Vanderbilt Law Review

Volume 16
Issue 1 *Issue 1 - December 1962*

Article 1

12-1962

The Western Hemisphere Trade Corporation:A Functional Perspective

Leo J. Raskind

VANDERBILT LAW REVIEW

VOLUME 16 DECEMBER, 1962 NUMBER 1

The Western Hemisphere Trade Corporation: A Functional Perspective*

*Leo J. Raskind***

Professor Raskind analyzes the Western Hemisphere Trade Corporation in the context of subchapter N of the Internal Revenue Code, as amended in 1962.

I. INTRODUCTION

Among the statutory forms available for the conduct of foreign operations the Western Hemisphere Trade Corporation, traditionally the Cinderella of the Internal Revenue Code, has been reoriented by the new provisions of the Revenue Act of 1962.[1] Unlike its storybook counterpart, however, the Western Hemisphere Trade Corporation does not emerge in a state of new magnificence. The new act, by curtailing, but not eliminating, the deferral of taxation on earnings retained abroad by United States controlled foreign subsidiaries, has initiated a process of review and of reorganization of the tax planning of foreign operations. Since the new statutory provisions affect existing foreign sales and service subsidiaries, operated through "base companies" and "tax havens," many foreign subsidiaries of United States corporations will be realigned, if not entirely eliminated.[2] Yet

*In revised form, this article will form a chapter in a forthcoming treatise on the United States taxation of foreign income to be published by Little, Brown & Co.

**Associate Professor of Law, Vanderbilt University.

1. INT. REV. CODE OF 1954, §§ 951-64, 970-72, as amended, Pub. L. No. 87-834, 87th Cong., 2d Sess., 76 Stat. 1006, 1027 (Oct. 16, 1962). See also S. REP. No. 1881, 87th Cong., 2d Sess. 78-94, 237-79 (1962).

2. Brudno, *Tax Considerations in Selecting a Form of Foreign Business Organization*, 13 VAND. L. REV. 151 (1959); Chommie, *Tax Planning The Foreign Investment: A Survey of the Jurisdictional Pattern*, 15 U. MIAMI L. REV. 361-68 (1961).

The so-called tax haven or base company operations describe the use of corportations domesticated under the laws of a foreign country that either imposes no income tax or taxes at a very low effective rate. Ordinarily the statutes of such countries exempt the earnings of their domestic corporations from tax on their foreign income. Such base companies may operate as a holding company or may provide managerial an increase in the use of the Western Hemisphere Trade Corporation is unlikely to result. Rather, the immediate consequence of the new provisions will be a re-examination of the benefits of the older forms as against new alternatives. An assessment of the Western Hemisphere Trade Corporation as a vehicle for the conduct of foreign trade is thus appropriate.

Prior to the new Revenue Act, the usual process of comparative selection which accompanied the choice of form in which a United States firm would conduct its foreign operations led to the conclusion that the Western Hemisphere Trade Corporation was of limited utility.[3] As a domestic corporation subject to the accumulated earnings tax[4] and the collapsible corporation provisions,[5] its principal, if not its only advantage was the lower applicable United States tax rate.

Aside from its advantageous use in the extraction of natural resources which permits the percentage depletion allowance[6] and the allowable deductions for exploration and intangible expenses,[7] the export trade was the primary activity in which the Trade Corporation was utilized. Ultimately, the choice was made on the basis of the differential arithmetical rate advantage which emerged from a comparison of foreign rates with the effective rate of the Western Hemisphere Trade Corporation considered as a subsidiary. In this computation the Western Hemisphere Trade Corporation would, by virtue of section 922, be taxed on earnings at an effective average rate of 32.5 per cent, taking into account the surtax exemption.[8] An effective foreign tax rate lower than this figure would have the advantage of limiting the tax liability to the foreign rate, if a foreign corporation were used and no dividends were remitted to the United States parent. Moreover, even if foreign tax rates were higher, not all of the excess of foreign taxes paid would be eligible for the foreign tax credit,[9] and unless the incremental intercorporate dividend tax were

services for active operations in other foreign countries. The primary basis of such arrangements is that they afford advantages beyond deferral of tax, but allow in addition to insulation of foreign earnings from United States tax, a limited accumulation without liability under § 531. This may be a material consideration to an undercapitalized venture. Moreover, maximum flexibility in tax planning is achieved outside the purview of the Internal Revenue Service. See Gibbons, Tax Factors In Basing International Business Abroad 20 (1957).

3. Brudno, *supra* note 2, at 177.

4. Int. Rev. Code of 1954, §§ 531-37.

5. Int. Rev. Code of 1954, §§ 341-42.

6. Int. Rev. Code of 1954, §§ 611-14.

7. Int. Rev. Code of 1954, §§ 615-16.

8. Taking taxable income of $100,000, this percentage is computed as follows: 100,000 − (14/52 x 100,000) = 73,076.92. $73,076.92 x 30% + (73,076.92 − 25,000.00) x 22% = $32,500 or 32.5% on the $100,000.

9. Int. Rev. Code of 1954, §§ 901-05.

eliminated by use of the consolidated tax return,[10] an additional tax of 4.05 per cent would have to be added to the effective Western Hemisphere rate.[11] A Western Hemisphere Trade Corporation would offer an advantageous alternative only in those cases where the United States effective rate (plus the incremental increase of the intercorporate dividend tax) was more favorable than the foreign rate.

Although the narrow consideration of lower effective tax rates is the dominant factor in the choice of the Western Hemisphere Trade Corporation as the appropriate form for the conduct of foreign operations, there are some peripheral advantages which are derived from its existence as a domestic corporation. Reference has already been made to the use of the consolidated return as the means of eliminating the additional tax on intercorporate dividends.[12] The privilege of filing a consolidated return is available to the Western Hemisphere Trade Corporation without the added liability of the 2 per cent additional tax ordinarily levied.[13] Moreover, the use of the consolidated return will enable the Trade Corporation to offset its losses against consolidated income of the affiliated group. If, however, the use of the consolidated return is not elected, the net operating loss carryover (and carryback) is available.[14] In addition, the domestic corporation has the advantage of incorporation without the recognition of gain or loss,[15] and of qualification for liquidation of a subsidiary into its parent without the need to obtain a Treasury Ruling, as required of foreign subsidiaries under section 367.[16]

In assessing the utility of the new statutory forms, particularly the Export Trade Corporation, examination and close comparison of the rate and related consequences of the Western Hemisphere Trade Corporation will be necessary.[17] For example, in reviewing the new consequences of a sales operation under an existing foreign subsidiary, it may be determined that some 35 per cent of its gross income will consist of foreign base company income—a component

10. INT. REV. CODE OF 1954, §§ 1501-04.

11. 7.8% x .52% = 4.05%.

12. See note 10 *supra* and accompanying text.

13. INT. REV. CODE OF 1954, § 1503(b); Treas. Reg. § 1.1502-30(b)(1) (1955).

14. INT. REV. CODE OF 1954, § 172. *But see* INT. REV. CODE OF 1954, § 172(d)(5). A resident foreign corporation may claim this deduction only on income from United States sources. INT. REV. CODE OF 1954, § 882(c)(2); Treas. Reg. § 1.882-3(b)(2) (1957).

15. INT. REV. CODE OF 1954, § 351.

16. INT. REV. CODE OF 1954, § 367; Chommie, *Handling Tax Avoidance Exchanges and Transfers Involving Corporations Under Section* 367, P-H TAX IDEAS ¶ 8059 (1960); Whitehill, *Foreign Corporation Exchanges*, 36 TAXES 622 (1958).

17. Some of the basic statutory criteria of the new Export Trade Corporation are virtually identical to those of the Western Hemisphere Trade Corporation. *Compare* INT. REV. CODE OF 1954, § 971(a)(1)(A), as amended, 76 Stat. 1029 (Oct. 16, 1962), *with* INT. REV. CODE OF 1954, § 921.

of sub-part F income which may be includible, pro rata, in the United States shareholder's gross income, even though undistributed.[18] It might then be desirable to decrease the amount of sales made to foreign purchasers by the foreign subsidiary and, instead, to examine the new Export Sales Company or the Western Hemisphere Trade Corporation as the vehicle for minimizing taxes.

There is yet another reason for interest in the Western Hemisphere Trade Corporation. The parallel and identical statutory phrases utilized in the new statute, such as the foreign gross income requirement of selection 971(a) and the determination of "export trade income" will immediately and perhaps ultimately be construed with reference to Western Hemisphere Trade Corporation criteria.[19]

II. Legislative History

It is a basic rule of the Internal Revenue Code that a domestic corporation is taxed on its global income, irrespective of foreign or domestic source. The Western Hemisphere Trade Corporation, as one of the two statutory exceptions to this rule,[20] is treated as a special class of domestic corporation, and is taxed at a lower differential rate of 38 per cent (ignoring the surtax exemption) on its income from qualifying Western Hemisphere countries.[21]

The legislative background of the Western Hemisphere Trade Corporation is brief. In contrast with the extended debates on the undesirable consequences of the "tax haven" operations of United States companies which preceded the 1962 enactments limiting them, the legislative history of the Western Hemisphere Trade Corporation is sparse and perplexing.[22] In their present form, the statutory antecedents of sections 921 and 922 originated in the Revenue Act of 1942.[23] But the concept of differential treatment for certain domestic corporations operating in particular regions can be traced to the Revenue Act of 1921.[24] From 1913 until 1921, domestic corporations were taxed uniformly on their global income without exception. In

18. Int. Rev. Code of 1954, § 951, as amended, 76 Stat. 1006 (Oct. 16, 1962).

19. See note 17 *supra*.

20. The Western Hemisphere Corporation and the Possessions Corporation are two statutory entities afforded preferential tax treatment under like gross income and source requirements. The China Trade Act Corporation does offer a preferential tax rate by means of an additional statutory deduction allowed by Int. Rev. Code of 1954, § 941(a); the basis of qualification, however, is its charter under The China Trade Act of 1922, 42 Stat. 849 (1922), 15 U.S.C. § 144 (1958).

