

1956

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Recommended Citation

Paul D. Seghers, *Foreign Trade and Federal Taxes: Present and Prospective*, 25 Fordham L. Rev. 47 (1956).
Available at: <http://ir.lawnet.fordham.edu/flr/vol25/iss1/3>

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FOREIGN TRADE AND FEDERAL TAXES: PRESENT AND PROSPECTIVE

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ECONOMIC development of the so-called "underdeveloped" countries throughout the world has received much attention from the United States government in recent years and many efforts have been made to stimulate and encourage the investment of private United States capital in these areas. This official encouragement and the increasing foreign market for United States goods has led many United States businessmen to explore and re-examine the business potential of operating abroad. This in turn has focused new attention on the tax consequences of operating abroad and has aroused great interest in the available tax advantages to be derived in foreign operations. This article points out various modes of operating abroad and their tax advantages and disadvantages.

I. ADVANTAGES IN DOING BUSINESS ABROAD

There are basically two great potential tax advantages in doing business abroad, as compared with doing business in the United States. First, a corporation doing business abroad can, by means of proper planning, keep more dollars of income after all taxes are paid. This may result from (a) paying a lesser aggregate amount of taxes on its income than a domestic (United States) corporation would pay on a like amount of income earned from sources within the United States, and/or (b) the benefits, for United States tax purposes, obtainable from the "foreign tax credit."

The other great tax advantage in operating abroad is the right to postpone the time for payment of United States taxes, thereby leaving more funds in the business available for reinvestment in its expansion. This postponement of payment of taxes may be accomplished in a number of ways, again depending upon the methods of foreign operation. For example, where a subsidiary of a United States corporation is organized in Panama and all its income is earned outside the United States, if the effective tax rate on its income averages 16 per cent,¹ it can retain 84 per cent of its income, available for use in its business in Panama or elsewhere. If, instead, United States tax at the top rate of 52 per cent were payable currently on this income, only 48 per cent could be retained in the business. Postponement in this manner (without incurring any lia-

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1. New Income Tax Law of the Republic of Panama, Law 52 of 1941, as amended art. 1, Law 2 of 1953.

bility for interest on the amount so deferred) may be so valuable to certain United States corporations with foreign operations as to outweigh the possibility, which may exist in some circumstances, that the aggregate tax burden on the income may, by the time it is received by the United States parent, be increased by three or four percentage points over what would have been applicable if immediate payment of United States taxes had been made. It may also be pointed out that a foreign corporation incurs no liability for United States tax on its income by reason of keeping United States dollars on deposit here, or elsewhere, available for use in any way it desires.

There are other tax advantages to be obtained in operating abroad which may be of great importance to particular taxpayers. For example, a United States corporation which derives the greater portion of its income in a United States possession may obtain complete exemption with respect to such income. The governments² of certain foreign countries are willing, in order to stimulate United States business within their country, to grant tax exemptions or other favorable tax concessions in the case of certain business activities. Outstanding examples of such exemptions are to be found in Puerto Rico and Panama, and are under consideration in other Latin American countries. Another important tax consideration in operating abroad is the freedom from liability for the penalty surtax on improper accumulations of income imposed by the United States.³ A foreign corporation having no income from sources within the United States is not subject to the penalty surtax on accumulated earnings, regardless of its motives for such accumulation.⁴

II. CREDIT FOR FOREIGN TAXES

In an attempt to prevent or at least alleviate the burden of double taxation in the case of income subject to both United States and foreign taxes, Congress has granted United States taxpayers the option of claiming, with respect to foreign income taxes, either a deduction⁵ in the computation of its taxable income, or a credit⁶ against the United States tax liability computed with respect to such income. The amount of such credit is, however, limited to that proportion of the income tax against which such

2. Canada, Uruguay, Panama, Venezuela, Liberia, Monaco, Luxembourg and Lichtenstein are some of the countries granting tax concessions to foreign corporations. These concessions range from low tax rates on income earned in the countries to complete exemption from taxation.

