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THE TAXATION OF BUSINESS INCOME FROM FOREIGN SOURCES

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THE United States emerged from the recent war in a position of world-wide industrial dominance unequalled in its history—probably unequalled by that of any nation in modern history. While every other manufacturing country has been physically devastated by bomb or shell and politically or financially disorganized by years of mortal struggle, American productive capacity has been developed to its highest point. At the same time, the whole world is desperately short of almost all kinds of goods. An extraordinary demand for most kinds of goods, and particularly durable consumer goods, likewise exists in the United States, but observers believe that high production from present domestic capacity will satisfy accumulated American demand in a relatively short period of time. Then will come a danger point, when excessive productive capacity and declining demand might lead to the accelerating downward spiral of depression. America looks to foreign trade both as a moral duty—or at least opportunity—to aid reconstruction and the re-establishment of satisfactory living standards abroad and, for the future, as a vehicle to provide a stabilizing outlet for American goods and services.

Many factors affect the practical availability and promise of foreign trade: exchange restrictions and import quotas, tariffs, and the special risks in the accumulation of foreign properties and foreign balances in whatever currency payable. Another major factor is multiple taxation. International double or multiple taxation has recently been defined as the situation which arises “when the taxes of two or more countries overlap in such a manner that persons liable for tax in more than one country bear a higher tax burden than they would if they were subject to only one tax

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jurisdiction."¹ The policies of the United States, and of foreign countries in which United States concerns do business, relative to multiple taxation will be an important determinant in the expansion of our trade abroad.

Foreign tax policies are beyond the control of the Government of the United States and American public opinion, save as those policies can be shaped through tax treaties. Such treaties have been negotiated with several countries. They are an important subject in themselves—too important for cursory treatment in an article concerned primarily with American law.² The domestic tax policy of the United States is determined by our Government and is within the control of American public opinion. If flourishing foreign trade, sufficiently profitable to attract adequate investment capital, is important to the economic welfare of the United States, the taxation of foreign trade is a matter of general concern.

It is well established that while non-resident aliens are taxable in the United States only upon income having its source within the United States,³ citizens of the United States, domestic corporations and persons here resident, regardless of nationality, are subject to United States income tax upon all of their income from whatever source derived.⁴ Subject to certain relief provisions, the various revenue acts under the Sixteenth Amendment and the Internal Revenue Code have fully exercised this jurisdiction to tax.⁵

It is obvious that to the extent that other nations take the same position, the result in many cases will be dual taxation of the same income. A resident of Canada, earning income in the United States, would pay tax on that income in the country of its source, the United States, and in the country of his residence, Canada; similarly, income derived from Canada by a resident of the United States would be subject to taxation in both countries.

This situation is ameliorated if the country of residence, in its computation of net income subject to tax, permits the deduction of the tax paid in

¹ League of Nations, Fiscal Committee, "Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion," at p. 37; Report of Second Regional Tax Conference, Mexico, D. F., July, 1943. League of Nations Official Publication, Official No. C.2., M.2., 1945, II, A.

² A very illuminating and comprehensive article on treaty relief against international double taxation was written by Mr. Ke Chin Wang, Attaché to the Chinese Embassy. Ke Chin Wang, *International Double Taxation of Income: Relief through International Agreement*, 1921-1945, 59 Harv. L. Rev. 73 (1945).

³ See Angell, *The Nonresident Alien: A Problem in Federal Taxation of Income*, 36 Col. L. Rev. 908 (1936).

⁴ *Cook v. Tait*, 265 U.S. 47 (1924).

⁵ 52 Stat. 527 (1938), 26 U.S.C.A. § 211 (1945).

the country of source, but this is not an adequate solution. If each country applied a 40 per cent rate, the net amount retained by the taxpayer would be only 36 per cent of the first amount taxable and the composite effective rate would be 64 per cent. A tax differential of 24 per cent of taxable net profit might prove a major deterrent to foreign trade. In the case of an exporter, it would operate much like a discriminatory protective tariff in the land in which the goods were sold. Other costs being the same, the exporter would derive a smaller profit from goods which he sold in the foreign country in competition with goods locally produced than would the local producer and seller or an exporter from a country which did not tax income earned abroad. The additional price which it would be necessary for the exporter to obtain in the foreign country in order to justify exporting his product rather than selling it in the domestic market in his own country would be increased. Both ways, the tendency would be to discourage American foreign trade by increasing the cost or price differential required to make such trade profitable.

