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The Western Hemisphere Trading Corporation; in Outline

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The Western Hemisphere Trading Corporation; in Outline

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ONE OF THE LAST FRONTIERS of effective tax reduction exists in the exporting field. This device was specifically created by Congress to enable American corporations trading in foreign countries within the Western Hemisphere to compete with foreign corporations and has been approved by the Commissioner of Internal Revenue. This tax device is called the "Western Hemisphere Trading Corporation" created by Section 109 of the Internal Revenue Code.

There is no federal law providing for the incorporation of Western Hemisphere Trade Corporations. The corporations are organized under applicable state law and qualify as Western Hemisphere Trade Corporations on the basis of the business they do.

Inducement

The tax advantages are such as to induce a present exporting manufacturer or producer to organize a domestic corporation for the sole purpose of purchasing goods from it and selling these goods in accepted foreign markets.

It is also an inducement to firms to export to markets in the Western Hemisphere as they will keep more after-tax dollars than on similar sales made in the U. S.

Tax Savings

Tax savings are accomplished by at least three methods:

(1) Such corporation is entitled to receive 27% of its net income tax free (30% for years beginning after March 31, 1954).[1]

(2) Such corporation is not subject to the Excess Profits Tax,[2] thus resulting in the following effective tax rates:

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1 I. R. C. § 26 (1) (2).

2 I. R. C. § 454 (f). Although the Excess Profits Tax is scheduled to terminate for taxable years beginning after January 1, 1954, such tax or a similar one may be enacted at a future time.

Net Income	*Ordinary Domestic Corporation*	*Western Hemisphere Trade Corporation*
Up to $25,000	30%	21.9 %
Between $25,000 and $34,000	52%	21.9 %
Excess over $34,000 (Not subject to Excess Profits Tax)	52%	37.96%
Excess over $34,000 (Subject to Excess Profits Tax)	May be 82%	37.96%

(3) In addition, the establishment of a Western Hemisphere Trade Corporation has the effect of siphoning income from an existing corporation paying at least 52% on income over $25,000 and transferring such income to a new corporation paying 21.9% on its first $34,000 of net income. The tax savings on $25,000 of income transferred amounts to $7,525.

Tax Savings, Giving Effect to Methods 1, 2 and 3 Above

Net Income

	$10,000	$25,000	$50,000	$100,000
Western Hemisphere Trade Corporation	$ 2,190	$ 5,475	$13,520	$ 32,500
Existing Ordinary Domestic Corporation* (No income subject to Excess Profits Tax)	$ 5,200	$13,000	$26,000	$ 52,000
Existing Ordinary Domestic Corporation** (Income subject to Excess Profits Tax)	$ 8,200	$20,500	$41,000	$ 82,000

* It is assumed that the existing ordinary domestic corporations earn at least $25,000 before profits are added from export sales.

** Tax rates used are those in effect during year 1953.

Definition—Western Hemisphere Trading Corporation

The Western Hemisphere Trading Corporation is one that is organized in the United States and meets the following tests:

(1) Its entire business must be carried on within the geographical limits of North, Central or South America or in the West Indies, or in Newfoundland; and,

(2) Ninety 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; and,

(3) Ninety-five per cent or more of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during

which the corporation was in existence) must be derived from sources without the United States.[3]

What Does Entire Business Mean?

Entire means 100%. Any business done in the taxable year with any country in Europe or Asia will disqualify a corporation from being a Western Hemisphere Trade Corporation. Puerto Rico is within the Western Hemisphere,[4] while Bermuda is not.[5] Some business, however, can be done in the United States so long as the corporation receives at least 95 per cent of its income over a three-year period from foreign sources (not necessarily confined to the Western Hemisphere). This 95 per cent is in the aggregate for the three years—not necessarily 95 per cent for each year.

For example, consider the following corporation:

Domestic Corporation Gross Income
(Thousandths)

Year	*U. S. Sources*	*Foreign Sources*	*Total*	*Percentage due to Foreign Sources*
1950	$ 70	$ 930	$1,000	93%
1951	50	950	1,000	95%
1952	30	970	1,000	97%
Total	$150	$2850	$3,000	95%

Such a corporation would fulfill the requirement.

The Senate Finance Committee Report on the 1942 Bill qualifies the requirement that no business be done outside the Western Hemisphere by stating that merely incidental economic contact with countries outside the geographical sphere will not place the corporations outside the exempt classification. The report states that the mere fact the corporation ships goods to England (for example) retaining title to the goods until acceptance of the bill of lading and draft in order to insure collection of the price will not be considered as carrying on business outside the Western Hemisphere.[6]

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3 Reg. 111, Sec. 29.109-11.

4 I. T. 3748; CB 1945, 152.

5 I. T. 3990; CB 1950-1, 57.

6 1942-2 CB 588.

What is Gross Income?