3. This follows from the fact that such income is excluded from gross income, leaving no tax base for tax under Int. Rev. Code § 531. All references herein to sections are to sections of the Internal Revenue Code of 1954 unless otherwise noted.

4. *Ibid.*

5. Int. Rev. Code § 164(b)(6).

6. Int. Rev. Code §§ 33, 901.

credit is taken which the taxable income from the foreign country bears to the taxpayer's total taxable income.⁷ For example, if a United States corporation has taxable income of \$100,000, of which \$84,000 was derived from Brazil, then the amount of the credit would be limited to an amount equal to 84 per cent of the taxpayer's United States income tax on its total income. Under this limitation, which is referred to as the "per country" limitation, if the average effective rate of tax on income earned by the corporation in any foreign country is higher than the effective over-all United States tax rate on its income, the amount allowable to it as a foreign tax credit with respect to its income from that country will be less than the full amount of its foreign tax thereon. If the effective rate of such foreign tax in any country is the same or lower than the effective United States rate, the corporation will receive credit for the entire amount of its foreign tax in that country. The Internal Revenue Code of 1954 eliminated the so-called "over-all limitation" which existed under the 1939 Code⁸ and which was an additional limitation on the amount of the foreign tax credit.

In addition to the above-described foreign tax credit, the Internal Revenue Code provides for an additional credit for taxes paid to a foreign country by a foreign subsidiary of a domestic corporation.⁹ Dividends received by a domestic corporation from a foreign subsidiary are includable in full in the former's taxable income, without the benefit of the 85 per cent dividends-received deduction allowable in the case of dividends received from a domestic corporation.¹⁰ However, if a United States parent corporation which elects to take foreign income taxes as a credit owns 10 per cent or more of the voting stock of a foreign corporation from which it receives dividends, it also is allowed, subject to certain limitations, credit for foreign income taxes paid by that foreign corporation, and also for foreign income taxes paid by any other foreign corporation in which that foreign corporation owns 50 per cent or more of the voting stock.¹¹

Although the United States has no tax treaties with any of the Latin American countries¹² it does have them with many other countries¹³ and

7. Int. Rev. Code § 904.

8. Int. Rev. Code of 1939 § 131(b)(2).

9. Int. Rev. Code § 902(a).

10. Int. Rev. Code § 243 only allows the 85 per cent credit on dividends received from a domestic corporation.

11. Int. Rev. Code § 902(b).

12. Treaties with the following South American countries are in preparation: Argentina, Brazil, Colombia and Uruguay.

13. Treaties are in effect between the United States and Australia, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Japan, Netherlands, New Zealand, Norway, Sweden, Switzerland, Union of South Africa and the United Kingdom.

is constantly negotiating for additional tax treaties. The provisions of these treaties vary and even a brief treatment of the content and effect of the treaties would exceed the scope of this article.¹⁴

The principal object of these treaties, which are as authoritative as any other treaty entered into by the United States and, hence, prevail over any conflicting provision of law, is to avoid double taxation. These treaties seek generally to provide a uniform manner for determining the amount of income resulting from doing business in each country for the purpose of the income taxes of both countries. They also provide which of the contracting countries shall tax each of a number of different classes of income and, where the same income may be subject to tax by both countries, to provide relief in the form of credit for taxes paid one country against the tax due the other. In addition they provide for the use of identical methods of determining income in each such country thereby preventing either the governments involved or the taxpayer from obtaining a double advantage.

III. DETERMINATION OF THE SOURCE OF INCOME

Regardless which type of organization is used to engage in foreign trade, the savings in United States taxes with respect to such operations are possible only as to income derived from sources outside the United States. It is, therefore, essential that in establishing any type of organization to engage in foreign trade, procedures be established to afford reasonable assurance that the necessary proportion of the corporation's income will qualify as income derived from non-United States sources. This is not always easy to accomplish, and a complete discussion of the problem of meeting the necessary tests to have income considered as arising from outside the United States would require a separate article¹⁵ but some of the basic principles are pointed out herein.