21. Int. Rev. Code of 1954, § 922.

22. *Compare Hearings on H.R. 10650 Before the Committee on Finance,* 87th Cong., 2d Sess. 4449-883, part II (1962), *with* S. Rep. No. 1631, 77th Cong., 2d Sess. (1942), 1942-2 Cum. Bull. 504, 588.

23. Int. Rev. Code of 1939, § 15 as amended, ch. 619, § 105, 56 Stat. 805 (1942). Int. Rev. Code of 1939, § 109.

24. Revenue Act of 1921, ch. 136, § 262, 42 Stat. 271.

1921, apparently in response to complaints from corporations operating in competition with British firms in the Philippines, a provision was written into the revenue bill exempting from United States tax the foreign income of such "foreign traders" where 80 per cent of the "foreign trade corporation's" income was derived from foreign sources.[25] This provision was defeated in the Senate. Although this form of outright exemption was rejected, Congress subsequently adopted a scheme of particular treatment for income from the possessions of the United States.[26] The legislative debates on the treatment of possessions income suggest that no more was intended by these provisions than a system of deferral of taxation on earnings, coupled with a provision treating the repatriation of such earnings as the taxable event. In 1942, this innovation in the treatment of possessions income became the basis of the Western Hemisphere Trade Corporation with sparse debate.[27] The dominant theme of the limited congressional discussion was the amorphous reference to an equalization of tax advantages of foreign competitors. As the Senate Report stated:

> [O]ur American corporations trading in foreign countries within the Western Hemisphere are placed at a considerable disadvantage with corporations organized under the laws of other countries.[28]

The examples of American corporations which were cited in this connection were almost entirely firms having indigenous foreign operations, primarily extractive.[29] Subsequently, the Western Hemisphere Trade Corporation has been widely adopted for the conduct of the export trade. Thus, provisions enacted for the purpose of equalizing the competitive position of United States firms with indigenous operations in the Western Hemisphere have also become the vehicle of favorable tax treatment for exporters.

25. H. REP. No. 486, amendment no. 8, 67th Cong., 1st Sess. 14-15 (1921); H. REP. No. 350, 67th Cong., 1st Sess. 8 (1921); 61 CONG. REC. 5186, 5279-84, 5969-78, 5883-86, 6489-94, 6540-49, 6573-74, 7338-89 (1921). See also Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 831 (1956).

26. Revenue Act of 1921, ch. 136, § 262, 42 Stat. 271; 61 CONG. REC. 7623, 7026 (1921); See INT. REV. CODE OF 1954, §§ 931-33.

27. S. REP. No. 1631, 77th Cong., 2d Sess. 32 (1942); 88 CONG. REC. 7795 (1942).

28. *Ibid.*

29. See Surrey, *supra* note 25, at 836-38. See also Baker & Hightower, *The Western Hemisphere Trade Corporation: A Problem in the Law of Sales*, 22 TUL. L. REV. 229, 237 (1947); Baker & Meek, *Tax Problems of Doing Business Abroad*, 1957 WIS. L. REV. 75; Gordon, *Some Aspects of United States Policy in the Taxation of Foreign Income*, 1959 U. ILL. L.F. 222; Mills, *Doing Business Abroad: Foreign Income*, N.Y.U. 17th INST. ON FED. TAX 473 (1959).

III. QUALIFYING CONDITIONS

In order for a corporation to qualify as a Western Hemisphere Trade Corporation under section 921, it must be a domestic corporation and

(1) derive 90 per cent or more of its gross income from the active conduct of a trade or business.

(2) derive 95 per cent or more of its gross income from sources outside of the United States but with certain designated foreign countries in North, South, or Central America, or the West Indies; all purchases other than incidental purchases must also be within this region.

(3) the above conditions must have pertained for a three-year period ending with the close of the taxable year in which the deduction section 922 is claimed (or for such part of a lesser period during which the corporation was in existence).[30]

There is no requirement that the Western Hemisphere Trade Corporation must be a new entity formed expressly for this purpose. Yet the three-year requirement may make it inconvenient for an existing corporation to meet some of the qualifying conditions. However, a new corporation may qualify if its meets the requirements for a period of less than three years if this shorter period includes its total period of existence. Where qualification is based on the three-year period, the Regulations do not expressly provide that the 95 per cent source of income qualification must be met for each of the three years of the qualifying period. Accordingly, the qualifying conditions may be computed by taking the three-year period as an aggregate.[31] Thus, an existing corporation that seeks qualification can effectively determine the outcome by controlling, where possible, the source of its third year gross income. A statement setting forth this source computation is required to be attached to the tax return of a corporation claiming qualification.[32]

IV. DOMESTIC CORPORATION

The Western Hemisphere Trade Corporation must be a domestic corporation—that is, one created or organized in the United States under the laws of any of its states or territories or the District of Columbia.[33] This basic definition of a domestic corporation has been widened by a ruling that a Canadian or Mexican corporation may qualify as a domestic corporation for purposes of section 921 if the Canadian or Mexican corporation meets two limiting qualifications:

30. INT. REV. CODE OF 1954, § 921.
31. CCH 1962 STAND. FED. TAX REP. ¶ 4347.0115.
32. Treas. Reg. § 1.921-1(c) (1957).
33. INT. REV. CODE OF 1954, §§ 7701(a)(4),(a)(5).

(1) that it is a wholly-owned subsidiary of a United States parent, and (2) that it was formed in the first instance to comply with the laws of either country relating to the holding of title in real property.[34]

V. Qualifying Income

The limiting geographic qualification of the Western Hemisphere Trade Corporation is the requirement of section 921 that "all . . . business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies. . . ."[35] Although neither the Code nor the Regulations offer a list of includible countries for purposes of section 921, a series of rulings have expressly extended the statutory region to include the Virgin Islands, Puerto Rico, the Bahamas, the islands off the shore of Venezuela, all the islands of the West Indies,[36] plus Greenland[37] and Newfoundland.[38] Bermuda and the Falkland Islands are expressly excluded.[39]

The requirement of section 921 that all business be carried on within this geographic region has proved onerous. A single transaction of any consequence would threaten qualification. In order to provide some flexibility in this strict geographic limitation, the 1954 revision of the Code added a parenthetical exception for "incidental purchases."[40] The Regulations interpret the exculpating phrase, "incidental purchases," to mean that if all other requirements are satisfied, Western Hemisphere Trade Corporation status is achieved despite some purchases made outside the statutory geographic region.

Two criteria for determining the dimensions of incidental purchases are provided by the Regnlations:

> (1) the amount of such purchases does not exceed 5 per cent of the taxpayer's gross receipts from all sources;
> (2) even if the 5 per cent limit is exceeded, these purchases in the light of all facts and circumstances are unusual or non-recurring in nature.[41]

It is clear from the language of the Regulations and the construction of this phrase by the courts that "incidental" in this context does not

34. Rev. Rul. 55-372, 1955-1 Cum. Bull. 339.
35. Int. Rev. Code of 1954, § 921.
36. I.T. 3748, 1945 Cum. Bull. 152; I.T. 4067, 1951-2 Cum. Bull. 55; Rev. Rul. 55-105, 1955-1 Cum. Bull. 94.
37. Rev. Rul. 60-307, 1960-2 Cum. Bull. 214.
38. Section 109, Int. Rev. Code of 1939, expressly included Newfoundland. The omission of a specific reference in the successor provision in the 1954 Code, § 921, should not disqualify this Canadian province. Presumably an express reference to Newfoundland is no longer necessary, since it achieved provincial status in 1949.
39. I.T. 3990, 1950-1 Cum. Bull. 57; Rev. Rul. 55-105, 1955-1 Cum. Bull. 94.
40. Int. Rev. Code of 1954, § 921; S. Rep. 1622, 83d Cong., 2d Sess. (1954); Otis Elevator Co. v. United States, 301 F.2d 320 (Ct. Cl. 1962).
41. Treas. Reg. § 1.921-1(a)(1) (1957).

mean incident to the conduct of the business.[42] An example in the Regulations states that a domestic corporation which operated a mine in South America was disqualified by purchases of mining machinery and equipment (in according with its usual practices) from France in an amount in excess of the 5 per cent limit.[43]

However, where the total of all purchases outside of the Western Hemisphere does not exceed 5 per cent of the taxpayer corporation's gross receipts from all sources, all such purchases are effectively "incidental" without further justification.[44] Yet purchases in excess of the limiting 5 per cent need not necessarily disqualify a corporation that would otherwise meet all requirements, if the excess purchases can be characterized as "unusual or non-recurrent."[45] A recent ruling refers to a South American mining operation that would not be disqualified even by a 15 per cent purchase of hydroelectric equipment outside of the Western Hemisphere, because of the non-recurring nature of this purchase.[46] There are, then, two classes of items purchased outside of the Western Hemisphere to be noted: those which are usual and recurring, but which are less than the limiting 5 per cent in amount, and those which exceed the limiting 5 per cent, but which can be justified as unusual and non-recurring. Purchases of inventory, raw materials, and related items cannot be considered unusual in this context.[47] The Tax Court has recently sustained this construction of the language of the Regulations.[48] Safety from disqualification through incidental purchases made outside the hemisphere could be attained by making any borderline purchases through a firm in a qualifying country.

