay the tax which the deceased shareholder had owed on thirty per cent of the corporation's undistributed profits.

In a display of solicitude for the taxpayer uncommon in the Tax Court's treatment of Foreign Personal Holding Company cases, nine of the Tax Court judges held that there could be no attribution between members of a family from a nonresident alien shareholder to a United States relative if the United States relative owned no stock in the foreign corporation. Four of these nine judges would have gone further to hold that attribution from a nonresident alien shareholder to a United States relative was impermissible even if the United States relative actually owned stock. However, the other five members of the majority would have allowed attribution if the United States relative was a shareholder.

The difference of opinion within the majority would result in different results in the following case. Consider a foreign incorporated pocketbook with five unrelated United States individuals owning only

96. 43 T.C. 760 (1964).
97. Ellsworth C. Alvord, 82 T.C. 1 (1959), rev'd, 277 F.2d 713 (4th Cir. 1960); Mary A. Marsman, 18 T.C. 1 (1952), rev'd, 205 F.2d 335 (4th Cir. 1953); A.G. Fides, 47 B.T.A. 280 (1942), aff'd, 137 F.2d 731 (4th Cir.), cert. denied, 320 U.S. 797 (1943).
98. Estate of Nettie S. Miller, 43 T.C. 760 (1964). Before deciding this point, however, the court held that "warrants" owned by the nonresident alien shareholder with the United States relative were in fact stock. Id. at 764. The Treasury had argued that they were more like options or convertible securities, which were to be treated as stock only if the effect was to make the corporation a Foreign Personal Holding Company, citing Int. Rev. Code of 1939, ch. 2, §§ 333(a)(4)(A), (b)(1), 53 Stat. 94 (now Int. Rev. Code of 1954, §§ 554(a)(4)(A), (b)(1)). If the warrants had not been treated as stock, the Treasury would have won its case without establishing that stock owned by a nonresident alien should be attributed to a United States relative, since actual ownership of stock by United States individuals, apart from the warrants, exceeded the required 50% ownership in the foreign corporation.
forty per cent of the stock. One of these individuals has a nonresident alien brother who owns eleven per cent of the stock. Five of the judges in the majority would have held this to be a Foreign Personal Holding Company. They would have utilized the family attribution rules to determine if United States individuals had more than fifty per cent control of the foreign incorporated pocketbook. The other four judges in the majority would have held otherwise. Family attribution would have been used only if the brother owning eleven per cent of the stock had been a United States individual. His stock could then have been attributed in order to determine if five or fewer individuals controlled the corporation. But these four judges refused to utilize the family attribution rules to determine if United States individuals "owned" more than fifty per cent of the foreign corporation’s stock. It was only after it had been determined that United States control actually existed that family attribution among the individuals in control could be utilized.

Two of the dissenting judges had no objection to applying the literal language99 of the statute and attributing stock ownership from a nonresident alien to a United States relative owning no stock. The third dissenter had some doubts about the constitutionality of an irrebuttable presumption of control between two relatives when one relative was a nonresident alien, and would have held that such a presumption was rebuttable. He concurred in the result reached by the other dissenters, however, because no evidence had been introduced to rebut this inference of control by the taxpayer, upon whom the burden rested.

We turn first to an analysis of the opinion of those four judges in the majority who would utilize family attribution rules only among United States shareholders who actually own more than fifty per cent of the foreign corporation’s stock. They suggested that there should be no attribution from a nonresident alien shareholder to his United States relative to determine if control by United States individuals existed because of the vital importance of United States control in the whole pattern of the Foreign Personal Holding Company law. They reasoned that the tax was imposed upon United States shareholders in order to pressure them into distributing the corporation’s undistributed profits. Unless United States individuals were clearly in control of the corporation’s dividend policy, they could not respond to the pressure of the tax and the statutory purpose would be frustrated.

