NORTH CAROLINA LAW REVIEW

Volume 32 | Number 2 Article 2

2-1-1954

Tax Advantages in Doing Business Abroad and How to Obtain Them

Paul D. Seghers

TAX ADVANTAGES IN DOING BUSINESS ABROAD AND HOW TO OBTAIN THEM†

PAUL D. SEGHERS*

This discussion describes the potential tax advantages of doing business abroad, and possible means of obtaining them. Presentation of the technical aspect of this topic is based upon the following conclusions:

(1) Substantial tax savings and other tax advantages can be obtained in doing business abroad;

(2) Such savings and advantages can be obtained by use of methods which are fully within the spirit and letter of the law;

(3) Methods applicable in a particular case may have potential business advantages which, in the long run, may exceed their tax advantages;

(4) If methods presently used to do business abroad clearly result in income from sources within the United States it is not safe to rely upon mere change in the forms of documents, without any other change in methods of doing business, in order to establish that income is thereafter derived from sources without the United States and entitled to the resulting tax advantages.

This discussion will outline the two great potential tax advantages in doing business abroad; will describe the forms which these advantages may assume; will point out three possible difficulties in obtaining these advantages; and, finally, will deal with the steps to be taken in obtaining such of these advantages as are available and practicable in the business under consideration.

I. THE TWO TAX ADVANTAGES IN DOING BUSINESS ABROAD

Two great potential tax advantages in doing business abroad, as compared with domestic business, consist of:

(1) Keeping more dollars of income after all taxes are paid, and,

(2) In certain circumstances, postponing the time for payment of United States taxes, thus leaving more funds available for use in the business.

† This article was written for the 1952 Tulane Tax Institute when the excess profits tax, which expired at the close of 1953, was still in force. Citations made in the original article to Regulations 111 have been changed in the footnotes to the corresponding sections of the new Regulations 118 which were approved September 23, 1953.

* Attorney-at-Law and Certified Public Accountant, New York, N. Y.

These are the two great tax advantages—all of the rest of this discussion relates to methods of obtaining them. These advantages can result in tax savings so substantial that no business can afford to fail either to investigate their potentialities, or to utilize them if they are available.

The Supreme Court has often said that tax avoidance is permissible. However, many cases in which this principle was stated were lost by taxpayers on various judicial theories: looking through form to substance; lack of reality of the transaction upon which the taxpayer relied; a judicial feeling that the interpretation advocated, although literally correct, was contrary to the intent of Congress; and, occasionally, an opinion that there was an attempt at unlawful evasion rather than permissible avoidance of taxation. In the case of a Western Hemisphere Trade Corporation,[1] however, the Internal Revenue Bureau has ruled[2] that avoidance of tax by use of a corporation organized to qualify for the credit allowed[3] is permissible and outside the reach of Section 129 of the Internal Revenue Code, which is intended to take away any tax advantages sought to be obtained by acquisitions made to evade or avoid income or excess profits taxes.

The methods suggested herein to obtain tax advantages in doing business abroad are founded on the belief that these advantages can best and most safely be obtained by a taxpayer who conducts his business so that its activity and resulting income unquestionably are, in fact as well as under technical rules of income tax accounting, created and earned in countries outside of the United States.

While the simpler, easier and less expensive "documentary" methods might prove successful, it is not believed that presently existing authorities afford sufficient support to justify reliance upon the efficacy of these methods if other satisfactory methods are feasible. Although the "documentary" methods may be useful in some cases, these methods are neither analyzed nor discussed herein as it is assumed that persons who desire to obtain the tax benefits of doing business abroad will prefer to do so with the least risk of losing those advantages or incurring the expense of litigation to sustain their position.

II. FORMS OF POTENTIAL ADVANTAGES IN DOING BUSINESS ABROAD

The various forms of tax advantages which may be obtained in doing business abroad are as follows:

[1] INT. REV. CODE § 109.
[2] I.T. 3757, 1945 CUM. BULL. 200.
[3] INT. REV. CODE §§ 26(i), 13(a), 15(a)(3).

A. Reduction in the Effective Rate of United States Corporate Income Tax

Reduction in the effective rate of United States Corporate Income Tax may result, for example, from operating through a United States corporation which qualifies as, and obtains the United States tax advantages accorded to, a Western Hemisphere Trade Corporation.[4] Such a corporation, in addition to exemption from excess profits tax, discussed later, is allowed a credit equal to 27% of its normal tax net income for both normal tax[5] and surtax[6] purposes (resulting generally in reducing the amount of the latter taxes by 27%, or a maximum liability for United States taxes on its income, at 1952 rates, of approximately 38%). The requirements for qualifying for this treatment are set forth concisely in Section 109 of the Internal Revenue Code, the following summary of the requirements of which will suffice for the present purpose:

(1) A United States Corporation;

(2) All of whose business "is done" in the Western Hemisphere (defined in Section 109), and;

(3) Whose gross income, if any, for the current and the two preceding taxable years was derived:

(a) 95% or more from sources outside of the United States and;

(b) 90% or more from the active conduct of a trade or business.

Qualification usually requires a newly organized United States corporation, making almost all its sales or otherwise earning almost all its income within the Western Hemisphere but outside of the United States.