Several devices can be and are used to limit or to eliminate dual taxation of foreign business. In the Union of South Africa, for example, income derived by local residents from foreign sources is entirely exempt from income tax.⁶ In Australia such income until recently was exempted from tax provided that it was subject to tax in the country from which derived.⁷ Between certain areas in the British Empire, reciprocal agreements provide for adjustments of rate so that no taxpayer pays more tax than would be imposed in the country of residence or the country of source, alone, whichever rate is higher.⁸ In the United States the principal protection against double taxation of profits derived from foreign trade is provided by the foreign-tax credit. The idea of the foreign-tax credit, now embodied in the Internal Revenue Code, section 131, is a simple one. Instead of the exemption of income derived abroad and subject to income tax in the country of its source, a credit is provided against United States income tax for the tax paid in the foreign country, the amount of the credit being limited to that proportion of the United States tax, computed without the credit, which the foreign income bears to the entire net income.⁹ The

⁶ [The Union of South Africa] Income Tax Act, 1941, Act no. 31, § 7.

⁷ [Australia] Income Tax (Assessment) Act, 1936, 1 George VI, no. 4440, § 14 (s).

⁸ *Ke Chin Wang*, op. cit. supra, note 2, at 74.

⁹ "(a) Allowance of credit. If the taxpayer chooses to have the benefits of this section, the tax imposed by this chapter, except the tax imposed under section 102, shall be credited with:

"(1) Citizens and domestic corporations. In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war-profits, and excess-profits taxes

evident purpose of this section, and in most cases its effect, is to subject all income derived by a United States resident either to the United States tax rate or to the rate in the country of source, whichever is the higher, but not to any combination of the two resulting in a still higher composite rate.

Two simple illustrations will show the normal operation of the section. Suppose that the American Exporting Company, incorporated in the United States, in 1946 has a total net income of \$2,000,000 of which \$800,000 is derived from United States sources and \$1,200,000 from Australia, where we will assume that the corporate rate is 35 per cent. The total United States tax, before foreign-tax credit, would be \$760,000. The Australian tax would be \$420,000. Since the Australian income represents 60 per cent of the total income, the limit on allowable Australian tax credit would be \$456,000, being 60 per cent of \$760,000. The entire Australian tax of \$420,000 would be allowed as a credit against the United States tax. The total tax payable would be \$420,000 (the Australian tax) plus \$760,000 minus \$420,000 (the United States tax less the foreign-tax credit), and the rate on all would be 38 per cent, the United States rate,

paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

"(2) Resident of United States. In the case of a resident of the United States, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

"(3) Alien resident of United States. In the case of an alien resident of the United States, the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

"(4) Partnerships and estates. In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

"Such choice may be made or changed at any time prior to the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter.

"(b) Limit on credit. The amount of the credit taken under this section shall be subject to each of the following limitations:

"(1) The amount of the credit in respect of the tax paid or accrued to any country shall not exceed, in the case of a taxpayer other than a corporation, the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources within such country bears to his entire net income for the same taxable year, or in the case of a corporation, the same proportion of the tax against which such credit is taken, which the taxpayer's normal-tax net income from sources within such country bears to its entire normal-tax net income for the same taxable year; and

"(2) The total amount of the credit shall not exceed, in the case of a taxpayer other than a corporation, the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources without the United States bears to his entire net income for the same taxable year, or, in the case of a corporation, the same proportion of the tax against which such credit is taken, which the taxpayer's normal-tax net income from sources without the United States bears to its entire normal-tax net income for the same taxable year." 52 Stat. 506-7 (1938), 26 U.S.C.A. § 131 (a) (b) (1945).

and in this case the higher one. If foreign income had been subject to excess profits (wartime company) tax in Australia to such an extent as to raise the effective rate there to 50 per cent, the Australian tax would be \$600,000. The limit on the foreign-tax credit allowable in the United States still being \$456,000, the total tax would then be \$600,000 plus \$760,000 minus \$456,000 or \$904,000. The effective rate on all would be 45.2 per cent, representing 38 per cent on 40 per cent of the income and 50 per cent on 60 per cent of the income.

In the first example above, if no foreign-tax credit were available, but the foreign tax were used as a deduction, the total tax would be \$1,020,400, being \$420,000 plus 38 per cent of \$1,580,000. In the second example it would be \$1,132,000, being \$600,000 plus 38 per cent of \$1,400,000.

Taxes paid by foreign subsidiaries of domestic corporations are governed by the so-called subsection (f) credit. This provision is as old as the foreign-tax credit itself, having been first embodied in almost its present form in the 1921 act and in a somewhat different form in the 1918 act. Under subsection (f)¹⁰ a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year, is deemed to have paid (and hence to be entitled to credit for) the same proportion of any income taxes paid or deemed to have been paid by any such foreign corporation to any foreign country or possession of the United States upon the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits. "Accumulated profits" is defined as profits less the tax thereon. Where the United States rate is higher than the foreign rate, the total tax

¹⁰ "(f) Taxes of foreign subsidiary.

