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BLOCKED INCOME OF CONTROLLED FOREIGN CORPORATIONS

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HISTORY AND RATIONALE

Sections 951-972 of the INTERNAL REVENUE CODE taxes certain income of controlled foreign corporations to certain United States shareholders.[2] An exception was added in section 964(b) of the Code to provide that no part of such income would be taxed[3] if it is established that such income "could not have been distributed by the controlled foreign corporation to United States shareholders . . . because of currency or other restrictions or limitations imposed under the laws of any foreign country."[4] Although no specific rationale appears in the committee report for this exception, one can be deduced. The purpose of Subpart F was to eliminate certain tax haven abuses[5] by taxing the income of the controlled foreign corporation directly to its

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1. INT. REV. CODE of 1954, §§ 951-72 [hereinafter referred to as Subpart F]. This term is used for convenience in spite of the fact that sections 970-72 are officially designated Subpart G of Part III of Subchapter N of Chapter 1 of Subtitle A. No rationale appears for the division of these sections into two subparts except that Subpart G was added entirely by the Senate Finance Committee. S. REP. No. 1881, 87th Cong., 2d Sess. 273 (1962). Subpart G has the same relationship to subpart F as INT. REV. CODE §§ 954 (6) (1) and 955.

2. The basic provisions are contained in INT. REV. CODE of 1954, §§ 951(a), (b); 952(a); 958. The rest of Subpart F has been referred to as "deels" [sic]—Definitions, Exceptions, Exemptions, Limitations, and Special Rules.

3. The technical means for obtaining this nontaxability is by excluding the blocked amounts from "earnings and profits for purposes of sections 952, 955, and 956" and allowing the earnings and profits limitations of those sections, which control the amount included in the gross income of the United States shareholders under section 951(a), to reduce the included income to the unblocked portion.

4. This provision was inserted in the bill by the Senate Finance Committee. *Compare* H.R. RES. 10650, 87th Cong., 2d Sess. (1962), *with* S. REP. No. 1881, 87th Cong., 2d Sess. 94 (1962). For a partial view of one country's exchange restrictions, see Brock, *The Reform of French Exchange Controls,* 22 THE BUSINESS LAWYER 985 (1967).

5. S. REP. No. 1881, *supra* note 1, at 79; H.R. REP. No. 1447, 87th Cong., 2d Sess. 57-59 (1962); 1 *Hearings on the President's Tax Recommendations Before the House Committee on Ways and Means,* 87th Cong., 1st Sess. 8-9 (1961).

controlling shareholders when earned. The advantages accruing to the shareholder of retaining practical economic control over the earnings without subjecting them to United States tax until they are actually distributed (tax deferral) are thereby eliminated. This is justified on the premise that the shareholders, by controlling the corporation, have the full power of disposition over its earnings. Because blocked foreign income, by definition, may not be distributed to the shareholders in the United States,[6] the controlling shareholders do not have the power to pay themselves dividends and an exception to the tax was made. Indeed, several witnesses opposed the entire concept of Subpart F on the grounds that earnings of controlled foreign corporations are often undistributable and should not be taxed to shareholders who cannot use the income to pay the tax.[7]

The Internal Revenue Service has recently promulgated the regulations for blocked foreign income,[8] the penultimate regulations to be issued under Subpart F.[9] While the final regulations are similar to the Notice published February 13, 1965,[10] there are several important differences. This article will consider only the final regulations, except where discussion of the Notice is appropriate to understanding the final regulations.

The regulations are divided into four paragraphs. The first restates the general rule set forth in section 964(b),[11] the second defines blockage more particularly,[12] the third defines the removal of blockage and discusses its consequences,[13] and the fourth prescribes the procedure by which a United States shareholder claims the benefits of blockage.[14] In general, the regulations follow Mim. 6475,[15] which established an optional accounting system under which blocked foreign income could be deferred, where appropriate.

6. It might be contended that investment of earnings and profits in United States property under section 956 is impossible if the earnings and profits are blocked. It is conceivable that a foreign country might permit a corporation to invest in United States property that might be useful to the foreign country, *e.g.*, stock of a United States importer of goods manufactured in the foreign country, while denying the corporation foreign exchange to distribute dividends. No such situation has been called to the author's attention.

7. 2 *Hearings on H.R.* 10650 *Before the Senate Finance Committee*, 87th Cong., 2d Sess. 568, 738, 776, 783 (1962).

