ST/ECA/18

Taxation in Capital-Exporting and Capital-Importing Countries of Foreign Private Investment in Latin America

United States Income Taxation of Private United States Investment in Latin America

UNITED NATIONS

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United States Income Taxation of Private United States Investment in Latin America

(A description of the United States system and some of its implications)

UNITED NATIONS
Department of Economic Affairs
New York
January 1953

NOTE

The present publication constitutes a revision and expansion of the material contained in "Taxation in Capital-Exporting and Capital-Importing Countries of Foreign Private Investment in Latin America" (document E/CN.8/69).

ST/ECA/18

20 January 1953

United Nations Publication

Sales No.: 1953. XVI. 1

Price: $0.75 (U.S.)
(or equivalent in other currencies)

PREFACE

The expansion of the role that foreign private capital may play in the economic development of under-developed countries has been an abiding concern of the United Nations. Some of this concern has been directed toward the part assumed by tax factors in determining the magnitude and direction of the flow of foreign private investment.

An earlier Secretariat publication, *The Effects of Taxation on Foreign Trade and Investment* (document ST/ECA/1), presented a factual discussion of the principal types of tax barriers and tax incentives, and of the problem of international multiple taxation and its avoidance; it also referred to the impact on the revenue of capital-exporting and capital-importing countries of measures designed to eliminate tax barriers or to offer positive tax incentives to foreign trade and investment.

The present study constitutes a further step in this investigation. It was undertaken in response to resolution 378 I 2 (*b*) (XIII) of the Economic and Social Council, approving the request of the Fiscal Commission for a "continuation of studies on the effects of taxation on foreign trade and investment" and resolution 3 (IV) of the Economic Commission for Latin America, requesting its Executive Secretary:

> "if necessary in collaboration with the appropriate organs of the United Nations, to prepare a report on the influence that the fiscal systems of capital-exporting countries may have on the decisions of private investors in those countries to make foreign investments."

In resolution 416 D (XIV) of the Economic and Social Council on Fiscal Incentives to Increase the International Flow of Private Capital for the Economic Development of Under-developed Countries, the Council took note of the studies requested by the Fiscal Commission and the Economic Commision for Latin America and called on the Fiscal Commission to:

> "give further consideration to the problems of taxation in relation to foreign investments . . . [and] to examine further the proposal that, through bilateral agreements or unilateral measures, income from foreign investments in under-developed countries should be taxed only in these countries, with such income being exempted from taxes by countries other than those in which the foreign investments are made . . ."

The study analyses the applicable provisions of the United States tax system as well as proposals for change currently under discussion, highlighting their implications for the business decisions of United States investors in Latin America. The study thus is not a treatise on the United States tax system as it applies to all United States taxpayers, but rather stresses those provisions and proposals which modify the tax obligations of United States investors abroad, and particularly in Latin America, or which are of special importance to them.

In its concluding chapter the study reviews the first results of an inquiry currently being carried on among United States investors interested in Latin America. This inquiry seeks to elucidate their attitudes toward the tax questions involved and the role which tax factors are likely to play in their investment decisions.

The annex gives additional information on the taxation of Latin-American income whose repatriation is blocked by currency restrictions; it also contains a comparative chart on the tax results which flow from the use of different methods of doing business (branch, domestic or foreign subsidiary, individual enterprise, etc.).

The Secretary-General proposes to continue this study. It is intended to carry on investigations into the tax systems and investment patterns of Latin-American countries, to expand the inquiry into the effect of the tax factor on business decisions of United States investors and to extend it to other capital-exporting countries. It is expected that the Harvard Law School through its Program in International Taxation will co-operate in these investigations, in response to resolution 378 G (XIII) of the Economic and Social Council.

Professor Stanley S. Surrey, Director of the Harvard Law School Program in International Taxation, and Dan Throop Smith, Professor of Finance, Graduate School of Business Administration of Harvard University, acted as consultants to the Fiscal Division of the Department of Economic Affairs and prepared the main part of the attached study on the United States tax system. Ira T. Wender, Esq., of the New York Bar, participated with them in the preparation of the study. Professor Smith completed his participation in the study prior to his appointment as Assistant to Secretary, United States Treasury Department; his status as joint author carries no implication as to the position of the United States Treasury Department on matters contained herein.

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A. GENERAL BACKGROUND OF UNITED STATES INCOME TAX

For the past ten years, over 70 per cent of the United States Government's tax revenue has been derived from income taxes. Three types are currently imposed—a highly progressive income tax on individuals and an income and excess profits tax on corporations. Individual income tax rates rise from 22.2 per cent of the first $2,000 of taxable income to 92 per cent of income in excess of $200,000 with an over-all maximum rate of 88 per cent of taxable income. Corporate income taxes consist of a 30 per cent normal tax on all taxable income, and a surtax of 22 per cent on taxable income in excess of $25,000. On income over a fixed percentage of a corporation's average income during the period 1946 through 1949 or in excess of allowed percentages on invested capital, an excess profits tax of 30 per cent is also imposed. However, the combined amount of income and excess profits taxes is, in effect, limited to 70 per cent of taxable income. The excess profits tax is under present legislation scheduled to end on 30 June 1953. Income from the sale of certain types of property is classified as capital gain, and, if held for at least six months, is subject to a maximum 26 per cent tax for both individuals and corporations in lieu of regular income taxes.

The base of the income tax is taxable income defined as gross income less statutory deductions, credits and exemptions. Gross income is broadly defined to cover net receipts from trades and businesses, profits from sales of property and compensation for personal services, dividends, interest, rent, and other typical income items. The most important deductions are interest, taxes (other than United States income taxes), losses, depreciation, depletion and other ordinary and necessary business expenses like supplies, repairs, rent, wages and salaries. The income tax is a unitary tax, under which all items of gross income and of deductions are combined to arrive at the over-all net income subject to the tax. The tax is thus not a schedular tax calculated separately on each category of income.

Generally, the entire income of resident and non-resident citizens, resident aliens and domestic corporations is subject to income taxes. Foreign corporations doing business in the United States (termed resident foreign corporations) are taxed only on their income from United States sources. A withholding tax of 30 per cent is imposed on the "fixed or determinable annual or periodical" income, as, for example, dividends, interest and rent from United States sources, paid to non-resident alien individuals and foreign corporations not engaged in trade or business in the United States.

Corporations and individuals are separate taxable entities, while partnerships and sole proprietorships are not. Corporate earnings are taxed to the corporation whether retained or distributed. When shareholders receive dividends, these dividends are taxed as part of their income. Dividends paid to individual stockholders are fully taxable. Corporate shareholders may exclude dividends of both foreign and domestic corporations from income subject to excess profits taxes. They are also allowed to exclude 85 per cent of dividends received from domestic corporations in calculating income subject to normal tax and surtax. This 85 per cent exclusion is called the dividends received credit. This credit also extends to the portion of the dividends of foreign corporations which are regarded as derived from sources within the United States.

The tax law is the Internal Revenue Code of the United States. It is implemented by regulations issued by the Treasury Department which, unless in conflict with the Code, have the force of law. The Bureau of Internal Revenue, in the Department of the Treasury, handles tax collection and administration. There are issued Revenue Rulings (Rev. Rul.; formerly styled G.C.M.'s and I.T.'s), which explain the Bureau's position on the application of tax laws. Administrative determinations of tax disputes are subject to review by the courts.

Income taxes are self-assessed. Returns are filed yearly and the tax shown to be due is paid at the time the return is filed, with instalment payment permitted in some cases.

B. FOREIGN INCOME UNDER THE UNITED STATES INCOME TAX

1. General Treatment of Foreign Income

(a) *Policy*

In general, United States corporations, citizens, and alien residents, are subject to tax on their entire income, whatever its geographical source. This treatment is apparently predicated on the principle of imposing equal tax burdens on taxpayers with the same amount of income. It has been also defended economically on the ground that United States tax considerations ought not to govern the choice between domestic and foreign investment. Thus, the basic United States approach is that foreign income should be taxed on a parity with domestic income.

(b) *Foreign Taxes*

Since income derived from sources outside the United States will usually be taxed by the countries in which it originated, the United States policy of also taxing such income poses the problem of international double taxation. Mitigation of double taxation of income derived from sources outside the United States is achieved under the United States law through (*a*) deduction of foreign taxes or (*b*) the foreign tax credit. Generally, foreign taxes of all types may be deducted from gross income in computing taxable income. At their option, domestic corporations and citizens of the United States, and —on the basis of reciprocity—resident aliens, are permitted to credit their foreign income taxes against their United States tax by applying the foreign taxes directly against the United States income tax. In most cases this application of the foreign tax against United States tax, i.e., a credit, is preferable.

Under the credit, when the foreign rate is lower than the United States rate, the taxpayer pays to the United States the excess of the American rate over the foreign rate on the foreign income. If the foreign rate equals or exceeds the United States rate, the credit completely offsets any United States tax liability. The amount of the credit is limited to prevent a foreign tax rate higher than the United States rate from reducing the United States tax on income from United States sources. If the credit is elected by a taxpayer, all foreign income taxes must be credited and none deducted. Foreign non-income taxes, however, may still be deducted.

(c) *Branches and Subsidiaries*

When operations abroad are carried on directly by a United States company, termed a *branch* operation, no segregation of profits or losses of the foreign branch is required for purposes of determining income and excess profits taxes. Losses in foreign branch operations will reduce United States income taxes if domestic profits have been earned. Branch earnings are subject to United States income tax and foreign taxes on those earnings may be credited or deducted as explained above.

If the foreign business is carried on by a *subsidiary* organized in a foreign country, the separate entity of the parent and subsidiary corporations is recognized for tax purposes and the earnings of the foreign subsidiary will not be taxed to its United States parent until distributed to it. Thus, a subsidiary may be used to defer United States tax on foreign income until received by the parent. The losses of the subsidiary may not be offset against the parent's earnings in calculating taxable income.

Usually, the claimant of a foreign tax credit must be the one who paid the foreign tax, but an exception is made in the case of a United States corporation owning 10 per cent or more of the voting stock of a foreign corporation. The United States parent may credit against its United States income taxes attributable to the dividends from its foreign subsidiary a portion of the foreign income taxes paid by the subsidiary on the earnings from which the distribution was made. The 10 per cent ownership requirement is designed to eliminate the administrative burden of applying the foreign tax credit in those situations where the United States parent owns only a few shares in the foreign subsidiary. No deduction of a subsidiary's foreign taxes is permitted to the parent. Of course, the parent can credit or deduct foreign taxes imposed on it because of the dividends received from its foreign subsidiary.

2. Exceptions in Treatment of Foreign Income

From the general United States policy of taxing income from all geographical sources, three types of exceptions have been carved. Since the addition of the provision covering Western Hemisphere Trade Corporations to the Internal Revenue Code in 1942, partial exemption by lower tax rates has been granted domestic companies deriving almost all their income from within countries in the Western Hemisphere other than the United States. Also, non-resident individual citizens earning income outside the United States are extended an exemption from tax for their foreign earned income. For citizens of the United States and domestic corporations deriving a substantial portion of their income from within possessions of the United States, complete tax exemption is granted income from the possessions.

(a) *Western Hemisphere Trade Corporations—Section 109*

Domestic corporations which derive substantially all of their gross income from sources within the Western Hemisphere outside the United States may elect to be taxed as Western Hemisphere Trade Corporations. The Western Hemisphere includes all the countries of South, Central and North America. Total exemption from excess profits taxes and partial exemption from corporate income taxes through a rate pegged at fourteen percentage points below the regular corporate rate are extended to these Western Hemisphere Trade Corporations.

For other purposes, Western Hemisphere Trade Corporations are treated as are all other domestic corporations. The credit for foreign taxes is allowed. A corporate shareholder may exclude from its taxable income 85 per cent of dividends received from a Western Hemisphere Trade Corporation.

(b) *Possessions of the United States—Section 251*

Citizens and domestic corporations of the United States, the gross income of which during a specified period is derived 80 per cent or more from sources within a possession of the United States and 50 per cent or more from the active conduct of a trade or business within a possession of the United States, are within section 251. Under that section, only income from United States sources is subject to tax. Corporations claiming the benefits of that section are generally treated as foreign, and their corporate shareholders are denied the dividends received credit. No foreign tax credit is allowed corporations claiming the benefits of section 251. The possessions are Puerto Rico (except as to individual residents of Puerto Rico), Guam, American Samoa, Wake Island, Midway Island, and the Panama Canal Zone. The Virgin Islands are not possessions under section 251.

(c) *The Earned Income Exclusion—Section 116*(a)

United States citizens, who are either bona fide residents of, or actually present for seventeen months out of eighteen months in a foreign country, may exclude compensation for personal service rendered outside the United States from their income subject to United States tax. Deductions related to the excluded earned income are not allowed and, hence, cannot be used to reduce other income which remains subject to United States taxes.

C. THE SOURCE OF INCOME

Since the foreign tax credit and the special exemptions discussed turn on the extent to which income is derived from sources outside the United States and within a particular country, their application necessarily requires tests for determining what is the source of income. The rules for classifying the source of income are schedular.

1. Sales of Personal Property

Under United States law, personal property consists of all property, except real estate. Thus, it includes all merchandise and manufactured products. The rules for determining the source of gain from sales of personal property are:

(1) Income from the sale of personal property which was produced within and sold without the United States is derived partly from sources within and partly from sources without the United States.

(2) Income from the sale of personal property which was produced without and sold within the United States is derived partly from sources within and partly from sources without the United States.

(3) Income from the sale of personal property which was originally purchased by the taxpayer is derived entirely from the country in which the property was sold by the taxpayer.

Since these source of income rules respecting personal property all turn on the place of sale, further rules are necessary to determine what is the place of sale. The test for determining the country in which property was sold is, generally, the place where the title to the goods passed from the seller to the buyer. However, the Bureau of Internal Revenue has indicated that if the sales transaction is arranged in a particular manner for the purpose of tax avoidance, then the place of title passage alone will not determine the source of the income. Instead, all factors of the transaction, including the negotiation and execution of the contract, the place of payment, and the location of the property will be considered, and the place of sale will be the country in which the substance of the sale occurred.

When the income is partly from sources within and partly from sources without the United States, rules for apportionments are provided by the Treasury Regulations. These rules provide for a fair allocation of the profit between production and sale.

2. Dividends

The source of dividends is usually the country in which the corporation declaring the dividend was incorporated. Consequently, the dividends from foreign corporations will generally be regarded as foreign income. However, dividends of a foreign corporation which derives 50 per cent or more of its income from United States sources are treated as income from sources within the United States in proportion to the United States gross income of the corporation. In addition, dividends of a domestic corporation which derives less than 20 per cent of its gross income from United States sources are income from sources without the United States.

3. Interest

Interest is from sources within the United States if paid by a resident of the United States, unless the payor derives less than 20 per cent of his gross income from United States sources.

4. Earned Income

Compensation for personal services is treated as income from sources within the country in which the services were performed.

5. Other Income

Gains, profits, or income from the sale of real property are treated as income from the country in which the property is located. A similar treatment is accorded to rentals and royalties from personal property, such as patents and copyrights, used in the country in which it is located.

II. EFFECTS OF THE UNITED STATES INCOME TAX PATTERN ON UNITED STATES INVESTMENT IN LATIN AMERICA

From the view point of a United States investor, individual or corporate, two major effects of the United States income tax are important. Initially, the tax could act as an impediment to foreign investment if provisions for relief from international double taxation were unsatisfactory. Without relief, combined United States and foreign income tax may reduce possible profits below the point at which foreign investment becomes attractive. Even with international double taxation eliminated, taxation may have a positive effect on the form in which the investment is made and may otherwise influence the investment.

A. RELIEF FROM INTERNATIONAL DOUBLE TAXATION— THE FOREIGN TAX CREDIT

1. General Description of the Foreign Tax Credit

The rules governing the foreign tax credit are:

(*a*) Only income (including excess profits) taxes or taxes imposed in lieu of such taxes by a foreign country may be credited against United States income tax.

(*b*) Generally, the foreign tax for which credit is sought must be a tax imposed on the taxpayer claiming the benefit of the credit.

(*c*) The exception to (*b*) is that a United States corporate parent, owning 10 per cent or more of a foreign subsidiary's voting stock, may credit against its United States tax on the dividends of the subsidiary a part of the parent's proportional share of foreign income taxes paid by the subsidiary on the earnings from which the dividend was distributed to the parent.

(*d*) The amount of the credit allowed under (*b*) or (*c*) is limited to the foreign tax paid or accrued, but cannot exceed the "per country" and "overall" limitations. The limitations are determined by the following formulae:

(1) *Per-country limitation*

$$\text{Maximum Credit} = \frac{\text{Total net income from } \textit{sources within foreign country}}{\text{Total net income from all domestic and foreign sources}} \times \text{United States income tax}$$

(2) *Over-all limitation*

$$\text{Maximum Credit} = \frac{\text{Total net income from } \textit{all foreign sources}}{\text{Total net income from all domestic and foreign sources}} \times \text{United States income tax}$$

In the above formulae, "net income" is gross income less deductions, including deductions for losses.

(*e*) In each taxable year, a taxpayer must elect between deducting and crediting foreign income taxes. If a credit is elected, all foreign income taxes must be credited instead of deducted.

2. Operation of the Foreign Tax Credit

The foreign tax credit does not permit the crediting of all types or amounts of foreign taxes. The most important limitation is that the foreign tax for which a credit is sought must be an income tax. The amount of foreign tax which may be credited is also limited to prevent reduction of United States tax on domestic income. In addition, the concepts on which the foreign tax credit is based may reduce or eliminate the credit. Ranked in order of importance, these limitations on the credit are:

(a) *Limitation to Foreign Income Taxes*

Only foreign income taxes (including war profits and excess profits taxes) or taxes imposed in lieu of them may be credited. A foreign tax is in lieu of a foreign income tax if the following three conditions are met:

(1) The foreign country has in force a general income tax law;

(2) The claimant of the credit would be subject to the general income tax in the absence of special provision applicable to him; and

(3) The claimant, subject to the substituted tax, is not also subject to the general income tax.

Since many foreign countries do not rely for revenue on income taxes to the same extent as the United States, an United States investor may not be able to credit the major portion of its foreign tax burden against United States tax on its foreign income. Typical non-creditable foreign taxes are export taxes, gross receipts taxes, production taxes and taxes imposed on the privilege of doing business.

> *Example:* United States corporation, P, derives all of its income from country A. Assume that net earnings before any taxes are $100 and that the United States tax rate is 50 per cent. Assume P's gross receipts are $250, exports $150, and capital in country A, $500. If country A imposes a 10 per cent tax on gross receipts, a 10 per cent tax on exports and a 2 per cent tax on capital, the revenue to country A equals that which would be derived from a 50 per cent income tax. However, P would net twice as much from country A operations if that country were to derive its revenue from an income tax, rather than the above taxes.
>
> (*a*) The net to P if country A imposes an income tax of 50 per cent will be $50.

	$
Earnings before taxes	100
Country A income tax	50
U.S. tentative tax	50
Credit	
Lesser of:	
Tax paid	50
Limit: $\frac{100}{100} \times 50$	50
Net U.S. tax	0
Net after all taxes	$50

(*b*) The net to P if country A imposes the assumed gross receipts, export and capital taxes will be $25.

	$	$
Earnings before taxes		100
Deductions for country A taxes		
Gross receipts tax	25	
Export taxes	15	
Capital tax	10	50
Taxable U.S. income		50
U.S. tax		25
Net after all taxes		$25

(b) *The Per-Country and Over-All Limitations*

The per-country limitation on the amount of the foreign tax credit treats foreign income received from each country as a separate unit and limits the credit to the amount of the United States income tax attributable to income from that country. Accordingly, if the income tax in a foreign country exceeds the United States tax on the net income from that country, the excess cannot be credited.

The over-all limitation treats all foreign income as a single unit and limits the credit to the amount of the United States income tax on the net income from all foreign countries. Consequently, losses in one foreign country are set off against income from another in calculating the over-all limitation on the amount of the credit.

The effect of the two limitations is, therefore, as follows:

(1) If operations are conducted in *only one foreign country*, the effect of the over-all and per-country limitations is the same, since net income from all foreign sources is the same as net income from the one foreign country in which the claimant of the credit operates.

Example: United States company, P, has net income of $100 from country A, and $100 from the United States. Assume the income tax rate in the United States is 50 per cent and in country A, 60 per cent. P's tentative United States income tax is $100 ($200 × .50). The tax paid country A is $60. The amount of the credit is:

Credit			
Per-country limitation	$	$	$
Lesser of:			
Tax paid	60		
Limit on credit, $\frac{100}{200} \times \$100$	50	50	
Over-all limitation			
Lesser of:			
Tax paid	60		
Limit on credit, $\frac{100}{200} \times \$100$	50	50	
			50

(2) If operations are carried on *profitably in two or more foreign countries,* the per-country limitation may reduce the amount of foreign taxes which may be credited. In this situation the credit for all foreign taxes cannot exceed the sum of the amounts obtained by using for each country the lesser of either the actual amount of tax paid to that foreign country or the United States tax on the income from that foreign country. Thus, if one foreign country imposes higher income taxes than the United States and another lower, the per-country limitation does not permit the foreign taxes to be averaged because the amount of the credit for the taxes imposed by the high-rate country is limited to the United States tax attributable to that income. On the other hand, in this situation the overall limitation does not reduce the amount of the credit, since under it the foreign income taxes are averaged so long as total foreign taxes on aggregate foreign income do not exceed the United States tax on the aggregate foreign income.

Example: United States company, P, has net income of $100 from country A, $100 from country B and $100 from the United States. Assume the income tax rate in the United States is 50 per cent, country A 60 per cent and country B 40 per cent. P's tentative United States income tax is $150 ($300 × .50). The tax paid to country A is $60 and to country B is $40. The amount of the credit is $90.

Credit				
Per-country limitation	$	$	$	$
Country A				
Lesser of:				
Tax paid	60			
Limit on credit, $\frac{100}{300} \times \$150$	50	50		
Country B				
Lesser of:				
Tax paid	40			
Limit on credit, $\frac{100}{300} \times \$150$	50	40	90	

Over-all limitation				
Lesser of:				
Tax paid	100			
Limit on credit, $\frac{200}{300} \times \$150$	100	100	100	
				90

(3) If operations are conducted in *two or more foreign countries and a loss is incurred in one of those countries,* the over-all limitation may reduce the amount of foreign tax which may be credited. Under the over-all limitation, the credit is limited to the United States income tax on the net income from all foreign sources, which is foreign income less foreign losses. Thus if, because of the loss, the United States tax attributable to the net foreign income from all foreign sources is less than the sum of the income taxes imposed by the foreign countries from which income was derived, the over-all limitation will reduce the foreign tax credit. The operation of the per-country limitation is not affected by the loss. The credit allowed under it will be the same as if no loss had been incurred. However, even in this situation the amount of the foreign tax credit may be reduced more by the per-country limitation than by the over-all limitation. This will occur when the foreign loss is small in relation to the foreign income and one of the foreign countries from which income is derived imposes higher income taxes than the United States and another imposes lower income taxes.

Examples: (1) United States company P, has net income of $100 from country A and $100 from the United States as well as a loss of $100 from country B. Assume the income tax rate in the United States is 50 per cent and in country A, 60 per cent, P's tentative United States tax is $50 ($100 × .50). The tax paid to country A is $60, but no credit is allowed for the country A tax because of the over-all limitation.

Credit			
Per-country limitation	$	$	
Country A			
Lesser of:			
Tax paid	60		
Limit on credit, $\frac{100}{100} \times \$50$	50	50	
Over-all limitation			
Lesser of:			
Tax paid	60		
Limit on credit, $\frac{0}{100} \times \$50$	0	0	
			0

Since no credit against tax is allowed, P would use the alternative of deducting the tax paid country A from its net income. Therefore, the actual amount of United States tax paid would be $20, since deduction of the $60 tax would leave net income of $40 subject to the United States tax rate of 50 per cent.

(2) United States company, P, has net income of $100 from country A, $100 from country B and $100 from the United States, as well as a loss of $20 from country C. Assume the income tax rate in the United States is 50 per cent, in country A, 60 per cent, and in country B, 30 per cent. P's tentative United States tax is $140 ($280 × .50). The tax paid to countryA is $60 and the tax paid to country B is $30. The amount of the foreign tax credit is $80 because of the operation of the per-country limitation.

Credit				
Per-country limitation	$	$	$	$
Country A				
Lesser of:				
Tax paid	60			
Limit on credit, $\frac{100}{280} \times \$140$	50	50		
Country B				
Lesser of:				
Tax paid	30			
Limit on credit, $\frac{100}{280} \times \$140$	50	30	80	
Over-all limitation				
Lesser of:				
Tax paid	90			
Limit on credit, $\frac{180}{280} \times \$140$	90	90	90	
				80

(c) *Conceptual Limitations*

(i) *The concept of the source of income*

Differing standards for determining the source of income may make the foreign tax credit ineffectual. As noted above, the United States rule is that the source of income from the sale of purchased personal property is the place where title passes. Other countries may ascribe the source of the place where the contract was made, executed or negotiated or where payment was made. A foreign country in which the transaction was negotiated might, for example, impose a tax on the income from the sale, though the title passed in the United States. No credit will be allowed for the foreign tax because there is by United States definition no taxable income from within that foreign country.

When a United States company's activities extend into two or more foreign countries this problem becomes aggravated. Contract, delivery, payment and passage of title may occur in different foreign countries. Any of these countries might tax the income from the sales. The foreign tax credit might be nothing, or limited to the taxes imposed by one of these countries, depending on the United States definition of the source of the income. Relief from this form of double taxation will be available only if the United States and each of the countries involved agree as to the source of the income.

Example: United States company, P, has taxable income of $100 of which $50 is attributable to sales in country A, $30 in country B, and $20 in country C. Assume the United States rate is 50 per cent, the rate in country A is 40 per cent, country B 20 per cent and country C 30 per cent. Sales in countries B and C are negotiated in country A.

(1) If the source of the income by U. S. and countries A, B and C standards are the same, the total taxes imposed will be limited to the U. S. rate of 50 per cent. Thus, if each foreign country treats the sales within it as giving rise to income from sources within it, the tax consequences are:

	$	$
Earnings		100
Tentative U.S. tax		50
Credit		
Country A (.40 × 50)	20	
Country B (.20 × 30)	6	
Country C (.30 × 20)	6	32
U.S. tax		18
Net after all taxes		50

(2) If the source of the income by United States definition is the United States but if each foreign country treats income from the sales within that country as derived from that country, the total tax burden exceeds the 50 per cent United States rate. No credit will be allowed since the numerator of the ratio by which the limit on the credit is calculated—income from sources within each of the foreign countries by United States standards—will be zero. Accordingly, foreign taxes may be deducted only with the following tax consequences:

	$
Earnings	100
Foreign taxes	32
Taxable U.S. income	68
U.S. Tax	34
Net after all taxes	34

(3) If the source of the income by United States definition is country A and each foreign country treats income from the sales as derived from that country, the total tax burden exceeds the 50 per cent United States rate. P can credit country A taxes or deduct taxes imposed by A, B and C. The tax consequences of the alternatives are:

	Deduction of countries A, B, and C's taxes	Credit of country A's taxes
	$	$
Earnings	100	100
Deduction for foreign taxes	32	—
U.S. taxable income	68	100
Tentative U.S. tax	34	50
Credit		
Lesser of tax paid $20		
Limit, $\frac{100}{100} \times \$50$	—	20
U.S. tax	34	30
Foreign taxes paid	32	32
Total U.S. and foreign taxes	66	62
Net after all taxes	34	38

(4) If the source of the income by United States and countries B and C definitions is the country in which the property was sold and by country A's definition all income is from sources within country A (therefore, A's tax is $40 instead of $20 as in the prior examples), the total tax burden exceeds the 50 per cent United States rate. P can credit all taxes imposed by countries B and C, and a portion of country A's taxes or deduct the amount paid countries A, B, and C. The tax consequences of the alternative are:

	Deduction of countries A, B & C's taxes	Credit of countries A, B, & C's taxes
	$	$
Earnings	100	100
Deduction for foreign taxes	52	—
U.S. taxable income	48	100
Tentative U.S. tax	24	50
Credit		
Country A 50/ 100 × 50 = $25		
Country B $6		
Country C $6	—	37
U.S. tax	24	13
Foreign taxes paid	52	52
Total U.S. and foreign taxes	76	65
Net after all taxes	24	35

However, the taxpayer may frequently be able to arrange the source of income by the manner in which the business is conducted. Consequently, differing standards as to the source of income will not be a major problem.