"(1) Foreign subsidiary of domestic corporation. For the purposes of this section, a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits. The term "accumulated profits" when used in this subsection in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the Secretary shall have full power to determine from the accumulated profits of what year or years such dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subsection shall be construed to mean such accounting period." 52 Stat. 508 (1938), 26 U.S.C.A. § 131 (f) (1) (1945).

paid on the income of a foreign subsidiary, after allowance of the credit provided by subsection (f), will be somewhat less than the total tax paid on a like amount of earnings of the foreign branch of an American company, all other factors being the same. In the first illustration given above the total tax worked out at 38 per cent of \$2,000,000 or \$760,000, since the foreign-tax credit was precisely equal to the foreign tax. Suppose, however, that the \$1,200,000 earned in Australia represented the earnings of an Australian subsidiary of the American taxpayer. The tax in Australia at 35 per cent would be \$420,000, leaving \$780,000 for dividends. If this entire amount were paid out, total taxable income in the United States would be \$1,580,000 and the tax at 38 per cent would be \$600,400. The limitation on available foreign-tax credit would be \$600,400 divided by \$1,580,000 and multiplied by \$780,000 or \$296,400. (In a simple case such as this, the same result can be reached by taking 38 per cent of \$780,000.) The Australian tax which the United States taxpayer would be deemed to have paid would be \$420,000 divided by \$1,200,000 and multiplied by \$780,000 or \$273,000. This last figure, being smaller than the \$296,400 limitation, would be the credit allowed. The total tax therefore would be \$420,000 plus \$600,400 minus \$273,000 or \$747,400. If all the earnings had been those of the American taxpayer, partly derived from the United States and partly from a branch in Australia, the total tax would have been \$760,000, representing 38 per cent of \$2,000,000.

In 1942 the so-called subsection (f) credit was extended to taxes paid by the foreign subsidiary of a foreign subsidiary.¹¹

The foreign-tax credit itself was first introduced into the law in the Revenue Act of 1918, in sections 222 and 238. The House Ways and Means Committee explained the new provision to the House as follows:

Under existing law a citizen of the United States can only deduct income, war, or excess profits taxes paid to a foreign country from gross income in computing net income. With the corresponding high rates imposed by certain foreign countries the taxes levied in such countries in addition to the taxes levied in the United States upon citizens of the United States place a very severe burden upon such citizens. The bill provides that a credit against the income tax imposed in the United States be allowed a citizen of the United States subject to income and war or excess profits taxes in a

¹¹ "(f) Taxes of foreign subsidiary.

"(2) Foreign subsidiary of foreign corporation. If such foreign corporation owns all the voting stock (except qualifying shares) of another foreign corporation from which it receives dividends in any taxable year it shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such other foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of the corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits." 56 Stat. 858 (1942), 26 U.S.C.A. § 131 (f) (2) (1945).

foreign country of an amount equal to the tax paid in such country upon income that is received from sources within such country. The bill further provides that, in the case of an alien resident of the United States who is a citizen or subject of a country which imposes income, war profits, or excess profits taxes, a like credit shall be allowed if such country allows a similar credit to citizens of the United States resident in such country.¹²

The 1918 act contained no limitation on foreign-tax credit. It was therefore possible, where a United States taxpayer received part of his income from domestic and part from foreign sources, and where the foreign rate exceeded the United States rate, for the foreign-tax credit to reduce or eliminate the United States income tax on the domestic income. Thus if the United States rate were 10 per cent and the applicable foreign rate 20 per cent, a taxpayer earning half of his income in the United States and half in the foreign country would pay no United States tax, since the foreign income tax on the portion of the income derived in the foreign country would be sufficient, as a credit, to eliminate the United States tax on the entire income. The United States would be not merely eliminating double taxation, but paying part of the foreign tax. This defect was corrected in 1921, with the introduction of the foreign tax credit limitation based on a proportionate part of the United States tax. The Finance Committee of the United States Senate explained the new provision as follows:

Section 222: The income tax law allows a credit, dollar for dollar, against our tax for any income or profits taxes paid to any foreign country or to any possession of the United States, with certain modifications in the case of alien residents of the United States. Where foreign income or profits taxes are imposed at rates higher than those carried by the similar taxes in this country, this credit may wipe out part of our tax properly attributable to income derived from sources within the United States. To prevent this abuse, section 222 provides that in no case shall the amount of this credit exceed the same proportion of our tax which the taxpayer's net income from sources without the United States bears to his entire net income.¹³

Even after the introduction of this limitation, the tax credit as applied to income derived in part from the United States and in part from two or more foreign countries still could result in a computation which seemed inequitable to certain Treasury officials. The objection and its cure, were described as follows in the Finance Committee Report on the 1932 Revenue Act:

Section 131. *Credit for Foreign Income Taxes.*

Subsection (b): Under section 131(b) of the existing law the credit allowed for taxes paid to foreign countries is subjected to a limitation in order to prevent foreign taxes from absorbing the tax on income from sources within the United States. This limitation being based upon the ratio of net income derived from all sources without the United States to the total net income, gives preferential treatment to some taxpayers

¹² Int. Rev. Bull., Cum. Bull., 1939-1 (Part 2) at 93.