In order to prevent the Western Hemisphere Trade Corporation from being used as a means of receiving passive income from the management of a portfolio of earning assets, section 921 requires that 90 per cent or more of gross income be derived from the active conduct of a trade or business. Since the identification of receipts from the active conduct of trade or business is a fundamental requirement of the Internal Revenue Code, the basic statutory (including Regulations) and judicial criteria developed elsewhere in the Code control the construction of the phrase for purposes of section 921.[49]

A domestic corporation has been denied status as a Western

42. *Ibid.*
43. Treas. Reg. § 1.921-1(b) example 3 (1957).
44. See note 43 *supra.*
45. Rev. Rul. 59-356, 1959-2 Cum. Bull. 177.
46. See note 45 *supra.*
47. Treas. Reg. § 1.921-1(a)(1) (1957).
48. Topps of Canada, Ltd., 36 T.C. 326 (1961).
49. Beck v. Commissioner, 179 F.2d 688 (7th Cir. 1950); Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code,* 49 Yale L.J. 171, 185 (1939); Norton L. Smith, 9 T.C. 1150 (1947).

Hemisphere Trade Corporation under this criterion where it merely held the stock of a Mexican mining corporation and retained contract rights to elect a minority of the directors as well as the right to observe and make suggestions in the operation of the properties.[50] The disqualifying nature of the holding of earning assets is further indicated by two earlier Rulings which stated that the holding of stock and the receipt of dividends from a qualifying country would not constitute active conduct of a trade or business.[51] A subsequent ruling indicates that the receipt of royalties from patent licensing is also not to be considered income from the conduct of a trade or business.[52] Presumably rents and related items would be equally troublesome. The receipt of interest would almost certainly qualify where it was directly related to the active conduct of business as, for example, where interest was received on unpaid and delinquent accounts arising from bona fide sales of merchandise. Similarly, some items of compensation related to royalties might qualify as active rather than passive income. As an example, where technical assistance was rendered under the license, such payments ought not to lose their identity merely because of their link to the payment of royalties. Gain from the sale of capital assets used in a trade or business will almost certaiuly satisfy the active trade or business requirement.[53]

VI. Income Derived from Sources Outside the United States

Perhaps the most important qualifying condition for the Western Hemisphere Trade Corporation is the requirement of section 921 that 95 per cent of the corporation's gross income must be derived from sources outside the United States for the three-year period preceding the close of the taxable year in which qualification is sought.[54] This concept of the source of income as a basis for the exercise of taxing power has a long history dating back to the 12th century practices of English kings in the taxation of foreign merchants within the kingdom.[55] As far as the United States experience in federal income taxation goes, the concept that source of income may be the basis for differential tax treatment has been part of the Revenue Code from

50. Towne Securities Corp. v. Pedrick, 44 Am. Fed. Tax R. 1258 (S.D.N.Y. 1953); Hausserman v. Burnet, 63 F.2d 124 (D.C. Cir. 1933).

51. "Dividends received by a citizen of the United States on stock in a corporation engaged in business in a possession of the United States are not income derived from the active conduct of a trade or business." I.T. 2318, V-2 Cum. Bull. 76 (1926); I.T. 1785, II-2 Cum. Bull. 258 (1923).

52. Rev. Rul. 56-512, 1956-2 Cum. Bull. 173.

53. Rev. Rul. 58-56, 1958-1 Cum. Bull. 355.

54. Int. Rev. Code of 1954, § 921.

55. Borchard, Diplomatic Protection of Aliens Abroad 95-96 (1915); Davies, Law Relating to Aliens 43-44 (1931); 1 Oppenheim, International Law § 317 (8th ed. Lauterpacht 1954).

its inception, although the application of the principle to specific classifications of taxpayers has varied.[56] Even prior to the enactment of the Western Hemisphere Trade Corporation provisions, the Code had developed a particular set of provisions for the determination of the source of income to serve the whole of subchapter N of the Code, which deals exclusively with the taxation of foreign income. These source of income rules accomplish a tripartite classification of gross income items derived from (1) sources within the United States, (2) sources without the United States, and (3) sources partly from within and partly from without the United States.[57] Thus, the determination of the geographic source of qualifying income for purposes of section 921 is made according to these provisions. Although there is no direct statutory reference in these source rules to the Western Hemisphere Trade Corporation, the language of section 861(a) is sufficiently broad to include all source of income questions within the subchapter N.[58] Despite the all-inclusive scope of these source provisions, they are not, however, entirely dispositive of the classification of any item of gross income, since the Commissioner is empowered by section 482 to reallocate income items.[59] Accordingly, the Commissioner could determine the qualification of a domestic corporation as a Western Hemisphere Trade Corporation by reallocating an item between a corporation and its Western Hemisphere subsidiary.

So basic is the source of income to the qualification of a domestic corporation as a Western Hemisphere Trade Corporation, that it is useful to examine the impact of these source rules and of their ancillary judicial and regulatory criteria on particular activities in which a Western Hemisphere corporation is likely to engage.

If the Trade Corporation is to be utilized in the manufacture or production of a commodity designed for sale in the Western Hemisphere, careful management will constantly be required if the corporation is to retain its status under section 921. As the source rules are structured, manufacturing, production, or related activities (such as indicated below), as distinct from the mere purchase of personal property within the United States, will give rise, under section 863(b), to income partly from within and partly from without the United States. Thus, the undertaking of certain processing activities will cause the corporation constantly to verge on disqualification by generating 5 per cent of income from sources within the United States.[60]

56. Revenue Act of 1913, ch. 16, § II(A)(1), 38 Stat. 166; Revenue Act of 1916, ch. 463, § 10, 39 Stat. 765. See also Dailey, *The Concept of the Source of Income*, 15 Tax L. Rev. 415 (1960).

57. Int. Rev. Code of 1954, §§ 861-64.

58. Int. Rev. Code of 1954, § 861(a) provides, in part, "The following items of gross income shall be treated as income from sources within the United States . . . ."

59. Int. Rev. Code of 1954, § 482; Rev. Rul. 15, 1953-1 Cum. Bull. 141.

60. Int. Rev. Code of 1954, § 863(b)(3).

A purchase of manufactured items within the United States which are sold in a qualifying Western Hemisphere country would, however, be governed entirely by section 862(a)(6), and would give rise to income entirely from sources outside of the United States.[61] Purchase and sale would raise no problem of income source like that which arises from production.

Production raises a further factor of uncertainty because of its definitional ambiguity. The elimination of direct manufacturing activities in the interest of insuring qualification may, within the broad definition of manufacturing provided by the Regulations interpreting section 863(b), reintroduce the domestic source income problem. For according to the Regulations, section 1.863-3(a)(2), manufacturing includes creating, fabricating, extracting, curing, and aging.[62] Where such "manufacturing" activity is found, a domestic income component will arise from the sale of the product abroad, and will be determined under the apportionment formulae of the Regulations.[63]

Like the source rules themselves, these regulations are drafted to serve the needs of subchapter N as a whole, and are applicable to the allocation of source of income between domestic and foreign origin for resident and non-resident aliens and foreign corporations, as well as for the production activities of a Western Hemisphere Trade Corporation. There are two methods of computing the amount of domestic source income generated by production activities of the Western Hemisphere Trade Corporation. Couched in terms of taxable income, rather than in the gross income terms of the qualifying condition of section 921, these formulae allocate the domestic income component of domestic manufacturing.

In applying the first formula in gross income terms,[64] there are in turn two alternative computations for allocating or apportioning domestic source income. Where the production or manufacturing activities can be valued by an independent price, such price is the benchmark for allocation. As, for example, where the manufactured or processed product is sold both through an independent distributor and through a sales subsidiary. In such circumstances the allocation or apportionment is computed by use of the independent factory or production price. Where a manufactured product is sold both domestically to independent distributors, and to a qualifying country through a sales subsidiary, the domestic portion of the gross income from final sales abroad would be determined by the ratio of the independent sale price to the total sale price abroad. The Regulations

61. INT. REV. CODE OF 1954, § 862(a)(6).
62. Treas. Reg. § 1.863-3(a)(2) (1957).
63. Treas. Reg. § 1.863-3(b)(2) (1957).
64. Treas. Reg. § 1.863-3(b)(2) example 1 (1957).

allow this same method of computation to be used even where there is no independent channel of distribution for the product, if the equivalent valuation of the production or manufacturing activities can be made by a proof of cost items, including profit, that passes muster with the district director, or the Director of International Operations.[65]

Where it is not possible to base the allocation of domestic source income on either the price to the independent distributor or upon a showing of cost, the Regulations provide another method of apportionment which involves an adjustment of gross income from the sale of personal property produced within the United States and sold abroad.[66] Under this formula, the determination for purposes of section 921 requires halving of the gross income from foreign sales, and adjusting it by two different weighted fractions. One half of such gross income is to be adjusted by a fraction in which the numerator is the value of the taxpayer's property within the United States, and the denominator is the sum of the taxpayer's property both within the United States and within the foreign country.[67] The remaining half of the total gross income is adjusted by multiplying it by a fraction in which the numerator is the taxpayer's gross sales for the taxable year within the United States, and the denominator is the taxpayer's gross sales for the same period both within the United States and within the foreign country.[68]

