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Tax Law: Deductions in Subpart F Income of Controlled Foreign Corporations Through Use of the Chain Deficit Rule Stanford v. Commissioner, 152 F.3d 450 (5th Cir. 1998)

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TAX LAW: DEDUCTIONS IN SUBPART F INCOME OF CONTROLLED FOREIGN CORPORATIONS THROUGH USE OF THE CHAIN DEFICIT RULE *Stanford v. Commissioner*, 152 F.3d 450 (5th Cir. 1998)

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I. FACTS

This comment reviews the interpretation of the chain deficit rule of section 952(c)(1)(C) of the Internal Revenue Code.[1] In *Stanford v. Commissioner*,[2] the petitioners, Robert A. and Susan Stanford,[3] claimed that the Respondent's assessment of a tax deficiency[4] against them for 1990 and an accuracy related penalty[5] for their resulting underpayment of tax were improper based on the tax law.[6] Robert Stanford[7] set up three corporations in the British West Indies, each of which qualified as a "controlled foreign

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** I wish to thank Marcy for all her love and support.

1. I.R.C. § 952(c)(1)(C) (1997). The chain deficit rule is used as a means of reducing a corporation's taxable income. Kurt A. Wagner, *U.S. Taxation of Foreign Income: The Use of Tax Havens in a Changing Tax Environment*, 18 S. ILL. U. L.J. 617, 633 (1984).
2. 152 F.3d 450 (5th Cir. 1998).
3. Susan Stanford became a party because she had signed the 1990 joint tax return. *Id.* at 452 n.2.
4. The deficiency was US$423,531.36, based on deductions of US$1,406,365 that were disallowed on audit by the Internal Revenue Service Commissioner. *Id.* at 454.
5. This case comment deals solely with the deficiency and not the accuracy-related penalty.
6. *Id.*
7. Robert Stanford is a U.S. citizen and a Houston resident. *Id.* at 452.

corporation" (CFC).[8] Stanford Financial[9] was the common parent to Guardian Bank and Guardian Services,[10] which were related as brother-sister corporations.[11]

Stanford filed suit in Tax Court[12] claiming that section 952(c)(1)(C)[13] allowed for a deduction of Guardian Bank's subpart F income because the services that were performed for Guardian Bank by Stanford Financial and Guardian Services created deficits in Stanford Financial and Guardian Services' earnings for 1989 and 1990.[14] The Tax Court ruled that the deficiency and the accuracy related penalty were appropriate because Guardian Services was not a qualified chain member with respect to Guardian Bank.[15] Additionally, the court found that even though Stanford

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8. *Id.*; *see* I.R.C. § 957(a). "A CFC is defined as any foreign corporation where more than 50 percent of the corporation's stock, either by voting power or value, is owned directly, or indirectly, or constructively by United States shareholders." *Stanford*, 152 F.3d at 453.

9. In 1987, Stanford Financial Group, Inc. (Stanford Financial) was incorporated to function as a holding company, and in 1989-90, it provided administrative and management services to Guardian Bank. *Id.* at 452.

10. During 1989 and 1990, Guardian Services supplied marketing and advertising services to Guardian Bank. *Id.*

11. *Id.*

12. Stanford v. Commissioner, 108 T.C. 344, 344 (1997).

13. I.R.C. § 952(c)(1)(C) reads as follows:

> (C) Certain deficits of member[s] of the same chain of corporations may be taken into account.
>
> (i) In general. A controlled foreign corporation may elect to reduce the amount of its subpart F income for any taxable year which is attributable to any qualified activity by the amount of any deficit in earnings and profits of a qualified chain member for a taxable year ending with (or within) the taxable year of such controlled foreign corporation to the extent such deficit is attributable to such activity . . . .
>
> (ii) Qualified chain member. For purposes of this subchapter, the term "qualified chain member" means, with respect to any controlled foreign corporation, any other corporation which is created or organized under the laws of the same foreign country as the controlled foreign corporation but only if —
>
> > (I) all the stock of such other corporation (other than directors' qualifying shares) is owned at all times during the taxable year in which the deficit arose (directly or through 1 or more corporations other than the common parent) by such controlled foreign corporation, or
> >
> > (II) all the stock of such controlled foreign corporation (other than directors' qualifying shares) is owned at all times during the taxable year in which the deficit arose (directly or through one or more corporations other than the common parent) by such other corporation.

Id.

14. *Standford*, 108 T.C. at 344, 349. Invoking Guardian Bank's section 952(c)(1)(C)(i) election, Stanford reduced Guardian Bank's 1990 subpart F income by the total deficits of US$2,789,722 in the 1990 earnings and profits of Guardian Services and Stanford Financial. *Stanford*, 152 F.3d at 453.