¹³ Ibid., at 193.

deriving income from more than one foreign country. This is illustrated by the following example of the cases of taxpayers A, B, and C:

	A		B		C	
	Amount	Foreign Tax Paid	Amount	Foreign Tax Paid	Amount	Foreign Tax Paid
Source of income:						
Great Britain.....	\$1,000	\$250	\$1,000	\$250	.....	.....
Argentina.....	.....	.....	1,000	None	\$1,000	None
United States.....	2,000	.....	1,000	.....	2,000	.....
Total income.....	\$3,000	.....	\$3,000	.....	\$3,000	.....
United States tax, before credit (at 12 per cent)...	360	.....	360	.....	360	.....
Proportion of foreign income to total income...	.....	.....	.....	.....	.....	.....
Credit for foreign taxes...	120*	.....	240†	.....	None	.....

* One-third.

† Two-thirds.

Thus B, who has paid no more foreign tax than A, is permitted to take twice as great a credit as A. Although B and C have each received \$1,000 income from Argentina free of any tax, B, in effect, pays no tax to the United States upon this income, while C pays the full United States tax thereon. It seems clear that the amount of income received by B from Argentina should have no bearing upon the amount of credit to be allowed for the tax paid to Great Britain.

Accordingly, a further limitation has been placed upon the credit so that in the case of any one country the credit for taxes paid thereto may not exceed an amount which bears the same relation to the total tax as the net income from the country imposing such tax bears to the total net income.¹⁴

The solution adopted was the so-called "per country" limitation, in which the credit for tax paid in any particular foreign country could not exceed that proportionate part of the United States tax computed without foreign tax credit which the income derived from that foreign country represented of the total income. This limitation was in addition to the over-all foreign tax limitation previously described.

Once the "per country" limitation was adopted, it is questionable whether any justification remained for retention of the over-all limitation. Mere variation in income level and tax level cannot bring the over-all limitation into operation after the "per country" limitation has been applied. The over-all limitation can come into effect only if the taxpayer has an actual loss derived from some foreign country. Suppose the American Exporting Company had, in 1946, income of \$1,000,000 from the United States, \$1,000,000 from country A, there taxed at a 50 per cent rate, and a loss of \$500,000 from country B. The United States tax before

¹⁴ Ibid., at 473-74.

credit would be \$570,000, or 38 per cent of \$1,500,000. The tax in country A would be \$500,000, but the credit would be limited to \$500,000 divided by 1,500,000 times 570,000 or \$190,000. The net United States tax would be \$380,000 (which is 38 per cent of \$1,000,000) and the total tax would be \$880,000 on \$1,500,000 of income, an effective rate of $58\frac{2}{3}$ per cent over all. Without the income from country A the United States tax would have been \$190,000 on taxable income of \$500,000. Hence, the additional income of \$1,000,000 from country A would be subject to a total effective tax of \$690,000 or 69 per cent, because the entire loss in country B was in effect charged against income from country A for United States tax purposes, although, of course, it could not be so charged in computing taxes in country A. Here we have multiple taxation within the definition given above. The taxpayer's income from country A is in effect taxed at a higher rate than that applicable either in country A or in the United States. The foreign business in country A is required to pay a tax subsidy to the domestic business, because of a loss incurred in country B. If operations in country A were conducted through a subsidiary, the effect of the overall limitation could ordinarily be eliminated by deferring dividends from A until the year after the realization of the loss in B.¹⁵

It will be noted that in the illustrations a non-progressive United States rate was assumed. Quite a different situation may result if we assume a progressive rate in the United States. Assume, for example, a United States corporation taxable at a rate of 40 per cent on the first million dollars of its income, but at a rate of 90 per cent on income in excess thereof, the applicable foreign rate being 70 per cent. In such a case the branch operation may become quite unprofitable. The United States tax on \$1,500,000 of earnings before foreign-tax credit would amount to \$850,000, or $56\frac{2}{3}$ per cent. If \$300,000 of this total were earned abroad the foreign tax would be \$210,000. The tax credit limitation would be \$170,000, representing $56\frac{2}{3}$ per cent of \$300,000. The total tax therefore would be \$890,000. Of this, \$580,000 would be the tax which would be collected on \$1,200,000 of United States earnings if there were no other earnings, so that the net tax on \$300,000 of foreign earnings would be \$310,000. The taxpayer would in effect have lost \$10,000 net after taxes on a profitable foreign business. Here is double taxation with a vengeance. If no