An initial hurdle which any argument emphasizing control over dividend policy must overcome is that the statutory requirement of

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99. INT. REV. CODE OF 1954, § 554(a)(2) provides in part: "An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family . . . ."
control of the corporation by five or fewer individuals is determined by the ownership of more than fifty per cent of the value of the stock, rather than ownership of more than fifty per cent of the voting control.\textsuperscript{100} Voting control is necessary to control dividend policy. If, by utilizing a value test, Congress intended that personal holding company status result when five or fewer individuals owned more than fifty per cent of the value of the corporation's stock, but did not have voting control, then the emphasis of these four judges was completely misplaced. An examination of the history of the personal holding company law, upon which the Foreign Personal Holding Company law was based, however, shows that "value" was used as the criterion only to avoid taxing the investment company whose voting stock was owned by a few individuals for purposes of management continuity, but whose beneficial ownership was widely dispersed.\textsuperscript{101} Such a corporation was not considered a tax avoidance device. Thus, the use of a value test was employed to exempt an investment company from personal holding company status. Congress simply did not consider the case of a corporation where five or fewer individuals would own more than fifty per cent of the value of the corporation's stock but would not also have voting control. The fact that the Senate still considered voting control essential despite its adoption of a value test is strongly suggested by the Senate Finance Committee's explicit statement that family attribution should be used to determine if voting control exists in the hands of a few individuals.\textsuperscript{102}

The greater difficulty with the argument of these four judges is that it is internally inconsistent. They would not hesitate to attribute stock ownership among United States relatives to see if the "five or fewer individuals" test is met. And yet they would refuse to attribute between relatives to determine whether United States shareholders meet the greater than fifty per cent control requirement. It is illogical to presume mutual control between relatives for the one purpose and not the other, since these two requirements serve the same function. They are both designed to insure that the foreign corporation responds to unified United States control.

It is true that there is a statutory precedent for the refusal to attribute stock ownership from a nonresident alien to his United States relative. Such family attribution is expressly prohibited by the attribution rules used in connection with the Revenue Act of 1962 dealing

\textsuperscript{100} Int. Rev. Code of 1939, ch. 2, § 331(a)(2), 53 Stat. 92 (now Int. Rev. Code of 1954, § 552(a)(2)).

\textsuperscript{101} The original 1934 House Bill had provided for more than 50% voting control. H.R. 7835, 73d Cong., 2d Sess., § 102(b)(1)(B) (1934); H.R. Rep. No. 704, 73d Cong., 2d Sess. 11 (1934). However, the Senate Hearings brought out the problem of the investment company with few voting shareholders, but with many beneficial owners. Hearings Before the Senate Finance Committee on H.R. 7835, 73d Cong., 2d Sess. 172 (1934).

with foreign business ventures. One of the main purposes of this Act was to prevent the formation of foreign corporations by United States persons to earn business income abroad. To that end it imputes some of the foreign corporation’s earnings to certain of its United States shareholders and taxes its other earnings to these shareholders at ordinary graduated income tax rates upon the sale of the stock. The effect of these provisions is to interfere with the decisions of persons doing business abroad, including the nonresident aliens with whom the United States persons may be collaborating, since the distribution of earnings may become more desirable than their reinvestment. In this context, however, it is understandable that there should be no doubt about the control of the foreign corporations by United States persons. Questions concerning the constitutionality of interfering with foreign business decisions had been raised at the Committee hearings. Foreign policy considerations based on the resentment of other countries at interference in the business affairs of their corporations might also have weighed heavily with Congress. All of these considerations are completely absent, however, in the case of a foreign incorporated pocketbook, which is not a business venture at all.

It should also be remembered that the failure to impute ownership of a nonresident alien’s stock in a foreign incorporated pocketbook

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104. “Tax haven” business income is imputed to United States shareholders owning 10% of a “controlled foreign corporation.” INT. REV. CODE OF 1954, §§ 951(a)(1) (providing for such imputation), 954(a)(2), (3) (defining tax haven income), 957(a) (defining a controlled foreign corporation).

105. The Treasury originally sought to tax United States shareholders on all business earnings of a foreign corporation controlled by United States persons. Hearings Before the Senate Finance Committee on H.R. 10650, 87th Cong., 2d Sess. 99-103 (1962). However, Congress would not agree and, while tax haven income was so imputed (see note 104 supra), other earnings were to be taxed as dividends upon the sale of the foreign corporation’s stock. INT. REV. CODE OF 1954, § 1248.