(ii) *The concept of taxable income*

Even where both the United States and the foreign country agree that the source of the income is from that foreign country, the amount of the taxable income from sources within the foreign country is determined by United States standards for purposes of the credit. Consequently, if the deductions allowed by the foreign country are less than those allowed by the United States, the effective rate of the foreign tax from the United States standpoint may exceed the United States rate. The result is that a portion of the foreign tax may not be credited against United States tax. Lower rates of depletion or depreciation under foreign law produce this effect.

A similar loss of credit may occur when income is imputed to a taxpayer under foreign law, but not under United States law. This may arise when the rental value of an owner-occupied building is imputed to the owner as an item of income.

Example: United States company, P, has total U. S. taxable income of $100. $60 of the $100 is derived from country A, in which it maintains a branch. Assume country A imposes a 40 per cent and the United States a 50 per cent income tax. Further assume the income from sources within country A is considered by that country as $90 rather than $60 because home office expenses considered under United States law as allocable to the branch may not be deducted under country A law. The tax consequences are:

	$	$
U.S. taxable income		100
Tentative U.S. tax		50
Taxes paid country A		36
Credit		
Lesser of:		
Tax paid	36	
Limit on credit, $\frac{60}{100} \times 50$	30	
		30
Net U.S. tax		20
Foreign tax		36
Total U.S. and foreign taxes		56

(iii) *The concept of the taxpayer*

Except in the case of a corporation using a credit for a subsidiary's foreign taxes, the claimant of the foreign tax credit must show that he is the one liable for the tax under the foreign tax statute. A tax imposed by a foreign country on a foreign corporation, not its shareholders, because of the declaration of a dividend may not be credited by a United States individual taxpayer (or a corporation owning less than 10 per cent of the stock of a foreign corporation) owning stock in the corporation even if the tax is based on and withheld from the dividend distribution. However, the same tax would be allowed as a credit if imposed on the shareholders of the foreign corporation.

B. INVESTMENT BY UNITED STATES CORPORATIONS IN LATIN AMERICA

Whether or not the United States tax acts as an impediment to investment, it may affect the way in which the investment is made. For example, the possible forms an investment might take are:

(*a*) A branch—a United States corporation doing business in the foreign country.

(*b*) A United States subsidiary corporation.

(*c*) A United States subsidiary corporation qualifying as a Western Hemisphere Trade Corporation.

(*d*) A foreign subsidiary corporation.

The form selected from a tax standpoint will largely be influenced by—

(*a*) Whether the investor plans to withdraw the earnings currently from the foreign business or desires to accumulate the foreign earnings for investment in the foreign business, and

(*b*) The type of business activity in which the investor intends to engage. Throughout this discussion the term subsidiary means a corporation in which 10 per cent or more of the stock is owned by the parent. It is therefore assumed that the credit for taxes paid by a foreign subsidiary is available to the parent corporation as a set-off against United States taxes on the foreign subsidiary's dividend distributions.

Much of the discussion that follows is equally applicable to individual investors. Special considerations prevailing in their case are discussed in D below.

1. Current Distribution or Accumulation of Foreign Income

(a) *Current Distribution*

(i) *Branch*

When a United States corporation directly engages in business in a foreign country, the foreign activity is called a branch for United States income tax purposes, although that term is not used by the Internal Revenue Code. A branch is not treated as a separate taxable entity. A branch's income is added to the taxable income of its United States corporation and is, therefore, subject to both United States income and excess profits tax. The branch's foreign income tax may be credited against the corporation's United States income tax.

The percentage return of a United States corporation from branch operations after foreign and United States income taxes (excluding the effects of the United States excess profits tax) is illustrated in graph I.

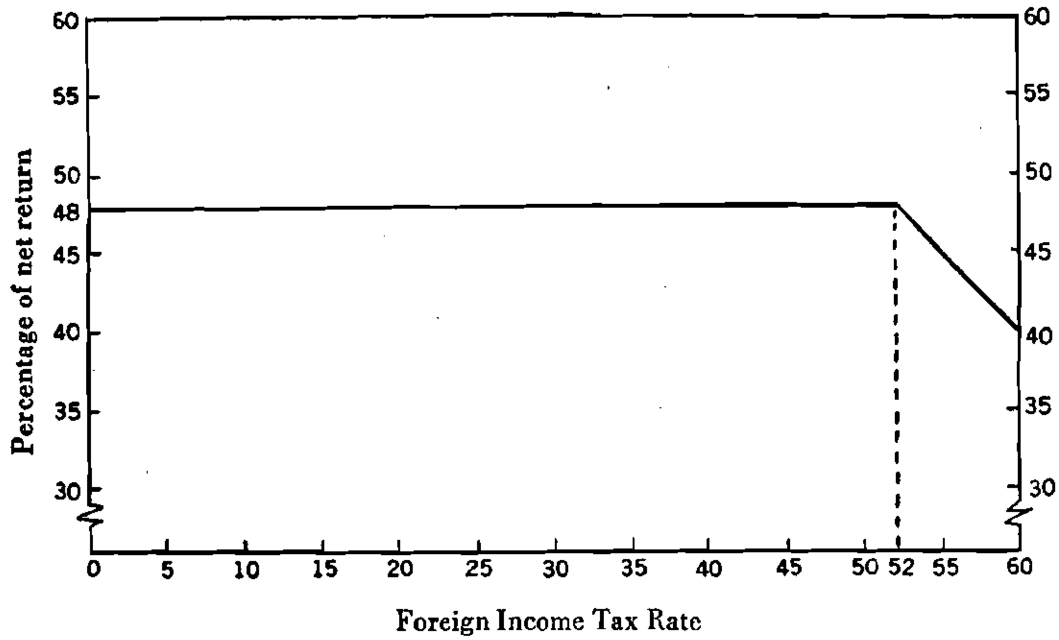
Thus, the corporation will receive from the earnings of a branch 48 per cent after taxes, provided the foreign income tax rate does not exceed 52 per cent. For each percentage point increase over 52 per cent, the return after tax will decline one per cent.

(ii) *United States subsidiary corporation*

Foreign investment can be conducted through the medium of a subsidiary incorporated in the United States. Since domestic corporations are taxed by the United States on their income from all sources, the foreign earnings of a United States subsidiary are subject to United States income and excess profits tax and a credit for foreign income taxes is allowed. In addition, the parent investor will pay the intercorporate dividend tax of 7.8 per cent on distributions of the subsidiary's earnings. (This figure is obtained by applying the corporate tax of 52 per cent to 15 per cent of the dividends received, the latter being the taxable amount of dividends after the dividends received credit.)

Graph I. Branch

Percentage of corporate investor's return on foreign earnings after United States and foreign income tax *



*** Calculations are made for foreign income tax rates between 0 and 60 per cent.**

The percentage return of a United States corporation from a domestic subsidiary after foreign and United States income taxes (excluding the effects of the United States excess profits tax which might be imposed on the subsidiary) is illustrated in graph II.

The United States parent's return is 44.26 per cent of the domestic subsidiary's earnings provided the foreign income tax rate does not exceed the United States rate of 52 per cent. For each percentage point by which the foreign income tax rate exceeds the United States rate of 52 per cent, the parent's return will decline .922 per cent from 44.26 per cent. The return will, of course, be reduced if the subsidiary is subject to United States excess profits tax.

(iii) *Western Hemisphere Trade Corporation*

Under the Western Hemisphere Trade Corporation provisions of the Code, domestic corporations are subject to a special rate of about 38 per cent if:

(1) All their business is done in the Western Hemisphere;

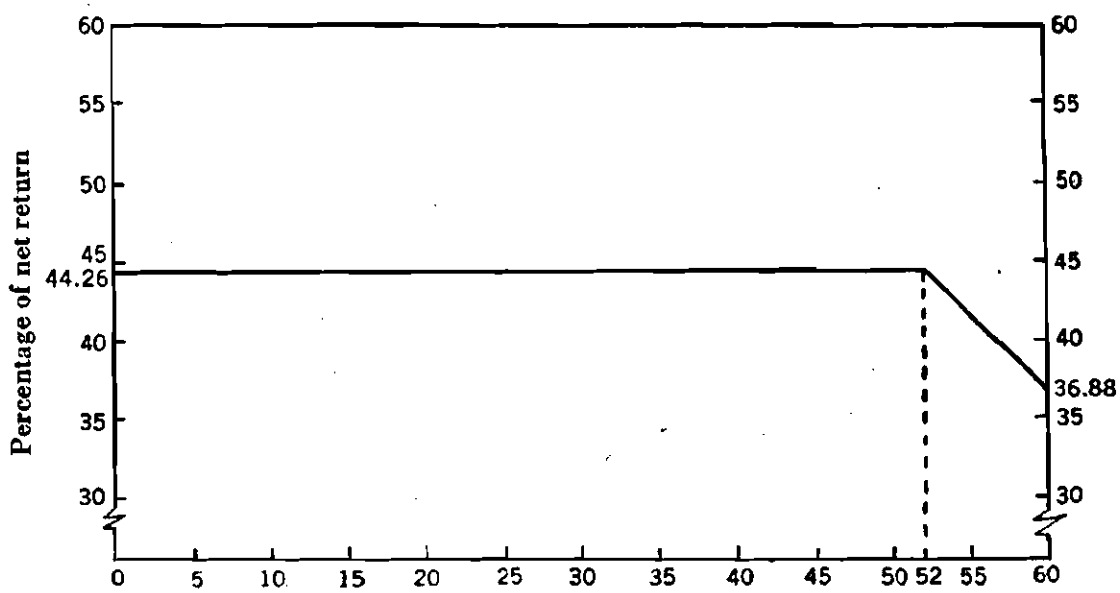
(2) 95 per cent or more of their gross income was derived from sources outside the United States; and

(3) 90 per cent or more of their gross income was derived from the active conduct of a trade or business.

Qualifying corporations are also exempt from excess profits taxes. Corporate shareholders of a Western Hemisphere Trade Corporation may exclude 85 per cent of dividends from their gross income. Only the 15 per cent balance is subject to normal tax and surtax of 52 per cent. As a consequence, corporate investors using a Western Hemisphere Trade Corporation will net 57.16 per cent of the subsidiary's earnings. The usual net from using an ordinary

Graph II. Ordinary Domestic Subsidiary

Percentage of corporate investor's return on foreign earnings after United States and foreign income tax *



* Calculations are made for foreign income tax rates between 0 and 60 per cent.

domestic subsidiary (excluding the subsidiary's excess profits tax) would be 44.26 per cent.

Example: United States corporation, P, owns all the stock of a Western Hemisphere Trade Corporation subsidiary, S. Excluding consideration of foreign taxes the maximum net to P on each $100 of S's earnings is:

	$
Earnings of S	100
U.S. tax	38
Dividend to P	62
Dividend received credit, 85 per cent	52.7
Taxable income to P	9.3
U.S. tax on P, 52 per cent	4.84
Combined U.S. taxes on S and P	42.84
Net after combined taxes to P	57.16

A Western Hemisphere Trade Corporation may credit foreign taxes against the United States taxes it pays, but the parent is not allowed a credit for the foreign taxes paid by the Western Hemisphere Trade Corporation.

If the foreign rate is less than 38 per cent, it is entirely absorbed by a credit against the United States income tax. However, the tax advantage of a Western Hemisphere Trade Corporation declines once the foreign income tax exceeds the 38 per cent United States tax, and is eliminated once the foreign rate reaches 52 per cent. The excess of the foreign rate over 38 per cent cannot be credited against either the Western Hemisphere Trade Corporation's or the corporate shareholder's United States tax.

If the foreign country in which a Western Hemisphere Trade Corporation derives its income imposes a tax on dividends paid non-residents, the tax benefit of the Western Hemisphere Trade Corporation to its corporate shareholders declines. The levy, being imposed on the corporate shareholders of the Western Hemisphere Trade Corporation, gives rise to a foreign tax credit only for the shareholder. Since only 15 per cent of dividends from a Western Hemisphere subsidiary is taxable income to a corporate shareholder, the maximum amount of the foreign tax credit will be the United States tax on the taxable portion of the dividend assuming the parent has no other income from that foreign country. Thus, the parent's net return would be reduced by the excess of the foreign tax on the dividend over the United States tax on 15 per cent of the dividend. If the foreign income tax on the Western Hemisphere Trade Corporation's earnings does not exceed the United States rate of 38 per cent, the effect of a tax on dividends to the parent of the Western Hemisphere Trade Corporation may be illustrated mathematically as follows:

Earnings of Western Hemisphere Trade Corporation before taxes $= x$

United States tax rate on Western Hemisphere Trade Corporation $= 38$ per cent

Dividend to parent $= x - .38x = .62x$

Portion of dividend to parent subject to U.S. tax (Taxable dividend) $= .15\,(.62x) = .093x$

Parent's tax on taxable dividend $= .52\,(.093x) = .0484x$

Net to parent before foreign tax on dividend $= .62x - .0484x = .5716x$

Foreign rate of tax on dividends to non-residents $= y$

Foreign tax on dividends $= .62xy$

Maximum credit for foreign tax on dividends $= .0484x$

Reduction in net to parent (assuming foreign tax exceeds U.S. tax on the dividends) $= .62xy - .0484x = x(.62y - .0484)$

$$\text{Net to parent} = .5716x - x\,(.62y - .0484) = x\,(.62 - .62y)$$

If x equals $100, the net to the parent is $62 —.62y. Thus a 15 per cent dividend tax reduces the parent's net from $57.16 to $52.70.

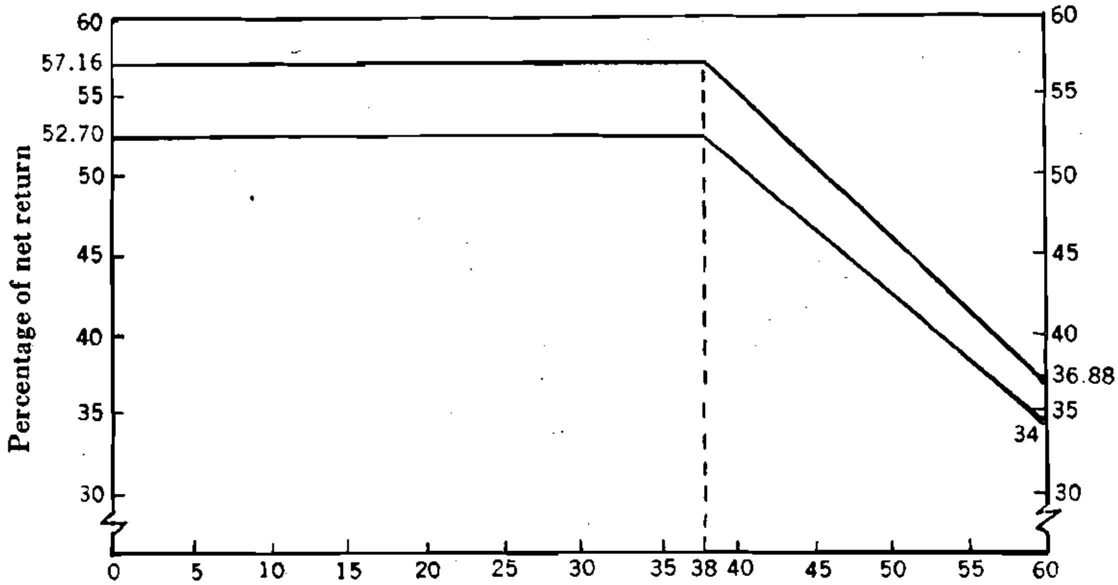
The relationship of foreign tax rates to Western Hemisphere Trade Corporation benefits and the effect of a foreign tax of 15 per cent on dividends to corporate investors are illustrated in graph III.

(iv) *Foreign corporation*

Under United States income tax law, foreign corporations are classified as resident or non-resident. Non-resident foreign corporations are subject to United States income tax only on fixed or determinable annual or periodical income, like dividends, rent and interest, from the United States. If a foreign corporation is engaged in trade or business within the United States, it is a resident. Resident foreign corporations are taxed on income from United States sources in the same way as domestic corporations, but their non-United States income is exempt from United States income tax.

Graph III. Western Hemisphere Trade Corporation Subsidiary

Percentage of corporate investor's return on foreign earnings after United States and foreign income tax (upper curve) plus a 15 per cent foreign tax on dividends (lower curve) *



* **Calculations are made for foreign income tax rates between 0 and 60 per cent.**

A parent corporation is not entitled to the dividends-received credit on the dividend distributions of its foreign subsidiary, unless the subsidiary is a resident and derives 50 per cent or more of its income from United States sources. Foreign corporations are not entitled to the foreign tax credit.

An analysis of the United States income tax consequences of utilizing a foreign corporation as the medium of foreign investment requires an examination of the credit for a foreign subsidiary's foreign taxes. Section 131 (*f*) of the Internal Revenue Code permits a United States parent to credit against its United States income tax on dividends from a foreign subsidiary a portion of the foreign income taxes paid by the subsidiary on the earnings from which the dividend distribution was made. The years out of the earnings of which the dividends are derived must be determined. For each year the amount of the credit is that portion of the foreign income taxes which bears the same ratio to the total foreign income taxes of that year as the dividend received by the parent out of the earnings of that year bears to the profits before foreign income taxes of that year. The foreign tax credit is the sum of the credits for each of the years from the earnings of which the dividend is derived. Mathematically it may be expressed as follows:

$$\frac{\text{Credit}}{\text{Foreign income taxes paid}} = \frac{\text{Dividend received}}{\text{Profits before foreign income tax}}$$

$$\text{Credit} = \frac{\text{Foreign income taxes paid} \times \text{Dividends received}}{\text{Profits before foreign income tax}}$$

Since foreign taxes paid divided by profits before foreign income tax equals the average foreign income tax rate, the credit is the average annual foreign income tax rate times the dividend. This is derived as follows:

$$\text{Credit} = \frac{\text{Foreign income taxes paid}}{\text{Profits before foreign income tax}} \times \text{Dividends received}$$

$$\frac{\text{Foreign income taxes paid}}{\text{Profits before foreign income tax}} = \text{Average foreign tax rate}$$

Therefore, by substitution:

Credit = Average foreign tax rate x Dividends received.

The credit for a subsidiary's taxes is also subject to the per-country and over-all limitation.

The mechanics of the credit for a subsidiary's taxes usually result in a lower tax on foreign earnings than the prevailing United States rate. The reason for this is that, in effect, both a deduction from taxable income and a tax credit is accorded the foreign tax paid by the subsidiary. United States income taxes are imposed on the dividends, that is earnings after deducting foreign income tax. In addition, that portion of the foreign tax attributable to the dividend is credited. The amount by which the parent's return on foreign earnings of the subsidiary exceeds the return on domestic earnings depends on the rate of foreign tax. The relationship of the foreign rate to the increased return to the parent may be expressed by the following formula:

Earnings of foreign corporation before taxes = x
Foreign rate of tax = y
Foreign tax = xy
Dividend to corporate shareholder = x−xy
Tentative U.S. tax = .52 (x-xy)
Credit = (Foreign Rate) (Dividend) = y (x−xy)
U.S. tax = Tentative tax less credit

$$= .52(x-xy) - y(x-xy)$$
$$= .52x - 1.52xy + xy^2$$
$$= x(.52 - 1.52y + y^2)$$

Income after foreign and U.S. taxes to parent

$$= \text{Dividend} - \text{U.S. tax}$$
$$= x-xy - x(.52 - 1.52y + y^2)$$
$$= x(.48 + .52y - y^2)$$

Income after taxes from domestic earnings of X

$$= x - .52x$$
$$= .48x$$

Excess of income after taxes from foreign earnings of subsidiary over domestic earnings $= x(.48 + .52y - y^2) - .48x$
$= xy\ (.52-y)$

For the credit to equalize taxes on foreign subsidiary and domestic earnings, the parent's taxable income would have to include the earnings from which the dividend was derived unreduced by foreign income taxes, and the credit would have to be the entire foreign tax paid on those earnings. Under the present system only the dividend actually paid is treated as taxable income. Thus, the foreign tax is in effect deducted from the earnings. In addition the taxpayer obtains a credit for the portion of the foreign income tax (the whole of which has already been deducted) attributed to the dividend. When the method described in the first sentence is compared with the present system, they both would result in inclusion of the dividend in income and a credit of the portion of the foreign tax attributed to the dividend. The difference between the two is that the taxpayer under the present system also obtains a deduction of the whole tax as contrasted, under the first method, with an inclusion of the balance of the foreign earnings in income together with a credit for the remainder of the foreign tax. If the foreign income tax rate is less than the United States rate, the deduction is worth more than the inclusion of the additional income with the offsetting additional credit (which credit would be the foreign rate times the additional income). Or, in other words, if the United States tax on earnings not included in taxable income (the amount of earnings used to pay the foreign income tax) exceeds the portion of the foreign income tax paid by the subsidiary which may not be credited (the foreign rate times the excluded earnings), a tax saving of that amount is obtained. Obviously, unless the foreign rate is zero (in which event no earnings are excluded) or equals (or exceeds) the United States rate, a tax saving will arise. Expressed algebraically using the symbols of the prior calculation:

Saving = U.S. tax rate times foreign tax paid—Portion of foreign tax paid not credited
$= (.52xy) - y\ (xy)$
$= .52xy - xy^2$
$= xy(.52-y)$

Thus, the same formula is derived from the two calculations.

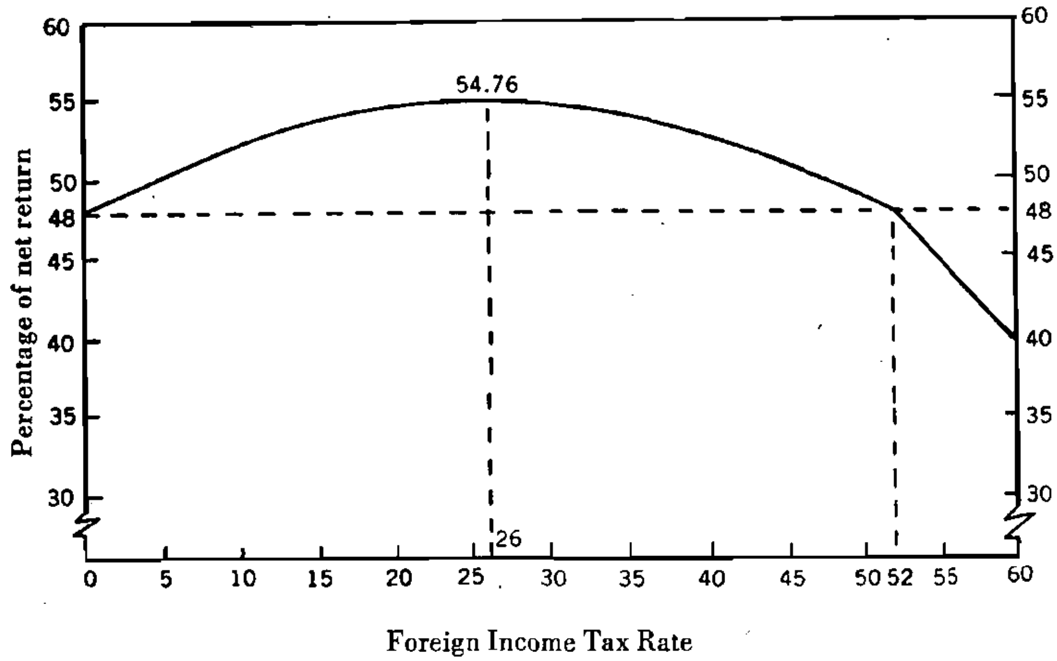
To generalize the formula for the increased percentage point return after foreign and United States income taxes, it may be expressed as $y\ (z-y)$, assuming $y =$ the foreign income tax rate, and $z =$ the United States income tax rate.

If x, foreign earnings, equals one, the percentage increase in a parent's return after all foreign taxes at varying foreign rates is illustrated in graph IV. It is assumed for purposes of the graph that the foreign corporation has no United States income subject to United States tax.

Since most Latin-American income taxes are between 20 and 35 per cent the after tax return to a parent will usually be about 54 per cent of the foreign corporation's earnings. In effect, under these conditions, the United

Graph IV. Foreign Subsidiary

Percentage of corporate investor's return on foreign earnings after United States and foreign income tax *



*** Calculations are made for foreign income tax rates between 0 and 60 per cent.**

States tax rate on foreign income, if the foreign business is conducted through a foreign subsidiary, is about 46 per cent. This means that a six-percentage point incentive is extended to foreign subsidiary operations, as a result of the foreign tax credit. In other words, the tax on foreign income from a foreign subsidiary is 11.5 per cent less than the tax on domestic income.

(v) *Corporate tax consequences of utilization of the alternate forms for investment*

Graph V illustrates the relative returns to the corporate investor from the various forms of investment after both foreign and United States income taxes.

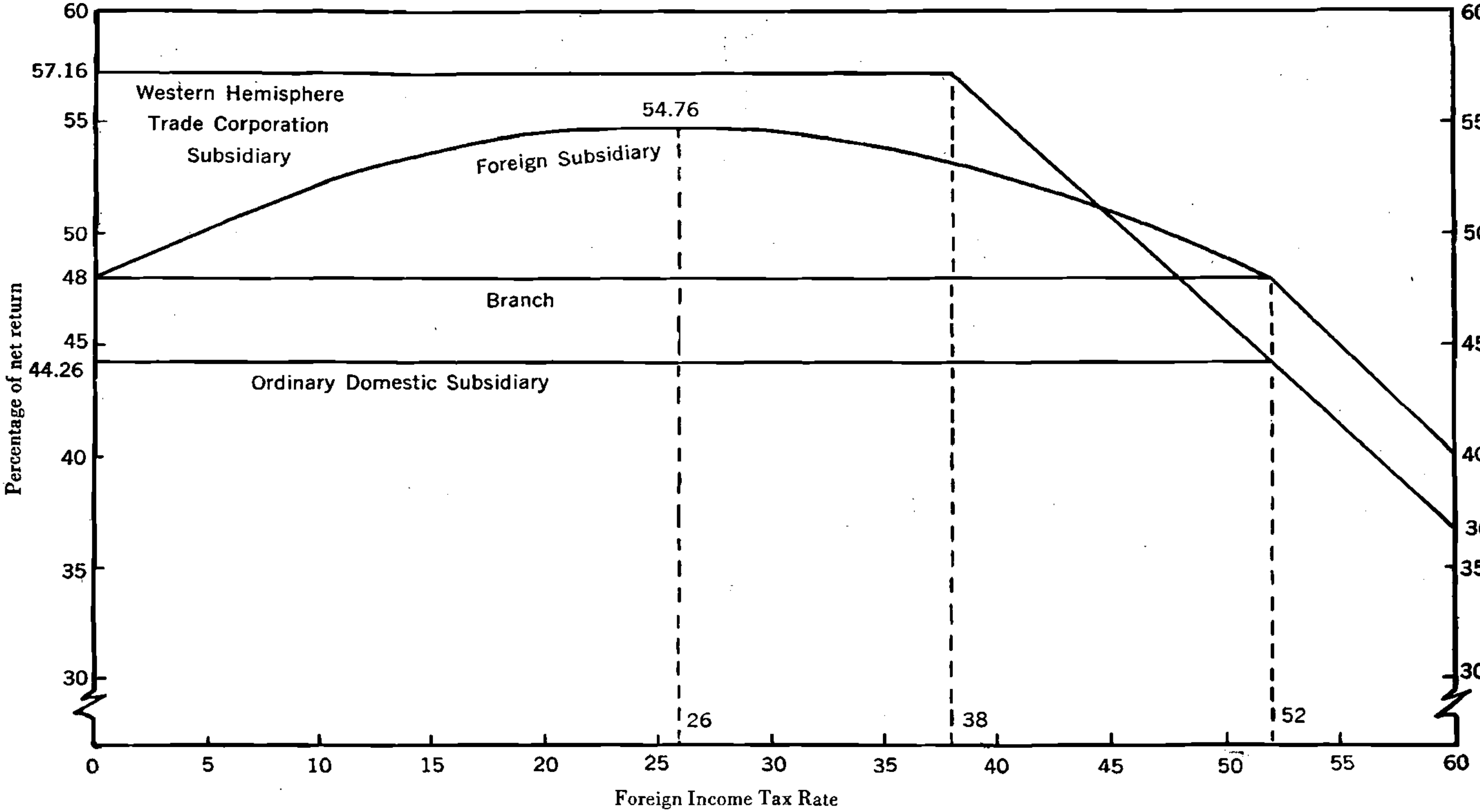
Note that a foreign subsidiary or a Western Hemisphere Trade Corporation usually offer the greatest return after taxes to the parent investor. Because of the operation of the foreign tax credit for a subsidiary's taxes, the only substantial advantage of a Western Hemisphere Trade Corporation compared to a foreign subsidiary occurs when the foreign country in which it operates imposes no income tax. If foreign income tax rates exceed 15 per cent the greatest advantage a Western Hemisphere Trade Corporation enjoys will never exceed 4 per cent of total earnings.

