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Western Hemisphere Trade Corporations

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The ever growing realization over the years on the part of bankers, manufacturers, and other interested groups within the United States of the need of a sound and profitable foreign trade and a sound and profitable system of investments abroad has accentuated the plea for the abatement, in some substantial measure, of those fiscal burdens imposed by the federal income tax laws of the United States on income derived from private international trade and finance.

The amelioration preferentially sought is naturally one which will bring the most direct and most liberal relief to the American taxpayer engaged in the exportation of goods, investment or venture capital, or special knowledge of industrial science. The urgency of such a plea rests upon the postulate of intelligent self interest in offering a competitive and continuing incentive to American capital to go abroad and to accept the greater risks attendant upon doing business by individual or corporate citizens of the United States in numerous foreign countries.

I

THE PRESENT SITUATION

Today the federal income tax law of the United States contains no clearly defined *modus operandi* of sufficient vigor or attractiveness to impel the American investor to undertake new foreign investments or to reward adequately the risks of investments already situated abroad. True, provision is made for special deductions or credits in a few instances. Each provision, however, contains its own counterlimitations which serve to hypothecate substantially the benefit which ultimately accrues to the taxpayer, although consultation with those who participated in the drafting of such legislation clearly discloses a conscientious intent to distribute the tax burden equitably.

Such instances include (a) a deduction for certain foreign taxes paid or accrued within the taxable year,[1] (b) a credit for certain foreign taxes paid

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[1] INT. REV. CODE OF 1954, §§ 164(a), (b)(6).

or accrued during the taxable year,[2] (c) a special deduction for Western Hemisphere trade corporations, discussed in detail later, and (d) a special deduction for China Trade Act corporations, the allowance of which is subject to unique computation, accompanied by detailed certification thereof by the Secretary of Commerce to the Secretary of the Treasury.[3]

A. Deduction or Tax Credit

In determining their United States income tax liability, individual and corporate citizens of the United States may deduct from gross income the full amount of foreign taxes paid,[4] or take a credit against the United States income tax for income, war profits, or excess profits taxes (or other taxes in lieu thereof) paid to a foreign country or to any possession of the United States. The amount of such credit with respect to any one foreign country or possession of the United States, however, may not exceed that proportion of the United States tax which the income of the taxpayer from sources within such country or possession bears to his entire taxable income for the same taxable year.[5]

Taxes of various kinds have long been recognized as part of the cost of doing business; consequently, they constitute a valid deduction from gross income in computing taxable income. However, as the volume of American foreign trade has increased and foreign countries have successively enacted income tax laws, the need of American business interests for equitable relief from foreign and domestic taxation of the same general income, reported by

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[2] INT. REV. CODE OF 1954, §§ 33, 901, 904, 905.

[3] INT. REV. CODE OF 1954, §§ 941–43. In view of existing conditions in those countries to which the China Trade Act, 1922, 42 Stat. 849 (1922), 15 U.S.C. §§ 141–162 (1952), might be adaptable, no practical purpose would be served by a discussion of China Trade Act corporations at the present time. For details of organization of this type of corporation reference should be had to the above-named act.

[4] INT. REV. CODE OF 1954, §§ 164(a)–(c).

[5] INT. REV. CODE OF 1954, §§ 901–04; Treas. Reg. § 1.904–1 (1957). Where the foreign taxes paid or accrued for any taxable year beginning after December 31, 1957, exceed the amount allowable as a credit under the per-country-limitation, the excess may, under strict limitations, be carried back to the 2 preceding taxable years and carried over to the 5 succeeding taxable years. INT. REV. CODE OF 1954, § 904(c), added by Technical Amendments Act of 1958, § 42, 72 Stat. 1639. The innovation, however, expressly stipulates that the excess over the allowable credit shall be deemed a tax paid or accrued "in the second preceding taxable year, in the first preceding taxable year, and in the first, second, third, fourth, or fifth succeeding taxable years, *in that order* . . . ." Further, for the purposes of this new subsection, the terms "second preceding taxable year" and "first preceding taxable year" do not include any taxable years beginning before January 1, 1958. Thus, taking the language of the new subsection at its face value, the taxpayer whose first taxable year (calendar or fiscal) for which this credit is sought begins after December 31, 1957, will have to wait two years and then claim his credit as a carryback in relation to foreign taxes paid or accrued in the calendar years 1958 and 1959 or in the first two fiscal years of the taxpayer beginning after December 31, 1957. See note 30, *infra*, as to meaning of "taxable year."

the same company in separate returns (consolidated if operating through subsidiaries), required more than a mere tax deduction.[6]

An unabridged tax credit, as an alternative to deduction of foreign taxes as a business expense, was first granted in 1918,[7] and until 1921 the tax credit was allowed in full, without the proportional or other limitation. This was changed to a general limitation by the Revenue Act of 1921,[8] which provided that the total tax credit could not exceed that proportion of the United States tax which the "net income" from sources without the United States bore to the "entire net income" for the same taxable year.

In 1932 the current per country limitation was added to the general limitation described above, with the result that both the general and per country limitations appeared simultaneously and were in full force and effect at the same time.[9]

Also a proportional tax credit may be granted a domestic corporation for taxes paid by a foreign corporation in which the domestic corporation owns at least 10 percent of the voting stock from which it receives dividends in any taxable year.[10] A similar tax credit may likewise be obtained for foreign taxes paid by a foreign subsidiary of such foreign corporation, provided the latter owns 50 percent or more of the voting stock of the foreign subsidiary corporation from which it receives dividends in any taxable year.[11]

A regulated investment company which meets the requirements applicable to such companies for the taxable year may, provided more than 50 percent of the value of its total assets at the close of the taxable year consists of stocks or securities of foreign corporations, elect to apply for a tax credit with respect to foreign income and like taxes paid by the investment company to foreign countries or possessions of the United States.[12] However, once having made the election for the application of this form of tax credit, the regulated investment company is naturally excluded from the

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[6] See INT. REV. CODE OF 1954, §§ 871–72.

[7] Revenue Act of 1918, ch. 18, § 238(a), 40 Stat. 1080.

[8] Revenue Act of 1921, ch. 136, § 238(a), 42 Stat. 258.

[9] Revenue Act of 1932, ch. 209, §§ 31, 131(b), 47 Stat. 169, 185, 211.

[10] The Internal Revenue Code of 1939 permitted a domestic corporation to claim a proportional tax credit for income taxes paid by a foreign subsidiary where the domestic parent held a majority of the voting stock of the former. Int. Rev. Code of 1939, ch. 1, § 131(f), 53 Stat. 57. The majority requirement was reduced to 10% in 1951. Revenue Act of 1951, ch. 521, § 332(a), 65 Stat. 506.

[11] INT. REV. CODE OF 1954, §§ 902(a), (b). Provision for a tax credit for taxes paid by a foreign subsidiary of a foreign subsidiary was added in 1942. Revenue Act of 1942, ch. 619, § 158(e)(2), 56 Stat. 858. As originally enacted, ownership of "all the voting stock (except qualifying shares)" of the second subsidiary was required; this was reduced to 50% in 1951. Revenue Act of 1951, ch. 521, § 332(b), 65 Stat. 506.

