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The Western Hemisphere Trade Corporation

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NOTES

THE WESTERN HEMISPHERE TRADE CORPORATION

I. INTRODUCTION

The existing complexity involved in the taxation of corporate income derived from sources without the United States has motivated Congress to undertake an extensive review of our governmental policy pertaining to this area of taxation. The particular provisions of the Internal Revenue Code of 1954 relating to this subject are merely an *ad hoc* accumulation, noticeably void of any systematic design. The intended purpose of the present congressional inquiry is to determine whether or not incentive taxation is a proper method by which this nation's foreign policies can be implemented. If it be deemed advisable to offer tax benefits to induce private participation in foreign economic development, Congress will be confronted with the task of completely revising the present Code sections dealing with taxation of foreign source income. Several varied programs are presently before Congress for its consideration.[1] In light of the immediacy of the situation, it seems proper to consider the intended effect and the actual application of the only effective[2] preferential tax treatment extended by the 1954 Code to corporate income derived from non-domestic sources. The favorable treatment referred to is provided for by section 921.[3] Previous bills[4] have already undertaken

1. S. 749, 87th Cong., 1st Sess. (1961); H.R. 5151, 87th Cong., 1st Sess. (1961); H.R. 5359, 87th Cong., 1st Sess. (1961). These bills provide for amendments to the Internal Revenue Code of 1954 in order to include a pro rata share of the income of foreign corporations in the gross income of taxpayers who own, directly or indirectly, 10% or more of the voting stock of such foreign corporation, and to repeal the foreign tax credit. On the other hand, H.R. 5, 86th Cong., 2d Sess. (1960), is a counter proposal in that it offers tax incentives to corporations involved in foreign commerce. President Kennedy has offered a third program which would eliminate tax deferral privileges in developed countries and "tax haven" deferral privileges in all countries. See N.Y. Times, April 21, 1961, p. 12, col. 1.

2. Since 1922, corporations trading in China have received special tax allowances. The requirements and effect of such are presently embodied in INT. REV. CODE OF 1954, § 941. Today, however, our government's policy in respect to trade with the Chinese mainland drastically limits the effectiveness of this provision. A more complete discussion of this preference and its application may be found at notes 18-19 *infra* and accompanying text.

3. INT. REV. CODE OF 1954, § 921. The actual reduction in taxes is granted by § 922.

4. Unsuccessful attempts were made in both 1948 and 1950 to expand the Western Hemisphere Trade Corporation (hereinafter referred to as a WHTC) benefits to cover all foreign trade. These intended expansions were commonly referred to as World Trade Corporation provisions, and would have been codified by proposed § 110 of the 1939 Code. A similar fate befell H.R. 8300, 83d Cong., 2d Sess. (1954).

to extend this preference to all corporations receiving income from foreign sources. The purpose of this note is to evaluate the effectiveness of this particular tax preference, keeping in mind that our nation's future taxation of foreign source income might well follow a similar pattern.

II. History of Taxation of Foreign Income

1. Jurisdiction.—In 1913 the United States determined that its lately acquired authority to levy a tax on the privilege of receiving income was not confined to income derived from sources within its own territorial limits.[5] The tax was not only levied on income actually produced within the United States and its possessions, but also on income from foreign sources when produced by a citizen of the United States. This world-encompassing jurisdiction to tax found its justification in the idea that one who is enhanced because of his relationship to a particular sovereign owes a corresponding obligation of support to that sovereign. The end result of this theory has been to expose the United States citizen to double taxation whenever the source of his income producing activity projects him into the tax jurisdiction of another authority.[6] However, at this early date the effective rate of taxation was so slight as to cause little or no actual distress.

2. Deduction From Net Income of Foreign Taxes Paid.—Prior to 1918 the only relief afforded to a taxpayer ensnared in such a situation was the deduction from his net income of any amount paid out in taxes. This provision—the forefather of the present section 164—treated the foreign tax as an expense incurred in the operation of the business.[7]

3. Foreign Tax Credit.—Recognizing the detriment inflicted by double taxation, the Congress in 1918 permitted corporations whose income was subject to taxation at the hands of foreign authorities to

5. Cook v. Tait, 265 U.S. 47 (1924); Peck & Co. v. Lowe, 247 U.S. 165 (1918); United States v. Bennett, 232 U.S. 299 (1914); United States v. Goelet, 232 U.S. 293 (1914). As these cases indicate the precedent for such a jurisdiction was found in a similar jurisdiction applied under various taxes prior to the income tax.

6. The overlapping of tax jurisdictions that brings on double taxation is caused by each taxing authority adopting the same theory for enforcement of their power. The only bilateral relief afforded world trade groups is found in the form of reciprocal tax treaties.

At first double taxation was tolerated due to our low rate of taxation, but the situation was aggravated by the increase in the corporate tax rate from 1% to 12% between 1913 (Act of Oct. 3, 1913, ch. 16, § II B, 38 Stat. 166) and 1918 (Revenue Act of 1918, ch. 18, § 230(a)1, 40 Stat. 1076).

7. Int. Rev. Code of 1954, § 164. This tax is still of paramount importance, since it applies to all taxes, whereas the tax credit is applicable only with respect to income, excess-profits and war-profits taxes.

credit such taxes against their domestic income taxes.[8] Pressure for such a provision was apparently created by an increase in the popularity of the income tax as a means of raising revenue coupled with the stepped up rates necessitated by the demands of World War I. Unlike the previous "deduction," this "credit" allowed the taxpayer to subtract the full amount of foreign taxes paid from the amount of income taxes due the United States.[9]

In the Internal Revenue Act of 1921 this provision was amended so as to substitute in place of the "full" credit an "over-all" credit.[10] The purpose of the change was to undo the effect of the 1918 enactment,

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8. "That in the case of a domestic corporation the total taxes imposed for the taxable year . . . shall be credited with the amount of income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States." 40 Stat. 1080 (1918). This credit in a new form is found in INT. REV. CODE OF 1954, §§ 33, 901.

9. For example:
A domestic corporation in the tax year 1918 has an income of $100,000 after all deductions except those for taxes paid have been taken out. In the same year the corporation paid out $10,000 in income taxes to countries other than the United States.

If only the deduction is taken.
$100,000—income before deduction for foreign taxes.
− 10,000—deduction for foreign taxes paid.

90,000—income subject to United States income tax.
× .12—rate of United States corporate tax in 1918.

10,800—taxes due the United States.
+ 10,000—foreign taxes due.

20,800—total taxes due in 1918 by use of deduction method.

If the tax credit is taken.
$100,000—income after all deductions (none for taxes here).
× .12—rate of United States corporate tax in 1918.

12,000—taxes due United States before credit taken.
− 10,000—foreign taxes paid.

2,000—total taxes due the United States.

$ 20,800—taxes due under deduction method.
− 12,000—taxes due under tax credit method.

8,800—total tax saving by use of the tax credit method.