The effect of a 15 per cent tax on dividends to non-residents on the relative advantages of the two forms of investment is illustrated in graph VI.

The effect of a dividend tax is to eliminate the advantage of a Western Hemisphere Trade Corporation over a non-resident foreign subsidiary if the foreign country imposes an income tax of over 10 per cent.

Graph V. Comparison of the Forms of Investment

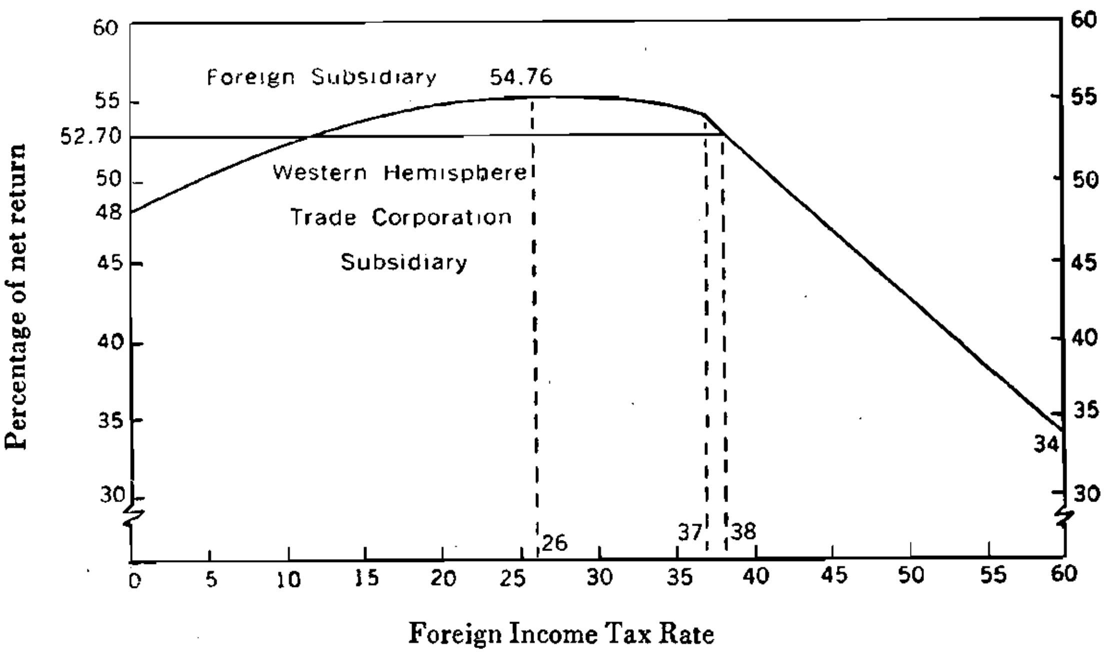
Percentage of corporate investor's return on foreign earnings after United States and foreign income tax *



* Calculations are made for foreign income tax rates between 0 and 60 per cent. At a foreign income tax rate of 52 per cent and above, the Western Hemisphere Trade Corporation curve coincides with the curve of the Ordinary Domestic Subsidiary and the Foreign Subsidiary curve coincides with the curve of the Branch.

Graph VI. Comparison of Foreign Subsidiary and Western Hemisphere Trade Corporation

Percentage of corporate investor's return on foreign earnings after United States and foreign income tax and a 15 per cent foreign tax on dividends to parent corporate investor *



*** Calculations are made for foreign income tax rates between 0 and 60 per cent. At a foreign income tax rate of 38 per cent and above, the Foreign Subsidiary curve coincides with the curve of the Western Hemisphere Trade Corporation Subsidiary.**

(b) *Accumulation of Foreign Income*

Often, United States investors plan to expand their foreign activity by reinvestment of the foreign earnings. Hence, the rate of accumulation which may be obtained through utilization of the various forms will be important. Ultimate realization can be obtained by liquidation of the foreign activity, or by dividends. If ultimate realization of earnings after the period of expansion is to be by dividend distribution, the tax consequences of the forms of investment as respects the dividends then distributed will be the same as discussed above in the section dealing with current distributions.

(i) *The rate of accumulation*

The maximum rate of accumulation obtainable by a branch, domestic subsidiary or Western Hemisphere Trade Corporation is limited by the United States income tax on their earnings. Thus, no more than 62 per cent of the earnings of a Western Hemisphere Trade Corporation can be accumulated or 48 per cent of the earnings of a branch or domestic subsidiary. However, if the foreign rate of tax exceeds the United States rate on the earnings of a branch, domestic subsidiary or Western Hemisphere Trade Corporation, the accumulation is limited to earnings after the foreign income tax. The rate of accumulation of a foreign subsidiary without income from United States sources is determined by the foreign income tax rate alone.

(ii) *Ultimate realization by liquidation*

Since a branch is not a separate taxable entity under United States law, no United States tax consequences flow from its liquidation by withdrawal of the corporation from activity in the foreign country.

If 80 per cent or more of the stock of a domestic or Western Hemisphere Trade Corporation subsidiary is owned by the corporate investor, liquidation of the subsidiary is permitted by the United States without imposition of tax. The gain on liquidation of a less than 80 per cent stock owned domestic subsidiary is subject to the 26 per cent capital gains tax.

Generally, the gain on liquidation of a foreign subsidiary is also subject to the United States capital gains tax. However, the net return to a corporate investor from liquidation of a foreign subsidiary will frequently be less than from distribution of the subsidiary's profits by dividends, since the credit for a subsidiary's foreign taxes under section 131 (*f*) applies only to dividends. If the parent's United States income tax on dividends after the section 131 (*f*) foreign tax credit is less than the capital gains tax, realization by dividends is preferable to a corporate investor. Under the present United States rate structure this occurs when the foreign income tax exceeds 26 per cent.

2. The Type of Business and the Manner in which Conducted

Theoretically, a corporate investor in Latin America will usually maximize earnings by utilizing a Western Hemisphere Trade Corporation or a foreign subsidiary as the vehicle for the parent's foreign activity. In practice, the form selected will be substantially influenced by the type of business activity planned. Operation as either a Western Hemisphere Trade Corporation or a foreign subsidiary imposes tax limitations on the manner in which business may be conducted. In certain types of activity these limitations may prove burdensome. Furthermore, extractive industries enjoy special deductions which would be lost unless the foreign investment is made through a United States taxpayer.

(a) *Tax Limitations on the Manner of Doing Business*

(i) *Western Hemisphere Trade Corporations*

Under section 109 of the Internal Revenue Code, domestic companies are Western Hemisphere Trade Corporations if:

(*a*) 95 per cent or more of their gross income was derived from sources outside the United States;

(*b*) All their business is done in countries of the Western Hemisphere; and

(*c*) 90 per cent or more of their gross income was derived from the active conduct of a trade or business.

The requirement as to the source of income

The United States rules on the source of profit from the sale of personal property described above are:

(*a*) Income from the sale of personal property produced within and sold without the United States is derived partly from sources within and partly from sources without the United States.

(*b*) Income from the sale of personal property produced without and sold within the United States is derived partly from sources within and partly from sources without the United States.

(*c*) Income from the sale of personal property which was originally purchased by the taxpayer is derived from the country in which the property was sold by the taxpayer.

The general rule is that property is sold outside the United States if title to the goods passes from the seller to the buyer outside the United States. Under United States sales law, title in specific goods passes where the parties intend. When no intention is expressed by the parties in the contract of sale, intention is determined by statutory presumptions. The most important presumption is that title passes at the place the goods are delivered to the buyer. For example, a sale f.o.b. New York effects passage of title within the United States, while a sale f.o.b. a port of entry in Latin America effects passage of title outside the United States. Thus, the source of income from sales is often within the control of the seller and buyer.

However, if the sale is arranged in a particular way for purposes of tax avoidance, the Bureau of Internal Revenue has ruled that the source of the income will be the place in which the substance of the transaction occurred. The scope of this tax avoidance qualification is uncertain. It may mean that if any transaction is markedly at variance with customary commercial practice, the source of the income will not be determined by the title passage rule. Further, despite the usual sales rule, a mere intent to pass title in Latin America unaccompanied by the commercial arrangements usually followed in effecting passage of title outside the United States may not suffice to create income from sources outside the United States. The title passage rule has never been incorporated in either the Internal Revenue Code or the Treasury Regulations, although several judicial decisions have utilized the test. In fact, the Treasury Regulations reject the title passage rule in another aspect of the source of income rules. Thus, for the purposes of apportioning income between manufacture in the United States and sales abroad, the formula used in part depends on whether there are any sales within the United States. For this purpose sales within the United States are defined as sales principally secured, negotiated or effected in the United States. Consequently, it is widely believed that reliance on the title passage rule is unsafe and that sales should also be negotiated and secured outside the United States if Western Hemisphere status is to be assured. The extent of the burden of this limitation in practice depends upon the nature of the activity. On exports to Latin America arrangements to negotiate contracts outside the United States would normally not appear to create difficulties.

Qualification as a Western Hemisphere Trade Corporation is impossible for a company manufacturing goods within the United States for sale in Latin America. The income from such sales is derived partly from the United States and partly from the country in which sold. Under the Treasury Regulations on apportionment the producing country will always have more than 5 per cent of the gross income from the sale attributed to it. Accordingly, a United States manufacturer always will have to establish a selling subsidiary to obtain the Western Hemisphere Trade Corporation tax rate on profits from Latin-American sales. The necessity of utilizing a domestic subsidiary ordinarily would not appear to create any problem in practice.

A Western Hemisphere Trade Corporation can also be used to import goods into the United States which the Western Hemisphere Trade Corporation either manufactured itself or purchased. However, on sales negotiated in the United States, there is the danger that the source of the income will not be Latin America despite title passing outside the United States. When the entire output of a Latin-American plant is sold to a single purchaser, negotiation of the contract within Latin America would probably not be difficult. On the other hand, if the goods are to be sold to a large number of small purchasers in the United States, it may be impossible to secure the contracts outside the United States. As a result the income may be considered as arising in the United States so that Western Hemisphere Trade Corporation status might be lost.

When the activity is exclusively within Latin America, there are no problems involved in satisfying the source requirement. Thus, a Western Hemisphere Trade Corporation running a railroad in Latin America or manufacturing and selling its products there, will obviously satisfy the requirements as to the source of income.

The requirement as to where business is done

The second condition is that all business be done within the countries of the Western Hemisphere—South, Central and North America. The extent to which this limits the sale of goods to other areas or the purchase of materials from other areas is uncertain. Merely incidental economic contact with countries outside the Western Hemisphere will not jeopardize the Western Hemisphere Trade Corporation status of a company. A sales agency, employees, or an exclusive agency or broker in Europe would probably make fulfilment of this requisite impossible, as would regular purchasing activities through an agent in a non-Western Hemisphere country. Sales to other areas can be made, but, to maintain status as a Western Hemisphere company, it would require passage of title and possibly negotiation of the contract in the Western Hemisphere.

The requirement as to active conduct of a business

No definition of an active conduct of a business is given by the Code or Regulations. However, the purpose of the provision is apparently to bar companies engaged in conducting an investment business from the benefits accruing to section 109 corporation.

(ii) *Foreign corporations*

A major problem in operating a business as a Western Hemisphere Trade Corporation is to ensure that income is treated as arising from sources without the United States. If a foreign subsidiary is utilized this problem is unimportant as long as the foreign corporation is a non-resident. Non-residents are taxed only on their fixed and determinable annual or periodical income from United States sources. Income from sale of personal property is not fixed and determinable annual or periodical income. Thus, a non-resident foreign subsidiary, one not engaged in trade or business in the United States, is not taxed on income from sale of goods in the United States even if the United States is the source of the income. The difficulties of ascertaining the place in which property was sold is thereby avoided.

Resident foreign corporations are taxed on all their income from sources within the United States. The same problems encountered in utilizing a

Western Hemisphere Trade Corporation are, therefore, raised if the foreign corporation is a resident.

A foreign corporation will be treated as a resident of the United States if it engages in trade or business within the United States. The standards for determining resident status are elusive. A company is doing business in the United States if employees are maintained in the United States to market its goods or if property is sold in the United States through an exclusive sales agency or a joint venture of which it is a member. Performance of services in the United States constitutes residence. Maintenance of a United States office is evidence of residence, but is not controlling. Purchasing activities in the United States by agents with discretionary power may make the company a resident although purchasing activities alone do not, of course, give rise to income from United States sources. Maintenance of non-resident status may become a problem where goods produced in Latin America are to be sold in the United States.

(b) *Extractive Industries*

Under United States tax law, most extractive industries are allowed in computing net income a substantial deduction for the depletion of natural resources whether they are located within or outside the United States. This deduction for depletion is allowed as a tax deduction in recognition of the fact that an asset is being expended in the production of income. A taxpayer may elect a deduction for depletion on either a cost or a percentage basis. Under the cost depletion deduction, the number of mineral units which remain in a mineral deposit is estimated yearly. That figure is divided by the cost of the mineral deposit (after subtracting from the cost of the deposit the amounts recovered in prior years through depletion) to give the depletion allowable per unit of output. The number of units produced that year is multiplied by the depletion allowable per unit and the figure obtained is deducted from taxable income. Cost depletion is thus similar to the depreciation deduction allowed under United States law for the exhaustion of any asset used in business.

The percentage depletion deduction, on the other hand, is entirely unrelated to the cost of the mineral deposit. Instead, a percentage of the gross income from the producing deposit may be deducted annually. The deduction cannot exceed 50 per cent of the net income from the deposit. The percentages vary according to the nature of the deposit and are fixed by statute. Oil producers are allowed a percentage depletion deduction of 27.5 per cent of the gross income from the oil-producing property. In the case of metal mines, the rate of percentage depletion is 15 per cent, for sulphur 23 per cent, and for other mineral deposits the rate varies from 5 to 10 per cent.

No depletion deduction is allowed, however, with respect to dividends from a foreign subsidiary conducting the natural resource activity. Since the depletion deduction is not allowed for dividends, operation of the resource through a foreign subsidiary is likely to be more expensive than operation through a branch or United States subsidiary which would be entitled to the deduction. Accordingly, much of the United States investment in extractive industries in Latin America is in United States subsidiaries or branch operations.

Example: United States company, P, owns oil wells in country A in Latin America. The tax consequences of owning the wells through a foreign corporation, FS, a Western Hemisphere company, WS, a domestic subsidiary, DS, or a branch, B, is given in the table below. Assume country A imposes a 20 per cent income tax and has no depletion deduction. The United States rate is 52 per cent. The United States depletion deduction is $40. The earnings of the wells before taxes and depletion are $100.

	FS $	*WS* $	*DS* $	*B* $
Earnings before depletion and income taxes	100	100	100	100
Country A tax	20	20	20	20
Depletion deduction	—	40	40	40
Taxable U.S. income of producer	—	60	60	60
Tentative U.S. tax	—	22.8	31.2	31.2
Credit for country A tax	—	20	20	20
Net U.S. tax of producer	0	2.8	11.2	11.2
Combined U.S. and country A tax of producer	20	22.8	31.2	31.2
Dividend to P	80	77.2	68.8	—
Dividend received credit	—	65.52	58.48	—
Taxable income to P	80	11.58	10.32	—
Tentative U.S. tax on P	41.60	6.02	5.37	—
Credit for subsidiary's tax	16	—	—	—
Net U.S. tax on P	25.60	6.02	5.37	—
Net to P after U.S. and foreign tax	54.40	71.18	63.43	68.8

When an extractive activity in Latin America is organized as a Western Hemisphere Trade Corporation, a contract for the company's entire output is usually made with the parent corporation. Under United States law title to unascertained goods like unextracted oil or ore occurs when the property is produced and appropriated to the contract. Appropriation is made at the place the goods are delivered to the parent—usually the mine or port from which shipment is made to the parent. Normally, therefore, there would appear to be no difficulties in operation as a Western Hemisphere Trade Corporation. In any event Western Hemisphere Trade Corporation subsidiaries are probably extensively used on the theory that if the Bureau of Internal Revenue denies the subsidiary Western Hemisphere Trade Corporation status the loss is slight. An ordinary domestic corporation is still superior to a foreign subsidiary. This is particularly true if, because of the depletion allowance, the effective foreign tax rate exceeds the United States rate so that only a portion of the foreign income tax may be credited by a Western Hemisphere Trade Corporation. In this event, a branch has even greater tax advantages.

Example: United States company, P, has a domestic subsidiary or branch S, which is engaged in producing oil in country A. Country A has no depletion allowance and imposes a 30 per cent tax. The United States rate is 52 per cent. S's earnings are $100 before taxes and depletion. Its depletion deduction is $40. The comparative net to P after foreign and United States income taxes if S is a Western Hemisphere Trade Corporation, an ordinary domestic subsidiary or a branch is shown in the following table:

	If S is a Western Hemisphere Trade Corporation	*If S is an ordinary domestic corporation*	*If S is a branch*
	$	$	$
Earnings before depletion and income taxes	100	100	100
Country A tax	30	30	30
Depletion deduction	40	40	40
Taxable U.S. income	60	60	60
Tentative U.S. tax	22.8	31.2	31.2
Credit for country A tax	22.8	30	30
Net U.S. tax	—	1.2	1.2
Dividend to P	70	68.8	—
Dividend received credit	59.5	58.48	—
Taxable income to P	10.5	10.32	—
U.S. tax on P	5.46	5.37	—
Combined U.S. and foreign taxes	35.46	36.57	31.2
Net to P after all taxes	64.54	63.43	68.8

Even if the foreign country permits a similar depletion allowance, a foreign corporation is disadvantageous. The subsidiary's distribution from earnings which were not taxed by the foreign country because of the depletion deduction are a dividend to the parent and fully taxed to it by the United States. The net is not therefore increased. The only effect is to reduce taxes at the source and increase the United States income tax.

Example: United States company, P, owns the stock of foreign subsidiary, S, which produces oil in country A. The country A income tax rate is 20 per cent, the United States rate 52 per cent. Assume S earns $100 before depletion and income taxes. The tax consequences of country A allowing or denying depletion deduction of $40 on P's net after taxes is illustrated in the following table:

	If country A allows depletion	*If country A does not allow depletion*
	$	$
Earnings of S before depletion and income taxes	100	100
Depletion	40	—
Taxable income in country A	60	100
Country A tax	12	20
Dividend to P	88	80
Tentative U.S. tax	45.76	41.60
Credit	10.56	16
Net U.S. tax	35.20	25.60
Total U.S. and country A tax	47.20	45.60
Net to P after taxes	52.80	54.40

The United States permits an immediate deduction from ordinary income of intangible drilling costs rather than requiring their capitalization. These costs usually represent up to 70 per cent of the cost of an oil well. Accordingly, an investor will typically undertake exploration for oil through a branch, partnership or unincorporated joint venture, in order to deduct the intangible drilling expenses. If a corporate subsidiary is used, the parent must put up the capital for exploration. It may not deduct its investment unless the subsidiary fails. The deduction allowed on the subsidiary's stock becoming worthless is a capital loss deductible only to the extent of the parent's capital gains. A capital loss is, therefore, much less favourable than a deduction from ordinary income. However, if the investor owns 95 per cent or more of the stock of the subsidiary, the loss from worthlessness of the subsidiary's stock is not a capital loss and can be deducted from ordinary income. An additional tax factor which induces exploration to be carried on directly by the investor is that, if no oil is found, the investor may abandon the property. Any costs not previously deducted may then be deducted from ordinary income. Once oil production begins it is likely in Latin America that the property will probably be operated as a branch or placed in a corporate subsidiary to take advantage of the special Western Hemisphere Trade Corporation rate.

3. Loss Aspects of the Forms of Investment

(a) *Operating Losses*

Ordinary operating losses of a branch may be deducted from a United States corporate investor's taxable income. On the other hand, since parent and subsidiary corporations are treated as separate taxable entities under United States tax law, similar losses of a subsidiary will not usually be deductible from the annual income of the parent investor. In the first years of foreign operation, therefore, a branch may be the most desirable form for investment if losses are expected. However, if the corporate investor has any profitable branches or foreign subsidiaries from which it derives current income, losses of a new branch may reduce its foreign tax credit. Net income from foreign sources will be lower and, hence, the amount of the foreign tax credit under the over-all limitation will decline. If the new foreign enterprise is in the form of a foreign subsidiary, the initial losses cannot be deducted by the parent, but the foreign tax credit arising with respect to other operations will not be reduced. Thus, in deciding between a branch or subsidiary operation where losses are expected, the benefit of the deduction of foreign losses must be weighed against the possible reduction or elimination of foreign tax credit. Since no deduction of a foreign subsidiary's tax is permitted by United States tax law, the loss of credit is particularly serious when a corporate investor derives its foreign income from dividends of a foreign subsidiary. However, this is often mitigated by deferral of the subsidiary's dividends until subsequent years in which there are no losses from other foreign operations.

When a domestic subsidiary is utilized, its initial losses cannot generally be deducted by the parent but can be carried back by the subsidiary for one year and forward five years. The losses are thus available against other income over a seven year span as a reduction of past or future taxable income of the subsidiary. In certain cases a parent and subsidiary corporation can elect to file a consolidated return under which their income is treated on an aggregate basis. If a consolidated return is filed, the losses of a subsidiary may, therefore, be deducted from the corporate parent's income. A consolidated return may be filed by a parent with any ordinary domestic or Western Hemisphere Trade Corporation subsidiary, 95 per cent or more of the stock of which is owned by the parent. However, an extra 2 per cent tax on aggregate income (other than the income attributable to a Western Hemisphere Trade Corporation subsidiary) is imposed for the privilege of a consolidated return. In addition, a consolidated return has two disadvantages: (*a*) a subsidiary's losses reduce the parent's foreign tax credit under the over-all limitation, and (*b*) the income of a Western Hemisphere Trade Corporation subsidiary is then subject to excess profits tax.

The filing of a consolidated return by a United States parent with a foreign subsidiary is not generally permitted. However, the income of a 100 per cent owned subsidiary organized under the laws of Canada or Mexico, and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, may be included in a consolidated return with the United States parent. When a consolidated return is filed, the income of the foreign subsidiary becomes currently subject to United States income tax. Hence, one of the major advantages of a foreign subsidiary under United States tax law, deferral of United States tax, is lost under a consolidated return.

(b) *Loss of the Foreign Business*

If the foreign activity fails, in the case of a branch, its losses would previously have been reflected as a deduction from the investor's other income as the losses occurred. A subsidiary's insolvency or complete worthlessness would result in a loss of the parent's investment, which loss is allowed as a tax deduction because of the worthlessness of the stock and securities of the subsidiary. Generally, the loss of the parent's investment would be treated as a capital loss and its deductibility severely limited, since deduction would only be allowable against capital gains. However, if the parent owns 95 per cent or more of the stock of the subsidiary, the loss is treated as an ordinary loss, rather than as a capital loss and is therefore deductible from ordinary income of the parent. No deduction is, however, allowed for partial worthlessness of stock and securities, so that a decline in the value of the stock and securities would not be reflected in the parent's tax, unless they are sold. If a consolidated return had been filed, the losses of the subsidiary would previously have been taken into account in determining the aggregate income of the parent and subsidiary.

A branch's loss of property through nationalization in a foreign country is deductible from the ordinary income of the investor, while the same loss of an ordinary domestic or Western Hemisphere Trade Corporation subsidiary is ordinarily deductible only by the subsidiary. However, if a consolidated return is filed, the corporate investor would be entitled to deduct the loss. Similarly, a corporate parent could deduct a foreign subsidiary's loss through nationalization only if a consolidated return were filed.

If, as a consequence of nationalization, the stock and securities in either a foreign or domestic subsidiary should become worthless, the parent could deduct the amount of its investment in the subsidiary. Ordinarily, the loss of the investment would be treated as a capital loss and the deduction would be allowable only to the extent of capital gains. It is extremely unlikely that the parent would have capital gains sufficient to absorb such a large capital loss deduction. However, here also, if the parent owns 95 per cent or more of the stock of the subsidiary, the loss is not a capital loss and is, therefore, deductible from ordinary income of the parent. The amount of the loss deduction is limited to the parent's investment in the subsidiary. Retained earnings and increases in the value of the subsidiary's property do not increase the amount of the investment which may be deducted by the parent.

C. INCOME EARNED BY UNITED STATES INDIVIDUAL CITIZENS OR RESIDENTS IN LATIN AMERICA

United States corporate investors may use trained United States personnel in the operation of a Latin-American enterprise. Since this participation of key employees may in some cases even be a prerequisite to investment, the tax incentives offered United States excutives and technicians performing services outside the United States may directly affect United States investment in Latin America.

For this reason section 116(*a*) provides an exception to the general rule that United States citizens are taxed on their entire income, both from domestic and foreign sources, even if non-residents of the United States. Under that section, United States citizens who are either bona fide residents of, or actually present for seventeen out of eighteen months in, a foreign country or countries may exclude from tax their earned income from sources outside the United States. Earned income is defined as compensation for personal services actually rendered and includes wages, salaries, professional fees and other remuneration. The source of earned income is outside the United States if the services for which the compensation is paid were rendered outside the United States.

The exclusion of earned foreign income is permitted if the individual *either*

(1) Is actually present in a foreign country or countries for 510 full days in any period of eighteen consecutive months, even though he has not become a bona fide resident therein; or

(2) Is a bona fide resident of a foreign country or countries for an entire taxable year.

The foreign earned income attributable to the eighteen months' period of foreign sojourn is not subject to United States tax, nor is foreign earned income attributable to a consecutive period of bona fide foreign residence which includes at least one entire taxable year. In contrast to the mere fact of presence in a foreign country for 510 days, the standards for determining bona fide residence are difficult to apply. Bona fide residence depends upon an individual's intention as to the nature and duration of his stay abroad. The intention is usually determined by such factors as whether the taxpayer is accompanied by his family, whether he lives in temporary quarters or rents or purchases a home, and whether he participates in the social life of the foreign community.

D. INVESTMENT BY UNITED STATES INDIVIDUAL CITIZENS OR RESIDENTS IN LATIN AMERICA

If tax considerations alone govern, an individual investor will establish a foreign corporation to carry on business in a foreign country. The amount of dividends or accumulation of earnings possible for a foreign corporation is determined by the foreign tax rate, which is usually less than the United States rate. A Western Hemisphere Trade Corporation must pay a United States tax of 38 per cent. The maximum dividend it can pay is 62 per cent of earnings. If the rate in the country in which the corporation operates is less, the benefit of the reduced rate is lost by a Western Hemisphere Trade Corporation. Both Western Hemisphere Trade Corporations and foreign corporations must bear the excess of the foreign rate over the 38 per cent United States rate. Profits on liquidation or sale of the stock of both foreign and domestic corporations are subject to capital gains tax.