[12] INT. REV. CODE OF 1954, § 853; Treas. Reg. § 1.853–1 (1957). See also, generally, INT. REV. CODE OF 1954, §§ 851–55.

benefit of a general tax deduction and a conventional tax credit.[13] It may, nonetheless, add the amount of the foreign taxes paid to its dividend deduction for the taxable year.[14]

B. Western Hemisphere Trade Corporations

For the purpose of favorable tax treatment of certain corporate income under federal tax legislation the words "Western Hemisphere trade corporation" mean a domestic[15] corporation all of whose business—other than incidental purchases—is conducted in one or more of the countries of North, Central or South America or in the West Indies—in short, within the Western Hemisphere.[16]

The Internal Revenue Service has no comprehensive list of the countries includible in the geographical territories enumerated.[17] However, inasmuch as section 921 of the Code in defining the term "Western Hemisphere trade corporation" specifically designates North, Central or South America or the West Indies as the geographical areas in which the business of such a corporation is to be conducted, all other geographical areas are necessarily excluded.[18]

The Virgin Islands, the Greater Antilles, the Lesser Antilles, the Bahamas, the islands off the coast of Venezuela, and the islands in the West

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[13] INT. REV. CODE OF 1954, §§ 853(b)(1)(A), 853(b)(1)(B), 164(a), 901; Treas. Reg. § 1.853 (1957).

[14] *Ibid.* For the effect of such an election upon individual shareholders of a regulated investment company, see Treas. Reg. §§ 1.852–53 (1959).

[15] A Canadian or Mexican wholly-owned subsidiary corporation may be treated as a domestic corporation for the purpose of determining its qualification as a Western Hemisphere trade corporation if it is organized and maintained solely in order to comply with the laws of either country as to title and operation, provided it is so treated in the consolidated return of the domestic parent corporation. INT. REV. CODE OF 1954, § 1504(d); Rev. Rul. 55-372, 1955-1 CUM. BULL. 339.

[16] INT. REV. CODE OF 1954, § 921. The Rand McNally World Atlas map of North America includes the Aleutian Islands, Greenland, Canada, Newfoundland, the United States, Mexico, Bermuda, Central America (the five countries comprising the historical Confederation of Central American States), Panama, British Honduras, and the West Indies (the Bahamas and the Greater and the Lesser Antilles), RAND MCNALLY, WORLD ATLAS 14, 15 (Int'l ed. 1939). As to the status of Bermuda, see note 18, *infra.*

[17] Rev. Rul. 55-105, 1955-1 CUM. BULL. 94.

[18] I.T. 3990, 1950-1 CUM. BULL. 57. It was held that Bermuda, although within the geographical limits of the western hemisphere, was not part of the American continent or of the West Indies, and "hence a domestic corporation which does business only in Bermuda cannot qualify as a Western Hemisphere trade corporation." *Ibid.* Similarly, Newfoundland, separated from the North American mainland by the Strait of Belle Isle and Cabot strait, was expressly mentioned in the Revenue Act of 1942. Revenue Act of 1942, ch. 619, § 141, 56 Stat. 838. At that time Newfoundland was a separate nation and a member state of the British Commonwealth. The fact that it became a province of Canada in 1949 doubtless explains its omission from the 1954 code. See Treas. Reg. 1.921-1(a)(1) (1957); 95 STATESMEN'S YEAR BOOK 388 (1958).

Indies are considered to be Western Hemisphere trade corporation islands.[19] Bermuda and the Falkland Islands are not.

Alaska—now removed from the question by its recently acquired statehood—was not deemed a "country" in North America, with the result that a domestic corporation doing business there could not be treated as a Western Hemisphere trade corporation.[20] On the other hand, Puerto Rico was considered a "country" within the meaning of section 109 of the Internal Revenue Code of 1939.[21]

In addition to the foregoing geographical limitations, other well defined tests have been established by statute as conditions precedent which must be satisfied before a domestic corporation may enjoy the advantageous tax status of a Western Hemisphere trade corporation:

> (1) 95 percent or more of the gross income of the domestic corporation for the 3-year period immediately preceding the close of its taxable year[22]—or for such part of that period during which the domestic corporation was in existence—must derive from sources without the United States.
>
> (2) 90 per cent or more of its gross income for such period or such part thereof must be derived from the active conduct of a trade or business.[23]

II

THE WESTERN HEMISPHERE RESTRICTION

By definition, *all* of the business (other than incidental purchases) of a domestic corporation which aspires to the status of a Western Hemisphere trade corporation *must* be transacted *within* the Western Hemisphere. In addition, 95 per cent or more of the gross income of such corporation *must* be derived from sources *without* the United States over the prescribed period.[24] Consequently, as much as 5 percent of the business of the corporation *may* be conducted wholly within the United States, or even partly or wholly outside the Western Hemisphere if such portion of the business does not exceed the allowable incidental purchases.[25]

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[19] See note 18, *supra.*

[20] I.T. 4067, 1951-2 CUM. BULL. 55; Rev. Rul. 55-105, 1955-1 CUM. BULL. 94.

[21] I.T. 3748, 1945 CUM. BULL. 152.

[22] Taxable income is computed on the basis of the taxpayer's "taxable year." Under the income tax law, a "taxable year" is (1) the taxpayer's annual accounting period, provided it is either a calendar or fiscal year within the meaning of the law, (2) the calendar year, if the taxpayer keeps no books, does not have an annual accounting period, or his annual accounting period does not qualify as a fiscal year, or (3) the period for which the return is made, if a return is made for a period of less than 12 months. INT. REV. CODE OF 1954, § 441.

[23] INT. REV. CODE OF 1954, § 921.

[24] INT. REV. CODE OF 1954, § 921; Treas. Reg. §1.921-1 (1957).

[25] It is this permissable tolerance of 5% that presumably influenced the regulatory rulings hereinafter discussed with respect to incidental purchases. See text at note 30, *infra.*

Moreover, the 95 percent requirement clearly relates to the aggregate gross income of the domestic corporation over the period of 3 years immediately preceding the close of the taxable year (or for such part of that period during which the corporation was in existence), not necessarily 95 percent of each year's business. Hence, the business of the corporation might fall far short of this percentage requirement until almost at the end of the prescribed period. Upon obtaining sufficient additional business to make up the deficiency the enterprise could still qualify as a Western Hemisphere trade corporation at the expiration of the specified period.

In determining whether all of the business of the domestic corporation for the taxable year[26] has been conducted within the Western Hemisphere, "incidental purchases" outside that area will not disqualify the corporation.[27] However, the term "incidental purchases" as used here does not have the same meaning as the phrase "purchases incident to the conduct of the business," frequently confused with the former.[28]

The term "incidental purchases"—of any kind or for any purpose—for the account of a domestic corporation which claims Western Hemisphere trade corporation treatment means only those which are minor in relation to the entire business or which are nonrecurring or unusual in character. Whether the purchases made outside the Western Hemisphere are incidental purchases within the meaning of the Internal Revenue Code and Regulations will be determined on the basis of all the facts of each particular case.[29]

Generally, in any case in which the aggregate total of such purchases—again, of any kind or made for any purpose of the domestic corporation—made outside the Western Hemisphere for the taxable year does not exceed an amount equal to 5 percent of the "gross receipts" of the corporation "from all sources" for the taxable year, such purchases will be treated as incidental.[30]

For example, a domestic corporation, engaged in the business of manufacturing and selling construction equipment in Argentina, purchased in Germany during the calendar year 1956 certain motor parts required as an integral part of the equipment it manufactures. Since the amount of such purchases equaled only 4 percent of the gross receipts of the corporation for 1956, they were treated as incidental purchases and did not disqualify the corporation as a Western Hemisphere trade corporation.[31]

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[26] Quaere, since § 921 specifies merely "all of whose business (other than incidental purchases)," does this test of status refer to the taxable year for which the return is made or to the entire period of 3 years? According to the Service, this test refers to the taxable year. Treas. Reg. § 1.921–1(a)(1) (1957).