The Treasury has, to an extent, recognized the use of the Western Hemisphere Trade Corporation as a sales subsidiary in the export trade by removing it from the ambit of section 269—a provision which empowers the Commissioner of Internal Revenue to disregard the beneficial tax consequences of a subsidiary created principally for purposes of tax evasion or avoidance. In I.T. 3757, the Treasury ruled that section 269 would not bar the formation of a domestic subsidiary and its qualification as a Western Hemisphere Trade Corporation even though the new subsidiary was formed principally to gain the benefits of the deduction allowed by section 922.[69] As a subsidiary, the Western Hemisphere Trade Corporation raises at least two problems that are also encountered in the operation of a foreign subsidiary. Under either form there must be a transfer of the business function to

65. *Ibid.*
66. Treas. Reg. § 1.863-3(b)(2) example 2 (1957).
67. Treas. Reg. § 1.863-3(b)(2) example 2(ii) (1957).
68. *Ibid.*
69. I.T. 3757, 1945-1 CUM. BULL. 200: "the creation of a new domestic corporation to carry on the business in the Western Hemisphere . . . of an existing domestic corporation does not constitute tax avoidance within the meaning of . . . [section 482] of the Internal Revenue Code, even though the new corporation was created for the principal purpose of gaining the benefits provided by . . . [The Western Hemisphere Trade Corporation]."

the subsidiary, and the pricing of products and services between the two corporations must be on an arm's length basis.[70] Also under either form, in export sales, where goods are purchased from the parent and sold abroad by the subsidiary, the passage of title in the goods to the foreign customer must occur outside the United States.[71]

VII. SALES INCOME FROM SOURCES OUTSIDE THE UNITED STATES

Given the structure of the source rules, goods purchased for export from the domestic parent and sold in a qualifying country of the Western Hemisphere, will give rise to qualifying income only if the passage of title to the goods takes place in the foreign country. Accordingly, it is essential to comply with section 862(a)(6), which provides that an income item shall be considered to originate from sources outside the United States where it was derived from the purchase of personal property within the United States and its sale abroad. The construction of this provision based on equating "sale" with "the passage of title" in the goods, became the controlling principle for source determination very early in the history of the Code.[72]

70. See note 59 *supra*.

71. United States v. Balanovski, 236 F.2d 298 (2d Cir. 1956), *cert. denied*, 352 U.S. 968 (1957); A. P. Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960); Pan American Eutectic Welding Alloys Co., 36 T.C. 284 (1961); International Canadian Corp. v. Frank, 7 Am. Fed. Tax R.2d 1028 (W.D. Wash. 1961); Barber-Greene Americas, Inc., 35 T.C. 365 (1960); American Food Prods. Corp., 28 T.C. 14 (1957); East Coast Oil Co., 31 B.T.A. 558, 560 (1934).

72. G.C.M. 25131, 1947-2 CUM. BULL. 85. G.C.M. 8594, IX-2 CUM. BULL. 354, 358 (1930). This memorandum was based upon the opinion in Compania General de Tabacos de Filipinas v. Collector, 279 U.S. 306 (1929). The case involved the applicability of a Philippine income tax on income derived from sales of goods where the negotiations for the sale of goods produced in the Philippines were carried on in the United States. The Supreme Court did not explicitly decide the question of where the sale was made or where the property interest in the goods passed, but affirmed the lower court opinion which held that the sale was made in Philippines.

Even prior to 1930, the Service accepted the passage of title rule. See O.D. 1100, 5 CUM. BULL. 118 (1921); I.T. 1569, II-1 CUM. BULL. 126 (1923); I.T. 2068, III-2 CUM. BULL. 164 (1924); G.C.M. 2467, VII-2 CUM. BULL. 188 (1928); Baker & Hightower, *The Western Hemisphere Trade Corporation: A Problem in the Law of Sales*, 22 TUL. L. REV. 229 (1947); Dean & Leake, *How To Arrange Forcign Sales So Title Will Pass "Outside the U.S." for Tax Purposes*, 94 J. ACCOUNTANCY 457 (1952); Meek & Baker, *Tax Problems of Doing Business Abroad: Some Practical Considerations*, 1957 WIS. L. REV. 74, 80; Seidman, *Western Hemisphere Trade Corporations as Sales Subsidiaries*, 31 TAXES 369 (1953); Siegal, *Place of Sale in Foreign Trade*, N.Y.U. 5th INST. ON FED. TAX 523 (1947); Slowinski, *Source of Sales Income Is Determined by Where Title to Property Passes*, 7 J. TAXATION 37 (1957).

Although the determination of tax consequences by reliance on the concept of passage of title in the goods has the advantage of certainty, it has tended to mask the underlying policy issue of effectively favoring export income in its tax treatment. Is such a blanket treatmcnt for this class of income warranted?

See also Dailey, *The Concept of the Source of Income*, 15 TAX L. REV. 415, 444 (1960); Kiralfy, *The Problem of a Law of Property in Goods*, 12 MODERN L. REV. 424 (1949); U.C.C. §§ 2-401, -501 (1958). *Hearings, Forty Topics Pertaining to the General Revision of the Internal Revenue Code*, 83d Cong., 1st Sess. 1463-71 (1953); 3 TAX REVISION COMPENDIUM 2171-80 (1959).

Despite at least two attempts to shake the dominance of the passage of title rule as the dispositive element of the source of income, the Treasury has not succeeded. It is not that the Treasury has entirely capitulated, but rather that the rule has become too widely accepted for any alternative to receive serious consideration. The attitude of the courts toward the passage of title rule is typified by the statement of the Report of the American Law Institute's Income Tax Project that

> after considering all the various possible alternatives and their inherent difficulties, the present title passage test was retained.[73]

The prevailing judicial attitude remains that the situs of the passing of title controls the source of income.[74] As the court expressed it in the *East Coast Oil* case, a leading opinion establishing this proposition, the determination of the source of income is entirely an inquiry to "ascertain when and where the title to the goods passes from the seller to the buyer."[75] This opinion marked one unsuccessful attempt by the Commissioner to adopt an alternative rule emphasizing the essential character of the transaction. Under such an alternative rationale, such factors as the place of making of the contract, the place of payment and of delivery, as well as the intent of the parties in designating the place of the sale and the source of income, were all to be weighed. Such a rule, unsuccessfully urged by the Treasury in the *East Coast Oil* case, was itself based on the Treasury's construction of an equivocal Supreme Court opinion. As the Treasury expressed it:

> [T]he technical rules as to the passing of the property and the goods and the assumption of risk are not determinative of the place of sale and the source of income from the sale of goods. The essential character of the transaction —the contract of sale—is the decisive factor in determining the place of sale for the purpose of determining the source of income.[76]

By his acquiescence in the *East Coast Oil* case, the Commissioner withdrew his direct attack on the passage of title rule, and in G.C.M. 25131 the rule was accepted that

> for the purpose of determining the source of income attributable to the sale of personal property, a sale is consummated at the place where the seller surrenders all his rights, title, and interest to the buyer.[77]

73. Surrey & Warren, *The Income Tax Project of the American Law Institute: Partnerships, Corporations, Sale of a Corporate Business, Trusts and Estates, Foreign Income and Foreign Taxpayers*, 66 HARV. L. REV. 1161, 1198 (1953).
74. See note 72 *supra*.
75. East Coast Oil Co., 31 B.T.A. 558, 560 (1934).
76. G.C.M. 8594, IX-2 CUM. BULL. 354, 358 (1930); see note 72 *supra*.
77. G.C.M. 25131, 1947-2 CUM. BULL. 85, 86.

In adopting this position, the Treasury sought to reserve a basis for a reversal of the rule in circumstances in which "the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance. . . ."[78] The existence of circumstances limiting the application of the passage of title rule was also expressed in a dictum by the Court of Appeals for the Second Circuit in an opinion which reaffirmed the basic validity of the rule. As Judge Clark concluded in his acceptance of the validity of the passage of title rule:

> Of course this test may present problems, as where passage of title is formally delayed to avoid taxes. Hence it is not necessary, nor is it desirable, to require rigid adherence to this test under all circumstances.[79]

However, the Treasury has been unable to succeed in developing any doctrine of exception to the passage of title rule based upon the element of tax avoidance. In three recent cases in which it has sought to attack the rule directly, the Treasury has failed.[80] In two of these cases the taxpayers, Western Hemisphere Trade Corporations, had based their claims of foreign source income on the passage of title rule, in circumstances where there were neither sales forces nor business establishments abroad.[81] In each instance the Commissioner had urged that the taxpayer's retention of title had no business purpose and that the copious references in their contract forms to the place of passage of title were contrived solely to control the tax consequences.[82]

The Commissioner failed completely in this attack upon the rule. The court, in the *Barber-Greene* case, identified this issue and rejected it in a manner representative of the other cases by stating:

> The real issue is whether the . . . retention of title was a sham. In retaining ownership [the taxpayers] undertook real responsibilities, risks, and obligations, quite at variance with those involved in the case of sales where title would pass in the United States. A contract to deliver in Chile by a

78. *Id.* at 86. The memorandum cited Kaspare Cohn, Inc., 35 B.T.A. 646 (1937) wherein a Canadian subsidiary was disregarded as a sham. No determination of the place of sale was made. The current Regulations continue the view that the Service does not accept the passage of title rule without exception: "However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the . . . [passage of title rule] will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred." Treas. Reg. § 1.861-7(c) (1957).

79. United States v. Balanovski, 236 F.2d 298, 306-07 (2d Cir. 1956).

80. A. P. Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960); Barber-Greene Americas, Inc., 35 T.C. 365 (1961); Ford Prods. Corp., 28 T.C. 14 (1957).