The year 1918 was chosen since limitations (which will be noted later) subsequently added have made the procedure somewhat more complex. This example which belabors the obvious is presented in order to contrast the different methods offered as remedies for double taxation. The tax credit is presently under fire in Congress. See note 1 *supra*.

The tax credit provision makes no allowance for the taxpayer to carry over the foreign taxes paid into the next year if in the present year his credit exceeds the amount of his United States taxes due. This excess is not likely to arise under the Code's present provisions.

10. "That the amount of credit taken under this subdivision shall in no case exceed the same proportion of the taxes, against which such credit is taken, which the taxpayer's net income . . . from sources without the United States bears to its entire net income . . . for the same taxable year." 42 Stat. 258 (1921).

which had allowed countries with a higher tax rate than the United States to reap all the tax benefits, even when the taxpayer also had income from sources within the United States. The "over-all" credit restricted the amount of tax to be credited so that it could not exceed that proportion of the domestic tax which the net income from sources without the United States bore to the entire net income for the same taxable year. Another change was felt to be necessary in 1932,[11] since the 1921 enactment operated unequally upon taxpayers who paid the same amount of foreign taxes but derived different proportions of their net income from foreign sources. To meet this situation the 1932 provision added a further limitation: that the credit for the tax of any country should not exceed that fraction of the United States tax equal to the ratio which the taxpayer's net income from such country would bear to his entire net income. As amended, the "over-all" credit remained unchanged until the present "per-country" limitation, adopted to correct the adverse effect in cases where a foreign loss was sustained, supplanted it in the 1954 Code.[12]

In 1936 the credit was extended so as to allow domestic corporations to credit against the taxes paid on dividends from their foreign subsidiaries the fraction of foreign income taxes paid by the subsidiaries equal to the ratio of the dividends received to the subsidiaries' total taxable income.[13]

The presence of the foreign tax credit in the Code has had the effect of equalizing the applied rate of taxation on a corporation's income regardless of its source. This provision is of paramount importance to our discussion since any corporation which meets the requirements of a Western Hemisphere Trade Corporation (hereafter referred to as a WHTC) can also qualify for the foreign tax credit.[14]

4. The Exemption for Trade With a United States Possession.—In 1921 a determined attempt was made to exempt from United States income taxes all foreign income of a domestic corporation which derived eighty per cent of its income from sources without the United States and which amassed fifty per cent of its income from the active conduct of a business.[15] This broad exemption had the support of the

11. Revenue Act of 1932, ch. 209, § 131(b), 47 Stat. 211.
12. INT. REV. CODE OF 1954, § 904.
13. Revenue Act of 1921, ch. 136, § 238(e), 42 Stat. 259. Under this provision the domestic corporation had to own a majority of the foreign subsidiary. The credit was allowed in proportion to the amount of dividends the domestic received from the foreign subsidiary. INT. REV. CODE OF 1954, § 902 reduced the ownership requirements from 50% to 10%.
14. This is derived from the fact that a WHTC is by definition a domestic corporation. The income which qualifies it for special tax treatment is derived from sources without the United States and can in many cases subject it to foreign taxation.
15. 61 CONG. REC. 5186, 5279-84, 5838, 5868-78, 5883-86, 6224, 6489-94, 7022-26, 7228-51 (1921).

State, Commerce, and Treasury Departments. Nevertheless, it fell in defeat at the hands of a post-war Congress that saw no justification for granting tax incentives which in the long run would only produce windfalls for the larger corporations that could finance overseas investments. To no avail, the advocates of the exemption pointed out the existing competitive disadvantages suffered by United States corporations involved in foreign commerce. Other countries such as France and England delayed the imposition of their taxes on foreign source income until it was repatriated. This policy allowed for reinvestment of foreign source income without its being reduced by domestic taxation. Perhaps the defeat of the original bill was attributable to the isolated nature of the circumstances that had prompted its introduction. Congress had recently granted the Philippines the power to tax income derived solely from sources within its own boundaries.[16] This hindered domestic private investment in our own possessions. The legislation ultimately passed applied only to this situation, which it remedied by deferring United States taxes on income obtained in our possessions until such was remitted to this country.[17]

The failure of the original bill is illustrative of the fact that no complete exemption from the application of United States income taxes has ever been afforded to corporate income from foreign sources.

5. China Trade Corporation.—In 1922 for the first time Congress deviated from its accustomed rule of equal taxation of income regardless of its source by allowing a preference to qualifying corporations trading in China.[18] These "China Trade Corporations" are allowed to credit against taxable income the amount of dividends paid out of income derived from sources within China.[19] In light of our nation's present policy towards trade with the Chinese mainland the importance of this provision is, for all practical purposes, negligible.

6. Pan American Trade Corporation.—Under the banner of stimulat-

16. Act of Oct. 3, 1913, ch. 16, § II M, 38 Stat. 180.

17. Revenue Act of 1921, ch. 136, § 262, 42 Stat. 271. This provision stated that if 80% of a corporation's gross income over the prior three years was derived from sources within a provision of the United States, and 50% of its gross income was derived from the active conduct of a trade or business within a possession, then no United States income tax was due until the income was actually brought into the United States. This deferral of income provision is found in the existing Code as § 931, and § 933 offers a more refined provision for income derived from Puerto Rico.

18. China Trade Act, ch. 346, § 2, 42 Stat. 849 (1922). The act included within the term "China": Tibet, Manchuria, Macao and Hong Kong.

19. China Trade Act, ch. 346, § 21, 42 Stat. 855 (1922) amended the Revenue Act of 1921, ch. 136 by adding § 246 which made special provisions for taxing such corporations. They received a credit of an amount "equal to the proportion of the net income derived from sources within China . . . which the par value of the shares of stock of the corporation bears to the par value of" all the corporation's outstanding stock.

ing trade with Central and South America, Congress in 1939 conceived the Pan American Trade Corporation exemption.[20] This enactment authorized an American parent and its fully owned foreign subsidiary (meeting particular requirements)[21] to file consolidated returns in order to set off the losses suffered by one against the earnings attributable to the other. After the 1940 reinstatement of the consolidated return in the case of all affiliated corporate groups,[22] this section lost its importance, but it had nonetheless provided a precedent for the forces demanding tax incentives for those United States taxpayers willing to risk capital in the development of Central and South America.

7. Excess Profits Tax and Exemptions.—An exclusion from the application of the excess profits tax was the next concession ceded to corporations extracting their income from foreign sources.[23] Since this provision arose in the form of a floor amendment attached to the excess profits tax bill, it is difficult to ascertain the actual reason for its introduction. However, we do know that the excess profits tax was necessitated by the need to meet the increased revenue requirements accompanying World War II, and also to combat the inflationary effect of the accompanying rise in domestic income. The consensus apparently was that foreign income should be freed from any tax that was designed to meet a purely domestic need.[24] From this somewhat questionable premise the exemption for foreign income was contrived. In order to reap the benefits of the exemption a domestic corporation had to receive 95% of its income from foreign sources, and 50% from the active conduct of a business. Although the last excess profits tax expired on December 31, 1953, its exemption for foreign income has had a lingering impact in the area of foreign trade. First of all, those businesses that could qualify for its exemption can, with but slight modifications, qualify now as WHTCs. Sec-

20. Int. Rev. Code of 1939, ch. 247, § 152, 53 Stat. 881. This enactment extended to Pan American Trade Corporations the right to file consolidated returns, since prior to this time only railroad corporations had received the treatment from the Int. Rev. Code of 1939, ch. 247, § 141, 53 Stat. 59.