For United States income tax purposes, the place of sale of goods or personal property of any kind is determinative of the source of income therefrom. In other words, the country where goods are sold is the country where income from their sale is deemed to be earned. With the exception of goods purchased in a United States possession,¹⁶ the sale of purchased goods gives rise to income only at the place where the goods

14. See Joseph, *Income Tax Treaties—A Comparison of Basic Provisions*, Proc. N.Y.U. 12th Inst. on Fed. Tax. 778 (1954).

15. See discussion in Seghers, *Tax Advantages in Doing Business Abroad and How to Obtain Them*, 1952 Proceedings, Tul. Tax Inst. 113, 126, the articles referred to therein and discussion in Brainerd, *United States Income Taxation of International Sale of Personal Property*, 32 Taxes 359 (1954).

16. Int. Rev. Code § 863(b)(3).

are sold.¹⁷ If goods are processed or produced by the seller in one country and sold in another country, the income is to be apportioned between the two countries.¹⁸ An apportionment must also be made in the case of income arising from the sale in the United States of goods purchased in a possession of the United States. The Regulations under the 1939 Code¹⁹ set out the manner and method of computing such apportionments. Regulations under corresponding provisions of the 1954 Code have not yet been promulgated.^{19a}

In essence the real problem is to determine under the present rulings and decisions where the sale was made. The Regulations under the 1939 Code state that the country in which sold ordinarily means the place where the property is marketed,²⁰ and hence, afford little help in determining at what precise point of time, and consequently where, in a sales transaction, the income arises. For many years, the Commissioner and the courts were unable to agree on the principles to be used in determining where, for federal income tax purposes, a sale was consummated. Since 1947, however, the Commissioner has adopted the interpretation of the courts that the sale is, in general, to be deemed to be made where title to the goods passes.²¹ Since that time there has been only one decision²² wherein the court disregarded the passage of title test in determining where a particular sale of property took place. The decision in that case is presently being appealed.

It is important to point out, however, that although the Treasury Department has accepted the view that a sale is made where title to the goods passes, the Commissioner has warned taxpayers that in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, then all factors of the transaction will be considered and the sale will be treated as having been consummated at the place where the substance of the sale occurred.²³

If goods are stored and warehoused outside the United States and orders for such goods are received, accepted and filled abroad, then it

17. Int. Rev. Code §§ 861(a)(6) and 862(a)(6) which are similar to but differ in wording from Int. Rev. Code of 1939 §§ 119(a) and 119(c), last sentence.

18. Int. Rev. Code § 863.

19. Reg. 118 § 39.119(c)-1(b) and examples contained therein.

19a. Proposed Rules covering Int. Rev. Code of 1954, §§ 861-94 were issued and appeared in 21 Fed. Reg. 2819 (1956), amending 26 C.F.R. pt. I (Supp. 1954), after this article was in print, and are therefore not considered herein.

20. Reg. 118 § 39.119(a)-6.

21. G.C.M. 25131, 1947-2 Cum. Bull. 85; *Comm'r v. East Coast Oil Co.*, 85 F. 2d 332 (5th Cir.), cert. denied, 299 U.S. 603 (1936); *Ronrico Corp. v. Comm'r*, 44 B.T.A. 1130 (1941).

22. *United States v. Balinowski*, 131 F. Supp. 898 (S.D.N.Y. 1955).

23. See note 21 *supra*.

is clear that the income from those sales will give rise to income from foreign sources. The establishment of a foreign branch office to solicit and consummate sales from goods located outside the United States affords assurance that such sales give rise to income from sources outside the United States. If for one reason or another all these steps cannot be taken, there are other courses that may be followed which might result in sales to customers abroad being classified as arising from sources outside the United States, but these other methods may occasion conflict with the Internal Revenue Service. There is some opinion²⁴ that the buyer and seller can, by agreement, fix the place of sale (for all purposes, including federal income taxes) at some place outside the United States, even though all or most of the other elements of the sale take place in this country. This is sometimes referred to as the documentary method of making sales abroad. There are many practitioners who seem to think that the use of this method is sufficient to justify the claim that such sales are made, and the entire income therefrom arises, from sources outside the United States. Regardless of which method of making sales abroad is finally adopted, it must, if it is to prove satisfactory, justify itself from a business standpoint as well as from a tax point of view.