A failure to meet either the 95% or the 90% test causes disqualification and deprivation of any resulting tax advantages. In consequence, if, as is usual, the shares of the disqualified corporation are owned by a United States corporation, the latter is subject to tax on dividends received from the former, and this, in turn, results in what is, in effect, a triple tax on the income of the disqualified corporation (*i.e.*, a tax on income of the subsidiary; a tax on dividends received by the parent—present maximum rate 7.8%; and a tax on dividends received by stockholders of the parent). The Bureau of Internal Revenue is said to have held that *purchasing* activities carried on by a corporation outside the Western Hemisphere disqualify it from obtaining the benefits of this provision.[7]

[4] INT. REV. CODE §§ 109, 26(i), 13(a)(2)(C), 15(a)(3), 454(f).
[5] INT. REV. CODE § 13(a)(2)(C).
[6] INT. REV. CODE § 15(a)(3).
[7] Proceedings, 38 NATIONAL FOREIGN TRADE CONVENTION 385 (1952).

The special tax advantages available to China Trade Act Corporations[8] are now of such limited interest that they are not discussed herein.

B. Exemption from United States Excess Profits Tax

Exemption from the United States excess profits tax is not of current importance since that tax expired on December 31, 1953. However, because of the great importance of the tax in the years in which it was in effect, and the possibility that it may be reenacted in the future, it should be mentioned.

The exemption was allowed as to the entire income of the corporation, or only as to its net income from certain technical services rendered abroad.

Complete exemption from the tax was allowed where a United States corporation met the test prescribed in Section 454(f) of the Internal Revenue Code. To satisfy these requirements there must be:

(1) A United States corporation (usually newly organized for the purpose);

(2) Whose gross income, if any, for the current and the two preceding years was derived:

(a) 95% or more from sources outside of the United States and;

(b) 50% or more from the active conduct of a trade or business.

The foregoing tests were less stringent than those for a Western Hemisphere Trade Corporation. Any corporation that qualifies as a Western Hemisphere Trade Corporation could have obtained complete exemption under Section 454(f) from the United States excess profits tax. The exemption was also available to a United States corporation doing business in other parts of the world if it met the statutory tests.

As with a Western Hemisphere Trade Corporation, however, any failure to meet either of the percentage tests resulted in forfeiture of all tax benefits obtainable under the provision.

If a corporation which claims status as a Western Hemisphere Trade Corporation under Section 109, and/or exemption from excess profits tax under Section 454(f) receives income consisting of dividends from a corporation which it organized, owns and manages or directs, and/or compensation for allowing others to use patents, trade marks and similar intangibles which it owns or controls, the question arises as to whether such income is "derived from the active conduct of a trade or business" for the purposes of those sections of the Internal Revenue

[8] INT. REV. CODE § 261 *et seq.*

Code. Arguments for the affirmative were cogently presented by Mr. Russell Baker to the 38th National Foreign Trade Convention in 1951.[9] Whether this position can be sustained will be revealed by subsequent events.

Even though a United States corporation's entire income was not exempt from the excess profits tax, an exemption was allowed with respect to certain income from technical services rendered abroad, coupled with disallowance of all related expenses.[10] Such services must have been rendered to a foreign corporation in which the domestic corporation then owned at least 10% of the stock; the services must have been related to the production or improvement of products of the type manufactured by the domestic corporation; and the income from those services must have constituted income from sources without the United States.

C. Exemption from both United States Income and Excess Profits Taxes with respect to Income Earned in a United States Possession

A United States corporation doing the greater portion of its business in a United States possession (such as Puerto Rico) may obtain complete exemption with respect to its income earned in such a possession.[11]

In order to obtain this exemption the corporation must be a United States corporation whose gross income, if any, during the current and two preceding taxable years was derived: (1) 80% or more from sources within a possession of the United States, and (2) 50% or more from the active conduct of a trade or business within a possession of the United States, and such exemption extends only to gross income derived from sources outside the United States, and not received in the United States by the corporation earning such income. This last provision regarding place of receipt of the income is unique in the Internal Revenue Code.

Part of the price for this exemption is forfeiture of the right to credit for income taxes, if any, paid to foreign countries and possessions of the United States[12] and forfeiture by a United States corporation receiving dividends paid by a corporation entitled to this exemption of the benefits of the 85% dividends-received credit.[13] However, if the receiving corporation owns at least 10% of the stock of the payor, it is allowed the same credit for income taxes paid by the latter to foreign countries and United States possessions, as if the latter were a foreign corporation.[14]

[9] Proceedings, 38 NATIONAL FOREIGN TRADE CONVENTION 369 (1952).
[10] INT. REV. CODE § 433(a)(1)(R).
[11] INT. REV. CODE §§ 251, 454(f).
[12] INT. REV. CODE § 251(h).
[13] INT. REV. CODE § 26(b).
[14] INT. REV. CODE §§ 131(g)(1), 131(f).

D. Postponement of Time for Payment of United States Taxes on Income

Postponement of the time for payment of United States taxes makes additional funds available for use by the business, with possible ultimate reduction or elimination of such taxes.