21. If a domestic parent owned 100% of another domestic corporation whose entire business activity was confined to Central and South America, then the corporation could file a consolidated income tax return. In addition the parent had to receive 80% of its income from the active conduct of a trade or business, while the Pan American corporation had to receive 90% from the source.

22. Int. Rev. Code of 1939, ch. 757, § 730, 54 Stat. 989 (now INT. REV. CODE OF 1954, § 1501).

23. Int. Rev. Code of 1939, § 727(g), added by ch. 757, 54 Stat. 988 (1940). This section controlled the exemptions from the World War II excess-profits tax the same as Int. Rev. Code of 1939, § 454(f), added by ch. 1199, 64 Stat. 1184 (1950) controlled the Korean War excess-profits tax.

24. BITTKER, TAXATION OF FOREIGN INCOME (1960); Surry, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815 (1956).

ondly, it can serve as somewhat of a precedent in posing arguments for preferential tax treatment for foreign income.

8. The WHTC.—In order to extract more revenue, Congress in 1942 hiked the corporate surtax from 7% to 16%, while it permitted the normal corporate tax rate of 24% to remain unchanged.[25] In keeping with the adopted policy of not subjecting foreign income to taxes designed to meet purely domestic needs, Congress promulgated an exemption from the increased surtax.[26] However, this time the exemption was not granted to foreign income regardless of its source, but was limited instead to the income derived from commerce confined to the Western Hemisphere. Thus the WHTC came into being.[27] Generally speaking, a corporation that wishes to qualify as a WHTC has to receive 95% of its income from within this hemisphere exclusive of the United States. In addition it must produce 90% of its income by the active conduct of a trade or business.[28] By the 1942 legislation, if the above qualifications were satisfied, the corporation was exempted from the new section 15 corporate surtax, and, as previously indicated, it was not subjected to the war time excess profits tax. This provision has now evolved into the 14 percentage point tax reduction embodied in sections 921 and 922, which will be discussed in detail herein.[29]

9. Legislative History of the WHTC.—The legislative history surrounding the enactment of the WHTC is ambignous to say the least. So much so that two conflicting theories for its existence have been grounded on the same language.[30]

The *raison-d'être* most often expounded supporting the exemption is that it places domestic corporations on an equal footing with foreign corporations engaged in commerce within the Western Hemisphere. Congress itself found that:

> American corporations trading in foreign countries within the Western Hemisphere are placed at a considerable competitive disadvantage with

25. Int. Rev. Code of 1939, §§ 15, 105, added by ch. 619, 56 Stat. 805 (1942) (now Int. Rev. Code of 1954, § 11). *Hearings Before the Senate Committee on Finance on the Revenue Act of 1942,* 77th Cong., 2d Sess. 2273-76 (1942).

26. See note 24 *supra.*

27. Revenue Act of 1942, ch. 619, § 141, 56 Stat. 838, amending Int. Rev. Code of 1939, § 109. See also *Hearings Before the Senate Committee on Finance on the Revenue Act of 1942,* 77th Cong., 2d Sess. 1204-10, 2273-76 (1942); *Hearings Before the Subcommittee on Tax Policy of the Joint Committee on the Economic Report,* 84th Cong., 1st Sess. 624 (1955).

28. These requirements now embodied in section 901 will be discussed in detail at p. 1454 *infra.*

29. Operative § 922 will be considered at p. 1464 *infra.*

30. *Compare* Baker & Hightower, *The Western Hemisphere Trade Corporation: A Problem in the Law of Sales,* 22 Tul. L. Rev. 229 (1947), *with* Surry, *Current Issues in the Taxation of Corporate Foreign Investment,* 56 Colum. L. Rev. 815 (1956).

> foreign corporations under the tax rates provided by this bill. To alleviate this competitive inequality, the committee bill relieves such corporations from surtax liability.[31]

It was thought that such action would have the effect of aiding our national policy of encouraging international commerce. Imposing a lower tax would not only place United States enterprises—regardless of their form—on a competitive basis with the European operators by alleviating the tax disadvantages, but would also compensate them for the risk involved in foreign trade.[32]

The form of the enactment contradicts this theory, and raises a perplexing question. If one concedes that the purpose was to aid international commerce, then why was it restricted to the Western Hemisphere? As a justification for this limitation it has been pointed out that the global effect of World War II left United States businesses with access only to the Americas. In addition, our paramount need for preservation of an amiable relationship with our neighbors during this period has been submitted as an answer.

A more feasible explanation can be found in the second interpretation of the legislative history. In light of letters presented in the 1942 hearings and discussions before the Senate Committee on Tax Policy in 1955, it has been contended that the exemption was an *ad hoc* remedy brought about by political pressures with no overall economic benefits in mind.[33]

The Patino Mines and Enterprizes, Inc., was a United States corporation with its principal operations in Bolivia. Its foreign shareholders, who constituted a majority, thought the increase in taxes too high a price to pay for a United States charter, and therefore wanted to relinquish it. The United States shareholders, fearing this unfavorable result, exerted pressure upon the administration to produce an exemption.

In Argentina the International Telephone and Telegraph Co. had made plans to change from a British subsidiary to a United States subsidiary of a United States parent. To prevent this transfer from being abandoned because of the new surtax, the United States shareholders lobbied to have their corporation exempted.

The rising war costs, plus increases in taxes, would not allow a

31. See S. REP. No. 1613, 77th Cong., 2d Sess. 32 (1942).
32. See Baker & Hightower, *supra* note 30.
33. See *Hearings Before the Subcommittee on Tax Policy of the Joint Committee on the Economic Policy*, 84th Cong., 1st Sess. 624 (1955); *Hearings Before the Senate Committee on Finance on the Revenue Act of 1942*, 77th Cong., 2d Sess. 2273-76 (letter from International Telephone and Telegraph Corporation), 1204-10 (testimony of Patino Mines and Enterprizes) (1942). The testimony brought out in these hearings is considered in the following textual paragraphs.

United States railway in Central America to meet its sinking fund requirements for reduction of indebtedness. If the debt were not paid then the control of the corporation would pass from the hands of the United States shareholders to the corporation's foreign creditors. To thwart this, a plea similar to those mentioned above was presented to Congress.

After a consideration of these examples it is difficult to escape the conclusion that the WHTC came into being for the purpose of aiding the United States shareholders of the above corporations. One might explain, however, that these were no more than particular examples of a general situation, and that the remedy was intended to expand to its present broad effects. But again this would leave unanswered the question: Why favor this hemisphere?