IV. MODE OF OPERATION

As pointed out earlier in this article, taxpayers engaged in foreign operations can effect substantial tax savings and obtain tax advantages which are not generally available to corporations engaged solely in domestic trade. The amount of savings or the nature of the advantages to be obtained depend to a great extent on the mode of operation of the particular taxpayer. There are basically three forms of organization which a United States owner of a business may employ in effecting foreign operations so that they will give rise to tax savings and/or other tax advantage:

- a) A United States corporation which qualifies as a Western Hemisphere Trade Corporation,
- b) A United States corporation operating in a possession of the United States, and
- c) A foreign corporation.^{24a}

Having in mind the necessity that income must arise from sources outside the United States to effect any of the tax savings or advantages mentioned, the tax advantages and disadvantages of the use of each of the foregoing three types of corporations are discussed below.

24. See note 15 *supra*.

24a. Business operations in the form of a sole proprietorship, trust or partnership are not considered herein.

a) *Western Hemisphere Trade Corporation*

In order to obtain the tax benefits afforded to a Western Hemisphere Trade Corporation, the following requirements²⁵ must be met. The corporation must be a domestic corporation which conducts all of its business (other than incidental purchases) within the Western Hemisphere (North, Central and South America and the West Indies). In addition 95 per cent of its gross income for the current taxable year and for the two preceding taxable years must be derived from sources outside the United States and 90 per cent or more of its gross income must be derived from the active conduct of a trade or business. It is usually necessary to organize a new corporation to meet the foregoing statutory tests. This, however, presents no United States income tax problem, as a domestic corporation can organize a wholly owned subsidiary and transfer to that corporation all of its Western Hemisphere activities, without recognition of (taxable) gain.

Although the Internal Revenue Code of 1954 has changed the *method*²⁶ of computing the tax on Western Hemisphere Trade Corporations, the amount of tax saving remains approximately the same as it was under the prior law. This type of corporation is now allowed, as a deduction in computing the amount of income subject to tax, an amount equal to a percentage of its taxable income as computed without this deduction.²⁷ The amount of the percentage to be used in computing this deduction is determined by dividing the sum of the corporate tax and surtax rate into 14 per cent. At the present 52 per cent combined rate this results in a deduction equal to approximately 26.9 per cent (14 per cent divided by 52 per cent). Since the denominator is the combined corporate normal and surtax rates, the percentage used in computing the deduction will change each time there is a change in the tax rate (*e.g.*, a reduction in the aggregate corporate rate to 47 per cent would change the deduction to approximately 29.8 per cent).

At present rates a corporation which qualifies as a Western Hemisphere Trade Corporation pays a United States tax equal to approximately 21.9 per cent of the first \$39,200 of its taxable income (computed without the special deduction) and approximately 38 per cent on the remainder of its income, as compared with the present corporate rates of 30 per cent on the first \$25,000 and 52 per cent on the excess. Although this results in a substantial tax saving, it is possible that, in an unusual situation where a large portion of the income of a Western Hemisphere Trade Corpora-

25. Int. Rev. Code § 921.

26. Int. Rev. Code § 922 provides for a special deduction in computing taxable income in lieu of the credit against tax provided in Int. Rev. Code of 1939, § 26(i).

27. Int. Rev. Code § 922.

tion is subject to foreign taxes at an average effective rate higher than the United States rate, the corporation might not get credit for the full amount of such foreign taxes. Therefore the net tax savings of a Western Hemisphere Trade Corporation may, in some instances, amount to less than 14 per cent of its income, depending upon the foreign income tax rates to which its income is subject.