15. *Stanford*, 108 T.C. at 353. The trial court ruled that Guardian Services and Guardian Bank, as brother/sister corporations, were only related to each other through their common

Financial was a qualified chain member of Guardian Bank, Stanford Financial's deficit in earnings and profits arose from the performance of administrative services.[16] Therefore, Stanford Financial's deficit in earnings was not attributable to the same qualified activity[17] as was Guardian Bank's subpart F income.[18] The Fifth Circuit Court granted review, and HELD, that the Tax Court's judgment in terms of the tax deficiency was correct, but vacated the accuracy-related tax penalty.[19]

II. HISTORY

The chain deficit rule in section 952(c)(1)(C) was added to the Internal Revenue Code in 1988 and was made retroactively applicable to any tax year ending after 1986.[20] A broader chain deficit rule, section 952(d), was in effect for tax years ending before 1987.[21] The old chain deficit rule focused on the stock ownership interests of the U.S. shareholder,[22] while the current chain deficit rule of section 952(c)(1)(C) focuses on the stock ownership interests of the CFC and the deficit corporation.[23]

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parent, Stanford Financial, and therefore, Guardian Services did not qualify as a chain member of Guardian Bank. *Id.*

16. *Id.* at 354.

17. For "qualified financial institutions," such as Guardian Bank, a qualified activity is one that gives rise to "foreign personal holding company income." I.R.C. § 952(c)(1)(B)(iii)(VI). In the instant case, it was agreed by Stanford and the Commissioner that Guardian Bank's qualified activity, through which it generated foreign personal holding company income, was banking. *Stanford*, 152 F.3d at 458; I.R.C. § 952 (c)(1)(C).

18. *Stanford*, 108 T.C. at 353.

19. *Stanford*, 152 F.3d at 452, 460 (stating that Stanford acted in good faith based on the advice of his attorney, thus the penalty was inappropriate).

20. Technical and Miscellaneous Revenue Act of 1988, Pub.L. No. 100-647, § 1012(i)(25)(A), 102 Stat. 3342, 3512 (codified at I.R.C. § 952(c)).

21. *See* I.R.C. § 952(d) (1986).

22. I.R.C. § 952(d) stated as follows:

> [F]or purposes of subsection (c), if (1) a United States shareholder owns stock of a foreign corporation, and by reason of such ownership owns stock of any other foreign corporation, and (2) any of such foreign corporations had a deficit in earnings and profits for the taxable year, then the earnings and profits for the taxable year of each such foreign corporation which was a controlled foreign corporation would, with respect to such United States shareholder, be properly reduced to take into account any deficit described in paragraph (2) in such manner as the Secretary would prescribe by regulations.

Id.

23. *Id.* § 952(c)(1)(C). The old chain deficit rule allowed for reduction of subpart F income of a CFC in a chain regardless of the relationship between the CFC and the deficit corporation, so long as each corporation was directly or indirectly held by the same U.S. shareholder. H.R. CONF. REP. NO. 99-841, at 623 (1986), *reprinted* in 1986 U.S.C.C.A.N. 4075, 4711.

A. *Legislative History*

Congress repealed section 952(d) in 1986 because of concerns that U.S. taxpayers operating abroad through CFCs could shelter too much income from current U.S. tax liability.[24] Deficits in earnings and profits of members within a chain of corporations were being used to reduce the subpart F income of CFCs within the chain even though the deficits bore little or no relation to the income that they offset.[25]

The legislative history of section 952(c)(1)(C) addressed curtailing taxpayer reduction of subpart F income of CFCs by deficits in earnings and profits of chain members that bore little or no relationship to that income.[26] However, the legislative history did not discuss qualified chain members or the extent of the "attributable to" phrase in section 952(c)(1)(C).[27] There are, to date, no cases on record dealing with the new chain deficit rule of section 952(c)(1)(C). *Unisys Corp. v. United States*, however, dealt with the old rule of section 952(d) as a case of first impression.[28]

B. *Judicial History*

In *Unisys*, the court held that the no diminution rule[29] must be applied when calculating CFC earnings and profits for purposes of the chain deficit rule.[30] The taxpayer claimed that the distributions from seven foreign subsidiaries of Burroughs International (BISA) to BISA should be included in the deficits of those seven corporations, thereby reducing BISA's subpart F income under the chain deficit rule of section 952(d).[31]

The *Unisys* court reasoned that the no diminution rule is within the scope of the express authority delegated by Congress to devise a chain deficit ratio that establishes the manner in which chain deficits may be taken into account for the purpose of reducing earnings and profits.[32] The court in *Unisys* did

24. H.R. CONF. REP. NO. 99-841, *supra* note 23, at 623. A tax shelter is a "device used by a taxpayer to reduce or defer payment of taxes." BLACK'S LAW DICTIONARY 1462-63 (6th ed. 1990).