8. Treas. Reg. § 1.964-2(1966).

9. Proposed Treas. Reg. §§ 1.960-1 to -6, 30 Fed. Reg. 5595 (1965) has not yet been issued in final form. However, many of the issued regulations require revision. *See, e.g.*, Treas. Reg. §§ 1.954-4(b) (1) (iv) (1964), 1.964-1(c) (6) (1964).

10. Proposed Treas. Reg. § 1.964-230 Fed. Reg. 2031 (1965).

11. Treas. Reg. § 1.964-2(a) (1966).

12. Treas. Reg. § 1.964-2(b) (1966).

13. Treas. Reg. § 1.964-2(c) (1966).

14. Treas. Reg. § 1.964-2(d) (1966).

15. 1950-1 CUM. BULL. 50.

BLOCKAGE DEFINED

The paragraph defining blockage is the most important provision of the regulation. The period during which distribution must be restricted in order to constitute blockage is limited to the 150-day period beginning ninety days before the close of the taxable year and ending sixty days after the close of such year. This period coincides with the last 150 days of the period for making a minimum distribution for the taxable year.[16] The Notice provided that the period of blockage was the 150-day period beginning immediately after the close of the taxable year. This created problems. When the blockage period does not terminate until the end of May for a calendar year, it is possible that the corporation would be unable to assemble the necessary financial data before the time arrives for filing the United States shareholders' federal income tax returns.[17] Moving the blockage period backward should ameliorate this difficulty. If the blockage period terminates at the beginning of March, a United States shareholder should be able to secure financial results before the middle of September. On first impression it seems more logical to require the restriction period to include all of the taxable year, or at least that part of the taxable year which follows the restriction period for the prior taxable year.[18] However, this would be unwise because current earnings and profits are generally not distributed until the end of the taxable year or the beginning of the following taxable year. That earnings and profits from a prior year may be readily distributable during the first 305 days of the taxable year should make no difference to the question of whether the current year's earnings and profits are blocked.

Blockage is determined under the facts and circumstances of each particular case. In general, a restriction must prevent either the ready conversion of the necessary funds to United States dollars

16. Treas. Reg. § 1.963-3(g) (1964).

17. District directors are authorized to grant extensions of time from the normal filing date but no extension may exceed six months unless the taxpayer is located abroad. Treas. Reg. § 1.6081-1(a) (1959). The fact that the taxpayer must secure information from abroad does not permit a district director to grant an extension exceeding six months if the taxpayer is in the United States. If the United States shareholder is a corporation, it is automatically entitled to a three month extension by filing Form 7004. Treas. Reg. § 1.6081-3(a) (1959). It is common to grant corporations the full six months authorized by statute on request. It would seem that the unavailability of necessary data to a United States shareholder should be sufficient ground for securing the full six months extension authorized by section 6081(a) of the CODE. This would permit a calendar year taxpayer to file his return as late as September 15.

18. The blockage period would be the same as the distribution period under Treas. Reg. § 1.963-3(g) (1964) for making a minimum distribution.

or distribution of the dividend to the United States shareholder. The regulation gives specific examples of blockage. Conversion to United States dollars may be accomplished by conversion to other currency which is readily convertible into United States dollars or by conversion into property, of a type normally owned by the controlled foreign corporation in the operation of its business, which is readily convertible into United States dollars. Presumably, property is readily convertible to United States dollars if it is readily convertible into a foreign currency which is readily convertible into United States dollars. The fact that a three-step process (blocked currency to property to foreign currency to United States dollars) must be used rather than a two-step process (blocked currency to property to United States dollars) should make no difference. That is, a foreign county must *both* restrict the conversion of its currency into United States dollars and prevent the ready conversion of property, of a type normally owned by the controlled foreign corporation in the operation of its business, into United States dollars. The significant factor is the ease with which the total conversion from foreign currency to United States dollars may be made. The use, by the Regulations, of the term "readily" introduces a question of degree. It seems to refer to the amount of effort required to accomplish the conversion rather than to any discount loss, for which a specific provision is made elsewhere.[19] Obviously, each additional step required for conversion renders the funds less readily convertible. Drawing the line between currency which is readily convertible and that which is not is a familiar judicial and administrative problem that must be solved on the facts and circumstances of each case.[20]

This definition substantially liberalizes the Notice, which could have been interpreted to require a corporation to deal in goods with which it was unfamiliar if such goods could be readily converted into United States dollars;[21] the risk of fluctuation in the price of unfamiliar goods would thus have been placed on the corporation. However, a corporation with blocked funds can often sell the foreign currency to a person who imports from the country concerned, taking

19. Treas. Regs. § 1.964-1(d) (1964).

20. For a similar problem of degree, see United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945), where Judge Learned Hand concluded that ninety per cent of the market constitutes a monopoly, sixty per cent might, and thirty-three per cent does not under section 2 of the Sherman Antitrust Act of 1890, 15 U.S.C. § 2 (1964).