The exclusion of earned income from taxable income of citizens of the United States actually present or resident in a foreign country will not usually determine whether the investment is to be incorporated. If capital is an income producing factor in an unincorporated business, the earned income exclusion is limited to not more than 20 per cent of the enterprise's profits. The tax advantage of a corporation is as great since an investor present or resident in a foreign country may exclude his salary from a corporation under section 116(*a*) of the Code.

III. SOME IMPLICATIONS FOR LATIN-AMERICAN COUNTRIES OF THE EFFECT OF THE UNITED STATES INCOME TAX PATTERN

If we assume that the United States and the countries of Latin America want to stimulate trade and private United States investment in Latin America, several questions follow:

(1) Does the present United States income tax pattern encourage or discourage trade and investment in Latin America?

(2) Can the tax structures of Latin-American countries act as an incentive or deterrent to trade and investment?

(3) Do the non-tax provisions of Latin-American law (apart from political, social and other non-legislative considerations) act to nullify the advantages given under United States income tax law to trade and investment?

A. INCENTIVES TO LATIN-AMERICAN TRADE AND INVESTMENT IN THE UNITED STATES INCOME TAX PATTERN

Broadly speaking the foreign tax credit operates to remove the impediment of international double taxation, which would exist without the credit. This is so whatever the form of the investment. Once the problem of international double taxation is passed, the inquiry is whether the United States tax law offers affirmative incentives to Latin-American investment. As a practical matter three incentives to Latin-American trade and investment exist in the United States income tax law: the preferential rate accorded a Western Hemisphere Trade Corporation; the rate resulting from the operations of the section 131 (*f*) tax credit for a foreign subsidiary's foreign income tax; and the deferral of United States tax on earnings of a foreign corporation until distributed to the investor. The Western Hemisphere Trade Corporation provisions and the section 131(*f*) credit are incentives in the sense that an investor may derive a greater net return after foreign and United States income taxes on foreign earnings than from equivalent domestic earnings.

1. The Section 131 (*f*) Credit

The incentive effect of section 131(*f*) appears to have arisen as a by-product of the mechanics of that section, not as the result of an intention affirmatively to encourage foreign investment. The formula for the percentage points of increased return after foreign and United States income taxes to a parent from foreign operations as compared with its domestic earnings is $y(z-y)$, assuming y is the foreign rate and z the United States rate (see: II B1*a*(iv)). The greatest benefit occurs when the foreign rate, y, is one half the United States rate, z. At the present United States rate of 52 per cent the maximum benefit is about 6.7 per cent. As the United States rate decreases the percentage point reduction in United States income tax rate declines. The increase in return also declines as the foreign income tax rate approaches zero or the United States rate.

It is doubtful if a foreign subsidiary is ever selected as the medium for foreign investment because of the incentive feature of the operation of section 131(*f*). Rather, corporate investors probably select a foreign subsidiary for other reasons and section 131(*f*) makes the choice more attractive.

2. Western Hemisphere Trade Corporations

The Western Hemisphere Trade Corporation provision of the Internal Revenue Code was intended as an incentive device. A rate of income tax fourteen percentage points below the prevailing United States rate is accorded to corporations which qualify under that section. The actual percentage point spread to a corporate investor is reduced to about nine percentage points because of the intercorporate dividends tax. Moreover, under present United States rates where a foreign subsidiary is feasible the Western Hemisphere Trade Corporation provision turns out to offer only a slight preference when compared to the operation of the foreign tax credit. Assuming foreign income tax rates of over 15 per cent, the difference does not exceed 4 percentage points. If the United States rate were to be decreased and the fourteen percentage point reduction in rate accorded Western Hemisphere Trade Corporations were maintained, the comparative advantage of the Western Hemisphere Trade Corporation would increase. However, in this situation if the foreign rate exceeds the Western Hemisphere Trade Corporation rate, this comparative advantage would decline accordingly.

The legislative history of the provision gives little indication of the reasons for the partial exemption or of the type of activities which were intended to be encouraged. However, it seems obvious that the provision was intended to benefit United States enterprises operating in Latin America. How the incentive actually operates and the types of activity it encourages are questions of importance to Latin America.

From the non-United States standpoint, the germane questions are whether the Western Hemisphere Trade Corporation provisions encourage activities which result in export from the Latin-American country, internal development in Latin America not involving exports, or imports into Latin America.

(a) *Export from Latin America*

The major areas of business endeavour which will result in the increase of the exports of the country in which the foreign investment is made are extraction of natural resources, manufacturing and to some extent agriculture.

(i) *Extraction of natural resources for export*

Almost all forms of resource extraction are allowed a depletion deduction by the United States. As noted above, the depletion deduction is a percentage of the gross income from the property varying from 5 per cent to 27.5 per cent depending on the mineral, but cannot exceed 50 per cent of taxable income. Except where percentage depletion does not exceed cost depletion, United States corporations engaged in resource extraction are indirectly given a reduced rate of income tax by the exclusion through percentage depletion of a portion of their gross income from the taxable income. Since the exclusion can run to one half of taxable income, the United States regular income tax rate could be as low as 26 per cent, or the Western Hemisphere Trade Corporation rate as low as 19 per cent. A corporate investor must, of course, pay a tax on dividends from the domestic subsidiary, but the rate of tax on dividends because of the dividends received credit is 7.8 per cent. Since no equivalent rate reduction by percentage depletion is granted to dividends from a foreign corporation engaged in resource extraction, use of a foreign subsidiary results in higher United States taxes.

If the minerals are sold to the United States and the form selected is that of a Western Hemisphere Trade Corporation, the problem of determining the source of income may become important. Title passage will ordinarily occur outside the United States. If a portion of the income is assigned to United States sources or if business is done outside the Western Hemisphere, then the Western Hemisphere Trade Corporation status is lost. However, the parent will still realize more than it would have from using a foreign subsidiary.

When a foreign country allows no percentage depletion, a Western Hemisphere Trade Corporation often has little advantage over an ordinary United States corporation. In this situation, the foreign income tax is likely to exceed the United States tax rate for an extractive enterprise. Since the subsidiary must pay the higher foreign tax, it makes no difference whether it is entitled to the Western Hemisphere Trade Corporation rate. The special exemption of Western Hemisphere Trade Corporations from excess profits tax may change the result in some types of mining. However, oil companies, which are major Latin-American investors, have usually not become liable for excess profits tax.

Example: United States company, P, owns all the stock of United States company, S, which is engaged in oil production in South American country A. Country A does not allow percentage depletion and has a 30 per cent income tax. The United States rate is 52 per cent. The United States depletion deduction is the maximum of one-half S's taxable income. The effect of S's claiming Western Hemisphere Trade Corporation status is illustrated in the following table:

	If S claims Western Hemisphere status	*If S does not claim Western Hemisphere status*
	$	$
Earnings of S before tax or depletion	100	100
Country A tax	30	30
United States taxable income before depletion of S	100	100
Depletion	50	50
United States taxable income of S	50	50
Tentative United States tax of S	19	26
Credit for country A tax	30	30
Net United States tax of S	—	—
Dividend to P	70	70

Since the excess profits tax is not usually a consideration in extractive industries, a branch offers as favourable a means of operation as a Western Hemisphere Trade Corporation or ordinary domestic subsidiary. Percentage depletion may be taken by the investor and no intercorporate dividends tax is imposed when earnings are transferred by the branch to the investor. A branch has the disadvantage, however, that the United States investor cannot control the year in which the earnings are taxed. Branch income is included in the United States corporation's taxable income in the year in which earned. If the investor is also engaged in exploration during that year, the deductible expenses incurred are set off first against branch income under the over-all limitation on the foreign tax credit. Consequently, the investor's credit for the foreign income tax paid by the branch may be substantially reduced. If, on the other hand, production is carried on by an ordinary domestic corporation subsidiary or a Western Hemisphere Trade Corporation subsidiary, foreign earnings need not be distributed during a year in which heavy exploration costs are incurred. The investor, thereby, can set off foreign exploration expenses against domestic earnings.

(ii) *Manufacturing and agriculture for export*

Two factors detract from the effectiveness of the Western Hemisphere Trade Corporation provisions in promoting manufacturing and agriculture for export products.

First, it is difficult to maintain Western Hemisphere Trade Corporation status if sales are made to buyers in the United States or non-Western Hemisphere countries. On sales to the United States, there is the danger that the place of sale will not be outside the United States and that Western Hemisphere Trade Corporation status will, therefore, be lost. In that case, the corporation faces liability for additional income taxes and, excess profits tax. Moreover, if sales are regularly made outside the Western Hemisphere, the company may not be able to satisfy the requirement that all its business be done within that area, and likewise might, therefore, lose its Western Hemisphere Trade Corporation status. The company's earnings would be exempt from excess profits tax, but the net to its parent would be substantially less than from a foreign subsidiary.

Secondly, most United States investors plan to develop foreign activity by reinvesting profits. If the foreign rate is less than the Western Hemisphere Trade Corporation rate of 38 per cent, a foreign subsidiary offers larger profits after taxes for reinvesting. Since the foreign rate is often less, this is a major consideration.

(b) *Internal Development not Involving Export*

Within this classification might be included utilities, retailing, manufacturing for local markets, and agriculture. Qualifications as a Western Hemisphere Trade Corporation will generally create no difficulties. When the investor wants current distribution of earnings, a Western Hemisphere company is advantageous. Unless the country in which the corporation operates imposes a tax on dividends to a non-resident corporate shareholder, the return to the parent will be greater than from a foreign subsidiary. If foreign earnings are to be accumulated, a foreign subsidiary is superior.

Individual investors in contrast to corporate investors will never receive a greater current return from a Western Hemisphere Trade Corporation than from a foreign corporation. The amount of earnings after tax which may be distributed as dividends by a foreign corporation is determined by the foreign income tax rate. A Western Hemisphere Trade Corporation must always pay at least the United States rate of 38 per cent and, therefore, can never distribute more than 62 per cent of its earnings. If the foreign income tax rate is lower than the 38 per cent Western Hemisphere Trade Corporation rate, an individual shareholder utilizing a foreign corporation can obtain larger dividends. Since both a Western Hemisphere Trade Corporation and a foreign corporation would bear the foreign rate if it exceeds 38 per cent, the earnings available for dividends would then be the same.

(c) *Imports into Latin America—United States Exports*

One of the major uses to which the Western Hemisphere Trade Corporation provisions have been put is the development of Latin-American markets for United States goods. Generally, a United States manufacturer establishes a domestic subsidiary with a branch in a country in Latin America to handle its exports. All sales are negotiated and secured from the branch. Goods may be stored and sold, with title passing in that country, or shipped from the United States to the purchaser on orders forwarded by the branch. An alternate method sometimes used is for the domestic subsidiary to operate without a branch in Latin America. The subsidiary retains ownership of the goods it sells until they reach their destination, so that title passes outside the United States. Payment is arranged through letters of credit or otherwise. When delivery is conditioned on payment, a customs broker or bank may be used to accept payment or endorse shipping documents. While section 109 by its terms does not specifically require maintenance of an office outside the United States, it is generally believed that Western Hemisphere Trade Corporation status would be harder to establish with the Bureau of Internal Revenue without a branch in Latin America.

Frequently, United States export subsidiaries will currently distribute earnings. A Western Hemisphere Trade Corporation then offers the advantage of a lower rate of tax to the parent on foreign earnings than would be imposed if sales were made by a foreign subsidiary. If a branch is established by the Western Hemisphere Trade Corporation, the advantage over sales through a foreign corporation will usually be 4 per cent of the earnings from the sales. However, on sales to Latin America without a Latin-American branch a United States company will realize 9 per cent more of the earnings from the sales by selling through a Western Hemisphere Trade Corporation than by selling directly. If accumulation of earnings is intended, a foreign corporation is advantageous, since the foreign rate will probably be less than the Western Hemisphere Trade Corporation.

Since a foreign office or place of business is generally utilized to assure Western Hemisphere Trade Corporation status, the credit for Latin-American income taxes may present problems. A country in which sales are made often imposes income taxes on the seller because title passes within the country. If an income tax is also imposed on the income from these sales by the country in which the office is maintained, the Western Hemisphere Trade Corporation can credit only the taxes imposed by the country in which title passed. The existence of a tax-free haven in Latin America for the location of a Latin-American office may then be important. If the country in which the office is located imposes a nominal or no income tax, loss of credit for that country's income tax will not be an impediment to export activities carried on in more than one country through a Western Hemisphere Trade Corporation.

(d) *Conclusions*

The Western Hemisphere Trade Corporation provisions seem analytically to offer an incentive mainly to natural resources development within Latin America and to export from the United States to Latin America.

The extent of the incentive to resource development is related to the deductions allowed by the foreign country. If no percentage depletion is allowed, there may be no tax advantage in a Western Hemisphere Trade Corporation compared to a branch. The depletion deduction substantially reduces the United States tax rate so that the foreign rate is likely to exceed the effective Western Hemisphere Trade Corporation rate and at least equal the effective United States corporate rate. In such a situation, a branch will be superior since the intercorporate dividends tax need not be paid on transfer of foreign earnings to the investor.

On the other hand, in the past few years, United States companies have heavily invested in natural resource development, particularly oil, in many areas besides the Western Hemisphere, although the special tax advantages of Western Hemisphere Trade Corporations do not apply to investment in other areas.

The major tax incentive which the Western Hemisphere Trade Corporation provisions offer, then, lies in the field of export to Latin America. Export generally involves no investment by the United States company. Often United States manufacturers may establish a Western Hemisphere Trade Corporation selling subsidiary without a branch outside the United States to take over Latin-American sales formerly made directly by the manufacturer. In this situation, the potential benefits of the Western Hemisphere Trade Corporation selling subsidiary after the intercorporate dividends tax are an income tax of nine percentage points less than would be imposed on the manufacturer, and exemption from the excess profits tax, which may save up to 30 per cent. If Western Hemisphere Trade Corporation status is lost, the loss from the additional tax on the selling subsidiary's dividends is slight compared to the advantage hoped to be obtained from Western Hemisphere Trade Corporation status. If the Western Hemisphere Trade Corporation maintains a branch in Latin America, a Western Hemisphere Trade Corporation offers about four percentage points better return after taxes to the parent than a foreign corporation. A foreign subsidiary also saves excess profits tax, but involves the complications of establishment of a corporation and maintenance of a staff of employees.

Since export requires little investment and most countries of Latin America must limit their imports due to the dollar shortage, some question is raised as to the value of this incentive from the point of view of economic development.

3. Deferral of United States Income Tax on Foreign Earnings

The greatest incentive the United States tax law offers to foreign investment is the privilege of deferring United States income tax when a foreign subsidiary is utilized since the foreign subsidiary's earnings can be reinvested without being reduced by United States income tax. The incentive was not affirmatively chosen with a view to favouring foreign investment but arises simply as a by-product of the policy of recognizing the separate tax entities of parent and subsidiary corporations. Since the earnings of a foreign subsidiary from non-United States sources will only be taxed by the United States when distributed to the parent, a deferral of United States income tax may be obtained until distribution occurs. In the United States present tax rates leave less than half of corporate earnings available for reinvestment. A much larger share of foreign earnings may be ploughed back into the business if the foreign rate of tax is low.

4. Conclusions

The conclusion which must be drawn is that from Latin America's standpoint the provisions specifically adopted to promote Latin-American activity, the Western Hemisphere Trade Corporation sections of the Internal Revenue Code, are of doubtful value. Development of natural resources may be encouraged, but the major benefit seems to be offered to United States exporters selling to Latin America without establishing a foreign branch or office.

On the other hand, other provisions of the United States law offer incentives to trade and investment in Latin America by United States taxpayers not engaged in resource development or in export without a branch or office. By virtue of the section 131(*f*) credit for a foreign subsidiary's taxes, a six percentage point lower United States income tax is imposed on the United States parent if the foreign income rate is between 17 and 35 per cent.

In addition, the deferral of United States income tax on the earnings of a foreign subsidiary until dividends are distributed, can be an inducement to Latin-American trade and investment since it permits reinvesting of profits without subjecting them to the higher United States tax rate. This incentive can be particularly effective if the foreign income tax on the corporation is also postponed until the earnings are distributed.

B. THE TAX STRUCTURES OF THE LATIN-AMERICAN COUNTRIES AS DETERRENTS OR INCENTIVES TO UNITED STATES INVESTMENT

The above discussion concerned the question of whether the United States income tax law offers incentives to investment in Latin America. The other aspect of the question is related to the interaction of these provisions with the tax laws of the countries of Latin America. Does the United States income tax permit the countries of Latin America to offer tax incentives to United States investment or does the United States income tax pattern make their tax system an impediment to investment? Chiefly the questions concern the level of Latin-American income taxes, their timing and the other taxes imposed.

1. The Level and the Timing of Latin-American Income Taxes

When United States investors abroad utilize branches, domestic subsidiaries or Western Hemisphere Trade Corporations, there are no effective income tax incentives which Latin-American countries can offer. Since these forms must pay annual United States income taxes on their earnings, the time of imposition of the foreign tax is irrelevant. The effect of the rate of foreign income tax is neutral, if the rate does not exceed that of the United States tax. A rate lower than the United States rate does not leave more profits after tax. When the foreign income tax rate is higher than the United States income tax rate, the high level of the foreign tax may be a deterrent to investment, since the excess cannot be credited. Complete exemption from foreign tax only results in a transfer of tax revenue from the foreign country to the United States.

Tax incentives may, however, be offered when the form utilized for the investment is a foreign corporation. United States income taxes are only imposed on the non-United States income of a foreign corporation when distributed to a domestic shareholder. This means that the amount of earnings which may be reinvested in the expansion of the foreign business is determined by the foreign income tax. When the foreign income tax on the foreign corporation is also deferred until distribution, the incentive effect of United States deferral is complemented. Therefore, earnings unreduced by taxes could be reinvested. In many industries, this would be a substantial inducement to investment.

If the foreign income tax is also deferred until distribution, a United States corporate shareholder of a foreign corporation can be given an additional incentive by imposing the tax on the foreign corporation, rather than the parent. Thus, a tax on the corporation in the neighbourhood of one-half the United States rate will result in a United States income tax below the prevailing United States rate, because of the operation of the section 131(*f*) credit. On the other hand, individual shareholders of a foreign corporation will receive the greatest net return if the foreign tax at the time of distribution is imposed on them, rather than their foreign corporation.

2. The Type of Taxes Imposed

Foreign non-income taxes may not be credited unless qualifying under the in-lieu-of-income-taxes provision. If they represent a substantial part of the tax burden of doing business in a country, they may act as a deterrent to United States investment. Typical non-creditable taxes are export taxes, gross receipts taxes, production taxes and taxes on the privilege of doing business. The seriousness of the deterrent effect of these taxes depends upon the extent to which they may be shifted to consumers and the effect of shifting. The proceeds from differential exchange rates may also result in a burden on the investor similar to taxation.

A number of Latin-American countries impose taxes on the amount of income in excess of a percentage of capital. Although these taxes qualify for the credit, impediments may arise because of the manner in which capital is defined. If reinvested earnings do not increase capital, the foreign tax rate may become very high and, thereby act as a deterrent. Corporate investors may operate by leasing machinery, patents and other property to their foreign subsidiaries. A failure to add to capital the value of the leased property may place the enterprise in an inordinately high tax bracket. The same problem may exist if the subsidiary is partially financed by loans from the parent.

C. NON-TAX PROVISIONS OF THE LAWS OF LATIN-AMERICAN COUNTRIES AS DETERRENTS TO INVESTMENT BECAUSE OF THE UNITED STATES INCOME TAX PATTERN

United States individual and corporate investors are often in the most favourable tax position if activity in Latin America may be conducted through a foreign corporation. Therefore, laws which limit incorporation of businesses by foreigners are deterrents to investment. Requirements for partial stock ownership by citizens of the Latin-American country, local directors and similar restrictions will discourage incorporation and, hence, may discourage investment. Similarly, requirements for local incorporation of natural resources extracting companies may deter investment because of the resulting higher tax burdens.

If a Latin-American country wishes to encourage imports from the United States, local law provisions which make passage of title within the country difficult, or which impose onerous restrictions because of title passage therein, will be a deterrent. Western Hemisphere Trade Corporation status cannot be maintained unless passage of title can be arranged within Latin America.

IV. DISCUSSION OF PROPOSALS FOR CHANGE OF THE PRESENT UNITED STATES INCOME TAX PATTERN ON UNITED STATES INVESTMENT ABROAD

The only major departure in the present United States tax pattern which has been seriously advocated is the exemption of income from sources outside the United States. Other proposals have been directed at modification of the foreign tax credit, amendment and extension of geographical partial exemptions like the Western Hemisphere Trade Corporation provisions, and extension of the privilege of deferral of United States income tax to branches until the income is brought back to the United States.

A. EXEMPTION OF FOREIGN INCOME

The suggestion has been advanced that income from sources without the United States should be completely exempt from United States tax. The exemption in the case of corporate investors is to extend to income from a foreign permanent establishment or a foreign corporation. In recognition of the criticisms that have been directed against a policy of flat exemption some proposals would limit benefits to new investment or to specific activities which were approved by a United States administrative agency. Incentive to individual investors by partial or complete exemption of foreign income has also been suggested. These proposals involve unilateral action by the United States. Since such an exemption may or may not be related to the needs of the foreign countries in which investment is made, exemption through bilateral treaty has been offered on the theory that private investment could then be channelled into directions mutually beneficial to the United States and the foreign country.

The basic assumption of any exemption proposal is that elimination of the United States income tax will stimulate foreign investment. A fundamental question which has not been discussed is whether a stimulant is needed because the tax is a deterrent or because subsidization is required. The principal points of emphasis by proponents of general exemption have been the equalization of the competitive position of United States business abroad and the lack of neutrality of the United States tax in failing to recognize that the risks in foreign business exceed domestic risks. Opposition has centred on the inefficiency of a general exemption and its effect on the United States tax structure and that of the Latin-American countries.

1. Competitive Disadvantage

Advocates of exemption have usually relied on the argument that the United States income tax places United States corporations doing business abroad at a competitive disadvantage with local companies in the particular foreign country, and other foreign owned companies also operating in that country. Local companies need pay only local income taxes and owners of other foreign businesses may not be taxed at home on their foreign income.

A competitive disadvantage because of different tax burdens on competing companies may become manifest in various ways. Taxes which constitute an element of cost of production will tend to make the prices charged by companies subject to the tax higher than those charged by other companies. However, an income tax, according to classical economic theory, is not an element of cost, and, hence, cannot be shifted to consumers. The effect of a higher United States tax on this assumption thus would be to reduce the net return from foreign activity, rather than add to an item of cost which is expected to be reflected in price.

Lower income taxes abroad may permit local companies, or companies from other countries, to operate profitably under price structures that would not give adequate net returns to United States corporations. If all costs are the same for local, United States, and other foreign companies, with differences in income taxation constituting the only differential element in the price-cost-net return calculations, the net return to the United States corporations would be less than those to other corporations, in proportion to the higher United States tax. This difference would become significant if companies needed the same net return, regardless of their nationality, to justify an investment. A net return just adequate for companies subject to lower income taxes would be inadequate for United States corporations. On the same assumption, a return adequate for a United States corporation would be higher than that necessary for a corporation subject to lower income taxes.

These comments on competitive disadvantages because of differing income tax rates are significant only when United States corporations are in effective competition with local and other foreign companies. The argument by implication is that United States taxes must be no higher than those enforced by foreign countries whose investors compete with United States investors, to permit United States corporations to participate in a market. However, much of the discussion in favour of United States trade and investment in Latin America is based on the assumption that the United States is currently the principal source of capital for development. To the extent that this is true, the competitive disadvantage argument is irrelevant. Secondly, most capital exporting countries tax at least repatriated foreign income at rates comparable to those imposed by the United States. Thus, as a practical matter, both United States and other foreign capital have the same competitive disadvantage in any particular foreign country. If the competitive disadvantage arises with respect to locally financed business activities, the need for United States investment is less significant.

The above discussion indicates that the justification for special United States treatment for United States investment abroad probably lies not in the sphere of competitive disadvantage but in an analysis of the risks of foreign investment and the net return after taxes necessary to counteract those risks. Here the need may well be for development of specialized tax incentives responsive to the special risks and problems of foreign investment, rather than for a general differential in tax rate.

2. Tax Neutrality

Proponents of exemption have advanced the argument that the present United States system of taxing income from all geographical sources at the same rates is not really a policy of tax neutrality. The failure to distinguish sources eliminates consideration of the substantially heavier risks usually involved in foreign investment.

Against this, opponents of exemption have pointed out that the income tax takes the same percentage of foreign and domestic profits. Thus, if the risks are twice as great in a particular foreign country, than in the United States, the return before taxes must be twice as great for capital to flow to that country. Since the United States income tax takes the same percentage of foreign and domestic profits, the relative rate of return between foreign investment and domestic investment is unchanged.

Analytically, the assumption of this argument in favour of exemption is that the income tax is defective in failing to take into account differing risks in differing industries. Thus, it raises an issue not as to the treatment of foreign income alone, but as to the validity of a unitary income tax. The risks involved in furniture, textile, and airplane manufacture within the United States are entirely different, as different as the risks in engaging in any of those activities within the United States or within a foreign country. The United States income tax rate takes no account of the differing risks on the assumption that the difference in risk between textile manufacture and airplane manufacture is balanced by differing rates of return from such investments. The greater the risk, the greater the return an investor will need before capital will be invested in the activity. An attempt to achieve neutrality based on risk would convert the income tax into an administrative monstrosity with as many different tax rates as types of business activities. No standards would exist upon which to base tax rates. The development of specialized tax incentives other than tax rate reductions to meet the special risks of foreign investment, as suggested above is not subject to these objections.

3. The Effect of Exemption on United States Income Tax Structure, Policy and Administration

(a) *The Definition of Foreign Income*

Under the present United States tax pattern, foreign income is income from sources outside the United States. Both foreign and domestic income is taxed so that the categorization of foreign income is of minor importance and is only necessary for relief provisions like the foreign tax credit and the Western Hemisphere Trade Corporation partial exemption. Despite this minor role, the determination of source has continued to be an unsolved problem. No completely satisfactory definition of the source of income from the sale of personal property has yet been evolved.

If complete exemption were to be extended to foreign income, the problem of determining the source of income would become a major issue. It is very doubtful if the present source rules should be subjected to this strain. The title passage rule is subject to manipulation and would therefore be unsatisfactory if substantial taxes depended upon its application. The alternatives so far suggested do not appear to be adequate to meet the problem. Thus, a rule based on the destination of goods is unsatisfactory as it results in sales to the United States creating income from sources within the United States. Moreover, a source rule dependent upon the place where the sale was principally secured, negotiated or effected is not more satisfactory since every sale would raise a new question and the likelihood of litigation.

(*b*) *Tax Policy and Equity*

The proposal for exemption of foreign business income raises basic policy issues on which opinions are sharply and clearly divided. The opponents of exemption contend that it would be discriminatory as between taxpayers with the same amount of income, and further that it would be a departure from the policy of taxation according to ability to pay, which is the basis for the Federal income tax structure. Any exemption of particular categories of income from taxation is considered to create the danger of undermining confidence in the system of income taxation which is dependent on self-assessment and hence must be widely accepted as fair and equitable.

Against the foregoing argument, the advocates of exemption assert that the concept of ability to pay has meaning only with reference to the taxation of individual income. Therefore, at least as far as corporate income is concerned, adherence to that concept would not prevent taxation of the income where, and only where, it is earned. They note further that precedents for exemption or special tax treatment have been established in connexion with the interest on bonds of state and local governments and in connexion with extractive industries.