The dividends received by an individual stockholder from a Western Hemisphere Trade Corporation are subject to United States income tax in exactly the same manner as dividends received from a typical United States corporation. However, the savings in United States income taxes realized through the use of a Western Hemisphere Trade Corporation as a result of the special deduction allowed it are reflected in the amount of its earnings that are available for distribution. Dividends received from such a corporation are reported in the gross income of the individual stockholder in the same manner as dividends from any other United States corporation and are to be included in computing the stockholder's dividends received credit and exclusion.

A United States corporation which conducts its foreign trade operations through the medium of a Western Hemisphere Trade subsidiary is entitled to the 85 per cent deduction with respect to dividends it receives from such subsidiary.²⁸ This means that the income of the Western Hemisphere Trade Corporation when passed up to its corporate parent as dividends, will bear a further United States income tax at an effective rate of 7.8 per cent at current rates (52 per cent of 15 per cent). Although this additional tax on the domestic parent must be taken into consideration in computing the tax saving which may be derived from the use of a Western Hemisphere subsidiary, the saving which can be accomplished through the use of such a corporation is, nevertheless, considerable.

The following example illustrates the savings available through the use of a Western Hemisphere Trade Corporation and further illustrates the mechanics of the computation.

Assume that a Western Hemisphere Trade subsidiary has \$200,000 taxable income (before the special deduction allowed it) for the calendar year 1955. Its tax would be \$70,500, computed as follows:

Taxable Income	\$200,000
Special deduction 14/52 of \$200,000	53,847
	<hr/>
Income subject to tax	\$146,153
Normal and Surtax	\$ 70,500

If the balance (\$129,500) of income remaining after paying this tax is paid as a dividend to the parent, only 15 per cent (\$19,425) thereof

28. Int. Rev. Code § 243.

would be taxed to the parent. If the parent had at least \$25,000 of income from other sources, the tax resulting from its receipt of the dividend would be \$10,101 (52 per cent of \$19,425). The aggregate tax paid by the parent and by the Western Hemisphere Trade subsidiary on the income earned by the latter would be \$80,601 (\$70,500 plus \$10,101). If the parent had engaged directly in the same foreign operations, the tax on the same \$200,000 of income from that source would have been \$104,000 (continuing the assumption that the parent had at least \$25,000 income from other sources). Therefore, in the above example, the tax saving realized as a result of operating through a Western Hemisphere Trade subsidiary would be \$23,399 (\$104,000 minus \$80,601).

It is important to point out that a ruling²⁹ issued by the Treasury Department under the 1939 Code held that the power of the Commissioner to allocate income between related taxpayers applies with equal force in the case of a domestic parent and a subsidiary which qualifies as a Western Hemisphere Trade Corporation. Therefore it is necessary to take the same care in the case of a Western Hemisphere Trade Corporation, to avoid any occasion for such an allocation, as in the case of dealings between a parent company and any other kind of subsidiary.

Distributions in complete or partial liquidation of a Western Hemisphere Trade Corporation are taxable to the stockholders in the same manner as liquidating distributions received from any other domestic corporation. In the usual case the individual stockholder will realize a capital gain or loss measured by the difference between his investment in the stock and the fair market value of all assets received by him in the liquidation. A corporate stockholder may liquidate a Western Hemisphere Trade Corporation tax free. The provisions of the Code which permit a parent to receive property in complete liquidation of a domestic subsidiary without the recognition of gain or loss to the parent have been re-enacted in the Internal Revenue Code of 1954.³⁰ Therefore complete liquidation of a Western Hemisphere Trade Corporation may be effected under those provisions without any tax cost to its domestic parent corporation even though in the liquidation only cash is passed up to the parent and the parent receives an amount of cash which exceeds its basis for the stock of the subsidiary.³¹

In connection with the liquidation of a Western Hemisphere Trade Corporation it must be pointed out that the liquidation would not be exempt from the collapsible corporation provisions of the Code under which a liquidating distribution may, in certain circumstances, be taxable as