21. Proposed Treas. Reg. § 1.964-2(b)(2)(i), 30 Fed. Reg. 2031 (1965). Dealing in unfamiliar goods is not foreign to corporate life. Movie companies buy gold or raise treasure ships to repatriate earnings. Wall Street Journal, March 3, 1966, at 1, col. 1.

payment in convertible currency.[22] The possibility of such a sale would render the currency convertible into United States dollars, even though it must be done indirectly. Presumably the Service must demonstrate the sale's possibility, as the taxpayer could hardly prove its nonexistence.

A further rule is imposed to prevent the pyramiding of corporations behind a first tier subsidiary whose distributions would be blocked. If a United States shareholder owns[23] eighty per cent or more of the total combined voting power of all classes of stock of a foreign corporation in a chain of corporations, the distribution of dividends by such corporation "will not be considered prevented *solely* by reason of the existence of a currency or other restriction or limitation at an intermediate tier in such chain if dividends may be distributed directly to such shareholders."[24]

This rule leaves several ambiguities. When may dividends be distributed directly to the shareholders? First, if the provision refers to direct distribution permitted by law, no corporation law has been found which would allow the distribution of dividends to anyone other than a shareholder in that corporation. This interpretation is not credible. Another possibility is that the regulation refers to a case where a distribution could be made directly from the controlled foreign corporation without infringing upon the interests of other shareholders. For example, where a United States corporation has a *wholly* owned subsidiary incorporated in *X* and the subsidiary has a *wholly* owned subsidiary incorporated in *Y*, the second-tier subsidiary (*Y* corporation) could make a direct distribution to the United States shareholder without infringing the rights any person might have in the first-tier subsidiary (*X* corporation) or second-tier subsidiary. Of course, this ignores the government of *X*, which will no doubt tax the receipt of dividends by the *X* corporation from the *Y* corporation[25] and their payment to the United States shareholders.[26] This, however, may not be the purpose of the rule, as the rule includes eighty per cent ownership. With less than full ownership of either corporation it would be difficult to make a distribution without infringing a rival shareholder's rights. Presumably, however, the United States corpora-

22. *Id.* at 1, col. 1; *id.* at 20, col. 4.

23. Either directly or through imputed ownership of shares owned by relatives, or by corporations, trusts or partnerships controlled by the shareholder, or subject to purchase at the shareholder's option. INT. REV. CODE of 1954, §§ 318(a), 958.

24. Treas. Reg. § 1.964-2(b)(2)(ii)(1966) (emphasis added).

25. *See, e.g.*, HARVARD LAW SCHOOL, WORLD TAX SERIES: FRANCE, 11/2.8b (1966).

26. *See, e.g.*, HARVARD LAW SCHOOL, WORLD TAX SERIES: FRANCE, 11/3.3, 3.4, 4.11b (1965).

tion and the minority interests could waive their rights to dividends from the first-tier subsidiary and receive their dividends directly. More problems arise where neither subsidiary corporation is wholly owned, and a complex accounting procedure may be required to determine whether or not the dividends may be distributed directly.

The direct distribution rule may have a third explanation. It may apply only when there is a consistent pattern of distribution which has been established and which the United States shareholder attempts to discontinue, for example, as a result of taxpayer's economic or tax situation. Where there is an absence of change in circumstances to demonstrate the impossibility of continued direct distribution, this interpretation makes sense. However, any factor that would prevent direct distribution to the eighty per cent shareholder, such as the termination of acquiescence by a foreign government, should be sufficient to establish the existence of blockage. If this is the rule intended by the Commissioner, the Regulation's expression of it is Delphic. Furthermore, such a rule should require the Commissioner to establish the past pattern of direct distribution rather than charging the taxpayer with establishing some unspecified condition for proving blockage, as the use of the term "solely" in the regulations implies. As paragraph (d) of the Regulations does not require information relating to patterns of distribution in previous years, the Commissioner is taking no steps to secure such information. Although the Regulation specifies eighty per cent ownership, the Service will probably use this provision only where a shareholder has full ownership. Lowering the requirement to eighty per cent guards against the divestment of a few shares to avoid the rule.