The argument for exemption is sometimes put in terms of the benefit rather than the ability to pay principle of taxation. Against the proposition that income earned abroad does not benefit from services rendered by the United States Government, at least to any degree comparable to that of enterprises engaged in domestic business, it is stated that general Federal taxation is not in any sense based on benefits received. Accordingly, since domestic income taxation is not related to benefits, the principle should be rejected when advanced as a basis for distinction between foreign and domestic income.

4. The Effect of Exemption on the Tax Structure of Foreign Countries

Proponents of exemption have argued that the present United States tax pattern prevents under-developed countries from offering tax incentives to United States investment. Without United States exemption, if the foreign country foregoes the imposition of tax, the investor gets no foreign income tax credit. Tax receipts are merely shifted from the country in which the income originated to the United States Treasury.

Against this argument it has been pointed out that under-developed countries can still offer a substantial incentive to United States capital. If foreign investment is made through the medium of foreign corporations, under-developed countries can postpone their imposition of an income tax until the earnings are transferred to the investor abroad. The privilege of accumulating profits without tax often is an effective stimulant particularly since United States businessmen often conceive of foreign investment as a gamble. The sums which will be immediately invested in non-extractive industries are small. Investors are usually willing to postpone realization of foreign earnings and aim chiefly at building up foreign operations by reinvesting earnings.

Opponents of exemption have also argued that the present United States system of taxing foreign income relieves foreign governments from demands for elimination of income taxes and the substitution of other forms of taxation. It has also been asserted that the present United States policy of neutralizing foreign income taxes by the credit permits those foreign countries which desire to use an income tax to work out their own fiscal problems without impeding United States investment. On balance, the present United States policy is a stimulant to adoption of net income taxation abroad. This stimulus has been regarded by some as a desirable indirect effect of the credit system; others regard it as an unfortunate result both because of its possible paternalistic implications and because it may induce other countries to adopt income taxation at periods or at rates which are not suited to their domestic requirements.

5. The Efficiency of the Device of Complete Exemption

The argument often appears that complete exemption is a costly and inefficient method of promoting foreign investment. It is pointed out that to encourage investment in one activity a reduction of the United States rate to 40 per cent would be sufficient, in another 30 per cent, and in a third 15 per cent. Complete exemption takes no account of these differing requirements.

In answer to this criticism, some advocates have proposed selective exemptions requiring approval of an administrative agency. One problem presented by such a programme is the concern in many business circles in the United States over the problems of negotiation and delay that generally arise in dealing with administrative agencies having discretionary power. Limitation of exemption to new investments has also been proposed, but the determination of what is new investment would also encounter serious difficulties.

The United States Treasury Department has not recently published official figures on United States income from abroad or the taxes collected on that income. Authoritative figures for the cost in United States tax revenue of a general exemption of foreign income are, therefore, not available. Estimates of the United States tax revenue after foreign tax credits have varied from $100 million to $400 million.

6. The Scope of Exemption

The scope of the exemption of foreign income has seldom been discussed by either its proponents or adversaries. If foreign income is to be exempt, presumably foreign losses would not be deductible from domestic income. As a result, the impact of exemption on established businesses abroad and companies interested in new foreign investment may differ. United States corporations with already profitable foreign enterprises which are less in need of special tax incentives would reap immediate benefits from the proposal. New enterprises, on the other hand, to whom tax incentives may be important, might be handicapped by the proposal, since the elimination of loss deduction may act as a deterrent rather than as an incentive to these investors, who often expect several years of unprofitable operations when the business is first established. Also, in the extractive industries, foreign exploration and development costs could not be deducted. If the risks in exploration are great, extractive enterprises might prefer deduction of those expenses to outright exemption. This is particularly true in view of the fact that percentage depletion substantially reduces the United States income taxes of these enterprises.

Other problems are raised. If, as has often been suggested, United States investors fear nationalization or other foreign governmental action, exemption with its concomitant loss of deduction may be an unsatisfactory method for promoting foreign investment. Losses through nationalization of a branch or from the worthlessness of a subsidiary's securities would not be deductible. As a consequence, enterprises requiring large capital investment might not be established.

It has never been clear whether the proposed exemption of foreign income would extend to individuals. The advantage to individuals of a complete exemption of income from foreign investment would be related to the amount of the individual's income. Those taxpayers who have a portion of their income in the 92 per cent bracket would find foreign investment twelve-and-a-half times as attractive as domestic, while a taxpayer in the 25 per cent bracket could net only one-third more on foreign income. The example indicates the potential effectiveness of exemption as an incentive to individual foreign investment, as well as its grossly differential value to different individuals. Individuals in high brackets have substantial capital and would presumably be more inclined to shift to foreign investment if the return from that investment were exempt from tax. The proposals for exemption which have considered this aspect have usually advocated only a partial exemption for individuals so as to reduce the disproportionate benefits to high-bracket investors. Even if limited, an exemption for individuals would present problems of abuse of the exemption and of tax avoidance as, for example, by shifting to a foreign corporation the profits of United States domestic enterprises, either directly or through stock ownership.

B. MODIFICATION OF THE FOREIGN TAX CREDIT

Criticism within the United States of the foreign tax credit has been chiefly directed at the limitation to and the definition of income taxes and at the over-all and per-country limitations. A number of proposals have been suggested to liberalize the credit.

1. Increase in Scope of Taxes for which Credit is Allowed

At present, the foreign tax credit is limited to income, to excess-profits or war-profits taxes, or to taxes imposed in lieu of such taxes. A tax is in lieu of an income tax and, therefore, creditable under the Treasury Regulations, if the following three conditions are met:

(1) The country has a general income tax law in force;

(2) The claimant of the credit would be subject to the general income tax, in the absence of special provision applicable to him; and

(3) The claimant subject to the tax in lieu of income tax is not also subject to the general tax.

Example: United States corporation, P, derives gross income of $100 from country A. Country A imposes a net income tax of 25 per cent, but, because of difficulty in determining the net income of foreign corporations, substitutes a 15 per cent tax on gross income of foreign corporations. P's $15 gross income tax may be credited against United States income tax on net income derived from country A.

The present interpretation has been criticized because it considers as paid in lieu of income taxes only taxes paid in lieu of a general income tax otherwise applicable. If United States policy is to relieve the burden of international double taxation, it may not serve effectively. Thus, no credit might be allowed for the non-income taxes of a country which has no general income tax law in force. In addition, even though a general income tax is in force, no credit will be allowed for non-income taxes unless they are in substitution for the general income tax, so that the taxpayer is relieved of the income tax.

The principal specific proposal which has been suggested is to change the interpretation of taxes in lieu of income taxes now contained in the Treasury Regulations. This proposal would remove the requirement that the non-income tax be in complete substitution for the general income tax; it does not deal with the problem of credits for non-income taxes when the country does not also impose a general income tax.

Under this proposal, a credit will be allowed for taxes measured, for example, by gross income, gross sales, or number or price of units produced in the foreign country, if the country has a general income tax law in force and if the tax for which credit is sought:

(1) Is intended to reach income in the broad sense;

(2) Is treated as a deduction from taxable income and therefore reduces the income tax due the foreign country; and

(3) Is not by law required to be passed on to the purchaser of goods.

Proponents of this change state that its purpose is not to give a credit for all excise taxes. Expressly, they advocate credit only for taxes which are imposed because of difficulty in using net income for a tax base. Against this modification, it is urged that unless the more stringent rules of the present Regulations are followed, most excise taxes will, in effect, be credited.

Analysis of the proposal indicates there is some justice to this objection. Rules (2) and (3) under the proposal come to the same thing. They provide that the tax must be a deduction from taxable income and not be required to be shifted to purchasers. If the tax is required to be shifted, the seller is made the tax collector. He receives the taxes from the purchaser as agent for the government, the taxing power. Under United States tax concepts, the taxes so received are not included in the gross income of the seller and, therefore, when paid over by the seller, are not deductible in determining taxable income. As limitations, these two rules merely mean that the claimant of the credit must be the taxpayer, as opposed to a mere agent for the collection of the tax.

The remaining requisites of the proposal are that the country have a general income tax and that the tax for which credit is claimed be intended to reach income in its broadest sense. The requirement that the tax fall upon income in its broadest sense is highly indefinite. If, by income in its broadest sense is meant gross income and not net income, almost all taxes imposed upon the claimant of the credit, other than property taxes, might be said to be on income in the broadest sense. Thus, gross receipts taxes would be allowed as credits. A sales tax and an export tax could also fall within this category, if the test is satisfied by a tax reaching a segment of the gross income.

From this consideration of the proposed change, its effect might be to permit credit for foreign excise taxes paid by the claimant of the credit if the foreign country also had a general income tax. If foreign excise taxes are thus to be credited where the country also imposes a general income tax, this proposal raises the question of whether these excises should be equally creditable even in the absence of a general income tax. In effect, the basic issue raised by this proposal is whether the United States should adopt a policy of allowing credit for foreign excise taxes. In the United States the income tax is the principal tax and all other taxes are subordinate to it. Therefore, the United States, which imposes both income and excise taxes, traditionally treats United States excise taxes as deductions in computing taxable income, not as credits against the United States income tax. It might be argued from this United States treatment that before even considering a credit for foreign excise taxes, those taxes should constitute the major tax burden of doing business in the foreign country.

The proposal has the merit of calling attention to important problems respecting the scope of the present credit. It calls attention to the fact that the basic difficulty in analysing the present system and the proposals for its modification arises from the absence of a clear definition of the objective of the foreign tax credit. Why is the present credit limited to income taxes and why is it felt that if additional taxes are to be included in the credit they must bear some relationship to income taxes?

From the standpoint of the United States income tax, all other taxes, domestic or foreign, can be viewed merely as costs of a business, along with its other expenses. Costs are generally *deducted* from taxable income, not *credited* against the income tax on that taxable income. As an exception, however, the foreign tax credit may provide for crediting rather than deducting foreign income taxes on the ground that they are an item closely resembling the United States income tax.

If the problem is not approached from the United States income tax structure, but from the standpoint of the taxpayer, it might be said that all taxes, including the United States income tax, constitute costs. Under this analysis, the policy of the foreign tax credit may be one of avoiding the doubling of particular tax costs. For example, in theory, a sales tax can be imposed by only one jurisdiction, because the taxable event, the sale, occurs in only one taxing jurisdiction. In the case of property taxes, a tax imposed by a country because property is within it cannot be duplicated by another country, because the property cannot also be within the second country. Then the argument follows that the United States policy of taxing net income from all sources requires allowance of a credit for net income tax of the country in which the income was earned, in recognition of the fact that the United States definitions have extended the taxable event, net income, to more than one jurisdiction, by taxing on the basis of residence or citizenship, not merely on the basis of source. However, this is only another way of posing the same problem. When are the foreign tax and the United States income tax reaching the same taxable event? A gross receipts tax, for example, is also a tax borne by net income, but is measured differently. If the foreign country imposes a net income tax for the privilege of doing business within the country, the subject of the tax differs from the subject of the United States income tax, but the measure is the same. Should a credit be allowed merely because the measure is the same?

Under the concept that the foreign tax is a cost, it could also be argued that the foreign tax credit operates as a subsidy to foreign investment. By treating the foreign income tax more favourably than other costs, foreign business activity by United States investors is encouraged. Then, the problem of modifying the foreign tax credit by liberalizing the kinds of taxes which may be credited is merely a question of determining the kind and amount of incentive the United States wishes to extend.

The lack of clarity in the purpose underlying the foreign tax credit makes the operation of the present rules difficult. Consider these various situations: (1) A country imposes a 50 per cent tax on net income from oil production in lieu of a 50 per cent royalty; (2) income taxes are raised and the foreign country contributes services which reduce operating costs, as, for example, free use of railways and housing and social services to the company's employees; (3) the foreign income tax is general in scope, but actually applies only to a United States firm operating in the country. Should the credit be allowed in these situations? In form, at least, the taxes satisfy the current requirements for the credit. Yet, should non-tax costs which are converted into foreign income tax costs be treated more favourably? Suppose a foreign country imposes only excise taxes. No credit is now allowed. If income taxes are shifted to consumers, the effect of an excise tax is not substantially different from an income tax. Denial of a credit because the form, but not the effect, of a tax is different seems an improper result.

Clarification of the policy underlying the foreign tax credit is one of the important areas for further study and analysis. Unless a policy can be developed, there will be no satisfactory resolution of the problem of the scope of the foreign tax credit.

2. The Per-Country and Over-All Limitations

It has been proposed by some that the per-country limitation be eliminated and by others that the over-all limitation be removed. Further suggestions are that an election between the two limitations be allowed taxpayers, that the taxpayer be permitted at his option to deduct or credit the income taxes of each country from which he derives income, or that in applying the over-all and per-country limitations the foreign rules on the source of income be used. A number of criticisms of the present limitations have been raised and it is in the context of these criticisms that the proposals should be considered.

(a) *Criticisms of the Per-Country and Over-All Limitations*

(i) *The per-country limitation*

Under the per-country limitation, the maximum amount of the credit for the foreign taxes of any country cannot exceed the United States income tax of the claimant multiplied by the ratio of the claimant's taxable income from sources within the country to the claimant's total taxable income from all foreign and domestic sources. In effect, then, the per-country provision limits the credit to the amount of United States income tax attributable to the income from the particular foreign country.

There is no basic objection to this rule when foreign income is derived from only one country. A higher foreign income tax ought not to reduce United States income tax on purely domestic income. However, the per-country rule does not permit the averaging of foreign taxes. If a taxpayer has income from two foreign countries, one of which imposes a higher and the other a lower income tax than the United States, the per-country limitation does not permit the rates to be averaged.

Another less significant criticism of the per-country rule is that it operates unfairly in situations where the United States and a foreign country utilize different source rules. Typical of the problem raised by differing source concepts are sales by a United States manufacturer to a foreign country with title passing in that country. The United States rules provide that the profit is allocated between the country of sale and the country of manufacture. The foreign country in which the property is sold may treat the whole profit as income from sources within it. As a consequence, the United States may not under the per-country rule allow a credit for the whole of the income tax paid to the foreign country.

A third area in which the per-country rule makes elimination of international double taxation impossible occurs where the foreign country taxes incomes which both its law and the United States tax law treat as not from sources within that foreign country. This situation may arise if (1) a citizen of the United States is a resident of a foreign country and has income which does not come within the section 116 (*a*) earned income exclusion, or (2) a United States corporation is a resident of a foreign country. In each of these cases the taxpayer is caught between two taxing jurisdictions, each exerting a taxing power based on factors other than source.

(ii) *The over-all limitation*

The further limit imposed by the over-all rule is that the maximum amount of the foreign tax credit cannot exceed the United States income tax of the claimant multiplied by the ratio of the claimant's taxable income from all foreign sources to the claimant's total taxable income from all foreign and domestic sources. Thus, the over-all provision limits the foreign tax credit to the United States income tax imposed on the taxpayer's entire foreign income. The effect of treating foreign income as a unit is to allocate, for purposes of the credit, foreign losses first to foreign income. The over-all rule only applies when a taxpayer derives income from more than one foreign country.

The major criticism directed at the over-all limitation is that it tends to impede the establishment of new enterprises by firms already successfully engaged in business abroad through branches. Its deterrent effect occurs since the over-all rule increases the burden entailed by a loss. If a taxpayer has a profitable business in the United States and in one foreign country, he might hesitate to open a branch in a second foreign country. If the new branch incurred substantial losses which offset the income of the old branch, the taxpayer would not be able to credit the taxes paid by the old branch against his United States income tax.

(iii) *The per-country and over-all limitations combined*

At present, the foreign tax credit is limited to the lesser of

(*a*) The sum of the foreign tax credit for income taxes paid to each of the foreign countries from which the taxpayer derives income. Each foreign tax credit cannot exceed the United States income tax on the taxable income from that country; or

(*b*) The United States income tax on income from foreign sources less foreign losses.
This result is achieved because the per-country limitation bars averaging of high and low foreign income taxes and because the over-all limitation assigns foreign losses first to foreign income.

The criticisms levelled at each of the limitations, separately, therefore, apply and have been asserted against the present system which combines the two limitations.

(*b*) *Proposal for Modification of the Limitations on the Credit*

(i) *Elimination of the per-country limitation*

Advocates of the proposal to eliminate the per-country limitation and retain only the over-all, have pointed out that this proposal has the advantage of averaging high rates in one country with low rates in another. It will also simplify the problems of determining source. In addition, it will relieve the difficulties resulting from one foreign country's taxing income which, under United States tax concepts, is considered as arising in another foreign country.

Against this proposal the argument can be made that permitting averaging of foreign income taxes shifts tax revenue from the United States and gives United States firms operating in both a high rate and a low rate country an unfair competitive advantage, as compared with a United States company operating only in a high rate country. The objection may be illustrated by this example: A taxpayer with $100 of income from United States sources also derives $100 from country A and $100 from country B. Assume that the United States income tax rate is 50 per cent, that of country A, 70 per cent, and that of country B, 30 per cent. Under the per-country limitation, the credit for foreign taxes is $80 ($50 in respect of country A, and $30 in respect of country B), the United States tax, $70 and the combined tax burden, $170 (United States $70, country A $70 and country B, $30). Without the per-country rule, the credit would be the full $100, the United States tax would then be $50, and the combined tax burden, $150. Thus, a United States firm operating in country A obtains a net return which is 20 per cent higher than that of local companies, other foreign companies or United States firms operating in country A which do not also operate in a low rate country.

A minor advantage of the elimination of the per-country rule is that the application of the United States source rules is simplified. At present, income must be attributed to sources within a particular country, thus compounding the strain on the rather unsatisfactory source rules. If a sale is negotiated in one foreign country and title passes in another, it is clear under the United States tax law that the sale was made outside the United States, but less clear as to the country in which the sale occurred. If the per-country limitation is dropped, the determination of the particular country of sale becomes unnecessary. Another benefit would exist when the country in which the sale was negotiated and the country in which title passed both taxed the income from the sale, since a taxpayer might be able to credit both foreign income taxes. A credit for both the foreign taxes could be obtained if the combined taxes did not exceed the United States rate or if income were derived in other low rate foreign countries.

(ii) *Elimination of the over-all limitation*

The argument for elimination of the over-all limitation is that it discourages new foreign activity by firms with a successful branch. It treats all foreign income as a unit, thereby increasing the burden of the losses in a new branch through reduction or denial of the tax credit.

Essentially, the over-all rule is a system of allocation. Under it, foreign losses are first set off against foreign income. If the over-all limitation is eliminated and the per-country limitation retained, a new system of allocation will be effected. Foreign losses will be first offset against domestic income and will not, therefore, reduce the foreign tax credit unless foreign losses exceed domestic income so that they also offset some foreign income. If the over-all limitation is abrogated and the per-country rule is retained, the effect will be to grant a foreign tax credit based on the United States income tax on something greater than foreign net income—foreign net income unreduced by the foreign loss deduction.

Usually it is proposed that, with elimination of the over-all rule, the taxpayer be allowed a separate election between deducting and crediting the income tax of each foreign country. Under this suggestion, a taxpayer would be permitted to credit the taxes paid to some foreign countries and deduct the taxes paid to others. Proponents of this change maintain that it is a logical corrollary to elimination of the over-all rule, since foreign income is no longer treated as a unit. The practical effect of a separate election would be to mitigate partially the burden of double taxation when income is taxed by a foreign jurisdiction but treated as income from domestic sources under the United States tax law. It would not help a taxpayer who derived income from a country which imposed tax at higher rates than the United States. A deduction would entail a greater tax saving than a credit only when the foreign income tax is more than twice the United States rate. At the current United States income tax of 52 per cent, this would occur only when the foreign tax exceeds the income actually earned in the foreign country, or exceeds the income from sources within that country for purposes of the United States tax.

(iii) *Permission for election between the per-country and over-all limitations*

While opinion has not fully crystallized respecting these limitations, the predominant trend appears to be in favour of the elimination of the per-country and the retention of the over-all limitation. However, it has also been proposed that taxpayers be allowed to choose between the per-country and over-all limitations. Presumably, a taxpayer selecting the per-country limitation would be allowed for each foreign country's income tax the alternative of deducting or crediting the tax. The effect of the election between the limitations would be to allow to each taxpayer the option of allocating foreign losses to United States income or to foreign income. Averaging foreign tax rates would be possible when the over-all limitation was chosen.

Analytically, this suggestion seems to be an attempt to achieve a compromise between the conflicting interests of different groups of United States investors. Taxpayers operating profitably in both high tax rate and low tax rate foreign countries prefer the over-all limitation because it permits the averaging of foreign tax rates. On the other hand, those taxpayers who have or expect losses in some of their foreign operations may prefer the per-country limitation, since it preserves at least a portion of the foreign tax credits by allocating losses to domestic income for the calculation of the credit limitation. The extractive industries would presumably fall within this latter group because the current deduction allowed for exploration costs may be largely offset by its adverse effect on the foreign tax credit under the over-all limitation.

Example: United States corporation, P, has net income of $100 from United States sources, $100 from country A sources and $100 from country B sources. The tax rate in the United States is 50 per cent, in country A, 60 per cent, and in country B, 40 per cent. P is considering the establishment of branch operations in country C and expects that in the first year there will be a loss of $100.

(1) If the branch in country C is not established, the limitations on the credit are:

Per-country limitation			
Country A	$	$	$
Lesser of:			
Tax paid	60		
Limit on credit, $\frac{100}{300} \times 150$	50	50	
Country B			
Lesser of:			
Tax paid	40		
Limit on credit, $\frac{100}{300} \times 150$	50	40	
			90
Over-all limitation			
Lesser of:			
Tax paid	100		
Limit on credit, $\frac{200}{300} \times 150$	100	100	
			100

Thus, on these facts P would prefer the over-all limitation which maximizes the foreign tax credit by permitting the averaging of the tax rates in country A and country B.

(2) If the branch in country C is established, the limitations on the credit are:

Per-country Limitation			
Country A	$	$	$
Lesser of:			
Tax paid	60		
Limit on credit, $\frac{100}{200} \times 100$	50	50	

Country B			
Lesser of:			
Tax paid	40		
Limit on credit, $\frac{100}{200} \times 100$	50	40	
			90
Over-all limitation			
Lesser of:			
Tax paid	100		
Limit on credit, $\frac{100}{200} \times 100$	50	50	
			50

Thus, on these facts P would prefer the per-country limitation, since under it the $100 loss in country C would be counted against the domestic income and would not reduce the amount of the foreign tax credit.

Under the per-country limitation, P's foreign tax credit is:

Country A			
Credits available:	$	$	$
Subsidiary's taxes	24		
Tax paid by P	15		
		39	
Limit on the credit:			
$\frac{60}{240} \times 120 = \$30$	30	30	
Credit for country A taxes			$30
Country B			
Credit available:			
Subsidiary's taxes	16		
Limit on the credit:			
$\frac{80}{240} \times 120 = \$40$	40		
Credit for country B taxes		$16	
Total foreign tax credit			$46

Under the over-all limitation, P's foreign tax credit is:

Credits available:	$		
S_1's taxes	24		
S_2's taxes	16		
Tax paid by P	15	55	
Limit on the credit:			
$\frac{140}{240} \times 120 =$		70	
Total foreign tax credit			$55

Opponents of this election proposal urge that the taxpayers ought not to be allowed to determine whether the United States revenue can be more substantially reduced by averaging foreign income tax rates or assigning foreign losses exclusively to domestic income.

(iv) *Use of the foreign law source of income rules*

Integration of foreign law source tests into the foreign tax credit has also been suggested. Under this proposal, the source of income rules of the foreign country imposing the tax would govern the operation of the foreign tax credit instead of the United States source rules.

The effect of the foreign law source test would be to assure a credit when the United States rule and the foreign rule as to the source of income differed. Consequently, problems of multiple international taxation, which may arise when a United States company sells products in one foreign country through a branch in another are mitigated. If the foreign concept of taxable income were used, the loss of credit which may occur because of the disallowance of deductions by foreign tax law would also be remedied.

A change to the foreign tax law source rules has been severely criticized. The foreign tax credit would, if it utilized a foreign source of income tests, be an inducement to foreign countries to enact unreasonable source rules. United States investors would be unaffected because of the broader credit and only the United States revenue would feel the consequences.

Alternatives to the outright adoption of foreign source rules and concepts of taxable income have been suggested. One proposal is that foreign source rules be applied unless unacceptable under standards which would be established by the Treasury Regulations. The objection to this proposal is that, in view of the difficulties the United States has encountered in developing source rules, it is unlikely that standards could be evolved.

(v) *Other technical changes*

In lieu of adoption of the foreign definition of taxable income, it has been advocated that in calculating taxable income from foreign sources no deductions, which are not also allowed under foreign tax law, should be used.

A number of minor technical changes have been proposed to deal with problems which arise because of use of the different accounting methods by a branch and the home office and because of problems raised by the statute of limitations when tardy adjustments in foreign taxes are made.

C. DEFERRAL OF UNITED STATES TAX ON BRANCH INCOME

Legislation, prepared in co-operation with the Treasury Department, has been introduced which would permit a United States corporation to defer United States income tax on income of a branch until distributed. The expressed reason for the proposal was to remove the differential between the tax treatment of a foreign subsidiary and a branch. The argument was that nearly one-third of United States private investment abroad was in the branch form although United States tax on the income of a foreign subsidiary is deferred. Consequently, it was urged that non-tax factors, like greater United States protection of directly owned property and fewer foreign requirements as to organization, personnel, and employees, must be of sufficient importance to outweigh the tax disadvantage of the branch form. The inability to defer United States tax on branch income introduced another differential into an already complex problem, and it has therefore been suggested that the differential be removed by permitting deferral in the case of a branch. In support of this proposal, it was noted that the effect would be to permit foreign countries to offer incentives to reinvestment and would alleviate some of the problems connected with blocked income.

The proposed Bill was introduced. It provides that any domestic corporation other than a Western Hemisphere Trade Corporation actively engaged in business in a foreign country may elect deferral of United States tax on income from sources within that foreign country. The election once made is binding for all subsequent years. Separate elections must be made for each foreign country. A branch for the income of which an election has been made must maintain separate accounts for deferred income, deferred capital gain and deferred foreign taxes. When profits are withdrawn, the withdrawal is apportioned between the deferred income and deferred capital gains accounts and these accounts reduced. The same percentage of the deferred foreign tax account is considered withdrawn as of the deferred income and capital gains accounts. The corporation includes the amount of the deferred foreign tax account deemed withdrawn in its taxable income and a foreign tax credit up to that amount is allowed. Complicated rules are provided for determining when a withdrawal has been made. Generally, a withdrawal has been made if the taxpayer's investment in the foreign branch at the beginning of the year plus its net income from that country for that year exceeds its investment in the branch at the close of the year. Any United States deductions which do not have a counterpart under foreign law are applied annually in calculating the deferred income account. The chief deduction so treated would appear to be percentage depletion. United States excess profits tax on branch income may not be deferred.

Except that deferral is permitted for both forms, the tax status of a branch under the proposal and of foreign subsidiary corporations differs. The foreign tax credit on deferred branch income cannot, like section 131 (*f*), result in imposition of a lower income tax rate. No excess profits tax exemption is accorded branch profits accumulated or withdrawn. Although branch income is currently subject to excess profits tax, the mechanics of the proposal are such that a foreign tax credit would seldom be allowed against excess profits taxes. Capital gains retain their status in the branch's deferred income account, whereas the distribution of a dividend by a foreign subsidiary from capital gains income does not retain its status as capital gain and is taxed at regular income tax rates. A foreign subsidiary operates to defer United States income tax on its income from all foreign sources. Under the proposal tax is deferred only on income from sources within the country in which a branch is operated and for which an election has been made.

The proposal, therefore, removes only one of the differentials which exist between taxation of branches and foreign corporations. It does have the consequences of permitting deferral of income tax together with the retention of the benefits of the percentage depletion deduction on deferred income.