1. Income not readily convertible into United States dollars, if the taxpayer elects to defer such income in the manner prescribed in the relevant Internal Revenue ruling[15]

Deferment under this ruling (and perhaps even in a case where such ruling is not complied with) may, in certain cases, prove of great advantage, where no other or better method is available for avoiding immediate payment of United States taxes at high rates on income which, wholly or partly, may never actually be received by the United States owner. This method of deferment involves various risks and uncertainties which are not dispelled by the ruling, nor, as yet, by court decisions. It is not permitted with respect to currencies readily convertible into United States dollars or other usable values which could advantageously be used in the business. Hence, this method of deferment is of limited application.

2. Income earned by a Western Hemisphere Trade Corporation but not yet paid over to its parent corporation or other stockholders as dividends

The tax rate on such postponed dividends is not substantial where the stockholder is a corporation. If, however, deferment of dividend payment is for the purpose of "preventing" (*i.e.*, postponing) payment of individual United States surtax with respect to such income, the Western Hemisphere Trade Corporation is exposed to the danger of the penalty surtax on improper accumulation of surplus.[16]

3. Income earned by a corporation organized abroad, until such time as its income may be paid over as dividends to the parent corporation or other owner of its stock

This form of postponement of time of payment of United States tax has great potential advantages. For example, if such income is taxed at only 16% in a foreign country the corporation can retain 84% of that income for use in its business in that country or elsewhere. If the income had been earned in the United States and taxed at the top bracket rate of 82%, only 18% could be retained in the business. Hence, postponement in this manner *(without incurring liability for interest on the amount so deferred)* may be so valuable as to outweigh the possi-

[15] MIM. 6475, 1950-1 CUM. BULL. 50, as amended by MIM. 6494, 1950-1 CUM. BULL. 54, and MIM. 6584, 1951-1 CUM. BULL. 19.
[16] INT. REV. CODE § 102; U. S. Treas. Reg. 118 § 39.102-1,2. (1953).

bility, which exists in some circumstances, that the aggregate tax burden on the income may, by the time it is received by the United States owner, be increased by three or four percentage points over what would have been applicable if immediate payment of United States taxes had been made. The foreign corporation which earns the income may keep United States dollars on deposit here, or elsewhere, or use the funds in any other way which does not constitute it a Foreign Personal Holding Company,[17] without thereby incurring any liability for United States tax on its income.

Moreover, use of the money in the business is not the sole advantage of such postponement. There is a real possibility that it may never be necessary to pay the full United States income tax on such earnings when ultimately received by the United States owner. For example, a tax-free liquidation of a foreign corporation which is owned by a United States corporation can be effected[18] upon satisfying the Commissioner of Internal Revenue that the liquidation does not have as a principal objective the avoidance of United States income taxes.[19] Subsequent events, such as currency restrictions, greatly increased taxes in the country of incorporation, or threats of "nationalization"—that is, confiscation—might satisfy the Commissioner that it is necessary to dissolve and liquidate such a corporation. Furthermore the stock of the foreign corporation might ultimately be distributed to the parent corporation's stockholders as a dividend with the result that United States taxes on the foreign subsidiary's income would be avoided. The gain to the parent corporation's stockholders on receipts, as a liquidating distribution, of the stock of the foreign subsidiary corporation would be taxable at capital gains rates. Individuals who own the shares of a foreign corporation would also realize capital gain upon either on sale of their shares or distributions received upon liquidation of the corporation.

Finally, if the stock was originally owned by an individual and became an asset in this estate, the gain, if any, subject to United States tax on the sale or other disposition by his estates or legatees, of such shares would be only the amount by which the proceeds exceeded the value of the shares for Federal estate tax purposes.[20]

The various restrictions and onerous provisions applicable to closely held corporations which are taxable as Foreign Personal Holding Companies[21] because they derive the major part of their income from sources other than the active conduct of a trade or business are not considered in this address.

[17] INT. REV. CODE § 233, *et seq.*
[18] INT. REV. CODE § 112(b)(6).
[19] INT. REV. CODE § 112(i).
[20] INT. REV. CODE § 113(a)(5).
[21] INT. REV. CODE § 331, *et seq.*

E. Lower Rates of Taxes on Income Earned in Countries Abroad Than Would Be Payable If Earned in the United States

Such lower tax rates seldom afford advantage where the entire income is immediately subject to United States taxes as in the case with a Western Hemisphere Trade Corporation, inasmuch as the only effect usually is to reduce the amount of the credit for foreign income taxes, without reducing the aggregate amount of income taxes immediately payable or affording the owners of the business any greater income currently in United States dollars after all taxes are paid.

If, however, payment of United States taxes is postponed, or, better yet, eventually reduced or eliminated, there can be a great advantage in doing business in a country with a low income tax rate (*e.g.,* Panama). For example, sales made out of supplies maintained in such a country, and shipped to buyers in other countries having higher income tax rates, may afford substantial tax advantage.

F. Exemptions from Taxes on Income in the Country Where Earned

Before starting or becoming committed to do business in any country abroad where substantial activity is anticipated, inquiries should be made regarding tax exemptions or other concessions obtainable from the local Government.