¹⁵ If no dividend is received from country A in the taxable year, there is no foreign income and the loss from country B must be offset against domestic income; there is no foreign-tax credit in that year. In the next year, if operations in country B show at least a break-even, two years' income can be declared out in dividends from country A, and foreign-tax credit obtained on account of both years' foreign taxes. If country A has an undistributed-profits tax (as, e.g., in Australia) the problem is more complex.

other foreign income is involved, the taxpayer may forego the foreign-tax credit, deducting instead the foreign tax and salvaging 3 per cent of his foreign taxable profit. If he has other foreign income, and especially if it is derived from a subsidiary, he may have to accept the loss.

In the situation described last above, the same amount of earnings derived from a foreign subsidiary would bear very substantially less tax. In such a case the \$210,000 of foreign tax would first be deducted from the foreign income and the balance of \$90,000 paid out as a dividend. The total United States tax, before tax credit, would then be \$661,000. The tax credit limitation would be \$661,000 multiplied by \$90,000 divided by \$1,290,000 or about \$46,000. The tax attributable to the dividend would be a greater figure—30 per cent of \$210,000, or \$63,000. Thus the total tax paid would be \$661,000 plus \$210,000 minus \$46,000, or \$825,000 as against \$890,000 where the foreign portion was derived from a branch. Prior to 1946, when a large number of the leading American companies engaged in foreign trade were subject to excess profits tax on a portion of their income, this disadvantage of branch operation as against a foreign subsidiary might prove an important factor in a number of cases. Today all of the larger American corporations are being taxed at a constant rate, 38 per cent, on all of their income.¹⁶ So long, however, as individual traders, partners, and small corporations continue to be subject to progressive rates, the problem has not been eliminated.

Another difficulty in the administration of the foreign-tax credit has been the determination of what foreign taxes constitute "income, war profits, and excess profits tax paid or accrued" by the American taxpayer. The Treasury has tended to be quite conservative in its determination of what constitutes an income, war profits, or excess profits tax, requiring that a foreign tax be quite similar to the income and excess profits tax system as levied in the United States. For example, taxes measured by gross receipts have generally not been regarded as income taxes for the purpose of foreign-tax credit.¹⁷ In 1942 a new subsection was enacted providing as follows:

For the purposes of this section and section 23(c) (1), the term "income, war profits, and excess profits taxes" shall include a tax paid in lieu of a tax upon income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.¹⁸

¹⁶ This is not always strictly true today, because of the carry-back of unused excess-profits tax credit from 1946. It will probably be true next year.

¹⁷ See 2 Montgomery, *Federal Taxes on Corporations* 164-70 (1944-45).

¹⁸ 56 Stat. 857 (1942), 26 U.S.C.A. § 131 (h) (1945).

It is still too early to tell how much scope will be given to this subsection in the administration of the law. Its limitations are obvious.

A similar problem arises where there is ambiguity in the foreign law as to the incidence of the tax. The outstanding instance is that of the British tax withheld on dividends, royalties, and similar payments. The United States Supreme Court has held this tax to be upon the payor and not upon the payee, so that no foreign-tax credit is available to the shareholder for British dividends tax unless the American shareholder holds a majority of the voting stock of the British corporation, thus obtaining the benefits of subsection (f).¹⁹ It appears that this situation will be cured by the Anglo-American tax treaty if this treaty is ratified by the United States Senate.²⁰ The difficulty still remains in principle and will probably arise in other cases.

Similar difficulties of practical and equitable administration arise where the measure of income in the foreign country is not identical with the measure of income in the United States. For example, suppose that the American Exporting Company, operating a branch in Australia, suffers a substantial capital loss in that branch. The capital loss will not be deductible in computing taxable income in Australia²¹ so that if there are operating profits in the branch, an Australian tax must be paid. However, the capital loss will operate to diminish income from Australian sources in computing taxable income in the United States, thus diminishing the tax credit available. If in the following year capital gains were realized in Australia, taxable in the United States but not in Australia, the Australian tax might be less than the United States tax on the Australian income, despite equal or higher rates in Australia. The taxpayer would thus lose both ways. Similarly, another country might adopt a different view as to source of income. For example, it might be held in India that where products are purchased in India, imported into the United States and sold here, a part of the profit is taxable in India. The United States, however, would not recognize that any part of this profit was derived from India, so that if this were the only Indian transaction no Indian tax credit would be available under the "per country" limitation.²²

In summary, the purpose of the foreign-tax credit provisions of the

¹⁹ *Biddle v. Com'r of Internal Revenue*, 302 U.S. 573 (1938); see *Irving Air Chute Co. v. Com'r of Internal Revenue*, 143 F. 2d 255 (C.C.A. 2d, 1944).