The opportunity to defer taxable income from a branch means that a company with several successful branches would be more willing to open a new branch although initial losses are expected. If the company elected deferral treatment for the profitable branches, their income could be accumulated during the period when losses are incurred in the new branch. Consequently, the company would be able to offset foreign losses against domestic income, and there would be no loss of ultimate foreign tax credit for branch income taxes. A taxpayer, therefore, in effect could supersede the over-all limitation on the foreign tax credit, since it would be within its power to allocate foreign losses exclusively to domestic income.

The second effect, no loss of the benefit of the percentage depletion deduction on deferred income, taken with the result of the proposal on the foreign tax credit, would appear to make the Bill particularly attractive to the extractive industry. Under present law, the branch form has the advantages of percentage depletion and no intercorporate dividends tax. Its major drawback is that the deduction of drilling, exploration and development costs incurred in foreign activities must be allocated to the income of profitable branches in calculating the foreign tax credit. Thus, two benefits in the present United States income tax pattern may cancel each other. If branch income could be deferred, exploration expenses of a branch could be deducted in one year and the income of other branches, for which elections had been made, withdrawn in another year. Both benefits would thereby be obtained provided the investor is prepared to postpone repatriation. Since few, if any, extractive enterprises incur excess profits taxes, non-deferral of that tax would not detract from the benefits of the Bill.

In other industries, the advantage of deferral of branch income seems substantially less. Deferral would be permitted only on income from within a country in which the corporation engaged in business. Thus, manufacturers within Latin America operating as a branch who export their products would be faced under the proposal with the problem of determining the country from which the income was derived. If organized as a Western Hemisphere Trade Corporation the source determination required would be simpler, since income must be allocated only between United States and non-United States sources. An additional factor against a branch would be that the foreign and United States rate of tax imposed on its withdrawn income would be higher than the combined taxes imposed on dividends from a Western Hemisphere Trade Corporation or a foreign corporation. Industries devoted to internal development of a country within Latin America could, of course, qualify for deferral since the source of their income would be the country in which they operate. However, it seems likely that the lower income tax rates offered to foreign corporations and Western Hemisphere Trade Corporations would be a greater advantage than deferral of United States income tax on branch income.

Even where foreign incorporation is impossible because of restrictions in the law of the country in which business is conducted, branch deferral does not seem a substantial advantage. A corporation in another foreign country can be established or a Western Hemisphere Trade Corporation may be utilized. There may, however, be some activities in which it is necessary under the law of the foreign country to operate as a branch and in which some retention of foreign earnings is required. This may be true, for example, in certain banking operations.

The Bill containing the proposal is quite lengthy and complicated. Reliance, and, hence, additional strain, is placed on concepts of the source of income. The effect of the proposal seems to be chiefly to encourage foreign resource development by United States private capital. The same objective is apparently attained by the proposal which has been made to permit percentage depletion on dividends of a foreign subsidiary and deduction of exploration and development costs from dividends. The mechanics of an affirmative grant of these deductions would, it is true, be simpler than the treatment provided in the proposal. A provision like the section 131 (*f*) credit could be enacted under which the parent would be allowed in computing the proportion of its dividends that represented taxable income to deduct its proportional share of the foreign subsidiary's percentage depletion and exploration cost. However, this proposal also represents a major departure from the present treatment of a corporation and its shareholders as separate taxable entities. This might constitute a precedent of far-reaching implications.

To reach conclusions on the practical importance of these proposals, information on the extent to which branches are actually used in the non-extractive industries and on the business reasons for such use is needed.

D. EXTENSION AND MODIFICATION OF THE WESTERN HEMISPHERE TRADE CORPORATION PROVISIONS

Proposals for extension of the lower rates accorded Western Hemisphere Trade Corporations to include domestic corporations operating in most areas of the world and for internal changes in the requirement for qualification under that section have been made.

1. Geographical Extension of Western Hemisphere Trade Corporation Provisions

It has been suggested that the Western Hemisphere Trade Corporation provisions be amended by extending the geographical area in which operation is permitted to the entire World. A special income tax rate would be granted a domestic corporation if (*a*) 95 per cent or more of gross income was derived from sources outside the United States and (*b*) 90 per cent or more of its gross income was derived from the active conduct of a trade or business.

Experience with the Western Hemisphere Trade Corporation provisions suggests doubts as to the value of this proposal unless further modifications in the requirements for qualification are made. At present rates, the extension of these provisions would chiefly be a boon to United States exporters and the extractive industry, if the branch form is not used. Bona fide foreign investmen with an office in a foreign country would not be greatly encouraged. In the highly industrialized countries of Western Europe the foreign rate would often exceed 38 per cent and foreign taxes would usually be imposed on dividends from the corporation to its parent for which little foreign tax credit could be taken because of the dividends received credit. As a result, net return on investment after taxes in such countries would generally be less favourable than through the medium of a foreign subsidiary. In less developed areas with lower income tax rates, the increased return from these corporations would be slight because of the section 131 (*f*) credit for a foreign subsidiary's taxes and the rate at which profits could be reinvested would be lower because of the higher United States income taxes.

In connexion with this proposal a lower income tax rate than that now imposed on Western Hemisphere Trade Corporations and a 100 per cent dividends received credit (present credit 85 per cent) is suggested. With these qualifications the proposal would offer a more substantial inducement to foreign investment in areas with low income tax rates provided expansion through retained earnings was not the investor's primary objective. Investment in countries with high income tax rates would not be stimulated since the excess of the foreign rate over the lower domestic rate would have to be paid.

2. Modification of the Western Hemisphere Trade Corporation Provisions

A number of suggestions for modification of the requirements for qualification as a Western Hemisphere Trade Corporation have been made. Among these, on the one hand, is the elimination or clarification of the requirement that all business be conducted within the countries of the Western Hemisphere, and on the other the imposition of an affirmative requirement that an established place of business be maintained in the Western Hemisphere, outside the United States.

If the requirement that all business be conducted within the Western Hemisphere were eliminated, Western Hemisphere Trade Corporations would be come a more attractive device for manufacture of goods within Latin America for sale to non-Western Hemisphere countries. It would not, of course, change the difficulties encountered in selling to United States buyers.

The proposal that a foreign branch be required is apparently based on the belief that lower tax rates ought not to be extended to United States exporters not actually conducting business outside the United States. The mere requirement that a place of business be established would probably not be a remedy because *pro forma* offices in countries with nominal or no income taxes could readily be established by exporters. The law of the foreign country in which business is conducted may, however, buttress this requirement, if it insists on the establishment of a place of business.

Another suggestion for modification has been to allow any United States corporation the Western Hemisphere Trade Corporation income tax rate on the portion of its income derived from sources without the United States but within the Western Hemisphere. This would eliminate the necessity of establishing a subsidiary in order to obtain the lower rate, and, therefore, would impose still lower taxes on income from Latin-American sources since there would be no intercorporate dividends tax.

The balance of the suggestions entail minor changes like lowering the gross income percentage requirements for qualification and clarification of the test for the active conduct of a trade or business.

E. LOSSES

Although much of the discussion of promoting United States private investment abroad through changes in the tax structure has been predicated on a need to overcome the greater risks of foreign as compared with domestic investment, few proposals for adapting the tax structure to the possible direct consequences of those risks have been made. Thus, no substantial change in the treatment of losses from foreign investment has been proposed. The only major proposal in this respect is to permit a wholly-owned foreign subsidiary to file a consolidated return with its domestic parent. In the extractive industries, the privilege of filing a consolidated return might be an effective stimulant. While the subsidiary's income would thereby be currently subject to United States income tax, the advantages of percentage depletion could be obtained even if foreign laws required the foreign incorporation of the resource activity. On the other hand, the proposal is far less attractive in other industries. At present the utilization of a foreign subsidiary permits deferral of United States income tax as well as a lower eventual rate of tax on the distribution of the earnings by reason of the operation of the section 131 (*f*) foreign tax credit. Both advantages would be lost if a consolidated return were filed.

The whole area of losses is one requiring further consideration. The nature of the risks which deter foreign investment might be explored, and changes in the United States tax treatment might be examined which are more directly related to the consequences of those risks than is a broad exemption of foreign income. Among the possible measures which have been discussed are:

(*a*) A reduction in the requirement of 95 per cent stock ownership in order to permit deduction from ordinary income of the loss from worthlessness of a subsidiary's stock and securities;

(*b*) Permission of amortization of the capital invested in foreign activity;

(*c*) An increased carry-back period for foreign losses;

(*d*) Extension and more flexible use of the privilege of filing a consolidated return.

F. INCOME TAX TREATIES

The United States now has income tax treaties with most European and Commonwealth countries. A list of these agreements will be found in *International Tax Agreements,* volume III, "World Guide to International Tax Agreements 1843-1951." The co-contracting countries generally—as does the United States—tax the foreign income of their resident individuals and corporations as well as the income derived from sources within their own territories by foreign residents. The treaties deal with the ensuing double taxation through combinations of tax credit, exemptions or reductions of tax.

The agreements with the Commonwealth countries generally oblige both parties to grant credit to their residents for such taxes as the other country is, under the agreement, permitted to impose on income derived from sources within its territory.

The agreements with the continental European countries, while following the same pattern as far as the United States is concerned, often provide for exemption in the European country of income derived by its residents from, and taxable in, the United States. The main features of the Anglo-American and continental European agreements are more fully discussed in the annex incorporated in the United Nations study on "Corporate Tax Problems" (document E/CN.8/66) and entitled *Treatment of Corporate Profits and Dividends in Tax Agreements.*

These treaties have proven helpful in eliminating a number of points of conflict and unnecessary overlapping of taxes resulting from the combined application of the taxes of two taxing jurisdictions.

While treaties with several Latin-American countries have been under consideration for some time, no general income tax agreements have been concluded so far. The explanation probably is that such treaties are thought by the Latin-American countries to be of less importance for them than they are for those countries referred to above. The Latin-American countries do not ordinarily tax foreign income of their own residents or corporations and they may feel that United States residents and corporations are sufficiently protected by the tax credit unilaterally provided by United States law. The underlying problems are further discussed in the Preface to volume II of the series *International Tax Agreements.*

V. THE NEED FOR AND SCOPE OF FURTHER INVESTIGATION AND ANALYSIS

It is apparent from the foregoing analysis that the significance of tax provisions affecting foreign income is likely to vary with the nature and form of the business activity and the objectives of the United States investors, corporate and individual. An appraisal of the actual effects of the existing tax law and of proposed modifications in it would require a systematic sampling of the attitudes of corporate management and individual investors regarding present and potential foreign investment. A thorough study, based on adequate field work, has not been possible within the limits of this preliminary study, but certain tentative observations are offered, subject to further investigation. First, a few comments may be made on the nature of the research work involved in an investigation of this sort.

A. METHOD OF RESEARCH

The research necessary to appraise business attitudes in the United States towards investment abroad requires extensive interviews among corporation executives and consultants. Interviews have been found to be much more useful than mail questionnaires in determining the basis of business action and beliefs. The interviews must be conducted by people who are themselves sufficiently well acquainted with the variety of problems which may be encountered to be able to carry on an intelligent discussion of the various points raised. Though a few common questions would be asked in all interviews, the conversation should be kept flexible to pursue in detail unexpected or distinctive topics as they arise.

It is important in appraising the significance of tax factors in decisions on foreign investment to talk to more than one person in a company, and it is especially useful to talk to people other than the tax specialists since the latter are inclined to over-emphasize the tax aspects of investment and operating problems. This point was confirmed in an effective manner in one company when, during the course of a three-hour discussion with senior officers on the subject of foreign investment, they remarked on two different occasions that the company's tax specialist, with whom an interview had been obtained earlier, would "blow his top" if he knew of the nature of the remarks being made in the later interview. On another occasion, officers joining a discussion in progress made comments that were incompatible with earlier remarks of others present; this led to a useful discussion among the individuals of which the interviewer was merely an interested observer.

Interviews of the sort which are necessary obviously must be obtained on a confidential basis. Experience extending over many years has indicated that it is possible to secure frank and comprehensive discussions with the great majority of businessmen, even on matters in which they have a special interest such as taxation. Some interviews will inevitably be ineffective or will lead to unreasonable and unreasoning invective on the generally bad effects of taxation. With reasonable experience in conducting interviews, however, ineffective ones are relatively rare and even the invective may be significant. In one of the conversations for this preliminary study, the interviewer had remarked on the danger of rationalization by those affected by taxation. At a later time, when the interviewer looked sceptical concerning a line of reasoning being developed by a corporate officer, the latter paused and, in a self-critical mood, said "I wonder if I'm rationalizing now—yes, I guess I am".

As the foregoing incident indicates, interviews to be useful must be conducted on a basis of mutual respect and confidence. It is often surprising to people from other countries that business executives in the United States are willing to talk confidentially about their actions and attitudes. During the past thirty years, however, business cases have been used extensively as teaching material in graduate schools of business administration in the United States and the experience gained in developing teaching cases has been transferred successfully in recent years to research projects.

On some elaborate studies it is possible to secure a scientifically constructed sample of companies or individuals to be interviewed so as to give an accurate cross section of the particular statistical universe being studied. In most problems, however, it is found satisfactory to proceed on a less ambitious basis and to select individual companies that may be expected to provide reasonably diverse examples and then to carry the study to the point where situations and reactions fall into fairly well-defined patterns, with additional cases providing only minor new material.

On the subject of foreign corporate investment, the selection of companies to be interviewed should be fairly easy. A fair sample of companies which have extensive investments abroad should be consulted, along with other companies which are conspicuous by not carrying on foreign activities. A reasonable coverage of different industries is obviously important, because of their differing problems and objectives, as is suggested in more detail below. During the course of an interview, suggestions are not infrequently made about other people who should be seen. It is interesting, and somewhat surprising, that suggestions are not typically made to secure a reinforcement of a particular position but rather with some such remark as "You ought to see ....; he has a different sort of problem; (or) I know he doesn't agree with me on this."

The end result of a study of the sort envisaged on this subject would be to develop significant categories of situations and reactions. It should be possible to distinguish common from rare cases, and tax factors can be described in perspective along with the many other factors which influence business decisions. The results cannot, however, be usefully presented in statistical tables. Not only would the sample be too small to justify precise quantitative groupings of categories, but the subtleties of business attitudes and the complex nature of the forces which bear on decisions can be made clear only by verbal descriptions.

In this preliminary study of the effects of United States taxation on investments of United States corporations in Latin America, it has not been possible to interview men in more than a few companies. The study has been pushed far enough to confirm the feasibility of a more elaborate research programme based on case studies. Even from the limited work which has been done, a few significant points begin to emerge; these are presented below on a very tentative basis.

B. TENTATIVE CONCLUSIONS ON UNITED STATES BUSINESS ATTITUDES ON FOREIGN INVESTMENTS

In most industries, United States corporation executives and individual investors do not consider investments abroad as a normal or regular part of their business activity. Domestic markets and investment outlets usually offer sufficient diversity and scope for available talents and funds. Even more significantly, investment abroad is typically regarded as being subject to high and unpredictable risk factors. This attitude applies to all countries except Canada, and even attractive investments in Canada must overcome a considerable element of inertia in the minds of most investors. Currency depreciation, exchange controls, and the possibility of nationalization are thought of as the principal special risks in foreign investment, but labour laws and unfamiliar aspects of property law also constitute real barriers. In general, foreign investment is regarded as a new frontier and appeals only to the more adventuresome investors.

The special risks of foreign investment, not unfavourable tax treatment, appear to constitute the principal deterrent to it. One man who had had extensive contact with potential and actual United States investors abroad made the remark during the course of an interview that "businessmen here do not feel thwarted by taxation on foreign income in the sense that it discourages them from doing something they really want to do". The problem seems to be not so much that of removing a tax barrier as of removing non-tax barriers and possibly creating tax or other inducements to overcome the lack of inclination for investment abroad.

When viewed in the light of the foregoing remarks, the immediate direct impact of a preferential tax treatment of foreign income becomes questionable. On some investments abroad, the prospective rates of return are sufficiently high to overcome the fear of loss; favourable tax treatment for them would simply increase their attraction by increasing their net yield. On other investments, no conceivable tax treatment would be adequate to overcome the risk of loss. Between these two extremes are many situations in which a differential tax treatment of foreign income would be one of many relevant factors in an investment decision.

Corporate executives and investment committees apparently do not often prepare rankings of all alternative uses of available funds, with foreign and domestic uses intermingled, or make decisions on a homogeneous comparison of returns and risks. Foreign investments are qualitatively regarded as separate and distinct and subject to special considerations and judgment. A good deal of further research would be necessary to develop a reasonably adequate understanding of the ways in which decisions on foreign investment are actually made in United States corporations. Specifically, it is important to know exactly how tax factors are presented and taken into account in estimates of prospective returns. In one large company with extensive activities abroad, calculations on actual and prospective earnings are made before taxes, after foreign taxes (including foreign income taxes), and after all taxes (including United States taxes on repatriation of income). But in another large company which also carries on considerable foreign business, one man in the foreign department spoke of his problems in getting what he felt was adequate recognition of tax differentials in various countries, in view of an inclination to look only at returns before income taxes. The extent to which tax factors influence decisions inevitably must be affected to a considerable extent by such simple matters as the form of presentation of projected earnings.

Further investigation would also be necessary to develop a reasonable understanding of the motivations which lead to the development of business activities abroad. The material accumulated thus far suggests a variety of situations and highly individual reactions. A general interest of the senior executive in other countries, or even an excuse to travel abroad, has been mentioned as a reason why some companies are engaged in foreign business and other similar companies are not. It is apparent also that consideration of foreign investment in some companies was started by the simple belief that "it was the thing to do" as part of a broad United States national policy for the development of under-developed countries.

A point advanced by one man who himself had had extensive contacts with executives in many companies was that investment in assembly plants or production facilities was likely to follow earlier merchandise exports to a country, especially if the exports were jeopardized by import quotas or exchange controls. The development of a manufacturing facility to maintain, from local production, sales previously handled through exports was, on this basis, considered a more likely development than was the acquisition of a foreign plant to enter the foreign market for the first time. In one company in which interviews were held with several officers, it was stated that production facilities abroad had been acquired as long as twenty years ago in anticipation of the development of national and regional trade preference areas.

Just as personal factors enter into favourable decisions on investments abroad, they may also be important in adverse decisions. The head of one company spoke, for example, of his strong reaction to an application of multiple exchange rates in a country he was visiting in anticipation of establishing a plant. The situation he encountered, through an acquaintance in another industry, indicated arbitrary action of a sort to which he was not willing to become subject, and he left the country forthwith. In several other cases, the national tax and social security laws and the manner of their administration were cited as requiring negotiations in a manner which was not consistent with a company's general policies. Very high severance pay was noted by some as a danger of business operations abroad. The establishment of a branch office to qualify for Western Hemisphere Trade Corporation status is thought in some cases to make a company vulnerable to local legislation and administration which would much more than offset any advantages under United States tax laws.

On the basis of limited interviews, it is quite apparent that the attitudes of United States executives towards the complexities of activities in other countries is by no means uniform. Some of them indicated a strong distaste, with emotional overtones, of any expansion of their business abroad; others appeared to take as a matter of course the special operating problems which arose. There was no apparent reason for differences in attitudes other than the basic one of personal temperament.

Three major kinds of business situations may be usefully distinguished in appraising the significance of various tax provisions. It is fairly common for both individual and corporate investors to want to make a small original investment, with the expectation of allowing profits to remain abroad to build up the foreign company or property. In this way, a minimum risk is incurred for a large potential gain. In these cases, there is little or no interest in the immediate net return after taxes in United States dollars.

The use of foreign corporations is made attractive in the foregoing situations if low tax rates exist in the countries in which they operate, since the rate of reinvestment is dependent exclusively upon the foreign tax rate. The foreign tax rate, rather than credits and exemptions under the United States tax law, is here the most important aspect of taxation. The circumstances under which profits will eventually be repatriated often are sufficiently remote in time to make the existing tax provisions applying to the repatriation relatively less important. The policy of making small original investments to be built up from accumulated profits is found in industrial, merchandising, and some agricultural activities; it is usually not possible in extractive industries.

A second sort of situation exists when a substantial investment is to be made abroad with the expectation of fairly prompt profits which are to be systematically repatriated as they are earned. Under these conditions, the aggregate tax burden on the repatriated profits is the important tax consideration. Multiple taxation, if it exists, becomes immediately apparent, but the distribution of the total tax as between countries is largely a matter of indifference to investors. In some instances, United States corporations have actually suggested ways in which other countries in which they operate might collect more tax revenue without increasing the company's total taxes because of the effect of the United States foreign tax credit. The objective of immediate withdrawal of profits may exist in all forms of business activity.

Extractive industries present a third and special situation in that they require a large capital investment in a single location, that is, under a single jurisdiction. A diversification of risks is thus not possible in the same way that it may be in manufacturing and, even more readily, in merchandising. This concentration of risk is said by some of those subject to it to make the incentives necessary for investment in foreign extractive industries especially great. However, in the extractive industries and in some agricultural industries, the need for sources of supply outside the United States imposes an urgency on investment abroad which is likely to be much stronger than that existing in other industries. United States oil and mining companies are by no means uniform in the extent of their interest in foreign investment. However, an exploration of the reasons for their differences in policy should be a topic for further research.

Further useful classifications of business could be made with reference to the impact of taxation on investments abroad. Merchandising companies require different sorts of investments than production companies, and production companies in turn differ in their reliance on local sources of material and the proportion of specialized capital equipment in a company's total investment. Agricultural companies also have distinctive problems arising from the specialized forms of their investments and activities. Enough companies in each of these categories should be studied to determine any distinctive ways in which taxation may affect them.

C. MAJOR OBJECTIVES OF ADDITIONAL RESEARCH

A more detailed and thorough investigation of the influence of taxation on investment in Latin America should contain two principal features. First, it would involve a determination of the attitudes of actual and potential investors concerning risks in foreign investment: What are the risks and how do they differ in various forms of business activity and among various sorts of investors? A more precise definition of risks is necessary as a basis for a consideration of the remedies and incentives appropriate to offset them.

General tax incentives may be simultaneously generous for many business activities and inadequate for other activities with particular definable risks. Incentives, if they are to be most effective and least costly, should be associated with the risks for which they are to compensate. Thus, for example, a further examination of risks may suggest that special loss allowances in cases of nationalization and foreign exchange depreciation would be preferable to more generalized differential tax rates.

The second aspect of a more thorough examination of the influence of taxation on foreign investment in Latin America would consist of an analysis of the application of the existing tax rules of the United States in the light of the tax legislation and practice in the countries of Latin America, and their application to the various methods by which United States corporations conduct their business in Latin America. Throughout this discussion assumptions have been made as to the impact of the United States income tax on United States business abroad, which should be further studied. In numerous places in the foregoing analysis of the tax law of the United States, it has been indicated that the significance of the present provisions or proposed changes will vary with the nature of the tax systems of countries in which investments are made and business is conducted. A judgment on United States tax law is possible only when the interrelation between it and the tax law in the other countries is made on an actual rather than a conjectural basis.

The present report has consisted primarily of a descriptive analysis of the existing tax law of the United States relevant to investment in Latin America and of current proposals for changes in that law. No recommendations concerning changes have been possible in this report, because of its preliminary and incomplete character. Recommendations may range from modifications in the mechanics of present tax rules to fundamental shifts in tax policy. But at whatever level they are made, recommendations to be well founded must be based on a more thorough examination of the attitudes of individual and corporate investors in the United States towards the risks inherent in investment abroad, a detailed analysis of the interrelationship between tax law in the United States and the tax law in Latin America, and the effect of this interrelationship in view of the manner in which United States business is conducted abroad.

One final comment should be made on the limitations of further research on the effects of taxation on investments abroad by United States corporations. It has sometimes been suggested that a generally favourable tax treatment of foreign income might have an impact quite out of proportion to what might be expected logically. Nothing in the foregoing analysis either confirms or refutes the validity of this idea nor is any research likely to give a useful indication of the probable results of such a tax policy. It is quite possible that tax exemption or low tax rates applied to foreign income might be adopted and publicized in a way which would attract attention to foreign investment and make it currently fashionable. The evidence accumulated thus far would be entirely consistent with this result, but it by no means makes it a foregone conclusion.

The fact that investment decisions are not made entirely on the basis of schedules showing relative returns from all alternative uses of funds raises the distinct possibility that a general and disproportionate interest in foreign activities might be created by some spectacular change in the tax laws. The distaste for the risks and difficulties of foreign operations may, on the other hand, be so firmly entrenched that even logically attractive incentives would be ignored. Business motivation in this area, as in others, is sufficiently complex and uncertain to preclude any high degree of assurance in predictions about the effects of a particular major change in a single relevant factor. Whether a favourable investment response, even if it could be anticipated with assurance, would be an adequate reason for exemption could be decided only after further consideration of the whole subject of foreign investment and the alternative methods of encouraging it.

ANNEX I

TAXATION OF BLOCKED INCOME AND FOREIGN EXCHANGE TRANSACTIONS

1. *Blocked Income—The Problem*

The Internal Revenue Code does not provide any special statutory rules (except in so far as I.R.C. 433 (*a*) (1) (M) excludes "blocked foreign income" from excess profits net income), as to how to report income and deductions when the country of the source of the income "blocks" the accounts of the taxpayer, and the whole development of the law on the subject has therefore been in the case law and rulings. The problem, simply expressed, is to determine to what extent the non-availability to the taxpayer of profit in a foreign country should excuse him from immediately reporting that profit for purposes of United States tax, or in cases where he has suffered a loss, should prevent him from taking the loss against other income. The problem is complicated still further, where the income although blocked against transfer to the United States at official exchange rates is available to the taxpayer at a conversion at less than the official rates, or at least can be used by the taxpayer in the country of the origin of the income.

Where business is done in Latin America through subsidiaries incorporated there, the blocked income problem does not normally arise, since dividends will not usually be declared to the United States parent until the means to pay them are available. To the extent that this is not the case, the rules in any event are no different than for computing blocked income in other situations, and the question of whether a blocked dividend is income depends on the same criteria as in the case of other blocked receipts. By far the main issue is with respect to branch operations, where, contrary to subsidiaries, the business income of the branch is *prima facie* immediately reportable by the United States taxpayer and made subject to United States tax. A Latin-American subsidiary can more or less look after its blocked income problems by seeing that the United States parent is not put in the position of receiving income until the income can be effectively transmitted. A Latin-American branch or agency, whether of a United States individual citizen or resident, or whether of a Western Hemisphere Trade Corporation or other United States corporation, is in no such position under ordinary tax law. In effect the question before the courts and the Bureau of Internal Revenue has been whether, in a blocked income situation, the Code should be so interpreted as to give a branch operation a position analogous to a subsidiary by not making branch income taxable until actually "available" to the United States taxpayer.

2. *Blocked Income—The Law*

A United States taxpayer with a blocked income situation has two choices under the current law. The taxpayer may either apply the various rules of the case law and report his income or loss accordingly, or else he may elect to follow the method of accounting outlined in Mimeograph 6475, 1950-1 Cumulative Bulletin, page 50.

(i) *The Case Law*

It is clear that where the taxpayer is precluded by the foreign blocking law from either converting the blocked currency to United States dollars, or spending or otherwise using the blocked currency in the issuing country, the blocked income will not be taxable in the United States until it has at least become available to some extent to the taxpayer, except perhaps under special Code provisions involving undistributed income. To the extent to which the taxpayer does convert income to United States dollars, he will receive immediate United States taxable income. On the other hand, the mere existence of a limited or costly possibility of conversion does not—in the absence of actual conversion—necessarily make such income subject to United States tax. Thus in a recent Tax Court case (Ceska Cooper v. Commissioner, *Tax Cases (United States Tax Court)*, volume 15, page 757 (1950)), partially blocked United Kingdom pounds were held to be taxable income immediately, but the value of the pounds was held to be calculable at the rate pounds were selling on the free market in New York, and not at the official rate of exchange.