[27] Treas. Reg. § 1.921–1(a)(1) (1957).

[28] *Ibid.*

[29] *Ibid.*

[30] Treas. Reg. § 1.921–1(a)(1) (1957).

[31] Treas. Reg. § 1.921–1(b)(2) (1957).

On the other hand, where a domestic corporation operated a mine in South America and during 1956, in accordance with its usual practices, purchased in France machinery and equipment "necessary in the conduct of its business," such purchases were substantial in proportion to the entire business of the corporation and disqualified it as a Western Hemisphere trade corporation.[32]

To illustrate the principle involved with respect to contracts of sale, a domestic corporation which operates a mine in South America, and from there ships its product to England, may retain title to its shipments until the draft attached to the bill of lading is accepted or paid, without losing its status as a Western Hemisphere trade corporation, where such retention is for the sole purpose of insuring collection of the price of the sale. Such a corporation will not be considered as conducting its trade or business outside the Western Hemisphere since the passing of title under the circumstances described is merely an "incidental economic contact" outside the prescribed area.[33]

Consequently, any business (other than allowable incidental purchases and the narrow exception as to passing of title) done in Europe, Asia, Africa or elsewhere outside the Western Hemisphere will disqualify a domestic corporation which is seeking the desired tax benefits. There is, however, possible refuge in a subsidiary.

If, having conducted some of its business—other than the exceptions noted—outside the Western Hemisphere, the corporation sees that the sources of its business for the taxable year in course will not permit its qualification as a Western Hemisphere trade corporation, it can immediately organize a domestic subsidiary which will conduct all of the Western Hemisphere business of the parent for the remainder of the current year and so qualify all of the gross income of the subsidiary during the time it was in existence in accordance with the Internal Revenue Code.

At first glance the conventional code phrase "all of whose business," as used in relation to Western Hemisphere trade corporations, at once suggests doing business in the aggressive sense, *i.e.*, production and sale of the products. In view of the preceding rulings, however, it is apparent that the Western Hemisphere restriction relates to purchasing, as well as selling, in the "conduct of the business."

III

THE ARTICLES OF INCORPORATION

A Western Hemisphere trade corporation must be initiated as a domestic corporation and must remain or be treated as a domestic corporation, even

[32] Treas. Reg. § 1.921-1(b)(3) (1957).

[33] Treas. Reg. § 1.921-1(b)(1) (1957).

when organized in contiguous countries,[34] in order to qualify for the corresponding tax benefits, a point forgotten or overlooked on occasion by those who seek to utilize this type of company organization for the reduction of their corporate taxable income. In the absence of a federal corporation law the domestic corporation must be organized under the appropriate law of a State or of the District of Columbia, or as a wholly owned subsidiary under the laws of Mexico or Canada.

There is no set or prescribed form of charter or articles of incorporation for a Western Hemisphere trade corporation although obviously the articles, of necessity, must be sufficiently broad and elastic to permit the corporation to engage in the commercial activities without the United States which are essential to qualification.

The *sine qua non* in this respect should be set out in the statement of objectives and purposes of the business. A Western Hemisphere trade corporation does not become such because its charter says it is one but by reason of the conduct of the business where and as required by the Internal Revenue Code. In order to assist in achieving the desired result the following provisions, among others customarily included in the charter of any business corporation, are offered for consideration by the incorporators of a trading coporation which intends to qualify as a Western Hemisphere trading corporation:

> The objects and purposes of this corporation shall be: To carry on a trading business in all its branches, and, in any country or countries in North, Central or South America, or in the West Indies, or in Newfoundland, and in connection therewith, to act as merchants in any country or countries in North, Central or South America, or in the West Indies, or in Newfoundland, and otherwise deal in any and all other objects and articles of commerce in any country or countries in North, Central or South America, or in the West Indies, or in Newfoundland.

Other charters coming to the attention of the author do not stress the specific geographical areas of the Western Hemisphere enumerated above but content themselves with the phrase "within the Western Hemisphere and outside of the United States." Still others use the phrase "particularly in the countries of the Western Hemisphere."

In any event, it appears desirable to repeat the reference to the geographical area or areas wherever in the context it is sought to identify the objects and purposes of the corporation as those of a Western Hemisphere trade corporation. The choice is with the draftsmen.

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[34] See note 15, *supra*.

IV

INCOME FROM TRADE OR BUSINESS

Still another limitation on the activities of a Western Hemisphere trade corporation may cause loss of status as such. In two of the definitions of gross income appearing in the Internal Revenue Code,[35] the all inclusive emphasis is laid upon gross income *per se*, of which interest and dividend income forms an integral part. However, although items of interest and dividend income from sources within or without the United States, included by a domestic corporation in its return for the taxable year, would still establish part of its tax liability, they would not be deemed allowable items of gross income to accredit its qualification as a Western Hemisphere trade corporation.

The Internal Revenue Code expressly provides that at least 90 percent of "gross income"—not sales—must be derived from the "active conduct of a trade or business" during the prescribed period of 3 years, or for such part of that period as the corporation may have been in existence, in order that a domestic corporation may qualify as a Western Hemisphere trade corporation.[36]

Income from interest and dividends is not derived from the active conduct of a trade or business. It is the result of investment. Moreover, "gross income" and "sales" are not synonymous terms. Gross income from a trading enterprise is the excess of sales over the cost of the goods sold.

Take, for example, the case of a domestic corporation trading as a Western Hemisphere trade corporation which has an aggregate gross income of $5,250,000 for the years 1956, 1957 and 1958 from sources within the Western Hemisphere but without the United States. This aggregate gross income is derived from sales, $5,000,000; dividend income, $200,000; interest income, $50,000. Against sales there is chargeable as cost of the goods sold, $3,000,000, leaving a balance of $2,250,000. For purposes of qualification as a Western Hemisphere trade corporation, however, the two items of dividend and interest income cannot be treated as part of gross income since they represent investment income and not earned income from the operation of a trade or business.[37]

In accordance with the foregoing figures, the "trading" gross income

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[35] INT. REV. CODE OF 1954, §§ 61, 861(a).

[36] INT. REV. CODE OF 1954, §§ 921(2); Treas. Reg. § 1.921–1(a)(3) (1957).