The outstanding example of such exemption is found in Puerto Rico, which, for any new industry included among 41 stated categories, grants an exemption from income tax of 100% until 1959, 75% in 1960, 50% in 1961, and 25% in 1962. This exemption may be obtained regardless of the form of the business and applies to United States as well as Puerto Rican and other corporations. It may be obtained in addition to the exemption from United States taxes allowed a United States corporation which derives most of its income from a United States possession.

The opinion has been expressed[22] that the income of a subsidiary United States corporation which is earned tax-free in Puerto Rico[23] can then be received tax-free by its United States parent corporation by liquidating the subsidiary.[24] This may be the letter of the law as it now stands, but if so, it is doubtful that it expresses Congressional intent.[25] If any part of such distribution were to be held to be substantially equivalent to payment of a dividend,[26] it would be taxable

[22] Baker and Sarabia, *The Function of Tax Incentives in International Trade,* 26 TULANE L. REV. 405, 410 (1952).
[23] See section C at page 188 *supra* in regard to the United States exemption under INT. REV. CODE § 251.
[24] INT. REV CODE § 112(b)(6).
[25] *Cf.* INT. REV. CODE § 251(h), 26(b), 112(i).
[26] INT. REV. CODE § 115(g).

as ordinary income, without benefit of the 85% dividends-received credit.[27]

The United States tax effect of subsequent liquidation of a United States corporation formed to obtain the benefit of these exemptions[28] would be controlled by the provisions of law then in force.

G. Getting the Maximum Benefit from the Credit For Foreign Income Taxes Against the Liability for United States Income Taxes of the Operator or Owner of the Business

Making the forecasts of income and related tax computations (hereafter discussed) is an essential step in deciding upon the methods to be used in doing business abroad and requires particular attention to the United States credit for foreign income taxes. Some peculiar results will be disclosed. For example, in the case of a foreign subsidiary of a United States corporation, the aggregate tax burden, including United States taxes on dividends eventually received by the parent, may, in certain circumstances, be increased as the effective foreign income tax rate falls below a certain percentage. However, this ultimate advantage is usually outweighed by the desirability of the foreign subsidiary's postponement of payment of as much of the aggregate income tax burden as possible for as long a time as possible.

It may likewise be discovered that, through use of a foreign subsidiary, the benefit of the credit for foreign income taxes levied at effective rates higher than the United States tax rate will not be lost as to dividends ultimately received from such subsidiary, to the extent that this would be the case if the income were earned in those countries by a United States corporation. This results only if the foreign subsidiary also earns income in other countries having *lower* effective income tax rates.

H. Freedom from Liability for the United States Penalty Surtax on Improper Accumulation of Income

A foreign corporation having no income from sources within the United States is not subject to the penalty surtax on improper accumulation of surplus,[29] regardless of its motives for accumulation. However, if a United States parent corporation owns its stock, the available undistributed surplus of the foreign corporation might be considered in determining whether the parent is liable for this penalty tax. No such freedom from liability is enjoyed by a United States corporation, whether or not it operates abroad or qualifies as a Western Hemisphere Trade Corporation or is taxable under Internal Revenue Code Section

[27] INT. REV. CODE § 26(b).
[28] INT. REV. CODE §§ 251, 454(f).
[29] INT. REV. CODE §§ 102, 102(d)(1), 231(c), 21(a).

251. However, in the latter case the penalty tax would apply only to that part of the corporation's income received in or derived from sources within the United States.[30]

III. PROBLEMS IN OBTAINING UNITED STATES TAX BENEFITS IN DOING BUSINESS ABROAD

Of the three problems most likely to be encountered in obtaining tax advantages from doing business abroad, the first is the problem of establishing the realty of the transactions and the separate ownership of the income arising from the business being done abroad.[31] If such income is actually created by the activities of the subsidiary doing business abroad, this problem will not arise. It will arise where the business done by the subsidiary is so closely linked to and interwoven with the activities of the parent that it is difficult to find a real separation of the two. In such case there is danger that the Internal Revenue Bureau will seek to attribute most, if not all, of the income of the subsidiary to the parent, with a consequent loss of the hoped-for tax benefits from the business done abroad.[32]

The second problem, in the case of sales of goods, is to establish that "the country in which sold," and hence the "source of the income," for United States tax purposes, is outside of the United States.[33] This usually is the heart of the problem of obtaining optimum tax advantages from doing business abroad. The words "doing business abroad" contain the clue to the solution. If the corporation is really doing business abroad and makes the sales there, in every sense of those words, there is no problem. It becomes difficult, and in some circumstances perhaps impossible, to establish that the sales are made abroad where the steps necessary in order really to do business and make the sales outside of the United States are not taken.

Perhaps Congress should afford the same tax treatment to income from all sales to buyers located outside of the United States regardless of the place where the sale is made. Perhaps the courts have too narrowly construed the words of the statute in determining "the source" of income from such sales.[34] Perhaps the Internal Revenue Bureau seeks too narrow a construction of these provisions and decisions.[35]

30 INT. REV. CODE §§ 102(d)(1), 251(a), 21(a).

31 INT. REV. CODE §§ 45; 1 P-H 1953 FED. TAX SERV. ¶ 6900 *et seq.* and cases cited therein, especially ¶ 6904.

32 *Cf.* Advance Machinery Exchange v. Comm'r, 196 F. 2d 1006 (2d Cir. 1952).