Where, however, the income in the issuing country can be used there for one or more purposes even though not convertible to United States dollars, the issue is far from clear, although in some instances there would appear to be an immediate United States tax. Thus, where notwithstanding the blocking there is a foreign market for the currency, or where the taxpayer can effectively use the currency abroad, the blocked income will be immediately reportable by the United States taxpayer to the extent of its actual value. Actually no cases have passed directly on the issue of foreign currency expendable only in the issuing country, but it may be that if the taxpayer can obtain a substantial enough economic satisfaction from the blocked currency, e.g., through investment or consumption, there will be taxable income in the United States immediately notwithstanding no convertibility to United States dollars. Where foreign income is taxable even though not convertible to United States dollars, the amount of the income is based on the actual value to the United States taxpayer of the blocked income, and not on a calculation based on the official rate of exchange. This was done in one instance—where specific legislation avoided the necessity of discussing the underlying legal issues—by valuing blocked pesos in Colombia on the basis of the relative prices in the United States and Colombia of foods and other commodities commonly used by United States citizens living in Colombia (Eder v. Commissioner, *Federal Tax Cases,* 2nd Series, volume 138, page 27, (1943)).

Beyond the above rules, where there is specific United States legislation which in any event taxes undistributed income, the blocking of the income will be irrelevant to its taxability. Thus in the case of the undistributed income of a foreign personal holding company, the income of a partnership, and the distributable income of a trust, the various applicable Code sections make the income of these entities taxable to the shareholders, partners, and beneficiaries, as the case may be, regardless of their actual receipt of the income. This, the courts have ruled, overrides the normal rule of no taxability without convertibility, and probably makes even fully blocked income immediately taxable in the United States to these taxpayers, to the extent of its actual value calculated as in the previous paragraph.

The vagueness of the above rules is compounded by the lack of substantial authority on various subsidiary and important questions. With respect to two important problems, however, the following would appear to be the case. Blocked income as yet untaxed will become taxable at the time of its unblocking, regardless of when it is actually withdrawn, and when unblocked, the income will retain its original nature (as dividend, capital gain, etc.) notwithstanding interim dealings with it (not substantial enough in themselves to constitute an unblocking). Losses and other deductions are probably deductible regardless of whether the income would have been taxable had the transactions in the foreign country given rise to net income instead of to net loss. That is, while deductions in a blocked income country must be first netted against the gross income of that country, if the over-all picture is a net loss, that loss may be taken immediately against other United States income.

(ii) *Mimeograph 6475*

The confusion surrounding the blocked income picture resulted in the promulgation in 1950 of Mimeograph 6475, 1950-1 Cumulative Bulletin, page 50, whereby the Commissioner now gives taxpayers the elective privilege of deferring payment of United States tax on "deferable income" until such time as the income should fall outside the definition of "deferable income". The election of this accounting method is made on additional income tax returns filed separately for each country in which the taxpayer has "deferable income."

Foreign income is "deferable" only if and to the extent that (*a*) money or property in the foreign country is not readily convertible to United States dollars, (*b*) no conversion has been made to United States dollars, or to other property or currency readily convertible to United States dollars (regardless of laws or regulations forbidding such conversion), and (*c*) the income has not been used for non-deductible personal expenses; gifts, bequests, etc.; dividends or other distributions; or in the case of a resident alien, the taxpayer has not terminated his United States residence. The happening of any of the above contingencies causes the income to be no longer "deferable," and, less costs in United States dollars attendant to the income, the whole blocked income becomes immediately taxable to the United States taxpayer. When there is "deferable income" in a given country, expenses incurred in that country will only be deductible when the "deferable income" becomes taxable, and similarly the deductions for depreciation and obsolescence, and the foreign tax credit of I.R.C. 131, will be postponed until the release of the "deferable income". Where, however, there are costs and expenses in United States dollars applicable in more than one country, and the taxpayer has normally not allocated these on a country-by-country basis, a reasonable allocation to current and "deferable income" is permissible without prior approval of the Commissioner.

The election to claim "deferable income" must be made no later than the time prescribed for filing the tax return for the first taxable year for which the deferment is desired. Once the election has been made, change from, or variation of, this accounting method must first be approved by the Commissioner.

Some of the above rules are illustrated by the following example. Assume a United States manufacturer sells goods in a given Latin-American country for 20,000 pesos (where the rate of exchange is $.05 per peso) and that the cost of the goods is $700 (i.e., 14,000 pesos), while the direct expenses attributable to the sale are $100. The United States manufacturer is only able to convert in the taxable year 15,000 pesos to United States dollars, which at the rate of conversion of $.05 per peso gives him $750. On these facts the United States manufacturer will be required (if he elects Mimeograph 6475) to include in his gross income only $50 ($750 minus $700), and he will be able currently to deduct $16.67 (one sixth of $100, i.e., that portion of the expenses allocable to the converted portion ($50 or 1,000 pesos) of the total profits (20,000 minus 14,000 or 6,000 pesos)).

3. *Foreign Exchange Transactions*

The law of reporting gain or loss consequent upon foreign currency value fluctuations is very confused, and shows no consistent pattern of reasoning. It is not proposed to give an exhaustive treatment of the subject here, but only to note a few of the apparent rules applicable to doing business in Latin America.

It appears as though no gain or loss can result from the borrowing and returning of foreign currency, even though when translated into United States dollars there is a difference in amount at the two points of the transaction. Thus, even though 100,000 pesos are borrowed when the peso equals $.05 ($5,000), and are returned when the peso equals $.03 ($3,000), this does not make the $2,000 difference a taxable gain, the courts considering the transaction as a borrowing and returning of a commodity. Where, however, goods are purchased on credit at one price, and paid at a subsequent time when there has been a currency fluctuation, the above rule does not apply. The courts have held here that the gain or loss from the fluctuation is a separate transaction from the purchase, that the cost of the goods purchased is their dollar value on the date of the purchase (at the then prevailing rate of exchange), and that the gain or loss due to the currency fluctuation is income or loss in the year of the payment. Thus where goods are purchased in 1951 for 100,000 pesos (1 peso equals $.05) and are paid for in 1952 (1 peso equals $.03), the inventory value of the goods which must remain at the level established at the time of purchase is $5,000, and the taxpayer has $2,000 taxable income in 1952 by paying a $5,000 debt with $3,000. Similarly, it has been held in the case of an accrual basis taxpayer (The Foundation Co. v Commissioner, *Tax Cases (United States Tax Court)*, volume 14, page 1333 (1950)) that the difference due to currency value changes between the accrued dollar income reported in one year, and the actual dollar income received in the years of payment, constitutes income or loss. The reason for the distinction is apparently that the cases recognizing gain or loss involved transactions made in the ordinary course of business, which "unlike a mere borrowing and returning of property, [i.e., foreign currency, as in the first example] obviously gave rise to tax consequences," (The Foundation Co., *supra*).

One of the most important problems facing United States investors in Latin America is the method of translating business income in foreign currency into United States dollars when, due to fluctuating currency values, the foreign profit or loss expressed in terms of foreign currency does not equal the economic gain or loss. Expressed in terms of an example, assume a United States company doing business in a Latin-American country through a branch office purchases goods for 100,000 pesos (1 peso equals $.05) at the beginning of the year, sells them six months later for 150,000 pesos (1 peso equals $.02) immediately converts 75,000 pesos to United States dollars, and that at the end of the year 1 peso equals $.01. On these facts how should the United States company report its Latin-American business? There have been two distinct approaches to this problem: the first being a comparison of the dollar equivalent of net worth, or of net current assets, at the beginning and end of the taxable year; the second being a computation of the profit or loss in terms of the foreign currency, with the United States income or loss based on the conversion rates at the time of remittance and/or the end of the taxable year. Under the first approach the United States company would have net current assets of $5,000 at the beginning of the year and $2,250 at the end of the year ($1,500 plus $750), or an operating loss of $2,750. Under the second approach the United States company would have a profit of 50,000 pesos, and (since profits are assumed remitted first) a taxable profit of $1,000, (conversion at 1 peso equals $.02). There has been a good deal of confusion as to which method of computation would be correct in these circumstances, but until lately it appeared as though the system of conversion of net assets at the end of the taxable year (the first approach) was to be used for branch operations, while in isolated currency transactions or foreign subsidiary operations the second approach was taken. The different treatment of subsidiaries and branches was based on the logical theory that a subsidiary is a separate and distinct entity whose investment is clear of its parent company until liquidation (contrary to a branch), and that dividends (the only means of transmitting the foreign "profits" to the parent company) depend on the availability of a foreign profit in terms of the foreign currency. In the latest case on the subject, however, (American Pad and Textile Co., v. Commissioner, *Tax Cases (United States Tax Court)*, volume 16, page 1304, (1951)), in which the Commissioner has acquiesced, the whole issue has been reopened, and the Tax Court has indicated that the question is one primarily of accounting and not of law, and that therefore the propriety of one approach as against the other will depend on the nature of the business, the method of bookkeeping, and the consistency of using the approach chosen.

Assuming a gain or loss, the question of whether such gain or loss is ordinary, or of a capital nature, depends pretty much on whether the foreign currency in question qualifies as a capital asset or not. Normally foreign currency held as an investment will give rise to capital gain or loss. Where, however, foreign currency is customarily received in trade or business it will give rise to ordinary gain or loss, because such currency is then held primarily for sale to customers in the ordinary course of business and is therefore not a capital asset.

ANNEX II

Comparative Chart

Tax Results of Different Methods of Doing Business in Latin America

The following Chart outlines the tax results under United States law which flow from different methods of doing business in Latin America in a number of respects. The methods considered are:

A. Branches of United States corporations;

B. Individual proprietorships or partnerships of United States citizens or residents;

C. Foreign corporations the stock of which is owned by United States corporations;

D. Foreign corporations the stock of which is owned by United States citizens or residents;

E. Western Hemisphere Trade Corporations the stock of which is owned by United States corporations;

F. Western Hemisphere Trade Corporations the stock of which is owned by United States citizens or residents.

The respects in which the tax results of the use of these different methods are considered are:

(1) United States normal tax and surtax: scope, effect and taxable income;

(2) United States excess profits tax;

(3) Latin-American tax;

(4) Foreign tax credit of I.R.C. 131;

(5) Dividends and other distributions of corporate profits;

(6) Accumulation of corporate profits;

(7) Consolidated returns;

(8) Incorporation.

There is added a dollars-and-cents Chart illustrating the over-all tax results under United States law of these six methods of doing business. This Chart cannot by itself indicate which method will be more advantageous in each individual case. This will depend on a number of other factors, such as the importance of limited liability, the need for seeking capital on the open market, the expectation for the initial period of profits or loss, the desirability of reinvesting or repatriating profits and many others. It is, however, the purpose of the Chart to provide the individual tax elements of the situation so that the reader will be in a position to determine the method which is most appropriate to a particular situation of fact.

It is, of course, possible to go beyond this and to construct rules indicating exactly under what set of circumstances one or the other method would be preferable. Such formulae, however, are without practical utility beyond a certain point. They would have to be so intricate and use so fine a line of demarcation that no taxpayer could use them, since he could not forecast the results of his foreign operations with sufficient precision to determine on which side of the fine line he would ultimately find himself.

There are, however, a number of basic facts and criteria which, because they are relatively simple, are of practical importance. They may be formulated as follows:

(1) The problem of whether to use a Latin-American subsidiary or a Latin-American branch depends on a number of variables. The two basic tax differences between these two methods are:

In the case of a Latin-American branch:

(*a*) The total net income of the branch before payment of foreign income taxes must be reported as part of the United States taxpayer's income and its losses may be deducted;

(*b*) The United States taxpayer may either deduct the foreign taxes paid by the branch from his reportable foreign income or may take a credit for them against his United States tax.

In the case of a Latin-American subsidiary:

(*a*) Only the dividends received, i.e., the distributed part of the subsidiary's net income after foreign taxes, need be reported as part of the United States taxpayer's income and losses of the subsidiary may not be deducted from that income.

(*b*) Only tax credit is available to the United States parent for the foreign taxes paid by its Latin-American subsidiary on its profits (both tax credit and deduction may be used on account of foreign taxes charged against the United States parent on the dividends paid to it).

Note: In the special case of the extracting industries operating in Latin-America the most important difference is the ability to take full deduction on account of exploration expenditures, development costs and depletion allowances in the case of branches only.

(2) The corresponding variables are:

(*a*) The relationship between the rate of the United States tax and those of the foreign taxes;

(*b*) The amounts of reportable net income and net loss resulting from the various foreign operations.

(3) If there are no losses, the credit system is always more advantageous than the deduction of foreign tax from income.

(4) If there are no losses and if no immediate repatriation of foreign profits is intended, a subsidiary is always preferable to a branch.

(5) If the credit system is used, and if in all foreign countries the total tax due on the foreign income is equal to or higher than the United States tax, there is no tax difference between a branch and a subsidiary as far as the tax on repatriated profits is concerned because, under the credit provision, the foreign income is in fact not taxed in the United States, so that the amount of the foreign income reported becomes irrelevant (but see No. 8(*a*) below).

(6) If there are no losses and if all profits are to be currently repatriated, a subsidiary is still preferable in those countries in which the rate is lower than the rate in the United States, because (according to 1(*b*) above) the reported foreign net income, on which the difference between the two tax rates is applied, is lower than in the case of a branch (but see No. 8(*c*) below).

The saving between the subsidiary and the branch methods of operation is equal to the difference between the United States rate and the foreign rate on the amount of foreign tax paid on the income of the company: If the United States company income tax is 50 per cent and the foreign tax is 40 per cent, the saving to the United States taxpayer resulting from the use of a subsidiary rather than a branch is equal to 50-40 per cent, (i.e., 10 per cent) of the foreign tax (40 per cent) or 4 per cent of the foreign income.

(7) If there are losses from some and profits from other foreign operations, it is largely impossible to establish workable rules to determine the choice between branch and subsidiary and tax credit and deduction. The myriad considerations that must be weighed and anticipated, such as extent of expected losses and deferability of foreign profits, would require any rules to be qualified beyond usefulness. For example, it could well be stated that if there are losses from some and profits from other foreign operations a deduction will be preferable to a credit if the total foreign taxes available for credit or deduction are greater than the total foreign net income—after foreign losses—reportable as income for United States tax. This is so, because, under the credit system, the maximum tax saving is the United States tax on the foreign income, while under a deduction the saving is the United States tax on the foreign tax, which, by hypothesis, is greater. This would in principle make a branch preferable to a subsidiary in cases of this kind. It should be noted, however, that if deduction is to be taken in one case, it must be taken for all foreign operations. This requires that all of these be organized as branches (see 1(*b*) above). Since the reportable foreign net income in the [illegible] be higher than in the case of subsidiaries, the conditions needed to make deduction, i.e., branches, more advantageous will be harder to fulfil. Since, however, income of foreign subsidiaries is subject to United States tax only if distributed, it is realistic to assume that in most situations, where some foreign operations result in losses while others produce profits, the latter will not be repatriated, so that there will be no need to make the choice between credit or deduction for foreign taxes. This example may suffice to demonstrate that in any loss situation, a specific solution must be worked out on the basis of all the facts.

(8) The above rules are still further complicated by the necessity to take account of such additional factors as:

(*a*) In the case of an individual United States taxpayer the over-all effective rate even on his domestic income will be boosted by his foreign income or lowered by his foreign losses; the increase in tax resulting in the former case is not available for tax credit. In case of a corporate United States taxpayer, this factor, however, will not be important, since the progression of the corporate tax rate in the income ranges of most United States corporations operating abroad is almost nil.

(*b*) Only United States corporations (and not individuals) may claim credit for foreign taxes paid by foreign corporations in which they hold stock (subsidiaries) and by foreign subsidiaries of the latter;

(*c*) A United States parent company which is subject to excess profits tax may increase or decrease its liability by the use of a Western Hemisphere Trade Corporation or a foreign subsidiary, depending on whether the exemption of the latter's income from that tax outweighs the disadvantage of eliminating the parent's assets invested in it from the computation of the parent's excess profits tax credit (i.e., exempt normal earnings) (see Nos. 9 and 11 in the Chart).

(*d*) Finally, the structure of the applicable Latin-American taxes (as in No. 8(*c*) above) are essential elements for consideration in the choice of the method of doing business.

The foregoing is intended rather as illustrations of the use of the Chart than as precise guidelines for the United States investor in Latin America. It shows the great complexity of the rules and the exactness with which each of them must be analysed, in itself and in combination with all others, in order to test tax consequences against the policy aims of the legislator and the business aims of the investor.

SHEET 1

Method of doing business in Latin America	*U.S. normal tax and surtax: scope, effect and taxable income*	*U.S. Excess Profits Tax (under present law, the Excess Profits Tax will not be levied on profits earned after 30 June 1953)*	*Latin-American tax*	*Foreign tax credit of I.R.C. 131*
A. *A branch of a United States Corporation.*	1. U.S. tax jurisdiction is based on three criteria: nationality, residence and source. Thus, tax is payable on all the net income from the U.S. and L.A. business activities together with any other net income of the corporation. Profits from the L.A. branch are taxable immediately, regardless of whether they are retained locally or are actually repatriated to the U.S. For years beginning after 31/3/51 the rate is 30 per cent on normal-tax net income and 22 per cent on surtax net income over $25,000. Where there are long-term capital gains (on assets held over 6 months) their excess over net short-term capital losses (on assets held under 6 months) will be taxed at only 26 per cent for years beginning after 31/3/51 (I.R.C.117(c)). The L.A. income is income to the U.S. company in the year it would be if it were earned in the U.S., whether or not retained in a foreign branch bank account, etc. In certain instances, however, where the currency is blocked in the foreign country and cannot be repatriated to the U.S. or effectively used in the foreign country, the taxation of the income may be postponed. In fact where there is a blocked income situation the treatment of this income results, in many aspects, in foreign branch operations being treated in the same manner as foreign subsidiary operations (see section IV). In netting the income, all allowable expenses and deductions connected or allocable to the foreign income may be taken, and where the L.A. operations result in a business loss (including losses resulting from a declining currency) these losses can be set off currently against profits of the U.S. corporation from whatever source derived (compare [illegible]). The tax on the shareholders of the corporation is at the rates set out in 2 and depends on the nature of the distributions to them (as in 25), dividends being taxed as ordinary income, (I.R.C. 115(*a*)), and distributions in complete or partial liquidation as capital gains, (I.R.C.115(*c*)).	7. Adjusted excess-profits net income (that is, roughly, the business net income less a credit equal to what is considered as normal profits), (I. R.C.430,431) from the U.S. and L.A. business is taxable in the year in which it would be taxable if it were all U.S. income. The rate is 30 per cent of adjusted excess-profits net income with a ceiling rate of 18 per cent of excess profits net income (i.e., without the credit) for years beginning after 31/3/51, (I.R.C.430, 433). The maximum over-all effective rate of income and excess profits taxes which can be levied is 70 per cent of net income. Remittances from earnings blocked before the effective date of the excess profits tax are exempt from that tax. (I.R.C.433 (*a*)(1)(M)). Income, otherwise subject to the tax, is not taxable if unavailable by reason of monetary exchange or other restrictions.	13. The L.A. tax is usually independent of the form in which the business is being carried on, and falls equally on business done through agencies or branches of U.S. persons or corporations or through L.A. subsidiaries. This, however, is far from being universally true (see the example of Chile in 15), and where the L.A. tax is an operative factor in determining the U.S. tax (see 19), the manner of doing business there may have an indirect tax consequence. The L.A. tax is generally related to the quantum of physical activity being carried on in the taxing area and is most often independent of the nationality of the person or corporation doing the business. On the other hand, the profits returned by the L.A. enterprise to its U.S. parent are usually subject to some additional tax, regardless of whether they are forwarded in the form of dividends by a L.A. subsidiary, or directly by a L.A. branch. (For more detailed discussion see "Taxation of Corporate Profits and Dividends"). In the case of larger foreign industrial enterprises, special tax arrangements may often be reached with the taxing authorities. The L.A. income taxes are normally based on a net income concept, but the definition of net income does not necessarily allow the same deductions as in the U.S. tax law, particularly in the extraction industries. Wherever a L.A. income tax is lower than the U.S. tax (as normally will be the case) the full amount paid in L.A. will usually be creditable (i.e., deductible) from the U.S. tax (see 19). In such a case the level of the L.A. tax will thus become irrevelant to the U.S. investor.	19. Income and excess pr taxes paid or accrued to L.A. countr by the U.S. corporation may be credit against (i.e., deducted from) its U.S. t due. This credit of I.R.C.13 subject to a "per country" and an "o -all" limitation (I.R.C.131(*b*)) and e: ot where (1) the effective tax rate in a .A. country (in terms of the U.S. d ition of net income) is higher than e U.S. rate so as to being the "per c try" limitation of I.R.C.131(*b*)(1) i: play and/or (2) losses have been suf d in foreign business so as to lower proportion of U.S. income available r the credit under the "over-all" lin ion, (I.R.C. 131(*b*)(2)), the whole unt of the L.A. taxes paid or accru can be effectively credited. Where e U.S. corporation has negligible no U.S. income, the limitation of .C.131(*b*)(2) has no practical effect, e regardless of rates or foreign losses entire U.S. tax will be payable with r ct to foreign income and will be ava le for credit purposes. Foreign taxes, to the ent they exceed the limits of I.R.C 1(*b*) may be credited under I.R.C.13 against U.S. excess profits tax, subj again to an analogous limitation as I.R.C.131(*b*) based on the proportion .S. and total excess profits net income. In no case can the exc of uncredited foreign taxes be deduct from *income* under I.R.C.23(*c*), alth h in lieu of any credit at all against , a deduction from *income* for foreig xes may be taken. The two metho however, are mutually exclusive, an the taxpayer must use either one or other for *all* his operations in all f gn countries during the taxable year. The credit is therefor t in all cases a guarantee that L.A. t paid will be deductible from U.S. t iability. No credit can be obtained i e L.A. tax is not an income or exce rofits tax by U.S. standards or if the . tax is levied on income which is in e from U.S. sources under I.R.C.11 and only a partial credit if the L.A. exceeds the U.S. tax because the r is higher or because the L.A. tax is o broader concept of taxable income t the U.S. tax.
B. *An individual proprietorship or partnership of United States citizens or residents.*	2. In the case of U.S. citizens and residents, tax is payable on the total net income from their U.S. and L.A. business activities, together with any other net income of the individual. The L.A. income in the same manner as the U.S. income is fully subject to the progressive tax rates on net income (after exemptions) applicable to U.S. citizens and residents, which tax consists of a flat 3 per cent normal-tax (I.R.C.11), plus a surtax ranging, for years after 31/10/51, from 19.2 per cent on the first $2,000 of surtax net income to 89 per cent on surtax net income over $300,000, (I.R.C.12). The total combined tax may not exceed 88 per cent of net income, (I.R.C.12(*f*)), and there are income-splitting provisions for married persons, (I.R.C.51(*b*)), and for those who are heads of households, (I.R.C.12(*c*)). For years after 31/10/51 the effect of the capital gains tax is the same as in 1. A partnership is not a taxable entity under U.S. tax law and the partners are taxable on their respective shares of the partnership net income as if individually received, regardless of whether there has been an actual distribution to them.	8. Individuals are not subject to excess profits tax.	14. Same rules as 13.	20. Same rules as 19. An an individual resident of the U.S. ma nly take the credit where the foreign try of which he is a citizen or subject ows a similar credit to U.S. citizens iding there, (I.R.C.131(*a*)(3)). [No sident aliens are allowed no tax credit ler I.R.C.131 but are also not taxable their income from L.A. sources.]

ːidends and other distributions of corporate profits

ɜ. Dividends, (I.R.C. (*a*)), from the U.S. corporation to its U.S. citizen or resident shareholders are taxable at the regular rates applicable to ordinary income, regardless of the source of the profits out of which the dividends are paid.

Amounts received in partial or complete liquidation of the U.S. corporation, (I.R.C. 115(*c*)), and which are not essentially equivalent to the distribution of a taxable dividend, (I.R.C.115 (*g*)), are taxed at capital gains rates.

Accumulation of corporate profits

31. Since all the income from L.A. operations becomes income to the U.S. corporation immediately upon its being earned, this income is fully subject to the Code provisions designed to prevent improper corporate accumulations for the purpose of postponement of distribution of earnings and the resulting surtax on shareholders. The foreign income thus is treated identically to U.S. income, and is equally subject to the penalty surtax of I.R.C. 102 where there are such improperly retained earnings as to make I.R.C. 102 applicable.

Since as a premise the U.S. company is an operating company, it will not be subject to the personal holding company surtax of I.R.C.500 *et seq.*

32. Accumulation of surplus problems does not apply to individuals doing business directly and not through the corporate form.

Consolidated returns

37. Consolidated return provisions, (I.R.C.141), do not apply to other than U.S. corporations with includible U.S. subsidiaries forming part of an affiliated group. While subject to very elaborate regulations, (Regulation 129), the general effect of a consolidated return is to allow a U.S. parent of subsidiaries controlled through 95 per cent stock ownership, or subsidiaries of subsidiaries, to combine the income and deductions of the group (disregarding intercompany transactions) toward a single consolidated net income subject to tax.

There is an additional 2 per cent tax on the consolidated corporation net income as the "price" for making a consolidated return, (I.R.C.141 (*c*), and all qualifying includible subsidiaries *must* join in the return, (I.R.C.141(*a*)).

38. Individuals cannot file consolidated returns.

Incorporation

43. Where assets which have appreciated in value since their acquisition are exchanged for corporate securities in an incorporation, taxable capital gain will result on the appreciated value unless the incorporation is made tax free under I.R.C.112(*b*)(5). The place where the corporation plans to do business is irrelevant to whether or not the incorporation is tax-free, i.e., gives rise to non-"recognized" capital gain, and here the problems of incorporation are the same as for any other domestic U.S. incorporation.

Examples
Statement of fact for all examples (see above 49)

Income:
$100,000 from U.S. sources
$100,000 from all L.A. sources

Taxpayers:
U.S. corporation (P)
1 shareholder (married) (X)
Excess profits credit of $150,000

Latin American Subsidiary (S)
Wholly owned by U.S. corporation in 51
Wholly owned by shareholder in 52

W.H.T.C.
Wholly owned by U.S. corporation in 53
Wholly owned by shareholder in 54

Taxes:
U.S. tax at 1952 rates
L.A. tax on the business—$40,000
L.A. tax on dividends from L.A. subsidiary—zero or fully creditable under I.R.C.131(*a*)

Problem: Income after taxes in the hands of the married shareholder (or individual proprietor in 50), assuming immediate dividends, and assuming the dividends (or income in 50) constitute surtax net income, and the only surtax net income of the shareholder (or individual proprietor in 50).

Figure with asterisk denotes in each example the final income of X after payment of taxes.