25. H.R. CONF. REP. NO. 99-841, *supra* note 23, at 623.

26. *Id.*

27. *Id.* at 621-26; *see* I.R.C. § 952(c)(1)(C).

28. 30 Fed. Cl. 552 (1994). The court applied the old rule because tax returns for 1977 through 1979 were at issue. *Id.* at 554.

29. The no diminution rule provides that earnings and profits of a corporation are to be undiminished by distributions. Treas. Reg. § 1.952-1(c)(1) (1965).

30. *Unisys*, 30 Fed. Cl. at 565.

31. *Id.* at 554.

32. *Id.* at 560. In dicta, the court stated that one of the main reasons for the repeal of section 952(d) was because non-subpart F income was being sheltered by non-subpart F deficits. *Id.* at 564.

not deal with "attributable to" because that phrase was not part of the old rule in section 952(d).[33] The court held that the no diminution rule precluded the seven foreign subsidiaries from including the distributions to BISA in their deficits for purposes of the chain deficit rule in section 952(d).[34]

In 1994, the Tax Court analyzed the "attributable to" phrase in *Lawinger v. Commissioner*.[35] The issue was whether petitioner's aggregate gross receipts were attributable to farming.[36] The court found that because the phrase was not defined anywhere in the Internal Revenue Code, it had to be given a plain meaning interpretation.[37] Based on analysis of the dictionary and other sections of the Internal Revenue Code where the phrase is used, the Tax Court reasoned that the "plain meaning of 'attributable to' is simply due to, or caused by, or generated by."[38]

III. Instant Case

The instant case followed the holding in *Lawinger* and created a similar meaning for the "attributable to" phrase with regard to section 952(c)(1)(C).[39] The instant court reasoned that section 952(c)(1)(C)(i) requires "a causal relationship between [the qualified] activity (banking) and Stanford Financial's deficits . . . before those deficits may offset that income; in short, the deficits must have been 'caused by' or 'generated through' the conducting of the same qualified activity which generated the subpart F income sought to be offset."[40] The instant court held that since Stanford Financial's deficits were not caused by Guardian Bank's banking activity or banking activity conducted by Stanford Financial, the deficits "were not [the] attributable" qualified activity that created Guardian Bank's subpart F income.[41]

The instant court also held that because Guardian Services was not a qualified chain member with respect to Guardian Bank, Guardian Services'

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33. *See* I.R.C. § 952(c)(1)(C).
34. *Unisys*, 30 Fed. Cl. at 565.
35. 103 T.C. 428, 435 (1994). Petitioner contended that her discharge of indebtedness of a Farmers Home Administration loan was excludable from income because the discharged debt was qualified farm indebtedness. *Id.* at 429. *Lawinger* has no factual similarity to the instant case.
36. *Id.* at 435.
37. *Id.*
38. *Id.*; *see also* Ogden v. United States, 432 F. Supp. 214, 216 (S.D. Miss. 1975) (citing WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY).
39. *Stanford*, 152 F.3d at 458.
40. *Id.* at 459.
41. *Id.* The parties stipulated that Stanford Financial was a qualified chain member with respect to Guardian Bank because Stanford Financial directly owned all of the stock of Guardian Bank. *Id.* at 457.

deficits were not deductible against Guardian Bank's subpart F income.[42] The court reasoned that according to section 952(c)(1)(C)(ii)(l), Guardian Services could only be a qualified chain member with respect to Guardian Bank if one of the corporations "own[ed] all of the stock" of the other corporation either directly or indirectly.[43] However, the instant court determined that based on the plain language of section 952(c)(1)(C)(ii) of the statute, the indirect relationship cannot pass through " 'the common parent [corporation].' "[44]

In his dissenting opinion, Judge Benavides agreed that Guardian Services was not a qualified chain member with respect to Guardian Bank.[45] However, he strongly disagreed with the majority's holding that Stanford Financial's deficits were not attributable to the qualified activity that had created Guardian Bank's subpart F income.[46] Although Judge Benavides agreed with the majority's definition of "attributable to," he felt that the majority applied the definition too strictly and should have deducted Stanford Financial's deficits from Guardian Bank's subpart F income.[47]