If, however, the exemption was intended to do no more than aid those corporations involved in activities within foreign countries similar to the firms mentioned above, then Congress framed it in excessively broad terms. Today its main effectiveness is in the export-import field, and not in actual foreign operations.[34] Congress, in offering *ad hoc* relief, constructed a Pandora's box.

10. The WHTC Since 1942.—During the interval from 1942 through 1947 the WHTC form was put to little use because of the emphasis on war machinery rather than consumer goods. After this period, however, it attained widespread popularity with foreign trading firms. In 1948 an attempt was defeated that would have granted the same exemption to a World Trading Corporation.[35]

The original surtax exemption was supplanted in 1950 by a special credit. Under the new plan a WHTC was allowed to reduce its normal taxable income by a certain percentage that varied from 27% to 33% depending on the particular tax year in question.[36] The remainder of its income was then taxed at both normal and surtax rates. In the 1954 Code, section 922 established the present 14 percentage-point reduction.

III. Requirements for Qualification

To gain the benefits extended to a WHTC, a firm must satisfy all

34. See Meek, *Western Hemisphere Trade Corporations and Base Corporations*, 9 De Paul L. Rev. 144 (1960); Seidman, *Western Hemisphere Trade Corporations as Sales Subsidiaries*, 31 Taxes 369 (1953).
35. See note 4 *supra*.
36. Treas. Reg. § 29.109-1 (1950) provided for a credit against net income to replace the previous exemption from the corporate surtax. For the calendar year 1950, the amount of this credit was 33% of the corporation's normal-tax net income, and for the calendar year 1951, it was 28%. For taxable year commencing after June 30, 1950, and before April 1, 1951 the amount of the credit was 30% of the normal-tax net income. For taxable years starting after March 31, 1951, the credit was 27% so long as the rates under the 1951 Revenue Act were applicable.

the requirements of section 921. This Code definition, which was patterned on the considerations expressed before the committee in hearings in 1942,[37] is a concise statement of the standards a WHTC must maintain.

> For purposes of this subtitle, the term "Western Hemisphere trade corporation" means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:
>
> (1) if 95 per cent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and (2) if 90 per cent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business . . . .[38]

While this terminology is apparently clear, it affords several intricacies which are worthy of note. One requirement not embodied in the Code has been added by the regulations, which provide that each WHTC must attach to its return a statement showing:

> (1) that its entire business is done within the Western Hemisphere and, if any purchases are made outside the Western Hemisphere, the amount of such purchases, the amount of its gross receipts from all sources and any other pertinent information, and (2) for the 3-year period immediately preceding the close of the taxable year (or for such part thereof during which the corporation was in existence), (i) its total gross income from all sources, (ii) the amount thereof derived from the active conduct of a trade or business, (iii) a description of such trade or business and the facts upon which the corporation relies to establish that such trade or business was actively conducted by it, and (iv) the amount of its gross income, if any, from sources within the United States . . . .[39]

1. Domestic Corporation.—A corporation may qualify under this section if it was organized under applicable state law, or under the law of Mexico or Canada.[40] Therefore, there is no distinct federal law providing for incorporation. Wholly-owned Mexican and Canadian subsidiary corporations can be treated as domestic if organized solely to comply with the laws of either country as to title and operation, and if it is so treated in the domestic's consolidated return.

While there are no Code requirements as to charter provisions, inclusion of terminology in accord with the Code's provisions would

37. See *Report of the Senate Finance Subcommittee on the Revenue Act of 1942*, 77th Cong., 2d Sess. 111 (1942); Tepper & Lotterman, *The Federal Tax Inducements to Western Hemisphere Trade*, 31 CORNELL L.Q. 205 (1946).
38. INT. REV. CODE OF 1954, § 921.
39. Treas. Reg. § 1.921-1(c) (1954).
40. Rev. Rul. 372, 1955-1 CUM. BULL. 339.

appear advisable. This will not in itself make the corporation a WHTC, but will aid in meeting the section 921 requirements.[41] It is important to recognize that since this provision is confined to domestic business all the normal tax attributes of a domestic corporation are applicable.[42]

2. All Business Within the Western Hemisphere.—The second provision requires all the business of the corporation to be carried on in the Western Hemisphere except for incidental purchases. The Treasury has defined incidental purchases as those that are minor in relation to the entire business, or which are of a nonrecurring or unusual nature.[43] Whether or not purchases are of an incidental character is a matter to be determined on the basis of all the facts of each particular case. However, if the aggregate of all such purchases made outside the Western Hemisphere does not exceed 5% of the gross receipts of the corporation they will be deemed incidental. This latter ruling coupled with section 921(1) would indicate that a corporation could do up to 5% of its business outside the Western Hemisphere and an additional 5% within the United States without being barred from qualification.[44] Also mere incidental economic contact with countries outside the geographical sphere will not place the corporation outside the exempt classification.[45]

3. Geographic Confines.—The Code expressly recognizes that North America, Central America, South America, and the West Indies are in the Western Hemisphere. The Commissioner, in various rulings, has indicated his abilities as a geographer by proclaiming Puerto Rico, the Virgin Islands, the Greater and Lesser Antilles, the Bahamas and the islands contiguous to Venezuela as within the Western Hemi-

41. See Crawford, *Western Hemisphere Trade Corporations*, 47 CALIF. L. REV. 621 (1959).

42. For further consideration of these problems see Dean, *The Current Importance of Western Hemisphere Trade Corporations*, N.Y.U. 10TH INST. ON FED. TAX 489 (1952); Crawford, *Foreign Tax Planning: Western Hemisphere Trade Corporations, and Possessions Corporation*, N.Y.U. 17TH INST. ON FED. TAX 369 (1959); McClure, *Foreign Operations of Extractive Industries*, N.Y.U. 15TH INST. ON FED. TAX 601 (1952); Seghers, *Tax Advantages in Doing Business Abroad and How To Obtain Them*, 32 N.C.L. REV. 184 (1954).

43. The following propositions are substantiated by Treas. Reg. § 1-921(a)1 (1954).

44. Section 921 requires all business (other than incidental purchases) to be carried on in the Western Hemisphere. However, the regulations state that purchases outside the Western Hemisphere will be considered incidental if they do not exceed 5% of the corporation's gross receipts from all sources. Section 921(1) permits 5% of the corporation's gross income to be derived from sources within the United States. While one might at first blush mistake this argument as maintaining that a total of 10% of the corporation's gross income could be derived from a non-qualifying source, a closer reading will point out that the activity outside the Western Hemisphere relates to business expenses rather than income.

45. Treas. Reg. § 1-921(a)1 (1954).

sphere, while determining that Bermuda and the Falkland Islands are not. A ruling, now academic, was handed down stating that Alaska was not a "country" within the Code's terms.[46]

4. Ninety-five Per Cent of Gross Income From Sources Outside the United States.—The requirement that 95% of the corporation's income over the past three years be derived from sources outside the United States actually embodies two separate problems. The first of these requirements is more easily understood when stated in the negative. No WHTC can have received more than 5% of its gross income over the three previous years from sources within the United States. This refers to the aggregate for the three years ending with the close of the taxable year (or such part of such three year period the corporation was in existence), not necessarily 95% of each year's business.[47] Consequently, if a large amount of Western Hemisphere trade came at the close of the three year period the corporation might qualify even though no likelihood that this would occur was apparent at the end of the first two years.