29. Rev. Rule 15, 1953-1 Cum. Bull. 141.

30. Int. Rev. Code § 332.

31. *Tri-Lakes Steamship Co. v. Comm'r*, 146 F. 2d 970 (6th Cir. 1945).

ordinary income.³² Further, it must also be pointed out that, as a domestic corporation, a Western Hemisphere Trade Corporation is subject to the penalty surtax under section 531 on the portion, if any, of its income which is held to be unreasonably accumulated.

b) *Operating through a Domestic Corporation
in a United States Possession*

A United States corporation doing the greater portion of its business in a United States possession may obtain complete exemption with respect to its income earned in such a possession.³³ In fact, if a corporation qualifies for exemption under section 931 of the Internal Revenue Code, its income from all sources outside the United States, and not merely its income from sources within United States possessions, would be completely exempt from United States taxes. A domestic corporation may qualify for this exemption if, during the taxable year and the two preceding taxable years (if any), 80 per cent or more of its gross income was derived from sources within a United States possession and 50 per cent or more of its gross income was derived from the active conduct of a trade or business within a United States possession.³⁴

This exemption does not apply to any income *received* in the United States, regardless of its source.³⁵ In other words, a corporation which qualifies under section 931 is taxed only on income arising from United States sources *or received* by it in the United States. This last provision regarding place of receipt of the income is unique in the Internal Revenue Code, as there is no other instance in the Code wherein exemption depends upon the place income is received, as distinguished from the place where income is realized or earned.

A corporation which qualifies under section 931 is denied the benefit of the foreign tax credit with respect to any taxes paid to a foreign country or United States possession. In most instances this is of little or no significance, due to the various tax exemption programs in certain of the possessions, and the low rates of income tax in many foreign countries. A section 931 corporation is entitled to deductions only to the extent they are connected with income from sources within the United States.³⁶

Dividend distributions received by an individual stockholder from a section 931 corporation are taxable to the same extent as dividends received from any other domestic corporation, except that the dividends

32. Int. Rev. Code of 1939, § 341.

33. Int. Rev. Code § 931.

34. *Ibid.*

35. Int. Rev. Code § 931(b).

36. Int. Rev. Code § 931(d)(2).

received credit³⁷ and exclusion³⁸ are not available to such distributions. However, the tax savings realized by the use of a section 931 corporation resulting from the complete exemption of its income from foreign sources from United States tax are reflected in the amount of surplus available for distribution as dividends. The tax benefits available to a section 931 corporation may largely be lost if it is formed as a subsidiary of a United States corporation. This is so because the parent is not allowed the 85 per cent dividend-received deduction with respect to dividends received from such a corporation,³⁹ and, therefore, the income which escaped United States tax in the hands of the subsidiary would be fully taxed to the parent. One way to avoid the problem would be to liquidate the subsidiary. Although there might be some question if the section 931 corporation had been in existence but a short time, it is probable that the tax free liquidation of such a subsidiary with a domestic parent could be accomplished if such subsidiary had operated for a reasonable period of time. As a practical matter the corporate parent could permit its section 931 subsidiary to accumulate all of its income until it is ready for liquidation. Although a section 931 corporation is, as a matter of law, subject to the tax on unlawful accumulations⁴⁰ it can accumulate its income, to the extent that it is exempt under section 931, without any liability for the penalty tax under section 531 and the undistributed portion of the remainder, if any, of its income must, of necessity, be relatively small.

It is apparent that individual rather than corporate ownership of the stock of a continuing section 931 corporation would be essential to effect eventual tax saving on any portion of its income paid out as dividends. This is true even though the dividends-received deduction and inclusion allowed under the Code are not allowed to an individual with respect to dividends received from a section 931 corporation. Such a corporation can, however, accumulate most of its earnings tax free, and the individual stockholder can either sell its stock or liquidate the corporation and thereby receive all its profits at capital gain rates.

c) *Operating through a Foreign Corporation*

Income derived from sources outside the United States by a corporation organized under the laws of any foreign country or United States possession and not classified as a Foreign Personal Holding Corporation⁴¹ is not subject to United States tax.⁴² This sweeping exemption