81. A. P. Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960); Barber-Greene Americas, Inc., 35 T.C. 365 (1961).

82. See note 80 *supra*.

> certain date a machine built in the United States is more burdensome than a contract to deliver such a machine to a dock in New York by a certain date. . . . Their retention of title was real and we find that under their contracts title passed in foreign places and their income from such sales was from outside the United States.[83]

Despite this recent judicial affirmation of the validity of the passage of title rule, some caution in planning export sales operations of the Western Hemisphere Trade Corporation is warranted. Two factors suggest such an approach. First, the Treasury continues to maintain its example in the Regulations which states that the passage of title rule cannot control in circumstances warranting an inference of tax evasion.[84] Second, the Commissioner's acquiescence to the *Barber-Greene* case was limited to the ancillary issue in the case of the source of certain commissions. No approval of the passage of title rule was indicated.[85] It is likely that the Treasury will continue its policy of hostility and probing by litigation.[86] Some smaller exporting firms have also attacked the uniform judicial adherence to this rule on the theory that it favors their larger competitors, but the likelihood of legislative revision of the rule appears remote.[87]

In managing the Western Hemisphere Trade Corporation in the conduct of foreign export transactions to minimize the likelihood of attack, it would be prudent to defer accounting entries on export sales until the title to the goods had actually passed. This would serve to keep the intent of sellers congruent with the event. Long-range planning might take account of the revealed antagonism of the Treasury to the passage of title rule by grouping as many of the operative events relating to the export transaction outside of the United States. Thus, if the passage of title rule is rejected, there are grounds for urging that under the alternative test, the substance of the transaction has taken place abroad.[88]

In any event, the structure of the source rules offers an alternative which, if feasible, can completely avoid the problem of compliance with the passage of title rule. For the performance of services, the source rules provide that the place where the services are rendered determines the source of gross income given in payment for them.[89] Sales commissions and fees for sales services are also foreign source

83. Barber-Greene Americas, Inc., 35 T.C. 365, 387-88 (1961).
84. Treas. Reg. § 1.861-7(c) (1957); See note 78 *supra*.
85. 1961-62 CUM. BULL. 4.
86. In none of the recent cases has the Commissioner acquiesced.
87. *Hearings, Forty Topics Pertaining to the General Revision of the Internal Revenue Code,* 83d Cong., 1st Sess. 1463-71 (1953); 3 TAX REVISION COMPENDIUM 2171-80 (1959).
88. Treas. Reg. § 1.861-7(c) (1957). See note 78 *supra*.
89. INT. REV. CODE OF 1954, § 862(a)(3).

income so long as the services for which the compensation was earned were rendered outside the United States.[90]

VIII. Other Income Items

As the reference to the source of income paid as compensation for services suggests, the other classes of receipts aside from gross income from sales must meet the 95 per cent qualifying requirement of section 921, as construed under the source rules. Under these rules the source of income from compensation for services is determined by the place where the services are rendered.[91] Services in this context include those performed by a corporation as well as by an individual.[92] Where all the services related to a particular item of gross income are rendered in the United States, the entire amount will be characterized as income from within the United States; conversely, where all the services are rendered abroad, all the compensation is foreign income.[93] Where services are rendered both in the United States and abroad, allocation of the compensation is made on a pro rata basis.[94]

The source of profits from the sale of real property is determined according to the geographic location of the property. Gain from the sale of real property located outside the United States will be considered income from the country of its location.[95] The source of rental income is determined by the same rationale.[96]

The determination of the source of royalty payments is made according to the place where the licensed rights are used.[97] In this connection, the meaning of the term "royalty" is broad enough to include compensation for services that are ancillary to the transfer of the patent right.[98] On this basis, compensation for the transmission of information, for instruction, and for the development of techniques that are required for the exploitation of the patent right would qualify as royalty payments. Similarly, compensation for so-called "know-how" of specific techniques required for the exercise of the basic right would also qualify as a royalty payment. But the rendering of services not so identified with the transfer of the basic right would be considered as merely the performance of services whose source would be determined by the place of their performance.

---

90. Int. Rev. Code of 1954, § 862(a)(3).
91. See note 89 *supra*.
92. Commissioner v. Hawaiian Philippine Co., 100 F.2d 988 (9th Cir. 1939).
93. Int. Rev. Code of 1954, § 862(a)(3).
94. Yardley & Co., Ltd., P-H 1942, B.T.A. Mem. Dec. ¶ 42,482. See also Treas. Reg. § 1.861-4(b) (1957).
95. Int. Rev. Code of 1954, § 861 (a)(5).
96. Int. Rev. Code of 1954, § 862 (a)(5).
97. Int. Rev. Code of 1954, §§ 861(a)(4), 862(a)(4). See also Treas. Reg. §§ 1.861-5, 1.862-1(a)(4) (1957).
98. Raymond M. Hessert, CCH Tax Ct. Mem. ¶ 16,120 (1947).

In general, interest payments are characterized by the source rules according to the nationality of the obligor. Interest paid by the United States, any state, or a political subdivision thereof, or the District of Columbia, as well as interest paid by United States residents, corporate or individual, is considered as income from sources within the United States.[99] Similarly, interest received from the United States in connection with a refund of federal income taxes is also considered income from a United States source.[100]

There are, however, three exceptions to this treatment of interest as income from domestic sources. First, interest paid by any banking institution in the United States is not considered United States source income if it is paid to persons not engaged in business in the United States.[101] Similarly, interest paid to a foreign central bank is exempted from the characterization of United States source income.[102] Presumably these two exemptions are made in order to induce foreign nationals and governments to utilize banking facilities in the United States by relieving them of any tax liability for so doing. The third exception is made for interest paid in the United States by a resident alien or a resident foreign corporation where it can be established that less than 20 per cent of the payor's gross income was derived from United States sources for a period of three years preceding the payment of interest.[103]

The same general principle controls for the determination of interest. Once the determination is made that an item of interest is from a foreign source because of the nationality of the obligor, that characterization is not removed by interposing a United States obligor as a financial intermediary, even though the actual interest payments received by the payee are made by a United States bank.[104]

A collateral problem in connection with interest payments, aside from the determination of source, arises from a consideration of its qualification as gross income within the meaning of section 921, where the interest is expressly made tax exempt under other provisions of the Code. The Treasury has ruled that the source question is moot for interest payments that would be tax-exempt under section 103.[105] As for the inclusion of tax-exempt interest in the gross income computation under section 921, the same ruling also provides that a qualifying Western Hemisphere Trade Corporation may not include interest

99. INT. REV. CODE OF 1954, § 861(a)(1).
100. Treas. Reg. § 1.861-2(b) (1957).
101. Treas. Reg. § 1.861-2(a)(1) (1957).
102. Treas. Reg. § 1.861-2(a)(3) (1957).
103. Treas. Reg. § 1.861-2(a)(2) (1957).
104. Electrical Export Corp. v. United States, 290 F.2d 923 (Ct. Cl. 1961).
105. Rev. Rul. 57-435, 1957-2 CUM. BULL. 462.

exempt from gross income for purposes of section 61(a)(4) in the computation of gross income under section 921.

Dividends are classified as to source according to the country of incorporation of the distributing corporation, and the source of that corporation's receipts. Dividends are United States source income if they are received from a domestic corporation (except one entitled to the benefits of section 931) which derived 20 per cent or more of its gross income from United States sources during the three-year period ending with the close of the taxable year preceding the declaration of the dividend.[106] Dividends received from a foreign corporation may still be considered as received from United States sources if the foreign corporation derived at least 50 per cent of its gross income from United States sources during a three-year period ending with the close of the taxable year preceding the distribution of the dividend.[107] If a dividend distribution by a foreign corporation is determined to be from United States sources because the foreign corporation received 50 per cent or more of its gross income from United States sources, the recipient of a dividend need not treat the entire amount of such dividend as income from the United States. Instead, the amount of dividends attributable to United States sources is determined by the ratio of the distributing corporation's United States gross income to the total gross income of the distributing corporation derived from all sources.[108]

Dividends from foreign corporations deriving less than 50 per cent of their gross income from United States sources are treated as income from the country of incorporation of the distributing corporation.[109] Care is required in keeping accounting records according to source, for the Regulations contain a presumption of United States source for dividends of foreign corporations deriving income from the United States.[110] This presumption can be rebutted by a showing of foreign source attached to the return.

Gain included in insurance proceeds from goods lost or damaged in transit between the United States and countries in the Western Hemisphere has posed a special problem of source identification. In a recent ruling, the Treasury has taken the position that the situs of the property at the time of loss is dispositive of the source question.[111] In this ruling the Treasury sought to clarify the implication of an earlier ruling that the residence of the disbursing insurance company

106. INT. REV. CODE OF 1954, § 861(a)(2)(A).
107. INT. REV. CODE OF 1954, § 861(a)(2)(B).
108. Treas. Reg. § 1.861-3(a)(2) (1957).
109. I.T. 4089, 1952-2 CUM. BULL. 142.
110. Treas. Reg. § 1.861-3(b) (1957).
111. Rev. Rul. 61-195, 1961-2 CUM. BULL. 133.

was a material factor in source determination.[112] The most recent ruling, Revenue Ruling 60-278, expressly states that the sole factor in the determination of source of any gain included in insurance proceeds derived from goods lost in transit between the United States and the Western Hemisphere is to be determined entirely by the situs of the property at the time of loss.[113] This approach will work well enough where the place of loss is determinate. If the place of loss of the insured property cannot be determined, the latest ruling strongly suggests that for goods shipped from the United States, the insurance gain, if any, will give rise to United States source income. As the language of the ruling states: "The situs of goods in transit . . . remain[s] at their original situs until they have acquired a permanent situs elsewhere."[114] In practice, where lost goods cannot be traced, this view will amount to a presumption of United States source income that can only be rebutted by actually locating the goods or the place of loss.