A secondary issue is a direct consequence of the 95% requirement. Practically all United States manufacturers who sell their products in the Western Hemisphere outside the United States are precluded by the 95% requirement from availing themselves of section 921 benefits.[48] The obvious solution to this situation is for the producer to organize a domestic subsidiary to purchase its wares and to resell them in the Western Hemisphere. However, such a practice has the effect of laying the corporation open to both section 269 and 482.

5. The Problem of Tax Avoidance.—Section 269[49] denies the taxpayer any tax saving effected by acquisition of a corporation for the purpose of avoiding tax. The desire to avoid taxes need not be either the principal or the sole reason.[50] In 1945, the Treasury denied the

46. Rev. Rul. 105, 1955-1 CUM. BULL. 94.

47. For a further discussion and examples of this see Crawford, *Western Hemisphere Trade Corporations*, 47 CALIF. L. REV. 621 (1959).

48. This problem is created by the determination of source under sections 861-64 as considered at p. 1459 *infra*. A domestic corporation engaged in manufacturing will by necessity be involved to such an extent in our economy that it would be impractical for it to attempt to market its goods solely in the Western Hemisphere outside the United States. If its operations would allow it to qualify, then it would generally be better for the corporation to have an actual base overseas.

49. INT. REV. CODE OF 1954, § 269. The effect of this statute is to allow the Commissioner to allocate income and deductions to the proper parties whenever a corporation acquires a second corporation for the principal purpose of avoiding taxes.

50. The "principal purpose" test adopted by the Code has been applied in the following cases: Commissioner v. British Motor Car Distrib., Ltd., 278 F.2d 392 (9th Cir. 1960) (disallowed the acquisition of a loss corporation); American Pipe & Steel Corp. v. Commissioner, 243 F.2d 125 (9th Cir. 1957); Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957) (pur-

applicability of the predecessor of this section in the case of a WHTC by ruling that the creation of a new domestic corporation to carry on the business of an existing domestic corporation in the Western Hemisphere does not constitute section 269 tax avoidance.[51] A recent Court of Claims decision[52] has carried this further by stating that a transaction otherwise within the exceptions of the tax code will not lose its immunity when used to avoid taxes.

One should feel free to adopt the subsidiary plan for an additional reason. On several occasions[53] when the Commissioner has attempted to apply section 269 to a division of business for sales purposes, the decision has been favorable to the taxpayer. It should be noted, however, that in each case the taxpayer was able to show an adequate business purpose for his action, and also that the courts stated that the validity of each acquisition or separation would be decided on its own facts. In addition to the grounds open to any corporation, justification for separation in the case of a WHTC can be claimed by a need (1) to limit liability of a parent in foreign trade, (2) to have a corporation that specializes in marketing goods in foreign commerce, (3) to allow increased capitalization.[54]

In light of the Treasury rulings and case law it would appear that manufacturers and producers need not fear the application of section 269.

The Commissioner's power to apply section 482[55] is another possible stumbling block to the utilization of a domestic selling subsidiary by

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chase to split income between two corporations in order to obtain two $25,000 surtax exemptions was disallowed). Generally the Commissioner prefers to apply the sweeping doctrine that a transaction lacking a "valid business purpose" is a sham and will be disregarded as stated in Gregory v. Helvering, 293 U.S. 465 (1935), in lieu of being confined to § 269.

51. "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 129 of the Internal Revenue Code, even though the new corporation was created for the principal purpose of gaining the benefits . . . ." I.T. 3757, 1945 CUM. BULL. 200.

52. The Court of Claims stated in A. P. Green Export Co. v. United States, 284 F.2d 383, 389 (Ct. Cl. 1960): "Neither the motives, occasion for, nor the time of the *organization* of the plaintiff corporation affects its eligibility for tax relief. The Code provisions themselves have created this new business norm, a norm motivated entirely by a tax result."

53. Alcorn Wholesale Grocery Co., 6 T.C. 75 (1951) (here the motive was to avoid absentee ownership from place where the goods of the business were actually sold); Berland's Inc., 16 T.C. 182 (1951) (here split to gain better negotiating power for rentals); Chelsea Prods., Inc., 16 T.C. 840 (1951) (here the business motive was to place the sales division of the business in its own separate branch). In each of these cases there existed a motive for tax avoidance, but the claimed business purpose was thought sufficient to outweigh such.

54. See Baker & Meek, *Tax Problems of Doing Business Abroad: Some Practical Considerations,* 1957 WIS. L. REV. 75.

55. INT. REV. CODE OF 1954, § 482. In general this provision allows the Commissioner to allocate income between organizations controlled by the same interests so as to clearly reflect the income of such firms.

a domestic manufacturer. This section permits the Commissioner to allocate gross income and deductions where it is necessary to do so to clearly reflect the income of the actual earner. In effect this is a codification of the rule expressed in *Helvering v. Horst*,[56] which adopted the general principle that income should be taxed to the party who earns it. The Commissioner ruled under the 1939 Code that he would apply section 482's predecessor where transactions between a parent corporation and its WHTC subsidiary are not at "arm's length."[57] The effect of such an allocation would not only result in income of the WHTC being taxed at its parent's 52% rate, but also might cause the WHTC to do more than 5% of its business within the United States and less than 90% in the active conduct of a trade or business.

The most logical situation for exertion of the Commissioner's power would be when the parent billed the WHTC at less than cost. To be on the safe side the price should fall somewhere in the range between the parent's cost and the fair market value. However, the cases indicate that in a transfer the question is not whether the profit is too small or too great, but whether the transaction is a sham rather than a valid sale.[58] An additional safeguard would be the separation of as many of the administrative affairs of the corporations as are financially feasible. Apparently if separate accounts, minutes, facilities, and staffs were maintained, the "arm's length" requirement would be satisfied so that there would be no reason to fear the application of section 482.[59]

6. Determination of Source.—The only substantial problem caused by the statutory requirements is the difficulty of interpreting the requirement that at least 95% of the business for a three year period must have been "derived from sources other than sources within the United States." While section 921 does not attempt a definition of this phrase, the regulations pertaining to it refer one to sections 861 to 864 and the regulations thereunder.[60] These latter sections were originally placed in the Code to indicate what income was derived