The fact that the Revenue Act of 1962 was designed to prevent business income from being earned by foreign corporations instead of by United States corporations is proven by the provisions that United States shareholders may elect to be taxed as corporations on any income imputed to them, INT. REV. CODE OF 1954, § 962, added by Pub. L. No. 87-834, § 12, 76 Stat. 1023 (1962), and that the tax imposed upon the sale of stock in a foreign corporation be limited to the tax which would have been paid by a domestic corporation on the earnings in question plus the capital gains tax which would have been paid upon the corporation’s liquidation. INT. REV. CODE OF 1954, § 1248(b), added by Pub. L. No. 87-834, § 14, 76 Stat. 1042 (1962).

106. Distribution was made desirable, not only as a means to pay the tax, but also as a means of avoiding the imputation of earnings by making a “minimum distribution.” INT. REV. CODE OF 1954, § 963, added by Pub. L. No. 87-834, § 12, 76 Stat. 1023-27 (1962).


to his United States relative may not prevent the nonresident alien from suffering adverse consequences. If Foreign Personal Holding Company status does not result, personal holding company status may, bringing with it a burden on the nonresident alien shareholders that would otherwise have been avoided. The refusal to attribute from a nonresident alien shareholder to his United States relative in order to avoid injury to the nonresident alien should not be a consideration when dealing with foreign incorporated pocketbooks, whatever may be the logic of such a rule under the Revenue Act of 1962.

So far we have been concerned with the opinion of the four tax court judges who refused to attribute from a nonresident alien shareholder to his United States relative, even if the United States relative owned stock in the foreign corporation. We turn now to the opinion of the other five judges in the majority who would have objected to attribution only if the United States relative owned no stock in the foreign incorporated pocketbook. These five judges were perfectly willing to assume that five or fewer United States individuals had control over dividend policy if a nonresident alien shareholder had a United States relative and his stock were necessary to establish United States control, even if the United States relative owned no stock. They were bothered, however, by the fact that the tax imposed upon shareholders of the foreign incorporated pocketbook was supposed to force them to make a dividend distribution and, if one of the five or fewer United States individuals who was considered to be in control owned no stock, the tax did not fall on him. If the tax did not fall on him he would have no incentive to use his influence to accomplish the dividend distribution. If the United States relative owned some stock, even if attribution of the nonresident alien's stock were required to give United States individuals more than fifty per cent ownership of the foreign corporation, a tax was imposed on the United States relative.

It may be conceded that the United States individual owning no stock in the foreign corporation would feel no incentive to distribute corporate earnings to himself since no tax is imposed on him. However, this does not mean that the tax does not fall on those persons who are effectively in control of the foreign corporation. It seems perfectly reasonable to presume that there is a relationship of mutual control among the small group which consists of United States shareholders in a foreign incorporated pocketbook and a United States individual with a nonresident alien relative who owns stock in the corporation. If this presumption is rational, then the tax does fall on those shareholders who are in a position to control dividend policy.

One of the dissenting opinions contained a suggestion that the United States shareholders of the foreign incorporated pocketbook
did have some control over the United States member of the controlling group who owned no stock, by virtue of the fact that the United States individual owning no stock would want to have some United States individuals actually owning stock in the corporation after he had given away his stock to a nonresident alien relative. However, it is not necessary to indulge in such speculation. It is enough to support the statutory presumption of mutual control among members of the controlling group that it consists of a small coherent group of five or fewer individuals.

It cannot be denied that tax avoidance by United States individuals who remain in effective control of a foreign incorporated pocketbook is a distinct possibility if attribution to a United States relative who owns no stock in the corporation is not permitted. Consider the case of a United States individual whose wife's two brothers are from Europe. Only one brother is a United States resident and he is close to both his United States brother-in-law and his brother in Europe. The United States individual gives fifty per cent of the stock in his foreign incorporated pocketbook to his brother-in-law in Europe and retains the other fifty per cent. Certainly, it is reasonable to presume that the United States individual will retain control of the corporation. Yet Foreign Personal Holding Company status will not result unless there can be attribution from the nonresident alien brother to his brother residing in the United States.

The majority opinions also pointed to what they considered an irrational result if there could be attribution to a United States relative owning no stock. Consider the case of a United States citizen married to a nonresident alien. The couple lives abroad. The husband gives all of his stock in his foreign incorporated pocketbook to his wife. There are no United States shareholders. Attribution from the wife to the husband would result in no United States tax being paid by anyone. The majority failed to point out the further fact that personal holding company status would also be avoided since Foreign Personal Holding Companies are exempt from the personal holding company tax. However, no such irrational conclusion need be reached. It is a simple matter to say that Congress would not have intended the absurd result of Foreign Personal Holding Company status when no United States tax would thereby result.