The requirements relate to gross income and not gross sales. Gross income from trading is excess of sales over cost of goods sold. Interest and dividend income, for example, are not from the active conduct of a trade or business.[7] These factors are significant in determining whether the corporation comes within the second requirement in Section 109(b)—that 90 per cent or more of the gross income for the three-year period be derived from the active conduct of a trade or business.

Assume these figures for a three-year period:

Sales	$600,000	
Cost of goods sold	300,000	
Gross income from trading		300,000
Interest income		20,000
Dividend income		30,000
Total gross income		$350,000

It should be noticed that the interest and dividend income, although less than 9 per cent of the sales, is over 14% of the total gross income. This would disqualify the corporation from being classified as a Western Hemisphere Trade Corporation for the current year.

What is "Active Conduct of a Trade or Business"?

There is no provision in the Internal Revenue Code which defines a "trade or business." It is often described as that which occupies the time, attention and labor of men for the purpose of livelihood or profit, but it is not necessary that it should be the sole occupation or employment. The doing of a single act pertaining to a particular business will not be considered engaging in or carrying on the business, yet a series of such acts would be so considered.[8] The business activities must be those which are ordinarily considered as constituting an active trade or business. It implies more than mere passive ownership or property or the minima of acts necessary to keep the corporation shell alive.

There is no specification as to where such business activities must be carried on. It may not be necessary to establish an office,

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7 I. T. 1785; II-2 CB 258.

8 Bouviers Law Dictionary.

warehouse, or factory outside of the United States and within a Western Hemisphere country. It may be sufficient merely to have an agent located in a Western Hemisphere country to solicit orders.

What Constitutes Gross Income From Sources Without the United States?

The statute requires that 95 per cent of the gross income must be derived from sources without the United States. However, Section 109 does not attempt to define this phrase. Rather the regulations require that determination be made under Section 119, which deals with various kinds of income.

COMPENSATION FOR PERSONAL SERVICES

Compensation for labor or personal services performed inside the territorial limits of the United States is includible in gross income from United States sources. The sole test is where the services were performed, and it has been held that the place where the salary or wages were paid, place where taxpayer was hired or where the employment contract was entered into and the residence or citizenship of the employer are immaterial.

RENTS AND ROYALTIES

The test here is location of the property giving rise to the rent or royalties. If the property or any interest in property is located in the United States, it is gross income from sources within the United States. If the property is located outside the United States, rentals and royalties therefrom are income from sources without the United States.[9] The property from which income is derived may be tangible or intangible; it may consist of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other similar property. If the income arises from the rental of property located in the United States, or from the privilege of using it in the United States, it is income from sources within the United States.[10]

Royalties received from a patented item which was sold in the United States for use in foreign countries is income from the United States, the place of ultimate use being immaterial. It is

9 I. R. C. § 119-(7) 4.

10 I. R. C. § 119 (a) (4); Reg. 111, Sec. 29.119-5.

the place and consummation of the sale giving rise to the percentage payments which governs.[11]

A transfer by a copyright owner of substantially less than the entire "bundle of rights" conferred by the copyright for one sum or several payments constitutes royalties even though the transfer may take the form of a sale.[12]

Sale of Real Property

Gain derived from the sale or other disposition of real property located in the United States is treated as income from sources within the United States.[13] If the property is located outside the United States, the gain is deemed to be income from sources without the United States.[14]

Sale of Personal Property

Income resulting from the sale of personal property is treated as being derived entirely from the country in which the goods are sold or exchanged.[15] The property may be purchased in the United States and sold in a foreign country or it may be purchased in a foreign country and sold in the United States. The place of sale and not the place to which the personal property is shipped determines the source of the income.

The regulations provide that the term "country in which sold" ordinarily means the place where the property is marketed.[16] The Bureau has ruled that the place of sale of personal property is fixed by the place where title passes. Where the seller retains bare legal title, the sale takes place where and when the buyer gets beneficial ownership and risk of loss. The Board has held that title to property passes, in the absence of contrary intent, at the place where the seller performs the final act making the sale effective.[17]

Where personal property is purchased in the United States and sold in a possession of the United States, the possession is

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11 Pedro Sanches, 6 T. C. 1141; *aff'd* 162 F. 2d 58; *Cert. denied* 332 U. S. 815.

12 Sax Rohmer et ux v. Com. 153 F. 2d 61; *Cert. denied* 328 U. S. 862; Com. v. Pelham G. Wodehouse 337 U. S. 369 *reh. denied* 338 U. S. 840.

13 I. R. C. 119 (a) (5); Reg. 111, Sec. 29.119-6.

14 Reg. 111, Sec. 29.119-7 (5).

15 Reg. 111, Sec. 29.119-8.

16 Reg. 111, Sec. 29.119-8.

17 Ardbern Co. Ltd. 41 B. T. A. 910; *mod. and rem'd on other grounds,* 120 F. 2d 424.

treated as a foreign country, separate and distinct from the United States.