²⁰ *Carroll, Income Tax Convention with Great Britain*, 23 *Taxes* 674 (1945).

²¹ In Australia, as in most British areas, taxable income largely ignores both capital gains and capital losses.

²² Cf. *Com'r of Internal Revenue v. Briskey*, 78 F. 2d 816 (C.C.A. 3d, 1935) where the taxpayer was fortunate to win in a somewhat similar situation.

United States income tax law is that all income derived from foreign countries by United States citizens, corporations, or residents shall be taxed at the higher of the foreign or domestic rate but not in excess of the higher. Saving for the moment the question whether this is adequate protection for foreign traders, the statute as drawn produces the intended result in the majority of cases, but by no means in every case.

Foreign-tax credit provisions are the most important provisions in the Internal Revenue Code for the special advantage or protection of income derived from foreign sources. There are other provisions more limited in scope but important in the fields in which they operate. One of these has been the section relating to China Trade Act companies. The China Trade Act was adopted in 1922 for the principal purpose of providing to American business a vehicle for China trade to compete with British Hongkong Ordinance companies. Supplement K of the Internal Revenue Code provides for the taxation of China Trade Act corporations. Its basic effect is that such a company is entitled to a credit against taxable net income for the amount of dividends paid out of net income derived from China to shareholders who are resident in China, the United States, or possessions of the United States, or were individual citizens of the United States or China. Such dividends are taxable income to the recipient, if he is a resident of the United States or a citizen of the United States not resident in China, but not otherwise. This special treatment conferred a considerable advantage on China Trade Act companies, the shares of which were held by individuals, particularly if the individuals were residents of China. There is no substantial tax advantage in a China Trade Act corporation, subsidiary of another United States corporation.²³ Since the abolition of extra-territoriality in China and pending clarification of the Chinese corporation laws, there is considerable doubt as to the status of a China Trade Act company.²⁴

Another instance of special treatment of foreign income is that of income derived from possessions of the United States, exempt under Internal Revenue Code, section 251. The origin of this section is even more interesting than its present application. In the 1921 Revenue Bill, as reported by the Committee on Ways and Means of the House, there was added a new concept, that of the foreign trader and foreign trade cor-

²³ For further discussion of China Trade Act corporations, see Berdon, Memorandum on China Trade Act Corporations, 24 *Taxes* 251 (1946).

²⁴ The present Chinese Corporation Act apparently will not permit the qualification in China of a foreign corporation not actually engaged in business in the jurisdiction of its incorporation. China Trade Act corporations are not "engaged in business" in the United States, as that term is understood in this country.

poration, defined to mean a citizen or resident of the United States or a domestic corporation less than 20 per cent of whose gross income was derived from sources within the United States. The House proposed that such foreign traders would be taxed substantially as non-residents—that is to say, only on income derived from sources within the United States. This provision was approved by the Committee on Finance of the Senate. However, it encountered difficulties on the floor of the Senate and emerged in substantially the present form of section 251 of the revenue code, containing similar provisions applicable only to citizens of the United States or domestic corporations 80 per cent or more of whose income is derived from sources within a possession of the United States, and 50 per cent or more of whose gross income is derived from the active conduct of a trade or business within a possession of the United States. To these provisions was added the qualification that there shall be included in the gross income of such persons all amounts received within the United States, from whatever source derived. A taxpayer entitled to the benefit of section 251 is not entitled, in addition, to a foreign-tax credit. Possessions of the United States within the meaning of section 251 now include Puerto Rico, Philippine Islands, Panama Canal Zone, Guam, American Samoa, Wake, Palmyra, and Midway, but not the Virgin Islands. The status of the Philippines will probably change this year, upon independence.

A more recent provision introduced for the benefit of American foreign trade is that concerning Western Hemisphere trade corporations.²⁵ A Western Hemisphere trade corporation is a domestic corporation all of whose business is done in any country or countries in North, Central, or South America or in the West Indies or Newfoundland, provided (a) 95 per cent or more of the gross income of such corporation for the three-year period immediately preceding the close of the taxable year (or such part thereof as the corporation was in existence) was derived from sources outside the United States, and (b) that 90 per cent or more of its gross income for such period was derived from the active conduct of a trade or business. The advantage accorded a Western Hemisphere trade corporation is a special rate of tax; it is subject to normal tax, at present 24 per cent, but not subject to surtax, at present 14 per cent. The requirement that income be derived from the active conduct of a trade or business prevents a holding company from qualifying even though the holding company exercises more or less active management over a subsidiary, the operations of which are clearly the active conduct of a trade or business.