37. Int. Rev. Code § 34.

38. Int. Rev. Code § 116.

39. Int. Rev. Code §§ 243, 246(a)(2)(B).

40. Int. Rev. Code § 531.

41. Int. Rev. Code § 882(b).

42. Int. Rev. Code § 882(b).

extends to all United States taxes on income, including freedom from imposition of the penalty surtax on improper accumulations of surplus under section 531 of the Code, to the extent that the income of such a foreign corporation is derived from sources outside the United States.⁴³

A foreign corporation is, however, subject to tax on income from sources within the United States.⁴⁴ If the corporation is a nonresident corporation; that is, one not doing business here, it is liable to tax at the flat rate of 30 per cent on interest, dividends, rents, and other fixed or determinable income, and no deductions are allowed such corporation. If, however, the foreign corporation is doing business in the United States, *i.e.*, it is a resident corporation, then it is taxed in the same manner as a domestic corporation on all income derived from sources within the United States and is entitled to all deductions incurred in connection with the production of income earned in the United States.⁴⁵

The complete freedom from United States taxes on income earned abroad which foreign corporations enjoy, affords possibilities of very great tax savings. In evaluating such savings, however, and in planning such operations, it is necessary to take into consideration the rate of foreign taxes on the corporation, the United States tax on its earnings when received by its United States stockholders in the form of dividends, and the extent to which such stockholders will be allowed credit against their United States income taxes on account of the foreign income taxes paid by the foreign corporation.⁴⁶

In determining the potential net tax savings on income from foreign sources which would result from the use of a foreign corporation, effect must be given to the foreign tax credit in determining what would be the net, after-tax income ultimately received and retained out of the earnings of such a business by the United States individual or individuals who are its direct or indirect owners.

The profits derived from the use in the business of funds retained free of United States taxes is not the sole advantage of such postponement. There is always the possibility that it may never be necessary to pay the full United States income tax on such earnings when ultimately received by the United States owner. For example, a tax free liquidation⁴⁷ of a foreign corporation which is controlled by a United States corporation can be effected, provided that, in advance of any steps in that direction, the Commissioner of Internal Revenue is satisfied that the liquidation does not have as a principal objective the avoidance of United States in-

43. See note 3 *supra*.

44. Int. Rev. Code §§ 881, 882.

45. Int. Rev. Code §§ 881, 882.

46. See subdivision II of this article.

47. Int. Rev. Code § 332.

come taxes.⁴⁸ Events, such as currency restrictions, greatly increased taxes in the country of incorporation, threats of nationalization; *i.e.*, confiscation, revolutions, etc. occurring years after incorporation, might satisfy the Commissioner that it is necessary to dissolve and liquidate such a corporation. Furthermore, the stock of the foreign corporation might ultimately be distributed to the stockholders of the parent corporation, with the result that the parent company would avoid United States taxes on the foreign subsidiary's income. The parent corporation's stockholders would be taxable, at the capital gains rate upon gain realized, on receipt of the distribution of the stock of the foreign subsidiary corporation if received as a distribution in liquidation of the parent company; otherwise the distribution would be taxable, to the extent of the accumulated earnings of the parent company, as dividend income, but double taxation would be avoided.

Individual stockholders of a foreign corporation who realize a gain on either a liquidation or sale of their shares would be taxable at capital gains rates. This would represent a substantial tax saving to an individual, which would not be offset, as would be that of a corporate stockholder, by the loss of the benefit of the credit for the foreign taxes theretofore paid by the liquidating corporation. Finally, if the stock of a foreign corporation owned by an individual becomes an asset in his estate, the gain, if any, subject to United States tax on the sale or other disposition, by his estate or legatees, of such shares would be only the amount by which the proceeds exceed the value of the shares for federal estate tax purposes.⁴⁹

In weighing the advantages of the use of a foreign corporation, as compared with the use of a Western Hemisphere Trade Corporation, consideration must be given to the benefit, obtainable only by the former, of postponing the payment of United States taxes upon its income, until some indefinite future date, without incurring interest expense. If, as is possible, the foreign corporation pays a low over-all average rate of foreign taxes on its income, and is able to use the money thus saved to expand its operations and thereby earn more income, an advantage may be obtained that can more than compensate for a slightly higher aggregate United States income tax burden on the income earned by such foreign corporation, payable only if and when its income is realized as taxable income by the United States owners of its stock.