[37] I.T. 1785, II–2 CUM. BULL. 258 (1923); Treas. Reg. § 1.921–1(a)(3) (1957); Towne Sec. Corp. v. Pedrick, Civil No. 53–223, S.D.N.Y., Oct. 14, 1953. Note also that in accordance with this decision the mere observation and making of suggestions by the taxpayer corporation with respect to the operations of another corporation, in which the taxpayer has stock, is not the active conduct of a trade or business. See also I.T. 2318, V-2 CUM. BULL. 76 (1926); Ct. D. 702, XII–2 CUM. BULL. 221 (1933).

for the 3 years, for purposes of a Western Hemisphere trade corporation, would be $2,000,000 (sales less cost of goods sold), in proportion to which interest income plus dividend income ($250,000) would be 12.5 percent (250,000/2,000,000).[38]

Inasmuch as this would exceed the permissable tolerance of 10 percent of gross income *not* required to be derived from the active conduct of a trade or business the corporation would be disqualified as a Western Hemisphere trade corporation for 1958 regardless of the fact that interest income and dividend income together equaled only 5 percent of sales.[39]

Moreover, in no sense can an operating corporation be considered as the "alter ego or agent" of an investor so that the latter acquires tax advantages as a Western Hemisphere trade corporation or otherwise,[40] and where the claimant is clearly a mere investor the special deduction against taxable income will be disallowed.[41] "The object of the law, obviously, is to prevent a corporation from obtaining the Western Hemisphere trade corporation credit on investment income."[42]

Even ownership of all the stock of the operating corporation is not sufficient to show that the creation and management of that corporation was a part of the ordinary business of the taxpayer, since under the general rule a corporation is an entity distinct from its stockholders for tax purposes.[43]

As an illustration of these principles, consider the following: A corporation (the taxpayer) was created pursuant to a reorganization plan to hold stock in a reorganized company which operated mines in Mexico. It received contractual rights to elect a minority group of directors and to observe and to make suggestions for the operations of the properties of the reorganized mining operator. However, its sole income consisted of dividends from the stock of the reorganized enterprise. In fact, the plaintiff

[38] See INT. REV. CODE OF 1954, §§ 61–63, 1001–13. The cost of goods sold is not a deduction and must be subtracted from gross receipts in order to arrive at gross income. The taxpayer may use the cost of goods sold in computing his profit, which alone is gross income for income tax purposes. Lela Sullenger, 11 T.C. 1076 (1948). Unquestionably, there are two possible opinions concerning the inclusion of interest and dividend income for purposes of qualifying under § 921. If items of interest and dividend income should be included in gross income for this purpose, the result, in the example, would be a combined gross income of $2,250,000. The qualifying ratio would then be 250,000/2,250,000 instead of 250,000/2,000,000. However, "dividends received by a corporation do not represent income derived from the active conduct of a trade or business," [Treas. Reg. § 1.921–1(a)(3) (1957)] and the author therefore offers the computation made in the absence of an authoritative ruling allowing other treatment. See U.S. Corporation Income Tax Return, Form 1120–1958, p. 2, 11. 1–15. See also text at note 89, *infra*.

[39] *Ibid.*

[40] Burnet v. Clark, 287 U.S. 410, 415 (1932); Haussermann v. Burnet, 63 F.2d 124, 127 (D.C. Cir. 1933).

[41] Burnet v. Clark, 287 U.S. 410, 415 (1932); Dalton v. Bowers, 287 U.S. 404, 410 (1932).

[42] P–H 1953 FED. TAX SERV. ¶ 4686; *id.*, ¶ 16, 705. See also I.T. 1785, H–2 CUM. BULL. 258 (1923).

[43] Dalton v. Bowers, 287 U.S. 404, 410 (1932).

had no right or privilege to exercise any activity whatever in the operation of the producing business. In view of these facts the exercise of the above described contractual rights did not augment the position of the taxpayer as an ordinary stockholder nor did it transform the dividend income of the latter into earnings from the active conduct of a trade or business. Accordingly, the taxpaper was not entitled to the tax benefits of a Western Hemisphere trade corporation.[44]

V

SOURCES OF INCOME

As previously shown, the Internal Revenue Code of 1954 makes it clear that in order to qualify as a Western Hemisphere trade corporation the enterprise must restrict its entire business[45] for the prescribed period immediately preceding the close of its taxable year to a country or countries within the Western Hemisphere. Although the Code itself does not require it, the regulations, nevertheless, specify that a corporation which claims the tax benefits of a Western Hemisphere trade corporation must attach to its income tax return a statement showing: (1) Its entire business is done within the Western Hemisphere, (2) the amount of the purchases, if any, made outside the Western Hemisphere, (3) the amount of gross receipts[46] from all sources, for the 3-year period immediately preceding the close of the taxable year under review—or such part of it during which the corporation was in existence—(a) its total gross income from all sources, (b) amount derived from "the active conduct of a trade or business," (c) description of the trade or business, (d) the facts upon which the corporation relies to establish that such trade or business was actively conducted by it, and (5) the amount of its gross income, if any, from sources within the United States.[47]

Thus, in discussing Western Hemisphere trade corporations there are five sources of gross income which should be considered: (1) Any source whatsoever, (2) any source within the Western Hemisphere, (3) sources within the United States, (4) sources without the United States, and (5)

[44] Towne Sec. Corp. v. Pedrick, Civil No. 53-223, S.D.N.Y., Oct. 14, 1953.

[45] This excludes the "incidental purchases" exception to the requirement. See text at notes 26-33, *supra*.

[46] Gross income and gross receipts are two different items of accounting. Gross income, as used in relation to income tax laws, means statutory gross income and not gross receipts, since these may include borrowed capital and return of capital as well as income. Gross income is the foundation of income tax liability; however, after deduction of non-income items, gross receipts may necessarily and properly reflect the adjusted gross income of the taxpayer which it was his duty to report. Southern Pac. Co. v. Lowe, 247 U.S. 330 (1918); Clark v. United States, 211 F. 2d 100 (8th Cir. 1954); Estate of Stein, 25 T.C. 940 (1956).

[47] Treas. Reg. 1.921-1(c) (1957). Note that gross income from sources within and without the United States is to be determined as provided in Internal Revenue Code of 1954, §§ 861-64, and regulations thereunder.

sources partly within and partly without the United States.[48] In view of the express limitations of the Code the first source may be largely disregarded except for purposes of definition.[49] The second source has already been treated in some detail.[50]

A. Within the United States

The identification of the situs of transactions giving rise to gross income of an ordinary domestic trading or manufacturing corporation in the United States is, by comparison, a relatively familiar matter. With certain exceptions, "gross income" in such a case means "all income from whatever source derived, including, but not limited to," 15 expressly enumerated items of income.[51]

The simplicity of the quoted text is mildly shaken, however, when one attempts to particularize income from sources within the United States, although a consanguinity naturally exists between "gross income," and specific "items of gross income" from sources within the United States as described in the Internal Revenue Code.[52].

These items include interest and dividends, as well as personal services, rentals and royalties, sale of real property, all within the United States, together with income derived from the purchase of personal property without the United States (other than a possession of the United States) and its sale within the United States.[53] However, the distinction between the situs of a transaction within the United States and one without the United States has frequently plagued both the federal courts and the Internal Revenue Service, not to mention the taxpayer.

For example, gain included in the proceeds of marine insurance received by a Western Hemisphere trade corporation as a result of the loss of goods in transit from the United States to Cuba constitutes income from sources within the United States.[54] Insurance proceeds are not mentioned in the Internal Revenue Code in this connection, hence the source of the gain included in the insurance proceeds must be determined by general principles of law. For purposes of taxation of personal property it is well established that the situs of goods in transit remains at their original situs

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[48] INT. REV. CODE OF 1954, §§ 61, 861–64, 921.

[49] See text at notes 15–21, *supra*.

[50] See text at notes 24–33, *supra*.

[51] INT. REV. CODE OF 1954, § 61. Among the enumerated items are interest (No. 4) and dividends (No. 7).

[52] INT. REV. CODE OF 1954, §§ 861, 863.