56. 311 U.S. 112 (1940).
57. Rev. Rul. 15, 1953-1 CUM. BULL. 141. The important words to keep in mind here are "at arm's length."
58. Birmingham Ice & Cold Storage Co. v. Davis, 112 F.2d 453 (5th Cir. 1940); Burrell Groves, Inc., 16 T.C. 1163 (1951).
59. See Meek, *Western Hemisphere Trade Corporations and Base Companies*, 9 DE PAUL L. REV. 144 (1960); Crawford, *Foreign Tax Planning: Western Hemisphere Trade Corporation, Possessions Corporation*, N.Y.U. 17TH INST. ON FED. TAX 369 (1959). In order to gain proper perspective it is important to note that here we have been dealing with tax avoidance as it is related to the intercorporate activities of a WHTC and its parent. Of equal note is the issue of tax avoidance in manipulation of the source of income so as to qualify as a WHTC. This problem is discussed in the following material.
60. Treas. Reg. § 1.921-1(c) (1957).

from within the United States for purposes of taxing nonresident aliens. Although it seems fair to apply the same rules to determine what income is without the United States, it should be noted that by so doing the domestic manufacturer is automatically placed outside the scope of section 921. Section 863(b)3 provides that income from the sale of personal property manufactured in the United States and sold without the United States will be treated as derived partly from sources without and partly from sources within the United States.[61] It was this section that led to the earlier discussion regarding the effects of dividing the corporate affairs to take advantage of the WHTC exemptions.[62]

On the other hand, in the case of a trader the place of sale governs the source of income.[63] In the situation where property is purchased within the United States but sold outside, the gain is treated as derived entirely from the country in which the sale takes place. The identical rule is applied to property bought in one foreign country and disposed of in the same country or in another foreign country. The only exception to this is in the case of a purchase in a United States possession and a later sale in the United States. In such a case the income is treated as derived partly from sources within and partly from sources without the United States.[64]

The important issue indicated by the previous discussion is: When, for purposes of taxation, is the sale made so as to determine the source of the income?[65]

From 1913 until 1930 the Commissioner adopted what is most commonly referred to as the "passage of title" test.[66] This theory considers a sale to be consummated when the seller relinquishes to the purchaser all his right, title, and interest in the particular property. The Commissioner's position was sustained by the 1929 Supreme Court decision in *Compania General v. Collector*.[67] It was held that a sale

61. INT. REV. CODE OF 1954, § 863(b)2. Income from the sale of personal property produced by the taxpayer within and sold without the United States, or produced without and sold within the United States shall be treated as derived partly from sources within and partly from sources without the United States.

62. The language of this provision excludes manufacturers from the opportunity of doing business as a WHTC. The situation previously discussed at p. 1457 *supra*, was activated by this particular section.

63. INT. REV. CODE OF 1954, § 862(a)6.

64. Treas. Reg. § 1.861-7(b) (1957).

65. For an excellent discussion on this topic see Baker & Hightower, *supra* note 30; Baker & Meek, *supra* note 54.

66. R. J. Dorn & Co., 12 B.T.A. 1102 (1928); G.C.M. 2467, VII-2 CUM. BULL. 188 (1928); I.T. 2068, III-2 CUM. BULL. 164 (1924); I.T. 1569, II-1 CUM. BULL. 126 (1923); O.D. 1100, 5 CUM. BULL. 118 (1921).

67. 279 U.S. 306 (1929). This case involved a sale to United States buyers of goods obtained in the Philippines. Orders were taken by an agent in the United States to be confirmed in the Philippines where all the terms were

took place outside the United States if the title actually passed there, rather than inside the United States where the contract to sell was executed.

A misinterpretation of the Supreme Court's ruling by the Commissioner resulted in the issuance of G.C.M. 8594[68] which adopted the view that the sale was made at the "place of contracting." This has also been referred to as the "substance of the sale" test. The Commissioner attempted to apply this test in several cases during the period from 1930 until 1947.[69] However, in the 1934 case of *East Coast Oil Co.*,[70] the "place of contracting" test was expressly rejected in favor of the "title passage" test. In light of this holding the Commissioner was thwarted on every occasion when he attempted to enforce his 1930 ruling.

In recognition of his mistake, the Commissioner in 1947 simultaneously issued G.C.M. 25131[71] and acquiesced in the *East Coast Oil Co.* decision.[72] In this manner the "passage of title" test, which had never been renounced by the courts, was again acknowledged by the Treasury. This ruling, however, attached an exception which has the effect of vitiating the "passage of title" test in cases where the sale transaction is arranged in a particular fashion for the primary purpose of tax avoidance. The purpose of this is to require an actual passage of beneficial interests coupled with a valid physical transfer instead of allowing formal recitations in a contract of sale to control the source of the income. When the avoidance situation is found to exist all factors of the transaction will be considered (and the sale will be treated) as having been consummated at the place where the "substance of the sale" occurred. The only authority that the Commis-

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to be established. The Court held the sale was in the Philippines and not the United States where the order was solicited.

68. G.C.M. 8594, IX-2 CUM. BULL. 354 (1930).

69. Amtorg Trading Corp. v. Higgins, 150 F.2d 536 (2d Cir. 1945); Exolon Co., 45 B.T.A. 844 (1941); Ronrico Corp., 44 B.T.A. 1130 (1941); Ardbern Co., 41 B.T.A. 910 (1940); Elston Co., 42 B.T.A. 208 (1940); Hazleton Corp., 36 B.T.A. 908 (1937); Briskey Co., 29 B.T.A. 987 (1934).

70. 31 B.T.A. 558 (1934), *aff'd*, 85 F.2d 322 (5th Cir. 1936), *cert. denied*, 299 U.S. 608 (1936), *acquiescing in* 1947-2 CUM. BULL. 2.

71. G.C.M. 25131, 1947-2 CUM. BULL. 85. This is now incorporated by the regulation's statement that:

> "For the purpose of sections 861 to 864, inclusive, . . . a sale of personal property is consumated at the . . . place where, the rights, title, and interests of the seller in the property are transferred to the buyer. . . . However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules 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 consumated at the place where the substance of the sale occurred." Treas. Reg. § 1.861-7(c) (1957).

72. See note 70 *supra*.

sioner cites for this proposition is the *Kaspare Cohn Co.*[73] case in which the issue actually decided was that the corporation involved was a sham.[74] On the other hand, several cases have stated that the government is limited to consideration of contractual provisions in determining the situs where the title passed, even though the sole motivation behind these provisions was the desire to minimize taxes.[75] These cases apply, for tax purposes, the general rule of contract law that the intent of the parties as expressed in the contract is the factor that determines the place of the passage of title.[76] It has also been argued that the tax avoidance exception of G.C.M. 25131 is by inference restricted from applying in the case of a WHTC since I.T. 3757 expressly permits tax avoidance manipulation in such instances without section 269 being brought into play.[77]

Two recent opinions have approved the utilization of the "passage of title" test as a means of deriving tax savings. In the cases of *Barber-Greene Americas, Inc.*[78] and *Green Export*,[79] both the Tax Court and the Court of Claims stated that the source of income was to be determined by the place of the "passage of title," even though the taxpayer's procedure was adopted to avoid United States income taxes.

In light of these considerations, it should be evident that while the "passage of title" element of G.C.M. 25131 is relevant to WHTCs, the tax avoidance exception is not.[80] Therefore, it seems safe to assume that contract terms setting forth the place of passage of title will control the future decisions of our courts. However, more cau-

73. 35 B.T.A. 646 (1937).