²⁵ 56 Stat. 838 (1942), 26 U.S.C.A. § 109 (1945).

Nevertheless, in many situations it should be possible to obtain the benefits of the Western Hemisphere trade corporation rate for a part or all of a Western Hemisphere export business, and for other types of Western Hemisphere business as well where foreign regulations do not forbid, by some reorganization of corporate structure.²⁶ The Bureau has held that a reorganization designed to secure the benefits of the Western Hemisphere trade corporation rate is not tax inspired in a sinister sense and hence does not fall with the inhibitions of section 129 of the revenue code.²⁷

All of the special statutory provisions discussed above have as their general purpose the encouragement of the foreign trade of the United States through the limitation of dual taxation or through special tax advantages. They are applicable to foreign trade conducted by American enterprises, whether or not incorporated. They represent a melange of legislative notions adopted at various times and variously amended. Obviously they are workable since, in fact, business is operating under them. However, through their complications they present endless room for dispute, settlement, and litigation. It is submitted that a simpler statutory scheme could be devised which would reduce the uncertainty and scope for dispute, insure and improve the benefits intended, and not substantially decrease the revenue.

Before debating a specific recommendation, consideration should be given to the competing advantages of foreign branches and foreign subsidiaries. By far the greater part of large-scale American business abroad is conducted through subsidiary corporations not organized under laws of the United States. To a considerable extent this is due to requirements of foreign law and would not be affected by changes in the laws of the United States. There are, however, advantages of foreign incorporation which result from the operation of United States tax laws. A relatively minor advantage was mentioned above in connection with the foreign-tax credit, under which the tax credit for dividends received from foreign subsidiaries may be more advantageous than the credit for foreign taxes paid by the American branch of a foreign corporation. In many cases this will be offset by higher foreign taxes, particularly where the foreign country collects a tax on dividends paid by its corporations to all shareholders or to non-resident shareholders. A much more significant advantage in many situations is the fact that the income of the foreign corporation is not subject to United States income tax until it is declared out as divi-

²⁶ For further discussion see Tomson, Ullman and Goldin, *Lets Be Practical about Western Hemisphere Trade Corporations*, 23 *Taxes* 1120 (1945).

²⁷ I. T. 3757, *Int. Rev. Bull.* 1945-17-12119.

dends. Where the foreign corporation is operating in an area having a corporate income tax with rates comparable to the United States rates, this point is of less importance since the foreign tax credit will in the main eliminate taxation by the United States, whether the foreign income is received by the American enterprise in its own right or as dividends from a foreign subsidiary. However, as noted above, if the American business operates in more than one foreign country, and also has domestic income, the ability to time the accrual of foreign income by the declaration of dividends may be very useful in preventing loss in one country from limiting tax credit available from another.

Where the area of foreign operation is a low tax or no tax area, the advantage of a foreign subsidiary may be much greater. The foreign low tax area is of major importance in United States foreign trade, because in most cases the foreign country with a low income tax rate has a relatively undeveloped economy in which the greatest mutual advantage may result from the investment of American capital and the development of American-controlled business. If an American company wished to invest money to develop a manufacturing or extractive industry in Afghanistan, the tax advantage of forming a foreign corporation might be substantial. It would permit the smallest possible original investment, with a plough-back of current profits into capital to increase the size of the enterprise without subjecting these current profits to United States tax. Whether or not such a postponement of tax would be sound policy within the United States, it has much to recommend it in the development of foreign investments where because the risks are large the investor may more reasonably expect to be tax free until the operation reaches such a level of successful development that sound management would countenance the actual withdrawal of current profits and their payment to the investor as dividends.

Mr. Charles R. Carroll, in a recent address to the National Foreign Trade Convention, advanced an argument somewhat similar to that outlined above, from which he moved to the conclusion that the sound and simple treatment of foreign income would be its entire exemption from United States income tax, provided that the foreign income was derived from the permanent foreign establishment of an American enterprise.²⁸ Multiple taxation was defined above as the situation in which the taxes of two or more countries overlap in such a manner that persons liable for tax in more than one country bear a higher tax burden than they would if

²⁸ Tax Committee Session, Report of Proceedings at the Thirty-Second National Foreign Trade Convention, New York, N.Y., November 12, 1945, at pp. 20-28 (National Foreign Trade Council, Inc., 1945).

they were subject to only one tax jurisdiction. Mr. Carroll's suggestion would eliminate multiple taxation of the profits earned by the permanent foreign establishment of an American business by subjecting such profits only to the tax rate of the country in which the income was earned, whether this rate was higher or lower than the United States rate.²⁹ This recommended treatment would permit the American business to compete in the foreign area on the same basis as local firms, with neither tax penalty nor subsidy. The relation between the foreign and the United States rate would be one factor, along with comparative risk and comparative price structure, in evaluating the advantages of foreign as against domestic operations for the American business. Without quarreling with Mr. Carroll's objectives, it may be doubted whether such a complete exemption from United States tax would be countenanced by the United States Treasury or Congress. Its result would be total and permanent loss of revenue from American income derived from permanent establishments in foreign countries having tax rates less than the effective rates in the United States.