Two of the judges in dissent thought that they answered the majority's objection to taxing minority United States shareholders by pointing out that a United States individual might own fifty-one per cent of the foreign corporation's stock and might command the corporation to the exclusion of the wishes of the other United States shareholders who were in a minority but who would nonetheless be taxed on their share of the corporation's undistributed profits. However,
this argument fails to consider the fact that mutual control among actual shareholders is at least more likely than mutual control among members of the "controlling" group, when one of such members owns no stock in the foreign corporation.

The same two dissenting judges also pointed to legislative history which clearly indicated that attribution could be made to one not owning shares in an incorporated pocketbook. However, the context in which this statement had been made indicated that such attribution was designed to prevent a head of a family from completely divesting himself of his stock in an incorporated pocketbook by giving it away to his family while still retaining effective control. Thus, a grandfather might distribute stock equally among six grandchildren, none of whom were siblings. Unless there were attribution to the grandfather, five or fewer individuals would not be considered to own stock in the corporation. This example indicates that attribution to one not owning stock was designed to establish that the requisite small number of individuals controlled the corporation, not to determine whether control rested in United States individuals. While this legislative history should not preclude the literal application of the family attribution rules to new situations involving possible tax avoidance, it does not support the proposition that attribution to one who is not a shareholder was intended to deal with the case where United States control was in doubt.

We have concluded, nonetheless, that the literal requirement of the statute must be followed and the stock owned by a nonresident alien attributed to his United States relative, whether the latter is a shareholder or not. The suggestion in one of the dissents that there be a rebuttable presumption of control between the United States individual and his nonresident alien relative is a reasonable solution to the problem, but one which cannot be supported as a matter of legislative interpretation. All of the attribution rules in the Code are in absolute terms. Furthermore, since the decision to attribute or not attribute from nonresident alien shareholders to United States relatives will often constitute a choice between a tax on United States shareholders under the Foreign Personal Holding Company law and a corporate tax on a personal holding company incorporated abroad, there can be little doubt that Foreign Personal Holding Company status is the preferred solution wherever possible. Certainly, this status is preferred when, as a result of the variations in the definitions of Foreign Personal Holding Company income and personal holding company in-

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110. Family attribution is limited to ancestors, lineal descendants, a spouse, and siblings; there cannot be attribution from a family member whose "ownership" of stock is itself the result of attribution. INT. REV. CODE OF 1954, §§ 544(a)(2), (5).
111. INT. REV. CODE OF 1954, §§ 267(c), 318(a), 544, 554, 1563(e).
come, personal holding company status would not even result if Foreign Personal Holding Company status were avoided.

It may be conceded that the Constitution requires control by United States individuals before undistributed profits may be attributed to United States shareholders, and that the whole purpose of a tax on shareholders is to force a dividend distribution, which purpose is frustrated if the tax does not fall on those in control. Still, we would allow attribution from a nonresident alien shareholder to a United States relative in all cases, since we are persuaded that the presumption of mutual control among members of the controlling group, whether or not they are all shareholders, is a reasonable one.

V. CONCLUSION

The problems discussed in this article are problems which arise when a statute is framed with a particular situation in mind but is then forced to deal with another situation for which it is not suited. The personal holding company tax was aimed at corporations whose shareholders were subject to graduated income tax rates. Its application to foreign corporations with nonresident alien shareholders turned out in certain situations to be both frustrating from a collection point of view and irrational from a legal point of view. Its application to foreign corporations with United States shareholders proved so unsatisfactory that the Foreign Personal Holding Company law was passed. However, it was never expected that shareholders of a foreign incorporated pocketbook would be both United States individuals and nonresident aliens or that nonresident alien shareholders would have United States relatives.

The suggestions offered in this article are made with a view towards rationalizing the taxation of foreign incorporated pocketbooks. It is probably true that laws to accomplish this result would further proliferate the tax legislation in the field of international taxation. However, the consequences of irrational tax laws are the existence of unnecessary loopholes and of traps for the unwary. Both of these results may be more undesirable than further legislation, especially in an area where taxes are likely to affect the flow of international investment.

112. See note 74 supra concerning the improbability of collaboration by United States individuals and nonresident aliens in the ownership of a foreign incorporated pocketbook.