Sale of Personal Property Produced: United States and Abroad

When goods are produced in whole or in part within the United States and sold in a foreign country, the gain on the sale is treated as income derived partly from sources within the United States and partly from sources without the United States. "Produced" is defined to include creation, fabrication, manufacture, extraction, processing, curing and aging. It can be seen that, in view of the above, it would be difficult to be a producer and try to have 95 per cent of the gross income be from sources without the United States. A Western Hemisphere Trade Corporation then is one generally that merely buys and sells and does not produce.

Relations Between Producing and Selling Companies

A domestic corporation that wishes to enter the export field would do well to organize a domestic corporation, sell products to it, and have the domestic corporation sell to the foreign sources. This would accord the sales company the preferential treatment granted Western Hemisphere Trade Corporations. Likewise a domestic corporation that already had been actively exporting could create a new domestic corporation to carry on the business in the Western Hemisphere (other than in the United States) even though the new corporation was created to gain benefits of the exemption.[18] The domestic producer's sales would in no way affect the nature of the subsidiary. Sales by the producer (parent) in the United States, Europe or Asia would not destroy the classification of the Western Hemisphere Trade Corporation.

It is often asked if there are any special problems which relate to parent corporations which organize domestic subsidiaries or closely held companies to purchase manufactured goods from it and sell them in the foreign markets. This type of transaction might be considered to come within the scope of Section 129 I. R. C., disallowing allowances, deductions or credits if acquisitions are made to evade or avoid income or excess profits tax. The regulations under Section 29.129-3 apply its provisions

18 I. T. 3757.

to splitups made to avoid taxes. However, a Bureau ruling states that Section 129 does not apply to the creation of a new domestic corporation to carry on the business in the Western Hemisphere (other than in the United States) of an existing domestic corporation.[19]

What about the Commissioner's power to apply Section 45, which authorizes him to allocate gross income and deductions among two or more organizations owned or controlled by the same interests? The Commissioner has ruled that he will apply Section 45 where transactions between a parent corporation and its Western Hemisphere Trade Corporation subsidiary are not at arms length.[20] Section 45 will be applied only where necessary to clearly reflect the income of either corporation or prevent evasion of taxes. It would mean in this case that the price structure between the producer and the Western Hemisphere Trade Corporation should be one at arms length and essentially equivalent to one that would exist to wholly independent distributors and other selling concerns. Prices may be lower to compensate the sales company for unusual risks of any kind, but not lower than manufacturer's cost.

Making Title Pass Outside the United States

Since 95 per cent of the income must be from sources outside the United States, a practical approach must be made to fulfill that requirement. There are a number of accepted methods for passing title outside the United States and each method must be considered with the kind of business risk involved.[21]

One of the clearest ways is to establish a branch office in the foreign country and have the corporation register to do business there. The domestic corporation ships the goods to its branch and sales are made by the branch to the foreign customers. The danger of this procedure is that the property and business are subject to control and taxation by the foreign government.

Another method is to establish an agent in the foreign country and consign goods to him. Title remains in the selling corporation until delivery is made to the foreign customer. Payment may still be conditioned on the dollar terms of a draft or

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[19] I. T. 3757; 1945 CB 200.

[20] Rev. Rul. 15, I. R. B. 1953-3, 22.

[21] See Dean and Leake "How to Arrange Foreign Sales So Title Will Pass Outside the U. S. For Tax Purposes." Journal of Accountancy, October, 1952, p. 457.

letter of credit. The business risk involved is that such consignment might establish liability for registration and taxation in the foreign country. Some companies prefer to use Panama as a central resting place for consigned goods.

A third method is to make shipment F.O.B. the foreign port and require payment against a draft upon arrival of the goods. Only when the draft is paid or accepted are the goods delivered to the buyer. This defers the passage of beneficial title until after the goods have arrived in the foreign country. This procedure has advantages in that the seller need not maintain a stock of consigned goods in the foreign country and is less likely to be subject to the tax and other laws of such country. This method is probably acceptable for the use of Western Hemisphere Trade Corporations for although it may have been concededly arranged for the "primary purpose of tax avoidance" such a corporation is deemed to have such a purpose. It is highly likely that this kind of sale would not be considered in substance as having occurred in the United States and would not be within the scope of G. C. M. 25131.

Other Characteristics and Functions

A Western Hemisphere Trade Corporation must operate as an independent, normal functioning company even though organized only for a specific purpose and closely related to a producing company.

1. It should buy and sell in its own name and maintain its own set of books.
2. It should select its own agents in the foreign countries.
3. It should register as an importer and observe the foreign countries regulations.
4. It should pay income tax to the foreign countries in accordance with their laws. Such foreign tax however may be used as a credit against the Western Hemisphere's tax paid in the United States.[22]

More After-Tax Dollars

It can be seen that the Western Hemisphere Trade Corporations may be a good device through which to increase sales volume in the export field and at the same time retain more after-tax dollars.

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[22] Code Section 131.