Another question can be raised with respect to this direct distribution rule. The legislative history specifically provides that earnings and profits are blocked where "the restrictions apply at some point in the chain of ownership."[27] It can be argued that regardless of the possibilities of direct distribution, this indicates that earnings are blocked if they cannot be distributed in ordinary channels. But it is better to view the language of the committee report as referring to bona fide, absolute blockage. If direct distribution can be made, no blockage would exist because there is no effective restriction on the distribution of dividends. The Regulation is directed to the question whether or not bona fide blockage exists at all. As such, the Regulation

27. S. Rep. No. 1881, *supra* note 1, at 272.

is well within the Commissioner's rule making power in this area.[28]

Nor is the provision inconsistent with another Regulation,[29] which provides for the exclusion from a group election for minimum distribution purposes of any foreign corporation whose pro rata minimum distribution cannot be distributed because of blockage. That provision keeps the group "pure". In contrast, the direct distribution rule helps to determine when blockage occurs. The rules have been formulated for different purposes so it is not unreasonable to have different rules.

The Regulations do not specify when foreign currency is "readily convertible" to United States dollars. In particular, is there ready convertibility when it can be done only at a discount or by making an interest free loan to the foreign government? The conversion loss is a serious and common problem which should not be ignored by the Internal Revenue Service. Mim. 6475,[30] the only other comprehensive treatment of blocked foreign income in the tax laws, also ignores this problem. While it can be argued that there is a "tip" point in conversion loss beyond which income is effectively blocked, the term "readily convertible" is probably not designed to make an exception for conversion at a discount. It is difficult to determine what percentage loss would be significant for blockage purposes. Clearly ninety per cent would substantially terminate the distribution of dividends by a

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28. INT. REV. CODE OF 1954, § 964(b) specifically grants the Secretary authority to issue Regulations relating to blocked foreign income. General authority is found in section 7805(a).

29. Treas. Reg. § 1.963-1(f) (1964).

30. 1950-1 CUM. BULL. 50. Under Mim. 6475, the taxpayer must also defer deductions and the foreign tax credit. Treas. Reg. §§ 1.461-1(a)(4), 1.905-1(b) (1957). Under Subpart F, the deductions are included already in calculating earnings and profits. For a view of some of the non-Subpart F tax problems of currency fluctuations, see Comment, *Income Tax Consequences of Foreign Currency Fluctuations*, 37 TUL. L. REV. 282 (1963). For a discussion of the background for Mim. 6475, see Angel & Kramer, *Income-Tax Problems Arising from Foreign Currency Restrictions and Devaluations*, 88 J. ACCOUNTANCY 502 (1949); Carroll, *The Need for a Practical Rule for Taxing Foreign Income in Blocked Currency*, 87 J. ACCOUNTANCY 229 (1949); Klarmann, *Taxation of Income in Blocked Currency*, 28 TAXES 477 (1959); Roberts, *Effect of Blocking of Currency on Gain or Loss*, N.Y.U. 7TH INST. ON FED. TAX 1224 (1959); Roberts, *Taxability of Income Received in Blocked Currency*, 86 J. ACCOUNTANCY 231 (1948); Shepard, *Foreign Exchange—Tax Consequences*, 1 TAX L. REV. 232 (1946); Stream, *Earned Income from Foreign Sources*, 26 TAXES 714 (1948). For comments on Mim. 6475, see Angel & Kramer, *Some Questions on Taxability of Foreign Income Left Unanswered by Mim. 6475*, 89 J. ACCOUNTANCY 496 (1950); Roberts, *New Developments in Foreign Exchange*, N.Y.U. 9TH INST. ON FED. TAX. 819 (1951); and Stuetzer, *Tax Problems Raised by Foreign Currency Devaluation and Blocked Foreign Income*, 6 TAX L. REV. 255 (1951).