74. In this case stock in two California corporations was purchased by a Canadian corporation set up for the sole purpose of buying out the California corporations and transfering their assets to interests in New York. The sale had been set up prior to the incorporation of the Canadian corporation. The Commissioner applied a step transaction theory in calling this transfer a sham.

75. United States v. Balanovski, 236 F.2d 298 (2d Cir. 1956), *cert. denied*, 352 U.S. 968 (1957); Amtorg Trading Corp. v. Higgins, 150 F.2d 536 (2d Cir. 1945); Commissioner v. East Coast Oil Co., 85 F.2d 322 (5th Cir. 1936), *cert. denied*, 299 U.S. 608 (1936); Hazleton Corp., 36 B.T.A. 908 (1937). The rule was used in a holding adverse to the taxpayer in American Food Prods. Corp., 28 T.C. 14 (1957).

76. Pictorial Paper Package Corp. v. Swamp & Dixie Labs., 197 Ark. 287, 122 S.W.2d 529 (1938); Atlantic Terra Cotta Co. v. Goetzler, 150 Wis. 19, 136 N.W. 188 (1912).

77. Apparently the Commissioner's intention in G.C.M. 25131 was to indirectly incorporate § 269, but as we have seen, I.T. 3757 would rule this out in the case of a WHTC. G.C.M. 25131 applies generally to the source of all foreign income, while I.T. 3757 refers only to income of a WHTC.

78. 35 T.C. No. 45 (Nov. 30, 1960).

79. 284 F.2d 383 (1960); Seghers, *Title Passage Method Outside the United States as Means of Tax Saving Approved in Two New Decisions*, 14 J. Taxation 95 (1961).

80. This is based on the premise that I.T. 3757 impliedly restricts the tax avoidance references in G.C.M. 25131 from application in the case of a WHTC.

tious corporations should attempt to satisfy the Commissioner's desire for actual economic penetration in foreign countries. This factor is implicit in the "substance of the sale" test. The term economic penetration implies actual overseas contacts with the foreign purchaser or seller. This can be accomplished by: (1) permanent establishments abroad, (2) stock piles outside the United States, and (3) negotiations and signing of contracts of sale outside the United States. A corporation that utilizes any one of these methods has to be sure that it does not become so active as to subject itself to foreign taxation, unless such taxation is in the form of an income tax that can be credited against United States taxes.[81]

A third type of income distinct from the two categories previously mentioned is that derived from personal services. Here the Code and the cases agree that "it is the situs of the activity which constitutes the source of the compensation paid."[82] If the services are actually rendered in more than one country, then the income is allocated among them in proportion to the percentage of services performed therein.

7. Ninety Per Cent of the Income From Actual Conduct of a Trade or Business.—The last requirement of section 921 is that 90 per cent of the corporation's income be derived from the active conduct of a trade or business. Income items in the nature of interest, dividends, and royalties have been excluded from the category of active income.[83] Since the Code does not express a preference, it may be inferred that such passive income may come from either within or without the United States so long as no more than 5% of it is from without the Western Hemisphere.

The only unusual facet to be pointed out in this requirement is that it refers to 90% of the gross income, as distinguished from gross sales. Therefore, a corporation attempting to qualify as a WHTC must take care not to figure its non-active income in a ratio to its gross sales, since after deduction of costs the passive income may constitute a

81. In G.C.M. 25131 the Commissioner was attempting to establish a requirement by which a qualifying corporation would be forced to actually enter into economic contact with a foreign country, *i.e.*, economic penetration. To require economic penetration would for all practical purposes emasculate the usefulness of the WHTC. Generally, actual economic penetration would subject a WHTC to foreign taxation, and if this is the case it is generally considered more favorable to establish a foreign subsidiary. See Dean, *The Current Importance of Western Hemisphere Trade Corporations,* N.Y.U. 10TH INST. ON FED. TAX 489 (1952).

82. INT. REV. CODE OF 1954, § 862(a)3; British Timken, Ltd., 12 T.C. 880 (1949).

83. Haussermann v. Burnet, 63 F.2d 124 (D.C. Cir. 1933); Towne Sec. Corp. v. Pedrick, 44 Am. Fed. Tax R. 1258 (S.D.N.Y. 1953); Rev. Rul. 57-435, 1957-2 CUM. BULL. 462.

much greater percentage of the gross income than it did of the gross sales.

Each one of the Code requirements discussed has to be satisfied by a corporation prior to the time it begins operating as a WHTC. It is wise to reproduce in the minutes of incorporation and in the charter, provisions similar in nature to those herein examined. By so doing the corporation can better pattern its future activities to facilitate its operations as a WHTC.

IV. The Consequences of a WHTC Operation

In considering the benefits received by corporations operating within the requirements of section 921, it is of paramount importance to keep two general thoughts in mind. First, the sole reason for any corporation to operate within the strict confines of the WHTC form is to reap the tax benefits offered by section 922.[84] These detailed requirements deprive the corporation of any element of flexibility, thereby rendering it incapable of grasping opportunities that may arise either outside the Western Hemisphere or from the passive conduct of a business. In most situations the WHTC is one of a group of affiliated corporations; its sole purpose is to market the group's products in the Western Hemisphere outside the United States. Second, the WHTC is primarily a domestic corporation, and, therefore, most of the sections of the Code which apply to domestic corporations are equally applicable to the WHTC. It is of interest to note that out of the four special benefits granted to WHTCs by the Code, only one is applied to these corporations exclusively.

Section 922 provides a special deduction against taxable income for a corporation qualifying as a WHTC.[85] To determine this special deduction the Code provides that the corporation's taxable income shall be multiplied by a fraction, the numerator of which is 14% and the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year involved. Therefore, for the past several years the fraction has been 14/52 (*i.e.* 14% over 30% normal tax rate plus 22% surtax rate). After the taxable income has been established by the normal processes and the special deduction has been subtracted therefrom, the remainder is multiplied by the appropriate rate to determine the corporation's taxes. The 14/52 fraction remains the same whether the amount of the corporation's taxable income is sufficient to subject it to the combined normal tax and surtax or only to the normal tax.

84. See note 52 *supra*.
85. Treas. Reg. § 1.922-1 (1957). This regulation sets out clearly the procedure for computing the tax reduction.