[53] INT. REV. CODE OF 1954, §§ 861(a), (b). These items of gross income are subject to deductions for "expenses, losses and other deductions" allowed by the Code, the remainder, if any, being "taxable income" from sources within the United States. INT. REV. CODE OF 1954, § 861 (b).

[54] I.T. 3902, 1948–1 CUM. BULL. 64, 65.

until such time as they acquire permanent situs elsewhere.[55] Under this rule it is clear that in the instant case the situs of the goods was still in the United States at the time they were lost since the taxpayer and owner, a Western Hemisphere trade corporation, necessarily domiciled in the United States, was the insured. Consequently, the situs of the lost personal property determines the source of the gain included in the insurance proceeds received as a result of the loss.[56]

However, under two rulings of the Attorney General of the United States, profit made by a *foreign corporation* from the sale in other countries of merchandise produced or purchased in the United States is not taxable income "from sources within the United States" within the meaning of the revenue acts.[57] Consequently, where a corporation organized under the laws of Scotland manufactures or partially manufactures articles in the United States which are sold in England after being exported to Glasgow, where they are finished at the home mill, there is no gross income from sources within the United States within the meaning of the income tax law.

"No income is derived from the mere manufacture of goods; before there can be income there must be sale; and there is no income from sources within the United States from goods manufactured here unless there is . . . both manufacture and disposition of the goods within the United States."[58]

A domestic corporation purchased products in the United States for resale to purchasers in Venezuela, and for this purpose it maintained offices and engaged agents in Venezuela to solicit orders subject to confirmation in New York. However, the corporation passed title to the goods in New York when it delivered them to the ocean carrier at New York and received payment there from New York banks against letters of credit. Under such circumstances the corporation could not qualify as a Western Hemisphere trade corporation since its income was not derived from "sources without the United States" within the meaning of the statute.[59]

Again, a domestic corporation, organized solely for the purpose of acting as purchasing agent for South American firms, derived its income from commissions on goods purchased in the United States and shipped by various sellers directly to South America, where the sale was consummated.

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[55] General Oil Co. v. Crain, 209 U.S. 211, 229 (1908); Kelley v. Rhoads, 188 U.S. 1, 7 (1902); COOLEY, TAXATION §§ 452–54 (4th ed. 1924).

[56] I.T. 3902, *supra* note 54. Costs directly attributable to the goods lost may be taken into account in determining the net insurance proceeds, provided such costs are readily identifiable and are deducted from the cost of the goods sold or inventoried.

[57] 34 OPS. ATT'Y GEN. 93 (1924); 32 OPS. ATT'Y GEN. 336 (1920).

[58] 32 OPS. ATT'Y GEN. 336, 337, 339 (1920). Although opinions of the Attorney General of the United States should be viewed with the respect to which they are entitled, they are, nevertheless, opinions.

[59] American Food Prods. Corp., 28 T.C. 14 (1957). See also INT. REV. CODE OF 1954, §§ 921–22; INT. REV. CODE OF 1939, ch. 1, § 119, 53 Stat. 53.

The commissions so received represented compensation for services rendered in the United States, inasmuch as the United States was the "situs of the income-producing service."[60]

B. Without the United States

The statute requires that 95 percent or more of the gross income of the business of a Western Hemisphere trade corporation for the prescribed 3-year period must have been derived from "sources without the United States,"[61] but does not clarify or define the meaning of the quoted phrase. However, section 862 of the Code lists six categories of income items which "shall be treated as income from sources without the United States."[62] Those six categories are as follows:

(1) Interest other than that derived from sources within the United States;

(2) Dividends other than those derived from sources within the United States;

(3) Compensation for labor or personal services performed without the United States;

(4) Rentals or royalties from property located without the United States or for the use without the United States of patents, secret processes, or like properties;

(5) Gains, profits, and income from the sale of real property located without the United States; and

(6) Gains, profits and income derived from the purchase of personal property within the United States and its sale without the United States.

The importance of the last of these categories for those seeking the benefits of Western Hemisphere trade corporation status will be discussed later.[63]

Inasmuch as the problem of the situs will be seen to be central to the determination of the questions we have been discussing, it will not be inapposite to consider the language of the Court of Appeals for the Fifth Circuit in construing the predecessor of section 862:[64]

> We think the language of the statute clearly demonstrates the intendment of Congress that the source of income is the situs of the income-producing service. The repeated use of the words *within* and *without* the United States denotes a concept of some physical presence, some tangible and visible activity.[65]

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[60] Rev. Rul. 56-477, 1956-2, CUM. BULL. 506.

[61] INT. REV. CODE OF 1954, § 921(1).

[62] INT. REV. CODE OF 1954, § 862(a).

[63] See discussion, text at notes 70-78, *infra*.

[64] Revenue Act of 1936, ch. 690, § 119(c), 49 Stat. 1693. This section is substantially identical with § 862, except that to the latter the sixth category of income items has been added. INT. REV. CODE OF 1954, § 862(a)(6).

[65] Commissioner v. Piedras Negras Broadcasting Co., 127 F.2d 260, 261 (5th Cir. 1942). (Emphasis added in part.)

In a decision rendered 6 years earlier the same court said:

> . . . the important question is when and where were the profits earned. The company is a Mexican corporation necessarily domiciled in that country. The property sold was produced in Mexico. The contracts provided for firm sales. No profit resulted from the mere execution of the contracts. The oil was delivered to the buyer in Mexico. The title passed to the buyer in Mexco. When title passed the profit was earned in Mexico. Collection of the price in the United States was incidental and did not earn the profit.[66]

The situs of the passing of title to personal property and the consummation of the sale is emphasized in similar vein and equal degree in the 1959 Regulations.[67] However, in any case in which the sale is arranged in a particular manner for the primary purpose of avoiding the income tax the foregoing rules of determination of the place of sale will not be applied and all of the circumstances surrounding the transaction will be taken into consideration.[68]

C. Within and Without the United States

Pursuant to the provisions of section 863(b) of the Internal Revenue Code of 1954, gains, profits, and income (1) from transportation or other services rendered partly within and partly without the United States, (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, or (3) derived from the purchase of personal property within a possession of the United States and its sale within the United States, are treated as derived partly from sources within and partly from sources without the United States. Moreover, "the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by" the Commissioner of Internal Revenue.[69]

While it is presumed that the formulas or processes devised by the Commissioner for the apportionment of income under the circumstances contemplated above would be fair and equitable, the fact remains that the application of such formulas or processes might—and probably would—exclude the domestic manufacturer from qualifying as a Western Hemisphere trade corporation. Under the examples which appear in the regula-

[66] Commissioner v. East Coast Oil Co., 85 F.2d 322, 323 (5th Cir.), *cert. denied,* 299 U.S. 608 (1936). Helvering v. Stein, 115 F.2d 468 (4th Cir. 1940); *cf.* Commissioner v. Hawaiian Phil. Co. 100 F.2d 988 (9th Cir.), *cert. denied,* 307 U.S. 635 (1938).

[67] Treas. Reg. §§ 1.861–7(a), (c) (1957).

[68] Treas. Reg. § 1.861–7 (c) (1957).

[69] It is established in the Treasury Regulations, in relation to the separate statement required of Western Hemisphere trade corporations when submitting their income tax returns that gross income from sources within and without the United States shall be determined in accordance with Internal Revenue Code of 1954, §§ 861–64. Treas. Reg. § 1.921–1(c) (1957).

tions more than 5 percent of the gross income of the producer-taxpayer could well be apportioned to sources within the United States over the conventional prescribed period.[70]

It is at this point that the necessity of a subsidiary corporation reveals itself with emphasis.