Mim. 6475 was amended by Mim. 6494, 1950-1 CUM. BULL. 54, and Mim. 6584, 1951-1 CUM. BULL. 19. The amendments are irrelevant to our discussion. Mim. 6475, as amended, was made applicable to the INT. REV. CODE OF 1954 by § 10 of Rev. Rul. 55-171, 1955-1 CUM. BULL. 80, 88.

foreign corporation, no matter how affluent. On the other hand, a ten per cent loss might be absorbed without difficulty. Since any earnings and profits would be included with consideration of the discount loss, arguments that a necessary exhange loss creates blockage would not prevail. Thus, if a loss of fifty per cent would be experienced on distribution, the United States shareholder may receive the distribution, absorb the loss, and pay tax on the received amount as a dividend. On the other hand, he may choose not to receive the distribution, in which case his gross income will be increased only by the amount of the distribution which he could have received. This is because the conversion of earnings and profits into United States dollars under section 1.964-1(d)[31] contains an adjustment for translation at a discount or premium.

The forced loan presents a different problem. For example, suppose that corporation *A* has earnings and profits of two hundred thousand dollars in *X* country, which requires the distributing corporation to make an interest free loan to the government equal to the amount distributed. It is doubtful that this would be considered in the translation process under section 1.964-1(d).[32] Nor is it likely to be taken into account under paragraph (e) of that section, relating to exchange gains and losses, since there is no exchange. Nonetheless, the forced loan problem can be handled under ordinary blockage rules. In the example given, 100,000 dollars of earnings and profits would be considered blocked, as that amount must be loaned to the foreign government if the corporation made the greatest distribution possible, *i.e.*, 100,000 dollars. The other 100,000 dollars, which could have been distributed, is not blocked. This result is consistent with the purpose of the section—imposition of the tax only where the United States shareholders have distribution control of the earnings and profits. That such a result may put a United States shareholder to a difficult choice is not doubted. To repatriate half his earnings, he must yield the opportunity to use the other half to produce earnings in the foreign country which might eventually be convertible. If he does not repatriate half, he is taxed on it nonetheless, with no money to pay the tax except that from other income sources.

Any official act by foreign authorities within the foreign country may impose blockage.[33] Blockage by means of unauthorized but fully effective acts of foreign officials should not, however, be excluded. For example, an official in the foreign finance ministry might without

31. Treas. Reg. § 1.964-1(d) (1965).
32. *Id.*
33. Treas. Reg. § 1.964-2(b)(3) (1966).

authority deny permission to export currency. As long as this denial of permission were not influenced by the controlled foreign corporation or its shareholders and could not be remedied by court action abroad, this should be considered a bona fide impediment to the distribution of dividends and should be recognized as blockage within the general rule.

Voluntary restrictions or limitations on the issurance of dividends or the converting of earnings and profits into United States dollars do not constitute blockage.[34] Examples are given of à stock dividend which has the effect of capitalizing earnings and profits, the restriction of earnings and profits or the making of certain investments as a means of avoiding or reducing current (foreign) tax, or the allocation of earnings and profits to an optional or arbitrary reserve. It seems consonant with the purposes of the section to forbid a United States shareholder to choose between relief from foreign tax and the benefits of blockage. The stock dividend and optional reserve rules regulate situations where the corporations consciously choose to limit distribution to effectuate certain goals; when they have a choice between repatriation of earnings and profits and voluntarily submitting them to restrictions, it can scarcely be said that the earnings and profits are blocked.

Where the controlled foreign corporation is required by a foreign country to establish a reserve out of earnings and profits for the taxable year, the earnings and profits of that year are only considered subject to blockage to the extent that the amount of the reserve exceeds the accumulated earnings and profits at the close of the preceding taxable year.[35] In determining the accumulated earnings and profits, amounts which have been included in gross income of the United States shareholder under section 951(a) or 551(b) and have not been distributed or amounts which became subject to voluntary blockage during a taxable year beginning before January 1, 1963, are not included.[36] This provision is designed to assure that amounts restricted before the effective date of Subpart F and amounts already taxed to the shareholder will not be reincluded in his gross income.