It is generally stated that the WHTC has an effective tax rate of 38%, and thereby acquires a 14 percentage—point reduction in taxes. However, the reduction can be greater whenever the special deduction can reduce the income to a sum less than $25,000, so that only the normal tax rate will apply. (Example: If the taxable income of a WHTC is $34,000, the reduction is $9,153.84 (computed by 14/52 × $34,000) and the original $34,000 of taxable income is reduced to $24,846.16. Only the normal tax rate will apply to this figure—30% × $24,846.16—producing a tax of $7,453.84, whereas if the corporation had not been a WHTC it would have been taxed at a rate of 30% on $25,000 and at 52% on the $9,000 excess, so as to produce $12,180 in taxes.) Although the above example represents the most dramatic tax reduction possible, it is easy to see that this special deduction does produce a substantial tax saving.[86]

If the tax benefits are passed on to a parent corporation in the form of dividends, then its total tax liability will amount to 38% plus 7.8% of the remaining 62% or 42.84%. This is true because the 85% deduction for intercorporate dividends applies in the case of a WHTC.[87] On the other hand, the parent and the WHTC can eliminate the intercorporate dividend tax by filing a consolidated return without imposition of the 2% additional consolidated tax on the WHTC's earnings.[88] By adoption of this latter plan the full benefits of the WHTC are passed on to the parent.

There is one drawback to the special deduction established by section 922: there is no way to receive credit for net operating losses. In light of this state of affairs it is wise to have a branch department suffer the earlier losses and set up the WHTC only after the profits start to come in. By doing this the early losses can be set off against the parent's income while the later profits are held separate.

We have already examined two of the tax boons extended to the WHTC in our discussion of the special deduction and the consolidated returns. Of the remaining two, one is no longer important; the other is applicable solely because of the source of WHTC income. Since the abolition of the excess profits tax the exemption therefrom granted to the original WHTC is of little importance. However, if the tax should be reinstated the WHTC would probably again receive an exemption similar to those previously granted. The dividends received from a WHTC by a non-resident alien are not subject to United States income taxes since the source of the income from which the dividends

86. See Crawford, *supra* note 47, for examples of the benefits gained by operating as a WHTC in comparison to the benefits received by operating within other forms.
87. INT. REV. CODE OF 1954, § 243(a).
88. INT. REV. CODE OF 1954, §§ 1501, 1504; Treas. Reg. § 1-1504 (1954).

were paid is not within the United States.[89] This statement also holds true in the case of a foreign corporation holding stock in a WHTC.

While there are important tax consequences to be considered in determining whether to operate as a WHTC or as a foreign branch, a far more important question is which form best suits the circumstances of the business in point. If actual economic penetration—such as mining or operating a railroad—is anticipated then it would appear that actual foreign incorporation would best meet the needs of the business. Since economic penetration generally results in the business being subjected to foreign taxation, it would appear advisable to take action to free it of United States taxes by using a foreign-based operation. Foreign incorporation also provides for a more flexible and diversified form of business.

Conversely, if the corporation is involved only in trade activities which do not subject it to foreign taxes, then the WHTC would seem to satisfy its needs. By incorporation in the United States the corporation is able to work within the framework of familiar laws and regulations. Also, in light of the present political situation, it might be wise to retain as much domestic control over the assets and operations of the corporation as possible.[90]

Only after a concentrated study of the above elements should the tax consequences be taken into consideration. The foreign tax credit may be utilized by either the WHTC or the parent of a foreign-based subsidiary. However, the parent of a WHTC cannot receive the credit for foreign taxes paid by the WHTC.[91] Also, the WHTC is limited to a credit of 38% of foreign taxes, which means that if the foreign tax is in excess of 38% the corporation will not receive the full benefit of the credit. The most important tax distinction between the two methods of operation, other than the special deduction, is that by utilization of the foreign-based corporation the earnings of the corporation are not subject to section 531 taxes on accumulated earnings. This allows the foreign corporation to retain its funds for overseas expansion while requiring the WHTC to distribute the greatest part of its income each year.

Aside from the pure arithmetic there are several other factors which bear materially upon the decision to use a WHTC. It may be incorporated tax-free under section 351 and may be liquidated into its parent under section 332 without the necessity for a ruling under section 367. Its losses may be set off against consolidated income of an affiliated group which files consolidated returns, and where there

89. INT. REV. CODE OF 1954, § 1503(b); Treas. Reg. § 1.1502-2(b) (1956).
90. See Dean, note 81 *supra*.
91. This is true because of the WHTC's domestic characteristics.

is no consolidation it is entitled to the net operating loss carryback and carry forward.[92]

For operating purposes a WHTC is merely a hybrid domestic corporation which is granted both a special deduction from taxable income and a limited concession if it files a consolidated return. These considerations must be weighed against the limitations placed on the permissible activities of such a firm in determining whether it is advantageous to seek the substantial tax benefits offered to a WHTC.

V. The WHTC's Future

As the previous discussions have indicated the WHTC is today useful only to those concerns trading in the import-export business. On the other hand, the drafters of the original bill apparently intended to have this provision apply to those businesses actually involved in operations in foreign countries within the Western Hemisphere. Today most corporations actually operating in the Americas find foreign incorporation the best method. In light of the existing state of affairs, it is evident that the original congressional intent has been completely subverted. Congress recognized this situation in stating that, "although your committee believes the present Western Hemisphere trade corporation provision produces some anomalous results, it has retained those provisions in order to avoid any disturbances at the present time to established channels of trade."[93]

After such a statement the least that one can say is that section 921 has a contingent future.

The American Law Institute has offered proposed changes to the WHTC.[94] The draft requires only that any domestic corporation claiming the special credit be engaged in active business within at least one country within the Western Hemisphere, thus eliminating the present percentage requirements in the statutory definition of a WHTC. The change would have the effect of applying the section 922 deduction to all income of a domestic corporation derived both from countries within the Western Hemisphere, exclusive of the United States and its possessions, and from the active conduct of a trade or business there. Such a revision would allow the congressional intent to be carried out and at the same time permit flexibility within the corporate form.

After a study of the source requirements, the Institute came to the

92. Int. Rev. Code of 1954, § 172.
93. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 77-78 (1954).
94. See Surry & Warren, *The Income Tax Project of the American Law Institute: Partnerships, Corporations, Sale of Corporate Business, Trusts and Estates, Foreign Income and Foreign Taxpayers*, 66 Harv. L. Rev. 1161, 1201 (1953).

conclusion that the "passage of title" test is the only one which does not distinguish between exporters and importers. They considered both the "destination of the property" and "selling activity" tests. Both were deemed to be open to manipulation and at the same time were difficult to administer.

In all probability this entire provision will undergo a complete revision in connection with the adoption of a new policy on taxation of foreign income. Those who advocate an over-all provision similar to that presently embodied in the WHTC should make a careful examination of the transformation that has occurred within this limited experiment. While the WHTC has failed to operate as intended, this is no indication that a similar provision might not prove to be quite suitable on a world-wide basis.

VI. CONCLUSION

As was stated at the outset, there is a definite demand for a complete renovation in our present system of taxing foreign income. The WHTC is merely one of the facets involved in this ultimate problem. However, it may well be a guide in determining the final course of action we should take. Its history is indicative of the danger that lies in approaching tax problems on an *ad hoc* basis. It also points up the fact that political and economic evolution can outdate the effectiveness of a congressional enactment. The most important factor that the history of the WHTC stresses, however, is that Congress should not attempt to change this particular provision of the Code without a thorough evaluation of our government's policy toward foreign taxation.

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