This problem of gain from insurance proceeds is not likely to be a factor of great significance in ordinary operations. Yet, in certain circumstances, this ruling might generate a sum of United States source income sufficient to defeat qualification of a Western Hemisphere Trade Corporation under the 95 per cent foreign source requirement of section 921.[115] This risk can be minimized by limiting the insurance coverage on such goods to the cost value of the goods; claims for partial losses can also be limited to cost rather than sales value.

IX. INTERCORPORATE PRICING

As a domestic corporate subsidiary engaging in the purchase of personal property from its parent, the Western Hemisphere Trade Corporation's pricing relationships with its parent are within the scope of the Commissioner's power under section 482.[116] Under this provision, the Commissioner has broad powers to reallocate gross income, deductions, or credits between or among corporations owned by the same interests to prevent evasion of taxes, or to more clearly reflect income.[117] In the use of the Western Hemisphere Corporation as a selling subsidiary, taxes between the domestic parent and the Western

112. Rev. Rul. 60-278, 1960-2 CUM. BULL. 214. See also I.T. 3902, 1948-1 CUM. BULL. 64.

113. "The Service will not consider either the choice of underwriter or the place of execution of a marine insurance contract in determining where the property is sold or the source of the income derived from the sale." Rev. Rul. 61-195, 1961-2 CUM. BULL. 133.

114. *Ibid.*

115. INT. REV. CODE OF 1954, § 921.

116. INT. REV. CODE OF 1954, § 482; Rev. Rul. 53-15, 1953-1 CUM. BULL. 141.

117. Polak's Frutal Works, 21 T.C. 953 (1954).

Hemisphere subsidiary can be minimized to the extent that more of the gain from the final sale can be channelled into the selling subsidiary. The tendency is to price the product from the domestic manufacturing parent to the subsidiary as low as possible—a transaction that is likely to invoke section 482. The controlling principle in the application of that provision is that the price charged between the related corporations must not vary from an arm's length price.[118] This means that each of the related firms must show not more than a reasonable amount of profit commensurate with its function and the value of its services.[119]

X. Worthless Securities

The 1954 revision of the provision governing corporate losses arising from the worthlessness of stock or securities introduced some uncertainty on the question of whether a domestic corporate taxpayer holding worthless shares of an "affiliated" (subsidiary) foreign corporation was required to treat such losses as capital losses.[120] If this were so, it would constitute an advantageous feature of the Western Hemisphere Trade Corporation because it had been understood that the worthless shares of a domestic corporation would be treated as ordinary losses.

Generally, losses of a corporation arising from worthless stock or securities are treated as losses resulting from the sale or exchange of capital assets and are subject to the limitation on the deduction of capital losses.[121] An exception to this general rule is made by section 165(g)(3) for worthless securities of an "affiliated" corporation; such securities are not treated as capital assets and losses therefrom are not subject to the capital loss limitation.[122] The ambiguity with regard to the difference between the securities of a domestic subsidiary as opposed to a foreign subsidiary arises from the language of section 165 (g)(3) which provides that "any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset."[123]

If the phrase "domestic corporation" modifies "taxpayer," then any worthless security of any subsidiary of a domestic corporation is entitled to ordinary loss treatment, and the shares of a domestic Western Hemisphere Trade Corporation offer no advantage over those of a foreign subsidiary. If, instead, the phrase "which is a domestic cor-

118. Baker & Baker, *The Pricing of Goods in International Transactions Between Controlled Taxpayers*, 10 Tax Executive 235 (1958).
119. *Ibid.*
120. Int. Rev. Code of 1954, § 165(g).
121. *Ibid.*
122. Int. Rev. Code of 1954, § 165(g)(3).
123. *Ibid.*

poration" is read to modify "corporation," then only the worthless shares of domestic affiliates of the taxpayer can enjoy freedom from the capital loss limitation.

It is most unlikely that this distinction between the worthless securities of a foreign and a domestic affiliate is dictated by the statute. In the antecedent provision of the 1939 Code, section 23 (g)(4), the reference was to stock "in a corporation affiliated with the taxpayer. . . ."[124] A separate subpart of this same provision, section 23(g)(4)(c), provided expressly that "the taxpayer is a domestic corporation."[125] Since the antecedent provision made no distinction between a foreign affiliate and a domestic one, and with no reference to any intended change by the draftsman of the 1954 revision, it is most unlikely that a court would infer this distinction from the present ambiguity in the statutory language. Moreover, the Regulations seem to reject entirely any distinction between the securities of a foreign and a domestic subsidiary by reverting to the substance of the 1939 provision; the current Regulation is couched in terms of "a taxpayer which is a domestic corporation . . . [which] owns any security of a domestic or foreign corporation. . . ."[126]

XI. THE FOREIGN TAX CREDIT AND THE WESTERN HEMISPHERE TRADE CORPORATION

Another factor in the calculus of tax advantage between the foreign and the domestic (Western Hemisphere Trade Corporation) is the computation of the foreign tax credit and its limitations.

As a domestic corporation, the Western Hemisphere Trade Corporation may, subject to the per country or elective overall limitations, deduct or credit foreign taxes paid or accrued to foreign states as income taxes.[127] This provision for claiming foreign income taxes as a credit is not limited, however, to taxes actually paid by a taxpayer. A domestic corporation owning 10 per cent or more of the voting stock of a foreign corporation from which it receives dividends, is permitted to take a credit for the foreign income taxes paid by the foreign subsidiary corporation as though the domestic parent corporation had in fact paid such tax.[128] The existence of this derivative tax credit and the structure of the statutory provision permitting it gives rise to a tax advantage for the domestic corporation conducting

124. Int. Rev. Code of 1939, as amended, ch. 619 § 23(g)(4), 53 Stat. 13 (1942).
125. Int. Rev. Code of 1939, as amended, ch. 619, § 23(g)(4)(c), 53 Stat. 13 (1942).
126. Treas. Reg. § 1.165-(5)(d)(1) (1960). *But see* 3B MERTENS, FEDERAL INCOME TAXATION 385 n.49 (1958) for the statement that "The present provision . . . Sec. 165(g)(3), extends the exclusion to domestic but not foreign subsidiaries."
127. INT. REV. CODE OF 1954, §§ 901(a), 904; Rev. Rul. 58-56, 1958-1 CUM. BULL. 335.
128. INT. REV. CODE OF 1954, § 902. See OWENS, THE FOREIGN TAX CREDIT 94 (1961).

its foreign operations through a foreign subsidiary rather than through a Western Hemisphere Trade Corporation—a domestic subsidiary.

This relative disadvantage of the Western Hemisphere Trade Corporation arises because the statutory limitation of the amount of foreign taxes that may be credited, devised to prevent the offsetting of United States taxes on domestic income, is expressed in terms of a limitation on the amount of the credit calculated with reference to the relationship of the foreign source income to domestic source income. Section 904(a)(1) restricts the amount of foreign taxes which may be credited to the amount of the United States tax on the foreign source income absent the credit provision.[129] This limitation restricts the portion of foreign income taxes which may be credited against United States tax to the portion of the total United States tax—the tax computed without the credit—which the taxable income from the foreign country is of the taxpayer's total taxable income from all sources. A separate computation of this limit, known as the per country limitation, was required by the present code until 1960.[130]

In its effect, the per country limitation has worked to the disadvantage of firms operating in two or more foreign countries by disallowing for the credit foreign taxes of a high-rate foreign country. For example, in 1960, a Western Hemisphere Trade Corporation, a calendar year taxpayer with $100 of income from each of two foreign countries having tax rates of 32 per cent and 42 per cent, respectively, would compute the limitation on the amount of taxes eligible for the credit under section 904(a)(1) on a per country basis. From this computation, the full $32 paid in the first country would be credited, but only $38 of the $42 paid in the second country would be allowed.[131] Uuless the ineligible $4 could be carried over or back, it would be lost.[132] However, the computation of the limit by adding together the income and taxes of both foreign countries would make eligible for the credit the full amount of foreign taxes paid, because the 38 per cent limitation would be $76 on the $200 or $2 in excess of the $74 which was the total amount of foreign taxes paid. The net effect of this computation on an overall basis allowed for an averaging of the foreign tax rates and thereby increased the amount of the limit on the credit.

In the years between 1954 and 1960, when the per country limitation was the only limitation on the credit, the foreign subsidiary

129. INT. REV. CODE OF 1954, § 904; OWENS, *op. cit. supra* note 128, at 195.

130. INT. REV. CODE OF 1954, § 904(a).

131. INT. REV. CODE OF 1954, § 904(a)(1); Treas. Reg. §§ 1.904-1(a), 1.904-1(e) (1957); Omega Chemical Co., 31 B.T.A. 1108 (1935).