It is doubtful that the mandatory reserve provisions will have much effect when all of the controlled foreign corporation's income is Subpart F income. Any earnings and profits retained from a prior year in which there was no blockage will already have been included in the gross income of the United States shareholders and thus excluded

34. Treas. Reg. § 1.964-2(b)(4) (1966).
35. Treas. Reg. § 1.964-2(b)(5)(i) (1966).
36. Treas. Reg. § 1.964-2(b)(5)(ii) (1966).

from accumulated earnings and profits. In such a corporation, this provision would be effective only where the foreign country places a restriction on current earnings and profits for the period of the succeeding taxable year. Since paragraph (c)[37] would include the amount which has become unblocked as a result of the passage of time in the gross income of the shareholders, this provision seems unnecessary for a corporation all of whose income is Subpart F income. This provision is designed rather for the corporation with substantial income that is not Subpart F income. Such a corporation might claim that a mandatory reserve results in the blockage of its Subpart F income even though other income is distributable. Such a contention is nonsense and this provision effectively forecloses it.

The United States shareholder must demonstrate either that the available procedures for distributing the earnings and profits have been exhausted or that the use of such procedures will be futile.[38] Generally the foreign corporation must apply for dollars at the appropriate rate of exchange and comply with applicable laws governing the acquisition and transfer of such currency. The fact that the applicable procedures for distributions were exhausted without success in prior years does not in itself constitute sufficient evidence that the procedures would not be successful in the current year. The Regulation does not suggest what additional evidence would be necessary. Presumably a starting point might be the introduction of an International Monetary Fund, Annual Report on Exchange Restrictions, showing the continuance of the prohibitions. In addition, a letter should be submitted from foreign counsel indicating that no change has taken place in the law or administrative practice of the foreign country between the time when the procedures were exhausted in the prior year and the end of the distribution period. The Annual Report could also be used to prove that the controlled foreign corporation could not have converted the foreign currency to property, with which it normally deals, which could, in turn, be readily converted into United States dollars; the Report generally will show whether or not such property is exportable for United States dollars. In addition, an opinion of counsel would be of assistance.

REMOVAL OF BLOCKAGE

Paragraph (c) of the Regulation[39] defines the removal of block-

37. Treas. Reg. § 1.964-2(c) (1966).

38. Treas. Reg. § 1.964-2(b)(6) (1966). Mim. 6475 specified no such requirement but the courts were quick to apply it. Edmund Weill, Inc. v. Commissioner, 150 F.2d 950, 952 (2d Cir. 1945).

39. Treas. Reg. § 1.964-2(c) (1966).

age and details its consequences. In general, blockage is removed (1) when money or property in the foreign country is readily convertible into United States dollars, into other currency, or into property, of a type normally owned by the controlled foreign corporation in the operation of its business, which is readily convertible into United States dollars; (2) when conversion is actually made; (3) when a reserve requirement is removed either by change in foreign law or by an accumulation of earnings and profits not subject to the requirement; or (4) when a distribution is made to the United States shareholder in the foreign country.[40] Thus, the removal of blockage is accomplished by eliminating the factor that caused or continued the blockage. Where the restriction is removed by distribution in a foreign currency in a foreign country, the shareholder may still elect a deferred method of accounting under Mim. 6475.[41] If he elects to defer the income, it is not included in his gross income until the blocked income becomes readily convertible into United States dollars, is actually converted into United States dollars, is used for nondeductible personal expenses or disposed of by gift, or, in the case of a resident alien, the alien terminates his United States residence. Investment in foreign business or securities does not constitute a nondeductible personal expense which would terminate the deferred character of the income.[42]

On the last day of the taxable year of the controlled foreign corporation in which the blockage is removed, each United States shareholder must include in his gross income the amount which would have been included in his gross income for prior taxable years but for the existence of the (now removed) blockage.[43] If, however, the percentage of stock owned by the United States shareholder has decreased since the blockage occurred, the inclusion is made on the basis of the pro rata share of the earnings and profits at the close of the taxable year immediately preceding the removal of the blockage. Thus, where a party owns eighty per cent of the stock on the date of the blockage and sells twenty per cent before the end of the taxable year preceding the removal of the blockage, only sixty per cent of the blocked income is included in his gross income. The remaining twenty per cent which he has sold carries no taint of blockage and is not subject to future inclusion. It is doubtful, however, that this provision will permit intra-company or intra-family dealings, which make no substantial

40. *Cf.* Mim. 6475, 1950-1 CUM. BULL. 50, 51
41. 1950-1 CUM. BULL. 50.
42. I.T. 4037, 1950-2 CUM. BULL. 31.
43. Treas. Reg. § 1.964-2(c)(1) (1966).

change in the beneficial ownership.[44]