IV. ANALYSIS

The instant case presented an opportunity for the Fifth Circuit Court of Appeals to create a foundation upon which future section 952(c)(1)(C) cases could be decided by the Tax Court and other Courts of Appeals.[48] Analyzing the new chain deficit rule as a case of first impression, the instant court created a strict interpretation of the law with regard to the "attributable to" phrase of section 952(c)(1)(C)(i).[49] The results of this interpretation will most likely fall hardest on small, vertically-integrated CFCs that perform

42. *Id.* at 457. The court did not need to analyze "attributable to" with regard to Guardian Services because the section 952(c)(1)(C) deduction requires that the corporation first be a qualified chain member. *Id.* (citing I.R.C. § 952(c)(1)(C)).

43. *Id.* at 456.

44. *Id.* at 457 (quoting I.R.C. § 952(c)(1)(C)(ii)). Based on the facts of this case, Guardian Services was an indirect owner of Guardian Bank, but only through Stanford Financial, the common parent. *Id.*

45. *Id.* at 463 (Benavides, J., concurring, in part, and dissenting, in part).

46. *Id.* (Benavides, J., concurring, in part, and dissenting, in part).

47. *Id.* (Benavides, J., concurring, in part, and dissenting, in part). Judge Benavides reasoned that because Stanford Financial's administrative services, which had created its deficit, were provided in support of Guardian Bank's qualified activity, the services were attributable to the qualified activity. *Id.* (Benavides, J., concurring, in part, and dissenting, in part).

48. Although the Fifth Circuit's opinion in the instant case is binding precedent only in the Fifth Circuit, other courts may decide to follow its reasoning in future section 952(c)(1)(C) chain deficit rule cases and apply a strict interpretation of the law.

49. *Id.* at 459. The majority realized that its "caused by" or "generated through" requirements were overly strict, but they felt that the wording of the statute called for such a strict interpretation. *Id.*

various services for each other, such as administrative and management services, in the course of their business.[50] Additionally, CFCs that are created merely as tax shelters with the sole purpose of offsetting another CFC's income will be affected, which was the intent of the legislature in drafting section 952(c)(1)(C).[51]

The instant court based its reasoning on the plain language of section 952(c)(1)(C)(i), foregoing the section's legislative history.[52] The instant court stated that Stanford Financial's management services to Guardian Bank were the cause of Stanford's deficit because it had not provided services to any other company.[53] Based on a broader interpretation of the statute, it might appear that Guardian Bank's qualified activity of banking did, in effect, "cause" Stanford Financial's deficits, or at least it bore more than little or no relationship to the deficits, as specified by the legislature in changing the old chain deficit rule of section 952(d) to the new rule of section 952(c)(1)(C).[54]

By failing to consider legislative history in its decision, the instant court appears to have nearly shut the door on any tax shelter possibilities with regard to chain deficit rule deductions under section 952(c)(1)(C).[55] As the dissenting opinion points out, it almost appears from the majority's holding that in order for a profitable CFC to reduce its subpart F income, the deficit

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50. *See id.* at 452. The instant court reasoned that in order to satisfy the chain deficit rule CFCs must be qualified chain members before going on to the "attributable requirement." *Id.* at 456. CFCs can only be chain members if one of the corporations owns all of the stock of the other corporations, either directly or indirectly, but not through the common parent corporation. *Id.*

51. *See* H.R. CONF. REP. NO. 99-841, *supra* note 23, at 623.

52. *Stanford*, 152 F.3d at 457. The court noted that where a plain reading of the statute unambiguously precludes a taxpayer's interpretation, no amount of favorable legislative history can rescue the taxpayer's interpretation. *Id.* (citing Nalle v. Commissioner, 997 F.2d 1134, 1140 (5th Cir. 1993)); *see* S. REP. NO. 100-445, at 273-74 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4786-87 (explaining that the legislative history of section 952(c)(1)(C) discussed curtailing taxpayer reduction of subpart F income of CFCs by deficits in earnings and profits of chain members that bore *little or no relationship to that income*) (emphasis added).

53. 108 T.C. at 344; *see Stanford*, 152 F.3d. at 454-55.

54. *See* S. REP. NO. 100-445, *supra* note 52, at 273.

55. *See Stanford*, 152 F.3d at 457; *see also* Wagner, *supra* note 1, at 633 (arguing that the "current tax regulations with respect to CFCs are primarily designed to increase tax revenue" and "to force greater compliance from taxpayers who have foreign investment income").