49.		$
Income of P		200,000
L.A. tax on P		40,000
U.S. tax on P:		
Tentative income tax	98,500	
(less) Foreign tax credit	40,000	
	58,500	
Excess Profits Tax	15,000	
	73,500	73,500
Total taxes on P		113,500
Income of P after taxes:		
Corporation income	200,000	
(less) Taxes	113,500	
	86,500	86,500
Dividend from P to X		86,500
U.S. tax on X (joint return)		47,752
Income of X after taxes		38,748+

50.		$
(*a*) *Income of X:*		200,000
L.A. tax on X:		40,000
U.S. tax on X (joint return):		
Tentative income tax	140,432	
(less) Foreign tax credit	40,000	
	100,432	100,432
Total taxes on X:		140,432
Income of X after taxes:		
Income of X	200,000	
(*less*) Taxes	140,432	
	59,568	59,568+

(*b*) If U.S. business is done through P corporation and L.A. business through individual proprietorship. (This is a combination of methods B and D):

Income of X:	$	$
Dividend from P to X (see 52)	53,500	
Income from L.A.	100,000	
	153,500	153,500
L.A. tax on X		40,000
U.S. tax on X (joint return):		
Tentative income tax	100,438	
(*less*) Foreign tax credit	40,000	
	60,438	60,438
Total taxes on X		100,438
Income of X after taxes:		
Income of X	153,500	
(*less*) Taxes	100,438	
	53,062	53,062+

Comparati

Tax results of different m ods of doing

SHEET 2

Method of doing business in Latin America	*U.S. normal tax and surtax: scope, effect and taxable income*	*U.S. Excess Profits Tax (under present law, the Excess Profits Tax will not be levied on profits earned after 30 June 1953)*	*Latin-American tax*	*Foreign tax credit of C.131*
C. *A foreign corporation the stock of which is owned by a United States corporation.*	3. A L.A. subsidiary is a foreign corporation in the meaning of United States tax law. To the extent the parent corporation receives a taxable distribution (as in 27) the rates are as in 1. The U.S. parent corporation has a credit, based on dividends received, for taxes paid by its L.A. subsidiary (see 21). Assuming the L.A. tax rate is lower than the U.S. tax rate, a L.A. subsidiary offers two tax advantages for an investor: postponement of U.S. tax until distribution of earnings, and, through the mechanics of the credit for a subsidiary's taxes, a lower rate of combined U.S. and L.A. taxes than would be imposed on an equal amount of branch profits (see 21). Postponement of tax is impossible (except in blocked income situations) when operations are conducted through a branch (see 1). On the other hand, since losses cannot be distributed to the U.S. parent corporation by the subsidiary, (except in so far as on liquidation accumulated losses may be taken by the U.S. parent as a capital loss), current operating losses of the L.A. subsidiary cannot be set off against the other income of the U.S. parent. This privilege conversely is open to a U.S. corporation (as in 1) operating through a branch, or to a U.S. corporation operating through a U.S. subsidiary which in turn operates through a L.A. branch (as in 5) and where a consolidated return can be filed. A foreign subsidiary is fully subject to the rules of I.R.C.45, which may result in allocation of L.A. subsidiary income to the U.S. parent corporation, where there have been dealings not at arms length and the creation of an artificial shift of income outside the U.S. A L.A. subsidiary will itself be subject to U.S. tax only on such of its income as is the nature of "fixed or determinable, annual or periodical gains, profits and income" (I.R.C.144), like dividends, interest, rents and management fees. On the other hand, profits from business transactions, such as sales to the U.S. by a L.A. subsidiary which is not engaged in trade or business in the U.S., will not subject it to U.S. income tax. This is an advantage of a L.A. subsidiary over a WHTC which may lose its status by receiving such income from U.S. sources as would not be subject to U.S. tax when earned by a L.A. subsidiary. The distributions of the U.S. parent to its individual shareholders are taxable in the same manner as in 1 and 2. No U.S. tax is due by the parent U.S. corporation until there is an actual distribution to it of profits by the subsidiary (I.R.C.115). Thus, in so far as the U.S. tax is concerned, the time of the earning of the L.A. income by the L.A. subsidiary is immaterial.	9. The L.A. subsidiary is not subject to U.S. excess profits tax if it is not engaged in trade or business in the U.S. If it is so engaged, the U.S. excess profits tax is imposed only on its U.S. income. The distributions of the subsidiary to the parent U.S. corporation are not subject to excess profits tax in the hands of the parent, since dividends and assimilated distributions do not form part of excess profits net income (I.R.C.433 (a)(1)(A)). The U.S. parent is taxable on its own direct business income as in 7. Notwithstanding the excess profits tax exemption of the L.A. subsidiary's dividends in the hands of the U.S. parent, the use of a L.A. subsidiary rather than a branch may nevertheless actually increase the excess profits tax liability of the U.S. parent company. This is because the invested capital or base period earnings of the subsidiary cannot be included in computing the excess profits tax credit (i.e., exempt normal earnings) of the parent. In each instance the advantage of taxability plus credit (branch) as compared to no taxability plus no credit (subsidiary) will depend, in the final analysis, uniquely on the facts.	15. Same rules as 13. Where it is desirable to incorporate in a place other than that in which business is being done, the technical incorporation can most advantageously be effected in a country which does tax corporations strictly on a source basis. The amount of earnings of a L.A. subsidiary available for reinvestment is determined by what is taken by the L.A. rate of tax whereas in the case of branches or WHTC it is determined by the higher of the U.S. or L.A. rate. Accordingly, L.A. subsidiaries will often be advantageous to U.S. corporations which intend to expand L.A. operations by the reinvestment of profits. The dividend or other distribution from the L.A. subsidiary to its shareholder(s) will itself often be subject to a L.A. tax withheld at the source, and even though the combined *rates* of corporate and withholding tax are no higher than if operations were conducted through a branch (as in 13), the overall *tax* may be lower. Thus, for example, in Chile income of a branch is taxed at 25 per cent, income of a Chilean corporation at 10 per cent and dividends at 15 per cent. Since a corporation can only declare dividends out of income that remains *after* taxes, the overall tax bill is 1.5 per cent (15 per cent of 10 per cent) less than if the same operations were carried on through a branch. In other L.A. countries, however, e.g., Peru, the income tax on subsidiaries and branches, and the withholding tax on dividends and branch remittances abroad, are at the same rate, thus eliminating any comparative tax benefits in this respect to either form of doing business, except in so far as the subsidiary by postponing dividends, and thereby U.S. tax liability, has a larger share of profits available for operations and may therefore, *inter alia*, be able to take advantage of provisions like that in Ecuador where 25 per cent of reinvested profits are exempt from tax.	21. The U.S. parent co ration is entitled to a credit not on for taxes paid to a L.A. country by ! f, (I.R.C.131 (*a*)), but also for taxes id by its L.A. subsidiary, (I.R.C.131(*f* + The taking of these credits effecti ; depends in both cases on the recei by the parent of a distribution from s subsidiary, as otherwise it will have income from the L.A. country levying e tax, and the "per country" limitati of I.R.C.131 (*b*)(1) will bar any allow e credit. The rationale for this approa n the case of a L.A. subsidiary is the he income is only taxable to the U.S rent upon a distribution to it by the bsidiary, and therefore the problem : the credit of I.R.C.131 (contrary to ! is one which will arise only when suc istribution is made, regardless of whe e subsidiary earned the income. The credits extend to taxes levied on the distribution itself. for instance, a L.A. tax on dividends foreign (i.e., here, U.S.) corporations, thheld at the source, (I.R.C.131(*a*)), (2) income and excess profits taxes d directly by the foreign subsidiary (o 50 per cent owned foreign subsidiarie f the foreign subsidiary) to countries ter than the U.S., (I.R.C.131(*f*)). The action of the subsidiary's tax which ir ich case can be credited is that amo of the tax which corresponds to the action of the subsidiary's total incom before taxes which is distributed to U.S. parent in dividends, (*not* any ot form of distribution). Provided L.A. income t rates are less than the U.S. rate, the 31(*f*) credit operates to tax income om an L.A. subsidiary to the U.S. poration at lower rates than if the sar income were earned by a branch. The amount of increased return is the for i tax multiplied by the difference be en the U.S. income tax rate and th .A. income tax rate. The combination of t credits in (1) and (2) is subject to th the "per country" and "over-all" mitation of I.R.C.131(*b*) outlined in , with the effect there set out. Since I.R.C.131 (*f*) credit is based on divi ds from the foreign subsidiary, and s e dividends are considered as income om foreign sources (provided the idiary has less than 50 per cent inc from U.S. sources under I.R.C.119(2)(B)), the full dividends received will termine the measure of the credit lin tion, while in the case of the foreig ranch only that part of the income re ved from it will be so available whic s not considered as derived from th .S. Similarly under I.R.C.131(*f*) credit is available whenever the ta income of the foreign subsidiary is p out in the form of dividends, while i he case of the branch, foreign taxes m be credited only on foreign income re ed (or accrued, I.R.C.131(*d*)), (see tion II(6) (iv)), in the same year in hich they were paid. The alternative to the I.R .131 credit of a deduction from income der I.R.C. 23(c), (see 19), is *not* grant n the case of taxes paid by foreign *sub aries*. Any excess credit barred the limitation of I.R.C.131(*b*) *cannot* sed under I.R.C.131(*j*) against exces rofits tax liability of the U.S. paren since (assuming no foreign income o r than the foreign subsidiary distrib ns which themselves do not const te excess profits income, see 9) the f gn excess profits net income numer r of the I.R.C.131(*j*) limitation fract (and consequently the fraction and allowable credit itself) will be zero. + (The term "subsidia is used here for convenience, alth h, since 1951, a 10 per cent stock ership is sufficient to allow the cre of I.R.C. 131(*f*)).
D. *A foreign corporation the stock of which is owned by United States citizens or residents.*	4. Same as 3. There is no tax on the individual shareholders of the L.A. subsidiary until there is a taxable distribution to them by the subsidiary. To the extent the individual shareholders receive such a taxable distribution, (as in 28), the rates are as in 2.	10. Same rules as 8 and 9. Neither the individual shareholders nor the L.A. subsidiary are subject to excess profits tax.	16. Same rules as 13 and 15. The amount of earnings available for dividends is determined exclusively by the L.A. income tax rate. Therefore, if the L.A. rate is lower than the WHTC rate, shareholders can receive greater returns from an L.A. corporation.	22. The shareholders, unde .R.C.131, are entitled to a credit for ign taxes to the extent these are lev on *them* with respect to the distrib ns from their L.A. corporation, (the t in 21(1) above), subject to the "p country" and "over-all" limitation o .R.C.131 (*b*), and, in the case of re nt alien shareholders, to the recipro requirement noted in 20. If levied the corporation by reason of the ribution, no credit is permitted. The shareholders are not titled to any credit for L.A. taxes pa by their L.A. corporation, regardless whether

Dividends and other distributions of corporate profits

27. Dividends from the L.A. subsidiary to the U.S. parent corporation are fully taxable while dividends from U.S. subsidiaries (which have already paid U.S. company income tax) are includible in the U.S. parent's income only with deduction of an 85 per cent credit (I.R.C.26(*b*) see 29). This advantage of doing business in L.A. through a U.S. rather than an L.A. subsidiary is offset by the fact that the U.S. parent has a credit for the foreign taxes paid by its foreign subsidiary (I.R.C.131 (*f*)), (see 21), but would have none for the foreign taxes paid by a U.S. subsidiary, (see 23).

Technically, I.R.C. 112(*i*) provides for the possibility of a tax free liquidation of a foreign subsidiary under I.R.C. 112(*b*)(6) thus eliminating any tax on the transfer of a subsidiary's corporate surplus to the U.S. parent corporation provided the Commissioner has ruled in advance that the liquidation is not undertaken for the principal purpose of tax avoidance. The obtaining of such a ruling has not been found to offer a very practical possibility so that a capital gains tax will be paid on profits from the liquidation of a L.A. subsidiary. The tax credit of I.R.C.131 (*f*) is barred to the U.S. parent on liquidation since this credit is based on "dividends" received and a liquidation distribution is deemed to be a payment for an exchange and not a dividend. Thus credit would be allowed only for foreign taxes on the distribution itself, (the tax of 21(1), and not for foreign corporate taxes under I.R.C.131 (*f*), (the tax of 21 (2)). For liquidation to be beneficial, therefore, the combined U.S. tax on the capital gain plus the L.A. tax must be lower than the U.S. tax on the same amount distributed as a dividend lowered by the credit of I.R.C.131(*f*). Where the L.A. subsidiary has losses, however, these are available to the U.S. parent upon liquidation, but as capital losses and not as ordinary business losses.

Dividends from the U.S. parent corporation to its shareholders are taxed as in 25.

Accumulation of corporate profits

33. Since income from the L.A. operations does not become income to the U.S. parent corporation until distributed to it by the L.A. subsidiary, (see 3), the U.S. parent is immune from the I.R.C.102 penalty surtax on the improper accumulations by the foreign subsidiary. Upon distribution, however, the U.S. parent may not itself improperly accumulate these earnings.

Moreover, if the U.S. parent is a closely held corporation which has not other sufficient direct business operations to bring it outside the definition of a personal holding company, (I.R.C.501), the dividends received from the L.A. subsidiary may make it liable to the personal holding company surtax on undistributed income (I.R.C.500).

The L.A. subsidiary is, on the whole, immune from the I.R.C. 102 surtax, which is only imposed on *U.S.* income of foreign corporations, although the whole of its distributions of income from *both* U.S. and foreign sources would be subject to U.S. surtax in the hands of its U.S. shareholders.

Due to the technical peculiarities of I.R.C. 500 *et seq.* and I.R.C. 27, foreign operating subsidiaries of closely held U.S. parent corporations may be subject to the personal holding company surtax on such *U.S.* income as is non-operating income, regardless of whether or not such income is distributed to their parent. In such cases, even U.S. capital gains which are normally not taxable to foreign corporations with no U.S. business, (I.R.C.231 (*a*)), will become subject to the high surtax rates provided in I.R.C. 500 *et seq.*

Since as a premise the L.A. subsidiary is an operating company, its L.A. income will not be subject to the foreign personal holding company provisions of I.R.C.331 *et seq.*

Consolidated returns

39. Foreign subsidiaries (except in certain limited instances in I.R.C. 141(*g*) not applicable here) cannot form part of an affiliated group, (I.R.C.141(*d*), filing a consolidated return.

Incorporation

45. Same problem as in 43 but with two added difficulties with respect to the incorporation of the L.A. subsidiary. Notwithstanding compliance with I.R.C. 112(*b*) (5), a capital gain derived from the exchange of appreciated assets for stock on the occasion of the incorporation of a foreign corporation will be "recognized," i.e., will be taxable, unless prior to the exchange the Commissioner has been convinced, in accordance with I.R.C.112(*i*), that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of U.S. income taxes.

Similarly where the transfer in incorporation is of stock or securities as paid-up surplus or as a contribution to capital, and prior to the exchange the Commissioner has not been convinced as above, gain on the exchange (the appreciation in value of the stock or securities from acquisition to exchange) will be subject, under I.R.C. 1250, to a 27½ per cent excise tax, besides the regular tax on the "recognized" gain.

The Commissioner's power under I.R.C.129 to disallow or allocate deductions and income when there are acquisitions made to evade or avoid income or excess profits tax is at least technically applicable to acquisitions involving foreign corporations, but the intent of this section would seem to indicate a limited actual application.

Examples
Statement of fact for all examples (see above 49)

51.

		$
Income of S:		100,000
L.A. tax on S:		40,000
Income of S after taxes		60,000
Income of P:		
Dividend from S to P	60,000	
Income from U.S.	100,000	
	160,000	160,000
U.S. tax on P:		
Tentative income tax	77,700	
(less) Foreign tax credit[i]	24,000	
	53,700	
Excess Profits Tax [ii]	—	
	53,700	53,700
Income of P after taxes		106,300
Dividend from P to X		106,300
U.S. tax on X (joint return)		62,684
Income of X after taxes		43,616

[i] Credit under I.R.C.131(*f*) $\frac{60,000}{100,000} \times 40,0$

[ii] Dividend from S does not form part of e cess profits net income; therefore, assumed exce profits credit of $150,000 results in no Exce Profits Tax.

Dividends and other distributions of corporate profits

28. The dividends from the L.A. corporation (in the same way as dividends from the U.S. corporation) are taxable at regular rates to the U.S. citizen and resident shareholders.

Amounts received in partial or complete liquidation (I.R.C.115 (*c*)), and equivalent to distribution of a taxable dividend, (I.R.C.115(*g*)), are taxed at capital gains rates (as in 25).

Accumulation of corporate profits

34. Same rule as 32 in so far as the individual shareholders are concerned.

The U.S. corporation is subject to I.R.C. 102 as in 31, but being an operating company will not be liable to the personal holding company surtax of I.R.C. 500 *et seq.* The L.A. corporation to the extent noted in 33 may be subject to I.R.C.500 *et seq.* on its U.S. income

Consolidated returns

40. Since neither (1) foreign corporations, (I.R.C.141(*e*)), (see 39), nor (2) corporations not related through the subsidiary method of control, (I.R.C.141(*d*)), (see 42), can file consolidated returns, clearly no consolidated return is available here.

Incorporation

46. Same rules as 45.

Examples

52.

		$
Income of S after taxes (see 51)		60,000
Income of P		100,000
U.S. taxes on P		46,500
Income of P after taxes		53,500
Income of X:		
Dividend from S to X	60,000	
Dividend from P to X	53,500	
	113,500	113,500
U.S. tax on X (joint return)		67,950
Income of X after taxes		45,550

Dividends and other distributions of corporate profits	*Accumulation of corporate profits*	*Consolidated returns*	*Incorporation*
29. Dividends from the W.H.T.C. to its U.S. parent corporation, like all other dividends received by a U.S. corporation, are entitled to the 85 per cent credit of I.R.C.26(*b*) (1) and therefore bear an effective 7.8 per cent rate in the hands of the parent. A tax free complete liquidation may be effected under I.R.C. 112(*b*)(6) or, if this is unavailable, a partial or complete liquidation at capital gains rates may be achieved under I.R.C.115(*c*). Since the U.S. parent has no foreign tax credit under I.R.C. 131(*f*) for the foreign taxes of its W.H.T.C. (see 23), the problems attendant thereto (outlined in 27) do not prevail here. A L.A. tax on the liquidation could be neither deducted nor credited if a tax free liquidation is effected. Dividends from the U.S. parent corporation to its shareholders are taxed as in 25.	35. Same rule as 31, *and to the extent the* W.H.T.C. improperly accumulates surplus which it does not distribute to its U.S. parent, it will be subject to I.R.C.102. The requirement of I.R.C. 109 that it derive 90 per cent of its income from active business prevents a W.H.T.C. from being classified as a personal holding company under I.R.C. 501. The U.S. parent must in turn distribute to its individual shareholders the earnings received from its W.H.T.C. or pay a penalty tax on such part of these earnings as are found to be improperly accumulated in violation of I.R.C.102, (or held by a U.S. parent considered as a personal holding company).	41. A W.H.T.C. may form part of an affiliated group filing a consolidated return, but, contrary to the general rule, a W.H.T.C. even though it may consent to be an includible corporation, is not required to join in a consolidated return being made by its U.S. parent and one or more other W.H.T.C. or ordinary includible subsidiaries. Once it has filed, however, (or had not withdrawn its election to consent to a consolidated return by 18 January 1952) a W.H.T.C. must continue to join in any consolidated return of its affiliated group, (I.R.C.141(*e*)(7)). The 2 per cent additional tax (the "price" for making a consolidated return, (see 37) does not apply to that part of the consolidated corporation surtax net income which belongs to the W.H.T.C., (I.R.C. 141(*c*)). Where a W.H.T.C. files as part of a consolidated return it loses its exemption from excess profits tax, (I.R.C.454).	47. Same rules as 43. The added difficulties outlined in 45 apply only to the incorporation of foreign corporations, since by definition I.R.C.112(*i*) and I.R.C. 1250 do not apply to domestic U.S. corporations, and the Commissioner has ruled that I.R.C.129 does not apply to W.H.T.C.
30. Same rules as 25 except that, as compared to 29, the procedure here avoids the 7.8 per cent tax on intercorporate dividends.	36. Same rule as 35 only here W.H.T.C. must distribute the surplus directly to its individual shareholders, who have no problems of their own relating to accumulation of surplus for the reasons set out in 32. The rules on the U.S. corporation carrying on the U.S. business are as in 31.	42. Same rule as 37. The fact that two or more U.S. corporations are owned by the same shareholders does not allow them to join in a consolidated return which is limited to corporations under the subsidiary method of control. Coordinately owned corporations do not constitute an affiliated group under I.R.C.141(*d*).	48. Same rules as 47.

Examples
Statement of fact for all examples (see above 49)

53.

		$
Income of W.H.T.C.		100,000
L.A. tax on W.H.T.C.		40,000
U.S. tax on W.H.T.C.:		
Tentative income tax	35,800	
Foreign tax credit [i]	35,800	
	—	
Excess Profits Tax [ii]	—	
	—	—
Income of W.H.T.C. after taxes:		60,000
Income of P:		
Dividend from W.H.T.C. to P	60,000	
85 per cent credit of I.R.C.26(*b*)	51,000	
	9,000	9,000
Income from U.S. business	100,000	
Income subject to U.S.tax	109,000	
Income credited under I.R.C.26(*b*)	51,000	
	160,000	160,000
U.S. tax on P:		
Income tax	51,180	
Excess Profits Tax	—	51,180
Income of P after taxes		108,820
Dividend from P to X		108,820
U.S. tax on X (joint return):		64,624
Income of X after taxes		44,196

[i] Limit of I.R.C.131(*b*).

[ii] No EPT on W.H.T.C. where no consolidate return is filed.

54.

		$
Income of W.H.T.C. after taxes (as in 53)		60,000
Income of P after taxes (as in 52)		53,500
Income of X:		
Dividend from W.H.T.C. to X	60,000	
Dividend from P to X	53,500	
	113,500	113,500
U.S. tax on X (joint return) (as in 52).		67,950
Income of X after taxes (as in 52):		45,550+

SHEET 3

Method of doing business in Latin America	*U.S. normal tax and surtax: scope, effect and taxable income*	*U.S. Excess Profits Tax (under present law, the Excess Profits Tax will not be levied on profits earned after 30 June 1953)*	*Latin-American tax*	*Foreign tax credit of .C.131*
E. *A Western Hemisphere Trade Corporation the stock of which is owned by a United States corporation.* To qualify as a Western Hemisphere Trade Corporation (W.H.T.C.), a corporation must be incorporated in the U.S. or its territories and must meet all of the following tests (I.R.C. 109): (*a*) its entire business must be carried on within the geographical limits of North, Central or South America, the West Indies, or Newfoundland; and (*b*) at least 95 per cent of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such part of such period as the corporation was in existence) must be derived from sources without the U.S.; and (*c*) at least 90 per cent of its gross income for such period or such part thereof must be derived from the active conduct of a trade or business.	5. Tax is payable in the case of all the corporations on all their respective net income as in 1. Under I.R.C.26(*i*) W.H.T.C.'s receive a tax free credit on their net income, so that their maximum effective over-all rate of tax approaches 38 per cent To the extent the distribution from the W.H.T.C.'s to its U.S. parent corporation constitutes a taxable dividend, (I.R.C. 115(*a*)), the 85 per cent tax free credit of I.R.C.26(*b*) (1) applies, so that the dividend is subject to an effective 7.8 per cent tax in the hands of the parent. Therefore, the net tax to the U.S. parent is about 42.84 per cent of foreign earnings (38 per cent W.H.T.C. tax plus 4.84 per cent intercorporate dividends tax (7.8 per cent x 62 per cent)). The distributions of the U.S. parent to its individual shareholders are taxable as in 1 and 2. The W.H.T.C. privilege extends to carrying on all forms of business in L.A. In practice, the W.H.T.C. procedure is now used chiefly by U.S. exporters whose L.A. tax (and consequent tax credit under I.R.C.131) is normally small. Because of U.S. tax rules, (I.R.C.119), which split income from sales abroad of goods produced by the vendor in the U.S. into U.S. and foreign income (I.R.C.119(*e*)), U.S. producing corporations must assign their selling activities to W.H.T.C. subsidiaries (as in E) or affiliates (as in F) in order to comply with I.R.C.109. With respect to the netting of the income from L.A., if all operations are done directly through branches of a U.S. corporation, as in 1, the losses are completely applicable and deductible from the other income of the corporation, whereas if the business is done through one or more W.H.T.C.'s, losses sustained in some or all of them cannot be offset against the incomes of others or against the income of the parent U.S. corporation, unless a consolidated return is used, (I.R.C.141). Operating losses, however, benefit from a one year carry-back and a five year carry-over, (I.R.C. 122). Due to the foreign tax credit, (I.R.C. 131), (see 23), the advantages of the reduced W.H.T.C. rates diminish in importance to the extent the L.A. effective tax rates exceed the reduced W.H.T.C. rates, and approach the normal U.S. corporate rates, since to that extent the normal U.S. rate would not be payable anyway, being absorbed by the tax credit for the higher L.A. tax. The major disadvantage of doing business through W.H.T.C. is the difficulty of qualifying the corporation as a W.H.T.C., (I.R.C.109), and the uncertainty of being able to have it maintain that status from year to year. The difficulty of establishing sales giving rise to non-U.S. income is considerable, (I.R.C. 119(*e*)), and the very limited 5 per cent U.S. income allowance is an extremely narrow margin on which to meet the unforeseen exigencies of an operating business. Beyond this, the sales of the U.S. producing parent to the selling W.H.T.C. will clearly be subject to the Commissioner's power of reallocation of profits between parent and W.H.T.C., in accordance with standards of independent dealings between them, (I.R.C. 45). Should this result in a sizable decrease in the W.H.T.C.'s recognized profits, the practical final result might well be such as to more than offset the ostensible benefits of the W.H.T.C. procedure.	11. A W.H.T.C. is not subject to excess profits tax unless it joins in a consolidated return, (I.R.C.454(*f*)), (see 41). Dividends from the W.H.T.C. to its U.S. parent corporation are also not subject to excess profits tax in the hands of the parent, since dividends do not constitute excess profits income (see 9). The exemption of the W.H.T.C. from excess profits tax makes its position in this respect identical to a foreign subsidiary, and therefore the reasoning in 9 applies equally here with respect to the *actual* advantage to the U.S. parent corporation of this exemption. The U.S. parent is liable on its own direct business income as in 7.	17. Same rules as 13. Taxes on repatriation of profits by a branch of the W.H.T.C. or by the W.H.T.C. to the U.S. corporation adversely affect the U.S. tax rate advantage granted W.H.T.C. If a tax is imposed on branch repatriation, the effective L.A. tax may exceed the W.H.T.C. tax. No credit for the excess may be taken by the U.S. corporation since the section 131(*f*) credit is limited to dividends of a foreign subsidiary (see 21). A tax on the W.H.T.C.'s dividends to the U.S. corporation will only partially be credited since the dividends received credit reduces the net income from foreign sources to 15 per cent of the W.H.T.C. dividend. The maximum amount available for credit would, therefore, be the 7.8 per cent intercorporate dividends tax.	23. Same rules as 19. S e by definition a W.H.T.C. is limited ı maximum of 5 per cent of U.S. incor the foreign net income figure will norı .y approximate or equal the total net i ıme figure and will therefore practice eliminate the *limitation of I.R.C.13 (2).* Where a L.A. tax is n effective rate greater than the W Γ.C's reduced U.S. tax, I.R.C.131(*b*)(effectively limits the creditable am t of tax from that country to an am :t calculated at the U.S. rate. The U.S. parent is entitled to any credit for the foreign :es paid by its W.H.T.C. subsidiary, I.R.C.131(*f*) applies only to *foreign* sidiaries.
F. *A Western Hemisphere Trade Corporation the stock of which is owned by United States citizens or residents.*	6. The tax on the W.H.T.C. is the same as in 5, and the distributions of the W.H.T.C. to its individual U.S. citizen or resident shareholders are taxable as are the corporate distributions in 1. [Non-resident aliens and/or foreign corporations can be the shareholders of a W.H.T.C., (I.R.C.109), the only requirement being that the W.H.T.C. itself be a U.S. corporation. These shareholders have an advantage over U.S. citizen or resident shareholders in that their dividends are not subject to tax, since W.H.T.C. dividends do not constitute income from U.S. sources under I.R.C.119(*a*)(2)(A). Since dividends from a U.S. corporation (as in 1) doing, *inter alia*, business in L.A. will often constitute taxable income from U.S. sources, it is apparent that non-resident aliens who wish to join with U.S. shareholders in doing L.A. business will normally be better served by the use of a W.H.T.C. than by joining in an	12. Same rules as 8 and 11. Only when the W.H.T.C. joins in a consolidated return is it liable to excess profits tax, (I.R.C.454 (*f*)). Individuals are never liable for this tax. The U.S. parent corporation is liable on its own direct business income as in 7.	18. Same rules as 13, but see also 24.	24. Same rules as 23. ıe shareholders of the W.H.T.C. cann ake a credit for any foreign taxes paid the W.H.T.C., as I.R.C.131(*f*) applie nly to U.S. *corporations* and *foreign su liaries.* However, a foreign on repatriation of profits imposed the W.H.T.C. shareholders may be f credited since the entire dividend is able income to the individual shareh er, in contrast to only 15 per cent in case of a corporate shareholder.