132. INT. REV. CODE OF 1954, § 904(d) provides for a two-year carry back and a five-year carry forward of foreign taxes paid that are excluded from the credit by per-country limitation.

enjoyed an advantage over the Western Hemisphere Trade Corporation because the derivative tax credit available to its domestic parent achieved such averaging of foreign rates. This feature of the derivative credit arises from the Regulations which provide that all foreign taxes paid by a foreign subsidiary are "deemed to have been paid to the country . . . under whose laws such foreigu corporation is incorporated."[133]

During these years of the existence of the per country limitation, the Western Hemisphere Trade Corporation was able to realize some of the benefits of averaging foreign taxes through the use of the consolidated return. When a 1961 amendment to section 904 returned the overall limitation as an optional election, the consolidated return provisions were also amended in order to preclude the use of the consolidated return as an additional means of offsetting foreign taxes prevented by the overall limitation from being credited against United States taxes.[134] Section 1503(d) provides that for any year in which the new overall limitation of section 904 is in effect a consolidated return by an affiliated group that included one or more Western Hemisphere Trade Corporations is further limited. The benefit of the lower rate of sections 921-22 will not be allowed to extend to ordinary corporations via the tax credit and the overall limitation.[135] The effect of this is a denial, where the overall limitation is used, of excess foreign taxes that would be barred by the limitation outside of an affiliated group from being used within the group to offset United States taxes on other foreign income received by members of the group which are not Western Hemisphere Trade Corporations. This limitation of section 1503(d) is itself modified for Western Hemisphere Trade Corporations that are also regulated public utilities by section 1503(d)(2).[136] By this partial removal of the bar against the application of foreign taxes beyond the 38 per cent rate (ignoring the surtax exemption), some excess taxes may be credited against the foreign income of other corporations that are members of the same consolidated group. The excess foreign taxes paid by the Western Hemisphere corporation or corporations that would not otherwise be available for the credit may be available for the credit to the extent that United States taxes on the other income in the group derived from the same foreign country or countries exceeds the taxes actually paid to these same foreign countries on this income.

For example, two Western Hemisphere Trade Corporations that are

---

133. Treas. Reg. § 1.902-1(c) (1960).

134. Int. Rev. Code of 1954, § 904, as amended, Pub. L. No. 86-780, 86th Cong., 2d Sess. (1960).

135. Int. Rev. Code of 1954, § 1504(d); S. Rep. No. 1393, 86th Cong., 2d Sess. (1960), 1960-2 Cum. Bull. 874, 877.

136. Int. Rev. Code of 1954, §§ 1503(c)(1)(A)(i), 1503(c)(1)(D).

regulated public utilities operate in two different Latin American countries and have an aggregate consolidated taxable income of $100,000 on which they paid foreign income taxes of $45,000, would have had a potential United States tax liability on the same income of $38,000 (ignoring the surtax exemption). If the overall limitation were elected, then as part of an affiliated group with another corporation that is not a Western Hemisphere Trade Corporation, the upper limit on the amount of foreign taxes which may be credited by the Western Hemisphere Trade Corporations would be $38,000, leaving $7,000 of foreign taxes ineligible for the credit. This would be the final result by virtue of section 1504(d)(1) were the Western Hemisphere Trade Corporations not regulated public utilities.[137] The ordinary Western Hemisphere Trade Corporation would not be able to use any portion of this excess of foreign taxes paid over foreign taxes limited for credit towards the credit on the taxes paid by an ordinary corporation that was also a member of an affiliated group filing a consolidated return. However, where the Western Hemisphere Trade Corporation is a regulated public utility, and meets the 80 per cent gross income test of section 1503(d)(2), the $7,000 would be available, in part, to be credited against the other income in the group.[138] The $7,000 would be available for the credit only to the extent that the United States tax on the other income in the consolidated group from the same foreign countries exceeds the taxes paid to those foreign countries.

Returning to the above example, if the other corporation in the same group with the two regulated public utility Western Hemisphere Trade Corporations received $50,000 of consolidated taxable income from the same two countries, on which it paid taxes to those countries of $22,000, section 1503(d)(2) would allow $5,000 of the $7,000 excess Western Hemisphere Trade Corporation foreign taxes otherwise limited to be applied to the credit allowable on this income. The $5,000 can be applied because it is the amount by which the foreign taxes actually paid ($22,000) is exceeded by the United States tax that would have been due on this $50,000 of foreign income, or (ignoring the surtax exemption) $27,000.

XII. The New Context

The statutory provisions of the 1962 Revenue Act impose a new calculus of advantage for assessing the Western Hemisphere Trade Corporation.[139] New statutory forms, such as the Export Trade Cor-

137. See note 135 *supra*.

138. *Ibid.*

139. Int. Rev. Code of 1954, §§ 951-64, 970-72, as amended, 76 Stat. 1006, 1027 (Oct. 16, 1962). See also S. Rep. No. 1881, 87th Cong., 2d Sess., 78-94, 237-79 (1962).

poration[140] and the Less Developed Country Corporation,[141] coupled with such new concepts as "the controlled foreign corporation,"[142] and "Subpart F income,"[143] have placed the functional attributes of the Western Hemisphere Trade Corporation in a different context.

The new provisions, the product of a series of revised Treasury proposals, are a compromise response to the President's request for an absolute end to tax deferral on the earnings of all foreign subsidiary operations.[144] The basic theme of the new provisions, with some exception, is to tax currently a United States shareholder on his pro rata share of undistributed earnings of a foreign subsidiary which is both a controlled foreign corporation and has the requisite subpart F income.[145] From the definitional requirements of subpart F income, it is apparent that only tax haven trading and holding company operations forfeit the deferral privilege; manufacturing operations conducted by foreign subsidiaries do not generate the tainted subpart F income.[146]

This emphasis on the curtailment of tax deferral on those classes of earnings ordinarily identified with particular tax-haven operations emerges from the definition of subpart F income provided by section 952. Subpart F income is there defined to include the gains from tax haven sales and service operations as well as the usual passive income items identified with a holding company.[147] In their operation, these provisions would reverse the deferral privilege of the typical foreign

140. INT. REV. CODE OF 1954, § 971, as amended, 76 Stat. 1029 (Oct. 16, 1962).

141. INT. REV. CODE OF 1954, § 955(c), as amended, 76 Stat. 1014 (Oct. 16, 1962).

142. INT. REV. CODE OF 1954, § 955, as amended, 76 Stat. 1013 (Oct. 16, 1962).

143. INT. REV. CODE OF 1954, § 952, as amended, 76 Stat. 1008 (Oct. 16, 1962).

144. The President's Message of May 3, 1961, requested the elimination of deferral privileges in developed countries and of "tax haven" deferral privileges in all countries. Deferral would be available for income from investment in the underdeveloped countries. See *President's Tax Message*, H.R. Doc. No. 140, 87th Cong., 1st Sess. 6-7 (1961).

145. INT. REV. CODE OF 1954, §§ 955, 957, as amended, 76 Stat. 1013, 1017 (Oct. 16, 1962).

146. S. REP. No. 1881, 87th Cong., 2d Sess. 80-81, 237-42 (1962).

147. The inclusion of foreign personal holding company income under the controlled foreign corporation provisions is coordinated by an amendment to § 551(b) that eliminates the § 551 liability to the extent that foreign personal holding company income is included in gross income of the shareholder under § 951(a) for the same taxable year. See INT. REV. CODE OF 1954, § 951(d), as amended, 76 Stat. 1007 (Oct. 16, 1962); S. REP. No. 1881, 87th Cong., 2d Sess. 240 (1962). As a component of subpart F income under § 954(c), foreign personal holding company income is defined with reference to § 553 initially, but some modifications are part of 954(c). Despite the inclusion for purposes of § 954(c) of all rents irrespective of the 50 per cent gross income ratio of § 553, foreign personal holding company income is more flexibly defined for purposes of the controlled foreign corporation's subpart F income. Rents and royalties derived from the active conduct of a trade or business with an unrelated person may be excluded from personal holding company income; dividends, interest, and gains from the sale or exchange of stock or securities derived from financial business or from investment by an insurance company may also be excluded.

base company subsidiary which received the earnings of European operations of the kind described by section 952. When thus taxed, United States shareholders are entitled to take the foreign tax credit[148] and subsequent distributions are made free of tax.[149] Moreover, a controlled foreign corporation that distributes earnings according to a statutory schedule of minimum distributions may avoid entirely any taxation of undistributed earnings to its United States shareholders.[150]

The dominant theme of isolating the earnings of tax haven trading and of service and holding company activities, for determining the pro rata share of earnings to be attributed to United States shareholders, is executed by the ancillary definitions in section 953 and 954.[151] The basic definition of section 952 contains the elements of subpart F income: 1) income derived from the insurance of United States risks; 2) foreign base company income.[152] Foreign base company income is further defined by section 954 in terms of three additional constituent elements: 1) foreign base company sales income, 2) foreign base company services income, and 3) foreign personal holding company income.[153]

Despite the detailed statutory emphasis on these classes of tax haven earnings, the new framework will hardly require an immediate realignment of such foreign operations, for the new provisions contain many exceptions and qualifications. Indeed, viewing these exceptions and major relief provisions as a whole, they constitute a framework that would not entirely eliminate every tax-haven operation. For example, the exception contained in section 954(b)(3), provides flexibility by forestalling pro rata attribution of earnings entirely if the total amount of tainted (foreign base company) income is less than 30 per cent of the total gross income of the corporation.[154] In certain instances, some minor realignment of existing sales and manufacturing operations will serve to bring a foreign subsidiary within this

148. INT. REV. CODE OF 1954, § 960, as amended, 76 Stat. 1020 (Oct. 16, 1962).

149. A United States shareholder as defined by § 7701(a)(8) and qualified to eliminate Possessions Corporations by § 957(d), would mean United States citizens, residents, domestic corporations, partnerships, and estates or trusts. To be taxed on the income of a controlled foreign corporation, the United States shareholder must own (actually or constructively by §§ 318 and 958) at least a 10 per cent interest in the voting power of all classes of voting stock of such corporation.

150. INT. REV. CODE OF 1954, § 963, as amended, 76 Stat. 1023 (Oct. 16, 1962). This statutory schedule of § 963(b) is so arranged that there is no tax to the United States shareholder on undistributed subpart F income when the combined foreign tax and the United States tax on distributed earnings is not substantially below the United States corporate tax rate.