VI

USE OF SUBSIDIARIES

A. Domestic

A domestic manufacturer may lawfully evade the effects of section 863(b), which have just been discussed, to a certain extent by organizing a domestic subsidiary for the purpose of purchasing the products of the domestic manufacturer and reselling them in the Western Hemisphere outside the United States. Gross income resulting from this arrangement would constitute "income from sources without the United States."[71]

This has the added advantage of permitting the domestic manufacturer (i.e., the parent corporation) to sell its products in the United States or in any other part of the world, within or without the Western Hemisphere, provided such sales are made by the manufacturer directly without the intervention of the subsidiary, and still preserve the status of the subsidiary as a Western Hemisphere trade corporation.

However, if the domestic manufacturer "acquires control" of the subsidiary, directly or indirectly, for the principal purpose of evading the federal income tax by securing tax benefits which the manufacturer would not otherwise enjoy, such benefits will not be allowed.[72] For the purposes here described "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock of the subsidiary entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.[73] On the other hand, the Commissioner of Internal Revenue may allow the tax benefits sought by apportioning gross income and the benefits sought between both corporations to the extent that he determines the allowances will not result in evasion of the federal income tax for which the acquisition of the subsidiary was made.[74]

Nevertheless, where the purchase price paid by the manufacturer for the acquisition of the subsidiary is substantially disproportionate to the value of the property acquired and tax benefits are achieved which would

[70] Treas. Reg. § 1.863-3(b)(2) (1957), and examples thereunder.

[71] INT. REV. CODE OF 1954, § 862(a)(6).

[72] INT. REV. CODE OF 1954, § 269.

[73] INT. REV. CODE OF 1954, § 269(a).

[74] INT. REV. CODE OF 1954, § 269(b)(2).

not be available to the manufacturer except as a result of the acquisition, a *prima facie* case is made that the principal purpose of the acquisition was to evade the income tax.[75]

A reasonable attitude has been adopted by the federal courts, however, where a well defined "business purpose" has been demonstrated as the motive for the acquisition; and it may be stated, as a general rule, that the subsidiary corporation acquired or organized by the parent and owned or controlled by the latter will not be deemed to have been acquired or organized for evasion of the federal income tax if there is a "business purpose" for the acquisition or organization or if the evidence shows that the claimant did not "acquire" a new corporation or new assets by forming the subsidiary to conduct certain operations.[76]

In reliance upon the foregoing judicial rulings there seems to be little likelihood of the punitive application of section 269 to a subsidiary formed by a domestic corporation to conduct operations as a Western Hemisphere trade corporation, provided there is no clear violation of the tax principles described above and that the intercompany accounting is such as to withstand severe scrutiny.[77] If such is not the case the Commissioner may exercise his powers to reallocate income and deductions between the two corporations wherever necessary to prevent evasion of taxes or to reflect clearly the taxable income of either.[78]

B. Foreign

By reason of the limitations imposed by law, a Western Hemisphere trade corporation, whether a domestic subsidiary or principle corporation, finds itself automatically restricted to the Western Hemisphere outside the United States for its entire foreign sales outlet.

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[75] INT. REV. CODE OF 1954, § 269(c).

[76] J. R. Dilworth Co. v. Henslee, 98 F. Supp. 957 (M.D. Tenn. 1951); Chelsea Prods. Co. v. Commissioner, 16 T.C. 840 (1951), *aff'd*, 197 F.2d 620 (3d Cir. 1952). According to the *Dilworth* case, § 269 of the Internal Revenue Code of 1954 applies only where one corporation acquires new assets, and was enacted to prevent a corporation that had large earnings from acquiring another corporation that had large capital tax exemptions. In any even, the burden of proof is on the corporation which acquires the subsidiary to establish by a preponderance of the evidence that the finding and determination of tax evasion by the Commissioner is erroneous. American Pipe & Steel Corp. v. Commissioner, 243 F.2d 125 (9th Cir.), *cert. denied*, 355 U.S. 906 (1957).

[77] I.T. 3757, 1945 CUM. BULL. 200. Taxing statutes are strictly construed against the Government and in favor of the taxpayer. Lilly v. United States, 238 F.2d 584, 585 (4th Cir. 1956). Taxes should be imposed by Congress, not by the courts, and when doubt arises as to taxability the doubt should be resolved in favor of the taxpayer. Gellman v. United States, 235 F.2d 87 (8th Cir. 1956).

[78] Rev. Rul. 57-542, 1957-2 CUM. BULL. 462; Rev. Rul. 15, 1953-1 CUM. BULL. 141; INT. REV. CODE OF 1954, § 482. The initiation of a newly organized wholly owned subsidiary presumably would avoid the unfavorable connotation of "acquisition" or "control" of "new assets" or of "another corporation" as these terms are used in the Internal Revenue Code of 1954, and related judicial decisions.

Assume that a domestic subsidiary corporation, duly qualified as a Western Hemisphere trade corporation, operates a mine or produces goods in an approved country in the Western Hemisphere outside the United States. Under such circumstances the domestic corporation would necessarily be qualified to do business in the country of operations and would be registered there accordingly.[79] The typothetical American mine operator or producer (as a Western Hemisphere trade corporation), upon organizing a foreign subsidiary under the laws of the country of operations within the Western Hemisphere but outside the United States, would thus gain a special sales outlet with which the Western Hemisphere trade corporation should maintain a *bona fide* relationship of buyer and seller at arm's length.

This would not only insure the passing of title to the respective goods outside the United States beyond question, but also would permit the foreign subsidiary (the vendee) to sell the mining products or other goods anywhere in the world without adversely affecting the status of the domestic parent corporation as a Western Hemisphere trade corporation.

In addition, if the domestic parent (the Western Hemisphere trade corporation) owns 10 percent or more of the voting stock of the foreign subsidiary from which it receives dividends in any taxable year, such parent is deemed to have paid the same proportion of any income taxes paid by the foreign subsidiary to the foreign country with respect to its accumulated profits as the amount of the dividends bears to the accumulated profits.[80]

Further, if the foreign subsidiary described above organizes a foreign subsidiary of its own (a foreign subsidiary of a foreign subsidiary), and retains 50 percent or more of the voting stock of the new foreign subsidiary from which it receives dividends in any taxable year, the first foreign subsidiary (now also a parent corporation) may claim a proportional tax credit similar to the one described above.[81]

C. Effect of Consolidated Returns

The use of a consolidated tax return evokes a penalty. In any case in which a consolidated return is made or required to be made "the tax imposed . . . shall be increased for any taxable year by 2 percent of the consolidated taxable income of the affiliated group of includible corporations."[82]

[79] This would have no effect upon its nationality as a corporate citizen of the United States organized and existing under the laws of a state of the United States. A corporation is to be regarded as a citizen of and legally domiciled in the State of its organization, although it may do business in all places where its charter permits and local laws do not forbid. First Bank Stock Corp. v. Minnesota, 301 U.S. 234, 237 (1937); Shaw v. Quincy Mining Co., 145 U.S. 444, 451 (1892); Lafayette Ins. Co. v. French, 59 U.S. (15 How.) 404 (1855). See also 5 HACKWORTH, DIGEST OF INTERNATIONAL LAW § 544 (1927).