33 INT. REV. CODE § 119(3).

34 Comm'r v. East Coast Oil Co., 85 F. 2d 322 (5th Cir. 1936), *cert. denied*, 299 U. S. 608 (1936); Ronrico Corp. v. Comm'r, 44 B.T.A. 1130 (1941), *appeal dismissed*, 5th Cir. 1942.

35 G.C.M. 25,131, 1947-2 CUM. BULL. 85. See the present author's discussion in *Federal Income Taxes on Foreign Transactions and Foreign Persons*, 26 TAXES 108, 121 (1948).

However, there are certain transactions which are now recognized as unquestionably constituting sales made outside of the United States and consequently giving rise to income from sources outside of the United States.

Writers who take a liberal view relative to the contractual power of the parties to attribute the origin of income to a place outside of the United States may be correct in their contention that the place of sale can be fixed by agreement between the buyer and seller even though orders are received and accepted in this country and goods are shipped from this country to the place where they are to be delivered to the buyer.[36]

If no other method is feasible, use of the "documentary method" may as well be tried. If so, it should be remembered that a corporation forfeits the right to be taxed as a Western Hemisphere Trade Corporation if more than 5% of its gross income is from sources within the United States, whereas a foreign corporation will not have to pay United States tax on its income from sales successfully shown to have been made by it outside of the United States, regardless of the percentage of its total sales which may be held to have been made in this country.

It is certain that where a supply of goods is maintained by the taxpayer outside of the United States and orders are solicited, received and accepted abroad and filled from such supply, there can be no difficulty in establishing that the resulting income is from sources outside of the United States. Each step away from those facts increases the probability of attack on the position that the place of sale, and hence the source, for United States tax purposes, of the resulting income are outside of the United States. Accordingly, the safest method of making sales to customers located abroad is through a branch or branches maintained abroad.[37]

[36] For articles dealing with this problem see: Baker and Sarabia, *The Function of Tax Incentives in International Trade*, 26 TULANE L. REV. 405, 410 (1952); Baker and Hightower, *The Western Hemisphere Trade Corporation: A Problem in the Law of Sales*, 22 TULANE L. REV. 229 (1947). *Cf.* the following articles of the present author: *Foreign Trade and Foreign Taxes*, 17 N. Y. CERT. PUB. ACCT. 145 (1947); *Federal Income Taxes on Foreign Transactions and Foreign Persons*, 26 TAXES 108 (1948); *How Americans Can Best Do Business Abroad and Foreigners Can Best Do Business Here*, N.Y.U. 6TH ANN. INST. ON FED. TAX 926 (1948).

[37] See the author's paper on "Tax Consideration in Doing Business Abroad," N.Y.U. 7TH ANN. INST. OF FED. TAX 10 (1949). The article by Stapleton, *Foreign Branch Operations and the Internal Revenue Code*, 30 TAXES 690 (1952) bears an editorial caption that it "Demonstrates How Tax-Conscious Management May Find Foreign Branch Operations an Expensive Luxury from the Viewpoint of Federal Income Taxation," but a reading of that article discloses that the operation of foreign branches of a Western Hemisphere Trade Corporation or a foreign corporation is recommended therein, on business and tax grounds, rather than criticized. This and related tax problems of operations abroad are

The third problem in obtaining United States tax benefits in doing business abroad is to establish that inter-company charges (especially by the parent against the subsidiary for goods manufactured by the former) are fair. The Commissioner of Internal Revenue has authority to adjust, for income tax purposes, the prices at which goods were sold by the parent to the subsidiary if he determines such adjustment to be "necessary in order to prevent evasion of taxes or clearly to reflect the income" of the parent.[38] Opinions of writers and speakers on this subject vary all the way from the view that it is sufficient, especially where sales are made to a corporation that qualifies as a Western Hemisphere Trade Corporation, for the parent to recover its costs, to the view that the same prices must be charged the subsidiary as are charged other unrelated buyers.[39]

Theoretically, the prices charged must be the fair market value of the goods, that is, the prices prevailing in arm's-length transactions. Such prices are not necessarily the same as are charged other customers in the United States. In determining fair value, due weight should be given to many factors, all of which cannot be dealt with fully here. For example, where the subsidiary's activities in making sales abroad create new and substantially expanded outlets in countries abroad for the parent's products which would not otherwise have been attained in those countries, the resulting business advantage to the parent manufacturing company of making the sales to its foreign trade subsidiary can readily be established. Such circumstances will prove helpful in justifying the parent company in granting more favorable prices to the subsidiary making such sales abroad than to smaller and less productive customers. This argument is not available where sales to customers abroad are made by the subsidiary in the same manner as they had theretofore been made by the parent, except for the form of the documents.

Whether the Commissioner is justified in making an adjustment having the effect of increasing the amount charged by the parent to the subsidiary is a question of fact in each case.[40] Any such adjustment would, of course, reduce the tax benefit anticipated from doing business abroad.