151. INT. REV. CODE OF 1954, §§ 953-54, as amended, 76 Stat. 1008-09 (Oct. 16, 1962).

152. INT. REV. CODE OF 1954, § 952, as amended, 76 Stat. 1008 (Oct. 16, 1962).

153. INT. REV. CODE OF 1954, § 954, as amended, 76 Stat. 1009 (Oct. 16, 1962).

154. INT. REV. CODE OF 1954, § 954(b)(3), as amended, 76 Stat. 1010 (Oct. 16, 1962).

exception. Or the burdens of managing transactions to attain the proper revenue mix to stay within the tax-free range of non-conforming income may prove sufficiently onerous to warrant careful consideration of the Western Hemisphere Trade Corporation as an alternative. But under the new act, the alternatives are not so narrowly drawn. The consequences of attribution can further be avoided by recourse to the exception of section 954(b)(1) which excludes dividends, interest, and gain from the sale or exchange of investments from the computation of foreign base company income, but only to the extent that these amounts are reinvested in a "less developed country corporation."[155] Under this exception, a controlled foreign corporation can, without being subject to a fixed percentage limitation on trade or business income, operate as a holding company, in part, without causing its shareholders to be taxed on this portion of foreign personal holding company income.[156] In this respect, the Western Hemisphere Trade Corporation is more rigidly restricted by the requirement that 90 per cent of its income must be derived from the conduct of active trade or business.[157]

The great degree of flexibility in the new provisions is further evidenced by the exception of section 954(b)(4) which provides that foreign base company income will not be attributed as part of a shareholder's pro rata share where the taxpayer can establish to the satisfaction of the Treasury that the particnlar tax haven operation did not resnlt in a substantial saving of income tax.[158] This is a feature of material importance. Unlike the all-or-none consequences of electing Western Hemisphere Trade Corporation status and failing to meet a material requirement, *e.g.*, the limit on incidental purchases, the controlled foreign subsidiary can come entirely within the formal, transactional requirements that would invoke the pro rata attribution of earnings. Yet, this result can be avoided by a showing that the substantive tax-saving ordinarily associated with such formal arrangements was not in fact achieved.

A qualifying provision which adds another variable to the computation of advantage is the election provided by section 962.[159] Under

155. INT. REV. CODE OF 1954, § 955(c)(1),(2), as amended, 76 Stat. 1014 (Oct. 16, 1962). This provision sets out two kinds of less developed country corporations. For these purposes, a less developed country means one (other than areas within the Sino-Soviet bloc or possessions of the United States) which the President has designated as economically less developed. For a discussion of some definitional problems in the concept of an economically underdeveloped country, see Raskind, *Policies and Proposals: Taxation Problems of Foreign Income*, in PROC. OF THE 1961 SOUTHWESTERN LEGAL FOUNDATION INST. ON PRIVATE INVESTMENTS ABROAD AND FOREIGN TRADE 358, 366 (1961).

156. S. REP. No. 1881, 87th Cong., 2d Sess. 86 (1962).

157. INT. REV. CODE OF 1954, § 921; see text accompanying note 30 *supra*.

158. INT. REV. CODE OF 1954, § 954, as amended, 76 Stat. 1009 (Oct. 16, 1962).

159. INT. REV. CODE OF 1954, § 962, as amended, 76 Stat. 1023 (Oct. 16, 1962).

this provision a United States individual who as a shareholder in a controlled foreign corporation is liable for the tax on undistributed earnings may elect to be taxed at corporate rather than at individual rates. The purpose of this election is to mitigate the impact of this mode of taxation on a high bracket taxpayer.[160]

Perhaps the most important major exception to the entire scheme of taxing undistributed earnings of foreign subsidiaries, is accomplished by the Export Trade Corporation.[161] This exception, not contained in the House bill, continues the deferral of taxation on the earnings of controlled foreign corporations, provided such foreign subsidiaries are engaged in exporting products which were manufactured, produced, or grown in the United States.[162]

The Export Trade Corporation shares two common characteristics with the Western Hemisphere Trade Corporation that will furnish the basis for close comparison of some existing Western Hemisphere operations. Both forms are directly suited to the export trade and both are defined according to qualifying income by source and by trade. Section 971(a) provides that an Export Trade Corporation is a controlled foreign corporation which derives 90 per cent of its gross income (either for the prior three-year period or for such lesser period during which it was in existence) from sources without the United States and which, for the same period, derives 75 per cent or more of its gross income from export trade.[163] The construction of this 90 per cent source requirement of section 971 will doubtless be derived, at least in the first instance, from the meaning given the same language in section 921.[164]

Continued tax deferral is accomplished by the Export Trade Corporation by allowing it to reduce its subpart F income, subject to certain limitations, by the amount of its "export trade income."[165] In thus reducing the amount of undistributed foreign earnings available to be attributed and taxed to United States shareholders, the Export Trade Corporation is intended as an inducement to the export trade.[166] As a form available to exporters, the new corporation offers, in addition to tax deferral, the further advantages of wider geographic scope and more flexible qualifying conditions. However, the differen-

160. See S. REP. No. 1881, *op. cit. supra* note 156, at 92.

161. INT. REV. CODE OF 1954, §§ 970-72, as amended, 76 Stat. 1027 (Oct. 16, 1962).

162. See S. REP. No. 1881, *op. cit. supra* note 156, at 273.

163. INT. REV. CODE OF 1954, § 971(a), as amended, 76 Stat. 1029 (Oct. 16, 1962).

164. INT. REV. CODE OF 1954, § 921.

165. INT. REV. CODE OF 1954, §§ 970(a)(1)(A),(B), 970(a)(2), as amended, 76 Stat. 1027, 1028 (Oct. 16, 1962).

166. See S. REP. No. 1881, *op. cit. supra* note 156, at 91.

tial rate advantage might still favor the Western Hemisphere Trade Corporation where deferral is not a feature of the operation.

XIII. Conclusion

The 1962 Revenue Act has added a number of new forms and concepts to the statutory frame for the United States taxation of foreign income. The Western Hemisphere Trade Corporation is now placed within a wider context of alternatives. In this larger environment the Western Hemisphere Trade Corporation will probably be examined more, but adopted less frequently.

As the first major piece of foreign tax legislation since the enactment of the Western Hemisphere Trade Corporation provisions in 1942, these new provisions raise basic issues of tax policy.[167] The curtailment of deferral on tax haven earnings by the new act is a major shift in tax policy. Yet, the implementation of this policy by a series of provisions containing so many exceptions is troublesome, particularly since some of the qualifying provisions bear the hammer marks of accommodation to the needs of particular foreign operations.[168]

Overall appraisal of these new changes requires a balanced viewpoint. The new act could be criticized for its limited attack on tax deferral, since the effective restriction of deferral privileges has not gone the entire distance requested in the President's tax message of 1961.[169] However, such criticism lacks perspective. Only two years earlier the version of the Boggs Bill, which was passed by the House, had gone entirely in the opposite direction by widening materially the availability of deferral.[170] On balance, these provisions constitute an announcement of the new principle diluted by its limited implementation. The present changes doubtless represent an accommodation between the intense pressure to bar any restriction of deferral opportunities and the announced goal to eliminate completely deferral for tax haven operations. And aside from deferral, the new act ends some obvious anomolies in the treatment of foreign situs realty and the computation of the tax credit.

---

167. See Bittker & Ebb, Taxation of Foreign Income 290 (1960). Some minor changes in the foreign tax credit had been made. See Owen, The Foreign Tax Credit 5 (1960).

168. See Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws,* 68 Harv. L. Rev. 745 (1955); Surrey, *The Congress and the Tax Lobbyist–How Special Tax Provisions Get Enacted,* 70 Harv. L. Rev. 1145 (1957). See also the statements of Sen. Gore concerning the 1962 Bill, 108 Cong. Rec. 17090 (Aug. 30, 1962); *id.* at 17460-68, 17495-96 (Sept. 5, 1962).

169. See note 144 *supra.*

170. Tillinghast, *Taxation of Foreign Investment: A Critique of the Boggs Bill,* 16 Tax L. Rev. 81 (1960).

In its mode of compromise the new act has honored both the principle and its exception, and has, accordingly, heightened the need for a clarification of the basic policy of tax neutrality.[171] By allowing the continuation of deferral for certain export earnings and for operations connected with underdeveloped countries, support is given to the view that these exceptions are warranted by Balance of Payments considerations. In point of fact, the 1962 exceptions are no more than understandable compromises. There is danger that these exceptions will be converted into permanent grants favoring export and other foreign earnings without thorough debate on the appropriate policy for the taxation of this income. If an acceptable case—aside from allegations of competitive disadvantage and general references to the Balance of Payments—can be made out, these exceptions should continue. If not, the forthcoming discussion of a general reduction in tax rates is an appropriate occasion for the Treasury to indicate its continued adherence to the basic policy of taxing foreign income without favor. If there is any validity to the thesis that tax reform ought to be linked to rate reduction, these anticipated changes will offer an opportunity for at least indicating limits on some of the 1962 exceptions.

171. Anthoine & Bloch, *Tax Policy and the Gold Problem: An Agenda for Inquiry*, 61 COLUM. L. REV. 322 (1961); Bell, *Taxation on Private Investments Abroad—Economic Aspects (Part 1)*, in PROC. OF 1962 INST. ON PRIVATE INVESTMENTS ABROAD AND FOREIGN TRADE 235 (1962); Solo, *Economics of the International Base Company*, 41 NAT'L TAX J. 70 (1961).