[80] INT. REV. CODE OF 1954, § 902(a).

[81] INT. REV. CODE OF 1954, § 902(b). See also INT. REV. CODE OF 1954, § 902(c), (d); Treas. Reg. § 1.902-1 (1959), and examples thereunder.

[82] INT. REV. CODE OF 1954 § 1503(a).

However, if the affiliated group which files a consolidated tax return includes a Western Hemisphere trade corporation, the increase in the rate shall be applied only on that portion of the consolidated taxable income attributable to the members of the group *other than the Western Hemisphere trade corporation,* without any increase with respect to the partially tax-exempt interest of the latter.[83]

In any event, the parent corporation and each subsidiary which is a member of the affiliated group during any part of a consolidated return period are severally liable for the tax—including any deficiency[84]—as well as for any addition to the tax[85] for underpayment of the estimated tax for the consolidated return period.[86] Moreover, any agreement entered into by one or more members of the affiliated group with other members of the group or with any other person will not have the effect of reducing the tax liability which arises under section 1502 of the Code.[87]

The parent corporation, whether or not it is a Western Hemisphere trade corporation, is, for all purposes related to the tax for the taxable year for which a consolidated return is made or required, the sole agent, duly authorized to act in its own name in all matters relating to the tax, in behalf of each corporation which was a member of the affiliated group during any part of the taxable year. Further, the common parent corporation must make the consolidated return for the affiliated group.[88]

However, those members of an affiliated group of corporations which operate in the Western Hemisphere outside the United States, and whose only source of income is from dividends, interest, and capital gains, are, for the purpose of consolidating the special deduction, excluded in determining the consolidated taxable income attributable to those members of the group which are Western Hemisphere trade corporations. The items of gross income enumerated above are not derived from the active conduct of a trade or business, and the ordinary members, therefore, cannot be classified as Western Hemisphere trade corporations.[89]

VII

THE SPECIAL DEDUCTION

A special deduction, equal to a percentage of taxable income, is allowed Western Hemisphere trade corporations.[90] This was first authorized under

[83] Treas. Reg. § 1.242–1 (1956); Treas. Reg. § 1.1502–30(b)(1) (1955).

[84] Computed as provided in Treas. Reg. § 1.1502–30 (1955).

[85] Computed as provided in Treas. Reg. § 1.1502–49 (1955).

[86] Treas. Reg. § 1.1502–15 (1955).

[87] Treas. Reg. § 1.1502–15(d) (1955).

[88] Treas. Reg. § 1.1502–12(c), 1.1502–16(a) (1955).

[89] Rev. Rul. 58–56, 1958–1 CUM. BULL. 335; Rev. Rul. 56–316, 1956–2 CUM. BULL. 597 (amplified). See also INT. REV. CODE OF 1954, §§ 863, 901, 904, 921, 922; Treas. Reg. § 1.1502–31(15) (1955).

[90] INT. REV. CODE OF 1954 § 922.

the Revenue Act of 1942[91] for the avowed purpose of placing American firms in a position to compete successfully against foreign competitors in Latin America. Provisions similar to those appearing in section 921 of the Internal Revenue Code of 1954 are found in the Revenue Act of 1939. What were actually Western Hemisphere trade corporations were then referred to as "Pan-American trade corporations."[92]

In the case of a Western Hemisphere trade corporation the impact of the normal tax rate and surtax rate[93] is reduced by a special deduction computed by multiplying the taxable income of such corporation by a fraction. The numerator of this fraction is 14 percent and its denominator is the sum of the percentages of the normal and surtax tax rates for the taxable year.[94] The numerator was selected as maintaining the previous value of the special deduction to the taxpayer in percentage points.[95] It was also the intent of Congress to maintain this value at a permanent level regardless of normal tax and surtax rate changes from time to time. Hence, when changes brought the normal tax rate to 30 percent of taxable income and the surtax rate to 22 percent of taxable income in excess of $25,000, the fraction 14/52 resulted from the language of the law.[96]

The amount which results from the multiplication of taxable income of a Western Hemisphere trade corporation by 14/52 is then subtracted from such taxable income. The amount which remains after the subtraction is the basis on which the normal tax and surtax are computed. The fraction specified for this computation remains the same, nevertheless, whether the amount of taxable income of the corporation is sufficient to subject it to the combined normal tax and surtax or only to the normal tax.[97]

A. Example One

In conformity with the rules governing taxable years[98] and computation of the special deduction, assume the following facts: A domestic corpora-

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[91] Revenue Act of 1942, ch. 619, § 141, 56 Stat. 838.

[92] Revenue Act of 1939, ch. 247, § 225, 53 Stat. 880, pt. 2.

[93] INT. REV. CODE OF 1954, §§ 11, 242. See also certain exceptions, INT. REV. CODE OF 1954, § 11(d). Beginning after June 30, 1960, the normal tax will be equal to 25% of taxable income. Tax Rate Extension Act of 1959, § 2, 73 Stat. 156 (Public Law 86–74).

[94] INT. REV. CODE OF 1954, §§ 11, 922.

[95] In 1945, Int. Rev. Code of 1939, § 15(b), as amended by Revenue Act of 1942, ch. 1, § 105(b), 56 Stat. 805, was again amended, and the surtax rate was decreased from 16% to 14% on corporate surtax net income over $50,000. Revenue Act of 1945, ch. 453, § 121(c), 59 Stat. 568.

[96] Treas. Reg. §§ 1.11–1, 1.21–1, 1.922–1(b) (1957). General instructions accompanying the corporate tax return use the decimal conversion, 26.923%. U.S. Corporation Income Tax Return, Form 1120–1958, General Instructions, para. 39. The special deduction is not allowed in a year in which a net operating loss occurs. INT. REV. CODE OF 1954, § 172(d).

[97] INT. REV. CODE OF 1954, § 922; Treas. Reg. § 1.922–1(a) (1957). See also INT. REV. CODE OF 1954, § 1201, and regulations thereunder, for rules applicable in determining the special deduction where the alternative tax is imposed.

[98] Taxable income shall be computed on the basis of the taxpayer's taxable year. For purposes of Subtitle A, Internal Revenue Code of 1954, the term "taxable year" means the tax-

tion has taxable income of $500,000, after allowable deductions from gross income, of which $350,000 comes from domestic business and $150,000 from sales in the Western Hemisphere outside the United States. The taxable year is June 30, 1957–June 30, 1958. During that taxable (fiscal) year it operated *without* a subsidiary and discovers that its total income tax is equal to 50.9 percent[99] of its taxable income.

Taxable income (net income from earnings)	$500,000
Normal tax (30% of $500,000)	150,000
Surtax on $475,000 (22% of $500,000—$25,000)	104,500
Total tax	$254,500

B. Example Two

Had the business been divided between a domestic parent corporation and a subsidiary qualified as a Western Hemisphere trade corporation the result would have been as follows, using the same earnings figures:

Income tax of domestic parent corporation:

Net income from earnings	$350,000.00
Dividends from subsidiary[100]	98,500.20
Total net income	$448,500.20
Allowance: Reduction of 85% of dividends from subsidiary[101]	83,725.17
Taxable income	$364,775,03
Normal tax (30% of $364,775.03)	$109,432.50
Surtax on $339,775.03 (22% of $364,775.03—$25,000)	74,750.50
Total tax of parent	$184,183.00

payer's annual accounting period, whether it is a calendar year or a fiscal year. INT. REV. CODE OF 1954, § 441. "Fiscal year" is the accounting period of 12 months ending on the last day of any month other than December. United States v. Mabel Elevator Co., 17 F.2d 109 (D.C. Minn. 1925). Where a corporation operates on a fiscal year basis it is entitled to have the tax payable by it computed on such basis and the Commissioner is powerless to deprive the corporation of this right. Monarch Mills v. United States, 96 Ct. Cl. 471, 44 F. Supp. 334 (1942).