The repeal of section 952(d) was based on Congress' belief that the old chain deficit rule allowed United States taxpayers to shelter through controlled foreign corporations excessive amounts of tax haven income from current United States tax. H.R. CONF. REP. NO. 99-841, *supra* note 23, at 623; *see also* Rekha Balu, *Helter Shelter: A Peek into the Arcane Offshore World that Helps Manufacturers Save Millions*, CRAIN'S CHICAGO BUS., Mar. 24, 1997 (noting that thousands of U.S. corporate subsidiaries are ethereal, merely paper companies, costing the U.S. Treasury an estimated US$1.8 billion annually).

chain member must be engaged in the same qualified activity as the profitable chain member.[56]

V. QUESTIONS FOR THE FUTURE

The instant case leaves unanswered the question of whether the qualified activity of a deficit CFC must be virtually identical to the qualified activity of the profitable CFC in order to satisfy the "attributable to" requirement of section 952(c)(1)(C) of the Internal Revenue Code.[57] The Tax Court, in the instant case, ruled that "the subpart F income of the profitable CFC and the deficits in the earnings and profits of the unprofitable CFC must relate to the same qualified activity."[58] In the instant case, the Fifth Circuit Court did not specifically address the Tax Court's ruling on this point, even though the Fifth Circuit's ruling appears to follow the same reasoning, which was based on a strict interpretation of what is required to satisfy the "attributable to" requirement.[59] Therefore, prospective taxpayers that want to invoke the chain deficit rule of section 952(c)(1)(C) do not have a clear understanding from the court of whether the qualified activity must be exactly the same or whether the causation principle will be followed by future courts, and if it is followed, to what degree of specificity.[60]

In the future, taxpayers in a position similar to Stanford may want to state that the deficits in earnings and profits of the unprofitable CFC were "due to, caused by, or generated by"[61] the profitable CFC's qualified activity, rather than saying "driven solely by" or "directly solely to," as Stanford did.[62] Another opportunity for taxpayers to avoid paying taxes on subpart F income of profitable CFCs would be to divest control of the CFC

56. *Stanford*, 152 F.3d at 463 (Benavides, J., concurring, in part, and dissenting, in part). Judge Benavides reasoned that "the costs of administrative and management services provided in support of a qualified activity are caused by a qualified activity." *Id.* (Benavides, J., concurring, in part, and dissenting, in part).

57. *Id.* at 458; *see* I.R.C. § 952(c)(1)(C).

58. *Stanford*, 108 T.C. at 352. The Tax Court found that the administrative and management services performed by Stanford Financial for Guardian Bank did not qualify as activities similar to those performed by a banking or financing business. *Id.* at 354. The Tax Court cited section 1.864-4(c)(5)(i) of the Income Tax Regulations, which covers foreign sources of income, and described transactions with the public that are characteristic of a banking or financing business, such as deposits, loans, letters of credit, and trust services. *Id.* at 353-54.

59. *Stanford*, 152 F.3d at 458.

60. *See id.*

61. *Stanford*, 108 T.C. at 435.

62. *See id.* at 463 (Benavides, J., concurring, in part, and dissenting, in part). Judge Benavides argued that Stanford's point was that administrative and management services are "attributable to" the activity they support, regardless of the language Stanford may have used. *Id.* (Benavides, J., concurring, in part, and dissenting, in part).

by transferring voting shares to non-U.S. citizens.[63] In any case, the decision in the instant case will most likely require that taxpayers vertically integrate their companies if they want to use the chain deficit rule.[64]

VI. CONCLUSION

United States shareholders of CFCs are now left unsure as to the correct interpretation of the chain deficit rule of section 952(c)(1)(C). The unresolved question remains: whether the Tax Court and other Courts of Appeals will follow the strict interpretation of the "attributable to" part of the rule, or whether these courts will elect to follow Judge Benavides' dissent and apply a broad reading of the rule. Taxpayers now may have a more difficult time deducting deficits of CFCs from profits of qualified chain member CFCs if the corporations are not engaged in the same exact activity. The strictness of the instant case interpretation is indicative, in some respects, of the belief in Congress that foreign corporations are not paying their fair share of U.S. taxes.[65]

63. Wagner, *supra* note 1, at 632; *see also* CCA v. Commissioner, 64 T.C. 137, 150 (1975) (noting that taxpayers can shed control of CFCs by transferring voting rights).

64. I.R.C. § 952(c)(1)(C); *see Stanford*, 152 F.3d at 457.

65. *See* Wagner, *supra* note 1, at 629-30 (stating that "Congress . . . appear[s] to be intent on adding even more base-broadening and anti-deferral provisions to the international sections of the Tax Code").