A more limited proposal would accomplish most of the same results without the same total and permanent loss of revenue. This proposal would be to establish a new category of taxpayers, American foreign trade corporations. Such corporations might be defined as American corporations deriving 80 per cent or more of their income from sources outside the United States and 50 per cent of their income either from the active conduct of a trade or business or from the dividends of controlled subsidiary companies at least 50 per cent of whose income was derived from the active conduct of a trade or business.³⁰ The foreign source income of such American foreign trade corporations would be entirely exempted from United States income taxes. However, dividends paid by such corporations would be fully taxable in the hands of shareholders, corporate or individual. To prevent abuse of the device, accumulations of income by the American foreign trade corporation would be subject to the provisions of section 102 of the Internal Revenue Code, penalizing unreasonable accumulation of surplus to avoid surtax on shareholders. The law should

²⁹ Mr. Carroll's suggestion is slightly more sweeping than the proposal for the exemption of foreign source income of foreign trades and foreign trade corporations, in the House bill version of the 1921 Revenue Act, in that Mr. Carroll's proposal would exempt the income derived from the permanent foreign trade establishment even of a predominantly domestic business concern.

³⁰ There is nothing sacred about these percentages. They are suggested by those used to determine exemptability under Code section 251, governing traders in American possessions. Some might prefer the 95 per cent and 90 per cent of the Western Hemisphere Trade corporation.

specifically provide, in accordance with the recent ruling on Western Hemisphere trade corporations, that adjustments of corporate structure designed to bring foreign operations within the benefits of the American foreign trade section would not be subject to tax penalties. Dividends received from American foreign trade corporations by American parent corporations would carry with them the right to foreign-tax credit essentially as and to the extent provided by the Internal Revenue Code, section 131 (f), appropriately adjusted to suit its new application. Going a step beyond section 131 (f) in its present form, the foreign-tax credit should be allowed even though more than one American corporation owns the stock of the foreign trade corporation, no one owning "a majority of the voting stock."

The situation envisaged as normal is that of an American foreign trade corporation, owned by another American corporation or corporations. In this situation, the rule suggested would result in an aggregate United States tax on distributed income approximately equal to the aggregate United States tax on distributed income under the present taxing system, save for the upstream dividend tax. The only substantial tax saving would be on undistributed income. A different result would obtain if the stock of the American foreign trade corporation were held by individuals. In this case the entire United States corporate tax would be saved to the owners and lost to the government. However, no tax credit would apply, so that the saving and loss would be limited to the excess of the United States over the foreign rate. It is most unlikely that this tax differential would be sufficient to induce the larger American businesses engaged in foreign trade to divorce their overseas departments or subsidiaries, distributing the stock in partial liquidation to their own shareholders. The net effect of this proposed legislation would be to create a class of American corporations the status of which, under our revenue laws, would be essentially that of foreign corporations. They would not be taxable on any income save that derived from United States sources, and their dividends would have the same tax status as dividends from foreign corporations in the hands of American shareholders.³¹ As compared with Mr. Carroll's suggestion, or the House revenue bill of 1921, this proposal would be more favorable to the revenue, since all income from foreign trade would be taxable once at American rates, less foreign-tax credit where available, before it became freely available to an American investor, corporate or individual. The present premium on foreign incorporation would be cancelled out, but no

³¹ With the one exception that the section 131 (f) credit would be allowed to several American shareholding corporations, as well as to a single corporate parent.

more. From the point of view of the competitive position of the American investor in foreign trade, it would do enough, but not too much. While the investor's funds remained subject to the hazards of foreign investment and use, they would be subject only to the foreign rate of tax, if any, even though the United States rate is higher; when profits withdrawn, in the exercise of prudent management, they would become subject to the full United States rate, subject to tax credit allowable by law.

Like any special provisions for the promotion of trade, the proposal advanced herein would entail some loss of revenue in certain cases and, in certain other cases, it might permit of manipulation. The Bureau of Internal Revenue in the past has proved quite astute and successful in preventing abuse of statutory privileges. Save in cases of abuse, if this country wants foreign trade, it should be prepared to pay some reasonable premium to get it.