[99] Total tax ($254,500) divided by net earnings ($500,000) equals 50.9%.

[100] Dividends from subsidiary are the difference between net income of subsidiary ($150,000) and total tax of subsidiary ($51,499.80).

[101] INT. REV. CODE OF 1954, § 243; Treas. Reg. § 1.243–1 (1956). The general rule in the case of a corporation is that there shall be allowed as a deduction (from net earnings) in computing taxable income an amount equal to 85% of the amount received as dividends (other than dividends described in § 244(1) of the Internal Revenue Code of 1954) from a *domestic* corporation which is subject to taxation under chapter 1 of the Internal Revenue Code of 1954. *Cf.* INT. REV. CODE OF 1954, § 244; Treas. Reg. § 1.244 (1956). (Deduction for dividends received on certain preferred stock). See also Technical Amendments Act of 1958, § 18, 72 Stat. 1614.

Income tax of Western Hemisphere subsidiary:

Net income from trade or business	$150,000.00
Special deduction—14/52 of $150,000	40,385.00
Taxable income after special deduction	$109,615.00
Normal tax (30% of $109,615)	$ 32,884.50
Surtax on $84,615 (22% of $109,615—$25,000)	18,615.30
Total tax of subsidiary	$ 51,499.80
Total tax of parent when using subsidiary	$184,183.00
Total tax of subsidiary	51,499.80
Total tax combined	$235,682.80

The tax savings resulting from the employment of a subsidiary to conduct operations as a Western Hemisphere trade corporation in the preceding examples is the difference between $254,500 (total tax without subsidiary) and $235,682.80 (total combined tax with subsidiary), or $18,817.20, equal to approximately 7.39 percent of the total tax due in the absence of the subsidiary. The use of a subsidiary which qualified as a Western Hemisphere trade corporation makes possible a ratio of total tax to taxable income of 34.3 percent instead of 48.3 percent, which would have been the ratio (using the same net income figure) had the subsidiary been an ordinary domestic corporation not qualified as a Western Hemisphere trade corporation.[102]

The actual dollar-to-dollar tax saving of the Western Hemisphere subsidiary in this instance is the difference between $72,500 (total tax without benefit of the special deduction) and $51,499.80 (total tax after special deduction), or $21,000, equal to 28 percent of the total tax ($72,500) due as an ordinary corporation.

C. Example Three

In order to confirm the potential tax saving illustrated by the last examples, assume a corporation is organized for the objectives of and qualifies as a Western Hemisphere trade corporation and has gross income of $100,000 for the taxable year June 30, 1957–June 30, 1958. It has allowable deductions (other than the special deduction) for that year amounting to $40,000, resulting in a taxable income of $60,000.

Tax if not qualified

Normal tax: 30% of $60,000	$18,000.00
Surtax: 22% of $35,000 ($60,000—$25,000)	7,700.00
Total tax	$25,700.00

[102] The beneficial effect of the special deduction here is quickly demonstrated by dividing $51,499.50 (total tax payable by the qualified subsidiary) by $150,000 (taxable income before the deduction). The result is 34.3%, a reduction of 14 percentage points; 48.3% minus 34.3% equals 14%.

Tax if qualified	
Taxable income	$60,000.00
Special deduction: 14/52 of $50,000	16,153.84
Taxable income after special deduction	$43,846.16
Normal tax: 30% of $43,846.16	$13,153.8480
Surtax: 22% of $18,846.16 ($43,846.16—$25,000)	4,146.1552
Total tax	$17,300.00
Comparison	
Total tax before qualification	$25,700.00
Total tax after qualification	17,300.00
Tax saving	$ 8,400.00[102a]

D. Example Four

The special deduction makes itself felt substantially where the taxable income of a Western Hemisphere trade corporation is not large enough to subject it to the surtax. The fraction used in computing the special deduction is, as previously stated, the same whether the amount of corporate taxable income is sufficient to subject it to the combined normal tax and surtax, or only to the normal tax.[103]

Assume that the facts are the same as in the last example except that the allowable deductions from gross income (other than the special deduction) amount to $80,000, leaving a taxable income of $20,000. The normal and total tax (in reality, the only tax in such a case) before qualification for the special deduction is 30 percent of $20,000 (taxable income), or $6,000. There is no surtax since taxable income is less than the exemption of $25,000.[104] The total tax after the special deduction is as follows:

Taxable income	$20,000.00
Special deduction: 14/52 of $20,000	5,384.61
Taxable income after special deduction	$14,615.39
Normal tax (30% of $14,615.39)	$ 4,384.62
Total tax	$ 4,384.62

Here the actual dollar-to-dollar tax saving is the difference between $6,000 (the total tax in the absence of status as a Western Hemisphere trade corporation) and $4,384.62 (total tax after the special deduction), or $1,615.38, equal to 26.9 percent of the total tax before the special deduction.[105]

[102a] $8,400 equals 14% of taxable income and 32.685% of total tax if not qualified.

[103] Treas. Reg. § 1.922–1 (1957).

[104] INT. REV. CODE OF 1954, § 11(c).

[105] Compare results of tax saving in Example Two (28%) of the text.

CONCLUDING QUESTIONS

In attempting to weigh the restrictive measures of the Internal Revenue Code of 1954 pertaining to Western Hemisphere trade corporations against the potential (as well as past) benefits granted such corporations by Congress, several questions suggest themselves almost automatically. Doubtless similar questions have been asked before and admittedly the issues raised may constitute imponderables.

(1) Is the exclusion of dividend and interest income, as items of gross income eligible for purposes of Western Hemisphere trade corporations, a serious obstacle to private lending or investment of American capital in countries of the Western Hemisphere outside the United States?

(2) Does the tax treatment of Western Hemisphere trade corporations have the effect of restricting them principally to trading operations?

(3) Has the special deduction heretofore allowed Western Hemisphere trade corporations fully discharged its declared purpose with respect to American business vis-à-vis foreign competition in the Western Hemisphere?

(4) Assuming that the usual probative investigations which customarily precede the transfer of private venture capital abroad reveal the project as a calculated risk type, if consummated, are the benefits accorded a Western Hemisphere trade corporation of sufficient scope and depth to influence the assumption of risk by the board of directors of a domestic corporation in diverting substantial sums of dollar venture capital to countries of the Western Hemisphere outside the United States?

(5) What would be the effect upon the foreign trade of the United States if the tax benefits accorded Western Hemisphere trade corporations were extended to all domestic corporations engaged in foreign trade and finance, subject to present requirements for qualification other than the Western Hemisphere limitation?

(6) What would be the effect upon existing and future investments of American private venture capital abroad if the tax benefits accorded Western Hemisphere trade corporations were extended to all domestic corporations engaged in foreign trade and finance, subject to present requirements for qualification other than the Western Hemisphere limitation but treating dividend and interest income as eligible items of gross income for purposes of the tax benefits contemplated?