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discussed in Tucker, *Federal Tax Problems of Domestic Corporations Performing Services Overseas,* 30 TAXES 697 (1952). See also the excerpt from HOLDEN, FISH AND SMITH, TOP MANAGEMENT ORGANIZATION AND CONTROL (8th ed. 1946) quoted in Baker and Hightower, *The Western Hemisphere Trade Corporation: A Problem in the Law of Sales,* 22 TULANE L. REV. 229, 242 (1947).

[38] INT. REV. CODE § 45.

[39] See the addresses and papers in PROCEEDINGS OF THE 38TH NATIONAL FOREIGN TRADE CONVENTION (1952).

[40] *Cf.* Holzman, *Arm's Length Transactions and Section 45,* 25 TAXES 389 (1947).

IV. INITIAL INQUIRIES IN PLANNING TO OBTAIN TAX ADVANTAGES IN DOING BUSINESS ABROAD

Finally we come to what is really the first step in planning to obtain the tax advantages of doing business abroad—making initial inquiries needed to analyze the present and prospective business abroad. The purpose of this step is to decide on the methods to be used in the particular case to obtain the most desirable combination of business and tax advantages.

A. In What Countries Is Business Being Done and To Be Done?

The choice of methods of obtaining tax savings or postponing payment of taxes will depend, in many instances, upon the countries in which substantial earnings are expected. Certain methods may immediately be discarded in the case of certain countries. All pertinent data respecting tax rates and methods, government controls, etc. (summarized further below) must be obtained for *each* country in which substantial business is anticipated.

B. How Is Business Now Being Done or To Be Done in Each Country Abroad?

No study of methods of obtaining desired tax advantages can even be started until after a determination of tentative answers to this question even though, when methods are planned and put into effect, these answers may very likely be changed. It may be difficult to obtain all facts for each country, but they are essential for adaquate tax study and planning.

The various methods of doing business abroad may be considered under the following headings:

1. Rendering service abroad

The problems of establishing the reality of the transaction producing the income and the ownership and amount of the income produced by the corporation doing business abroad are unlikely to cause difficulty where the income is from services rendered abroad. Income from services does not raise the difficult problem of determining geographical source. It is now unquestionably recognized that the source of income received from services is the place where the services are rendered. The Tax Court has said that, "It is the situs of the activity . . . which constitutes the source of the compensation paid . . ."[41]

Questions may arise as to the extent that the income is actually received from the rendering of services outside of the United States.[42]

[41] British Timken Limited, 12 T.C. 880, 887 (1949).

[42] See Tucker, *Federal Tax Problems of Domestic Corporations Performing Services Overseas*, 30 TAXES 697 (1952).

2. Processing goods abroad (manufacturing, mining, drilling, refining, etc.)

The "source," for United States tax purposes, of such income is within the country where the activity occurs, except that where the same corporation processes goods abroad and sells them in the United States (or vice versa), part of the income must be apportioned to this country.[43]

Where goods which are manufactured abroad are involved, the advantages of making the sales thereof outside of the United States are generally so substantial, and so easily obtainable, under present rules that the methods of apportionment of income between the place of manufacture and place of sale are likely to be of importance only where, for some reason, the corporation processing the goods outside of the United States must itself sell them in this country to the ultimate buyer here.

The Treasury Regulations contain detailed rules[44] for apportionment of income derived from the production of goods in one country and the sale thereof in another country, where one of these countries is the United States. In general, three methods are authorized:

(1) Use of an established independent buyer price (if any) for the goods at the factory or place where processed;

(2) Use of a formula for apportionment, based upon the ratio of investment and sales in the respective countries, except that if the other country is a United States possession (such as Puerto Rico), compensation paid and costs incurred are also to be considered as factors;[45]

(3) Use of the taxpayer's books of account, established in good faith and unaffected by considerations of tax liability.

In addition to taxes, local factors must be weighed in making a decision as to whether it would be feasible to carry on productive operations in a particular country. Only if otherwise feasible need the tax advantages be considered in making the final decision.

3. Sales made in a country abroad of goods purchased in the United States, or elsewhere, from a related taxpayer or from others, out of stocks maintained abroad by the taxpayer

There should be no difficulty in establishing that the source of income from such sales is outside of the United States. In making overall tax plans it is, however, important to decide whether the stocks from which sales and shipments are to be made will be maintained:

(1) In warehouses or stores of the taxpayer located in the country where sales are to be made, or

[43] INT. REV. CODE § 119(e).
[44] U. S. Treas. Reg. § 39.119(e)-1(b) (1953).
[45] U. S. Treas. Reg. § 39.119(e)-1(c) (1953).

(2) In distribution centers maintained by the taxpayer in some other country abroad, for example, in the Foreign Trade Zone or a private "Zonita" in Panama.

Here is an instance where inquiries as to present and contemplated methods of doing business abroad may lead to management's adoption of methods not previously considered.

Using a distribution center abroad not only avoids doubt that the place of sales and source of income is outside of the United States, but may, in certain circumstances, also afford positive business advantages. If transportation and handling costs or other non-tax considerations render such methods impracticable, no further consideration of its tax advantages is warranted.