No justification for requiring the inclusion, in the gross income of the United States shareholder, of amounts from which blockage has been removed can be found either in the statute or in the legislative history. The only precedent for this procedure is Mim. 6475.[45] However, the reinclusion under the mimeograph is supported by the agreement of the taxpayer to include the blocked income in his gross income when it becomes unblocked as a condition to adopting the accounting method. No such consent appears in the case of section 964(b), although it might be claimed that the use of blockage under section 964(b) operates as an implied consent to the reinclusion in the shareholder's income of unblocked income. Although section 964 (b) is not a section subject to an election, no adverse tax consequences befall the United States shareholder who wishes to ignore the fact that his income is blocked. He simply pays the tax in an earlier year than required. No amount is included when blockage is removed because no amount "would have been included in his gross income. . . for prior taxable years but for the existence of the (blockage)."[46] The result can be justified, however, by looking to the policy of the act. Congress only intended to remove from United States shareholders the burden of paying tax on income which they could not reach. The means used to reach this result was by excluding the amount from earnings and profits. The fact that the exclusion (over a period of years) does not exactly match the inclusion (all at once) should not permit a person to avoid tax completely by the simple institution of blockage.

Removal of blockage results in the inclusion in earnings and profits for the year in which the formerly blocked earning and profits were accumulated.[47] Translation into United States dollars, however, is made at the exchange rate for the translation period during which

44. The same result is obtained in determining the pro rata share of a United States shareholder's increase in investment in United States property under section 956(a)(2). Treas. Reg. § 1.956-1(d) (1964).

In the aera of wash sales to create capital losses, the courts seem to be groping toward a test aimed at determining whether the subsequent acquisition of the stock by a family member or business associate was on behalf of the seller or genuinely for the buyer. *Compare* Cole v. Helburn, 4 F. Supp. 230 (W.D. Ky. 1933), Frank B. Gumney, 26 B.T.A. 894 (1932), DuBois Young, 34 B.T.A. 648 (1936) *with* Elliot W. Mitchell Est., 37 B.T.A. 161 (1938), W. E. Bronchon, 30 B.T.A. 404 (1934), and Shoenberg v. Commissioner, 77 F.2d 446 (8th Cir. 1935). McWilliams v. Commissioner, 331 U.S. 694 (1947) now disallows the deduction for the sale by one taxpayer and the subsequent purchase by a related taxpayer under INT. REV. CODE, § 267(a)(1).

45. 1950-1 CUM. BULL. 50.

46. Treas. Reg. § 1.964-2(c)(1)(i) (1966).

47. Treas. Reg. § 1.964-2(c)(1)(ii) (1966).

the blockage is removed[48] because this is the first time these earnings could have been distributed.

The status of blocked earnings which are distributed during the taxable year is determined under other rules.[49]

CONCLUSION

In general, the Regulations, in a difficult area, seem to strike an equitable balance between assuring taxpayer compliance and fairness to the taxpayer. In addition, they should encourage substantial repatriation of dividends wherever possible since the Commissioner seems unlikely to accept anything but the strongest evidence of blockage.

Election of the deferred accounting method under Mim. 6475[50] was difficult for many individuals because of our progressive rate structure. Blockage built up over several years was likely to be removed entirely in one year, leading to the inclusion of the entire amount in the taxpayer's gross income for one year, with a resultant high tax burden. With the enactment of income averaging provisions,[51] permitting the taxation of income received in one year as though it had been received during the five years ending with the termination of the year in which the income is actually received, more individuals may take advantage of Mim. 6475.[52] Since the same problem of bunched income may occur where a controlled foreign corporation has blocked foreign income under section 964(b), the use of that section will also be encouraged.

48. It would involve an extra step to include the earnings and profits using the translation rate applicable when the earnings become blocked, then provide a special provision for determining translation gain or loss if the earnings had been distributed at the time at which they were included in gross income.

49. Treas. Reg. § 1.959-3 (1965).

50. 1950-1 CUM. BULL. 50.

51. INT. REV. CODE of 1954, §§ 1301-05. These provisions were added by section 232(a) of the Revenue Act of 1964, 78 Stat. 105. Previously, only certain compensation for personal services, income from inventions or artistic work, certain backpay, compensation for damages for patent infringement, breach of contract damages, and damages for injuries suffered under the antitrust laws could be averaged.

52. 1950-1 CUM. BULL. 50.