V. PROSPECTIVE LEGISLATION

A bill⁵⁰ presently pending in Congress is intended to afford certain tax benefits to taxpayers engaged in foreign trade. This embodies the recom-

48. Int. Rev. Code § 367.

49. Int. Rev. Code § 1014.

50. H.R. 7725, 84th Cong., 1st Sess. (1955).

recommendations made by President Eisenhower in each of his annual State of the Union messages regarding favorable federal income tax treatment for business income from foreign sources. In an attempt to give effect to these recommendations, the House of Representatives in 1954 included in a proposed enactment⁵¹ (this bill, with various revisions, ultimately became the Internal Revenue Code of 1954) provisions for a 14 point tax rate reduction on foreign income. If the Internal Revenue Code of 1954 had been passed in the form in which it was originally introduced in the House, certain business income from sources in any country outside the United States would have been afforded the benefit of a 14 percentage point reduction similar to that presently allowed a Western Hemisphere Trade Corporation.⁵² This benefit would have been extended only to certain strictly limited types of income, earned by a foreign subsidiary or sub-subsidiary or by a segregated foreign branch which elected to defer, under elaborately stated conditions, payment of tax upon its income until it was transferred out of the foreign country in which earned. Income earned by a segregated branch or received in the form of dividends from a foreign subsidiary, arising from the sale of goods other than through a retail establishment, or from activities of any kind falling outside of certain narrowly defined categories, would have been excluded from the benefit of the provision.

A great many business and professional organizations sought to obtain a liberalization of these provisions. Unfortunately, there was a considerable difference of opinion as to the extent and manner in which these restrictions should be relaxed and the final outcome was that the Senate struck these provisions out of the bill with an expression of hope that the differences could be worked out. Unfortunately, however, these provisions were not reinstated in any form in the 1954 Internal Revenue Code as enacted.

In the final days of last year's session of Congress a bill⁵³ was introduced in the House of Representatives for the purpose of giving the recommended preferential income tax treatment to income from foreign sources. To a great extent the provisions contained in the 1954 bill⁵⁴ were incorporated in the legislation proposed last year with a few modifications, granting new and additional tax advantages to taxpayers engaged in foreign operations. At present there appears to be very little possibility that this bill will become law during the course of this year. However, it is important to point out that in addition to the tax advantages now available to taxpayers engaged in foreign trade, there is a real movement

51. H.R. 8300, 83d Cong., 2d Sess. (1954).

52. Int. Rev. Code § 921.

53. See note 50 *supra*.

54. See note 51 *supra*.

afoot to obtain, through legislation, additional benefits in that area, and it is hoped that in the near future a bill granting such additional incentives to foreign trade will be passed.

VI. SUMMARY AND CONCLUSION

Substantial tax advantages in doing business abroad *can* be obtained, and the methods of tax saving and postponement of payment of United States taxes which promise the best over-all, long range results should be selected. The methods available in obtaining such advantages appear to be in harmony with congressional intent and are clearly within the specific provisions of the Internal Revenue Code and are supported, or at least not contrary to, the Treasury Regulations and rulings and court decisions.

Management may at first be reluctant to adopt any of the methods described above for organizing their foreign operations, because of the complexity and initial expense which they apparently involve. However, further study may disclose that these methods afford not only great tax advantages but also great potential, long-range business advantages.

There is no quick, easy or automatic means of obtaining these advantages, although some articles recommending such methods have appeared. The methods indicated herein, however, are believed to afford safe and feasible methods of obtaining substantial tax advantages, together with real long-range business advantages.