4. Soliciting and obtaining, in countries abroad, orders for goods thereafter to be shipped from the United States under agreements whereby title is to pass to the customer only after goods have left the United States or reached their destination

This method is less satisfactory, taxwise, than one involving maintenance abroad of stocks of goods and establishments of some kind, because of the problems of determining the place of sale of the goods and justifying the prices paid for goods purchased from a related taxpayer. However, because of transportation and handling costs or other business reasons, no method which is more satisfactory, taxwise, may be feasible.

The initially strong preference for this method of direct shipment from the United States to countries where customers are located abroad is, in many instances, abandoned after a thorough study of all tax and other business reasons in favor of maintaining branches and stocks of goods abroad. If, however, it is decided that only direct shipment method can be used, the more extensive the other activities carried on abroad by the taxpayer (and its agents) in selling, promoting, advertising or otherwise creating the income in the countries where it is desired (for United States tax purposes) that such income be earned, the better.

At one time it was, and again may be, of great importance to determine where the order for the goods is accepted; where the final act occurs which creates the agreement of sale between the buyer and the taxpayer.[46] Hence, the possibility of having such orders accepted outside of the United States should be considered in connection with this method of doing business abroad. This has been discussed above in connection with the determination of the place of sale.

[46] G.C.M. 8594, IX-2A Cum. Bull. 354 (1930), restated in G.C.M. 13475, XIII-2 Cum. Bull. 224 (1934) and I.T. 2869, XIV-1 Cum. Bull. 113 (1935), revoked by G.C.M. 25131, 1947-2 Cum. Bull. 85. Also see note 35 *supra*.

5. Obtaining and accepting orders in the United States from buyers located in countries abroad and shipping goods to them from the United States

Persons who believe that the place "where the goods are sold" or "marketed" may be fixed by the agreement between the parties as to where title passes, may be satisfied that use of this method makes it possible to place the source of income outside of the United States. However, as previously stated, management often prefers to take what is believed to be a safer course, even though it may not appear, at first sight, to be as simple, convenient and inexpensive.

C. Detailed Forecast and Operating Budget Should Be Prepared for Each Country in which A Substantial Amount of Business Is Expected To Be Done

This usually involves a great deal of work. However, a considered decision, from the standpoint of both business and taxes, as to the most advantageous methods to use in each country cannot be reached without these facts.

D. What Are The Anticipated Needs for Working Capital in Each Foreign Country?

These facts have a direct bearing upon the desirability of adopting methods to postpone payment of United States taxes on income from business done abroad and thereby to obtain the use of funds for desired working capital. Methods for accomplishing this purpose have been discussed in Part II.

E. What Are United States Export Control Requirements?

These controls may occasion considerable uncertainty or even constitute an absolute bar to use of otherwise desirable methods of doing business in or with buyers in certain countries. Hence, the nature of such controls should be investigated in connection with the study of feasible methods of doing business in each country abroad.

F. With Which of the Countries Where Business Is To Be Done Does The United States Have Tax Treaties In Effect or Under Negotiations, and What Are Their Relevant Provisions?

As yet, the United States has no tax treaties with Latin American countries, but does have them with many other countries and is conducting negotiations for additional tax treaties. Even a brief treatment of the content and effect of these treaties would exceed the scope of this paper.

The principal object of these treaties, which prevail over any conflicting provisions of law, is to avoid "double taxation." They seek generally to provide a uniform manner for determining the *amount* of

income resulting from doing business in each country for the purpose of the income taxes of both countries; to provide which contracting country shall tax each of a number of different classes of income; and, where the same income may be subject to tax by both countries, to provide relief in the form of credit for taxes paid one country against the tax due the other. Use of identical methods of determining income in each such country tends to prevent either the governments involved or the taxpayer from obtaining a double advantage.

G. What are the Rates and Methods of Taxation in Each Country Where Business Is To Be Done, With Special Attention To Basic Differences from United States Tax Principles and Methods?

If operations are carried on in a country abroad (other than Puerto Rico or another United States possession) through a United States corporation, which immediately obtains full credit for foreign taxes on income against its United States income taxes, the only reasons for minimizing such foreign taxes are based upon patriotic and long-range considerations. On the other hand, if operations are carried on through a foreign corporation, and it is desired to postpone payment of dividends and thereby postpone the time for payment of United States taxes, it may be of great immediate importance to minimize all foreign income taxes, thus increasing the portion of profits and consequently of funds that will remain available for use by that corporation in its business.

In any event, with respect to each country where a substantial profit is expected, at least a preliminary idea of income tax rates, and a rather definite idea of taxing methods, should be obtained.

H. Can Exemptions From or Reduction Of Taxes In Any of the Countries Abroad Be Obtained and In What Manner?

Today the outstanding example is Puerto Rico, which has provisions, previously discussed in Part II, granting complete exemption until 1959 from all taxes on certain income.

This illustrates the importance of considering not only every feasible method of doing business abroad—here, for example, manufacturing—but also the effect of the local laws and conditions in each country upon each such method.

I. What Other Laws, Regulations and Customs of Each Country Must Be Considered in Planning To Do Business in That Country?

This covers a wide field, including:

(1) Foreign exchange and import controls of each country abroad in which it is intended to do business. These two controls, naturally inter-related, are actually linked together in many countries. They

may eliminate some *methods* of doing business in a particular country which otherwise might be feasible or desirable taxwise, and might even result in a determination that it is not commercially practicable to do any business in a particular country.

(2) Each country's customs duties on the goods intended to be sold there must be studied, as the rates of such duties are likely materially to affect selection of methods for doing business there.

(3) Other local laws and regulations, such as labor laws, sales taxes and requirements as to stock ownership by nationals, in each country where business will be done, may affect tax planning and must be investigated before embarking on business in any new country. For example, a high rate of local sales or personal property taxes might weigh heavily against any plan for maintaining a stock of goods in a particular country, as compared with shipments from some other country abroad to customers there.

J. How Will the Business in Each Country Be Owned?

Details of ownership cannot be decided upon without careful consideration of all tax and business factors affecting this and other questions regarding possible methods of doing business in each country. As this article is limited to business done abroad in corporate form, this question relates only to the form of corporation (or corporations) that could be used, and the ownership of its shares of stock.

As to form, the corporation to be used in each country abroad may be organized:

(1) In the United States,

(2) In the country where the business is to be done, or

(3) In some other country.

Tax advantages of these different corporations have already been considered.

The stock of the corporation operating in the foreign country may be owned by:

(1) Individuals (directly, as partners or as beneficiaries of a trust), or

(2) An existing United States corporation, or

(3) Some other corporation.

Stock ownership directly by the individuals interested is usually more advantageous, taxwise, than ownership by another United States corporation because it enables avoidance of the "double tax" which results where income is first taxed in the hands of a corporation and then in the hands of its stockholders when what is left is received as

a dividend. Other potential tax advantages of such direct, individual ownership are discussed in Section D of Part II.

Few large, widely owned United States corporations are, however, in a position to organize the business done or to be done abroad so that the stock of the new corporation or corporations will be owned directly by the stockholders of the original corporation. Hence individual stock ownership must, in most instances, be ruled out as a possibility.

V. CONSIDERATIONS IN DECIDING ON THE METHODS TO BE USED IN DOING BUSINESS IN EACH COUNTRY ABROAD

After all possible methods of doing business in each foreign country have been considered, together with their tax consequences and the problems likely to arise in connection with their use, the final stage is the weighing of all tax and business factors and the reaching of conclusions as to what methods are to be used in doing business in each such country.

First of all, decisions must be reached, at least tentatively, as to what methods are feasible from a business standpoint for getting the goods into the country and the money out, or dealing with the problems of manufacturing there; for making the sales there; and for making a profit after duties and all expenses there have been paid. These are not tax decisions, but necessarily affect the decisions on the tax questions involved.

The next step is to determine the minimum aggregate tax burden on the basis of existing tax rates, making computations of all taxes payable under each feasible method of doing business abroad. This tax accounting procedure—making estimates of income from anticipated operations in each country under each method of operations believed to be feasible and then making actual, detailed computations of all taxes, both foreign and domestic, on such estimated income—involves a substantial amount of work, even after all necessary investigations have been made and the required data obtained and assembled (see Part IV above). However, this step is so essential, and its potential value so great, that it is unwise to omit it or to substitute any short-cut in estimating the aggregate tax savings under each method under consideration.

The probability or likelihood of future changes in United States and foreign tax rates, foreign customs duties, United States export controls, import and foreign exchange controls in the various foreign countries, and the possible business and tax effects of war losses should next be given due consideration, as having a bearing on the choice of

methods of doing business in each country abroad. How much weight should be given to each of these contingencies is a business decision.

The final step, before deciding upon the methods to be used in doing business in each country abroad, is to compare:

(a) the net profit of the corporation operating abroad (after all taxes thereon) under each method contemplated;

(b) the net profit remaining in the hands of the stockholders of such corporation after payment of United States taxes on receipt of such net profit as dividends; and

(c) the net profit (after all taxes) that would result to such owners if such methods were not adopted.

After deciding on the methods to be used in doing business in each foreign country, the factors considered in reaching the decision, especially the forecasts of income and expenses and the computation of all resulting taxes, should be carefully reviewed and verified.

There then remains only the task of putting into effect the decisions thus reached.

VI. CONCLUSION

Substantial tax advantages can be obtained in doing business abroad. Those methods which afford means of tax saving and postponement of the time for paying United States taxes and promise the best over-all long-range results should be selected.

Methods are available which seem to be in harmony with Congressional intent, within the specific provisions of the Internal Revenue Code, and supported by (or at least not contrary to) Treasury Regulations and rulings and court decisions.

Management may at first shrink from some of the steps suggested because of their apparent complexity and initial expense. However, further study may disclose that these methods afford not only great tax advantages but also great potential, long-range business advantages.

No quick, easy or automatic means are recommended herein for obtaining these advantages in connection with all sales made to customers outside of the United States, although articles recommending such methods have been cited. However, what are believed to be safe and feasible methods to obtain substantial tax advantages have been pointed out.

An entirely new Revenue Code is now in the making and may have appeared in print by the time that this article is published. It is rumored that the new code will contain many significant changes in the provisions relating to U. S. taxation of income from foreign trade and foreign sources. If this new code is enacted in 1954 with these changes

it will be necessary to take into consideration their effect in reaching any decision as to the most desirable method, from the Federal income tax standpoint, of carrying on operations involving foreign sources of income.