

Fall 1964

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## Recommended Citation

Popkin, William D. (1964) "Less Developed Countries and the Revenue Act of 1962," *Indiana Law Journal*: Vol. 40 : Iss. 1 , Article 1.  
Available at: <http://www.repository.law.indiana.edu/ilj/vol40/iss1/1>

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# INDIANA LAW JOURNAL

Volume 40

FALL 1964

Number 1

## LESS DEVELOPED COUNTRIES AND THE REVENUE ACT OF 1962

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### I. INTRODUCTION

The Revenue Act of 1962<sup>1</sup> was not supposed to discourage most investment in less developed countries.<sup>2</sup> In the proposed enactment offered by the Treasury a conscious effort was made to exempt less developed countries from many of the intended effects of the act on doing business abroad.

The primary reasons for the Treasury's proposals to discourage foreign investment were the outflow of gold and the drain on domestic investment.<sup>3</sup> These reasons were considered inapplicable to less developed countries. Forty cents of each dollar of foreign investment in less developed countries returned to the United States, as opposed to three cents per dollar of investment in other countries.<sup>4</sup> Furthermore, the encouragement of investment in less developed countries as well as domestic investment is a policy of the United States government.<sup>5</sup>

In view of the policy not to discourage investment in less developed countries, the purpose of this article is to analyze how the act affected the taxation of operating income, tax haven income, passive income, sales of patents, secret processes, etc., foreign investment companies, and dividends from foreign corporations in less developed countries. The conclusion reached is that investment in less developed countries has been seriously impeded and that relief measures, either by way of amendments to specific sections of the act or by way of general legislative programs, are necessary.

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1. Revenue Act of 1962, 76 Stat. 960 (1962).

2. *Hearings on H.R. 10650 Before the Senate Committee on Finance*, 87th Cong., 2d Sess. 99 (1962) [hereinafter cited as *1962 S. Hearings*]; H.R. REP. No. 1447, 87th Cong., 2d Sess. 57 (1962) [hereinafter cited as 1962 H.R. REP.]; S. REP. No. 1881, 87th Cong., 2d Sess. 78 (1962) [hereinafter cited as 1962 S. REP.].

3. *1962 S. Hearings* 99.

4. *1962 S. Hearings* 100.

5. *1962 S. Hearings* 453.

## II. REVENUE ACT OF 1962

A. *Deferral of Operating Income*

As the bill passed through the Congress, its primary thrust was deflected from the Treasury's original purpose of preventing tax deferral, and the more narrow aim of preventing tax avoidance prevailed. The Treasury had sought total elimination of tax deferral for foreign corporations in developed countries controlled in the United States.<sup>6</sup> The House partially agreed but would have allowed the deferral of operating income if reinvested in the same business or in certain businesses within less developed countries. However, the Senate allowed the unconditional deferral of operating income to continue.<sup>7</sup> This retreat, ultimately concurred in by the House, was based on the possible unconstitutionality of a United States tax upon foreign income earned abroad by a foreign entity<sup>8</sup> and the disadvantageous competitive position in which United States enterprise would have been placed if such a tax had been imposed.<sup>9</sup>

However, the retreat from the taxation of operating income was not complete. Although refusing to tax operating income annually, Congress taxed operating income at ordinary rates upon the sale or exchange of stock by certain controlling shareholders in controlled foreign corporations,<sup>10</sup> to the extent of the shareholder's portion of earnings and profits not already taxed at United States rates.<sup>11</sup> Operating income would thus be taxed when the investment terminated. The adoption of the act in this form would have meant that businesses in less developed countries and developed countries would be taxed alike as far as annual operating

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6. 1962 H.R. REP. 57.

7. 1962 S. REP. 79-80.

8. 1962 S. HEARINGS 3016 (Tax Committee of the New York City Bar Association); 1962 S. HEARINGS 4513, 4675-76. Previous experience with the taxation of foreign income not received by United States persons was limited to foreign personal holding companies where the justification for such treatment was the prevention of tax avoidance, not the taxation of foreign income merely because its distribution was controlled by United States persons, *Eder v. C.I.R.*, 138 F.2d 27, 28-29 (2d Cir. 1943).

9. 1962 H.R. REP. 58; 1962 S. HEARINGS 200.

10. In order for a United States shareholder to incur such a tax he must own 10% of the voting stock of the foreign corporation and over 50% of the foreign corporation's voting stock must be owned by such United States shareholders, INT. REV. CODE OF 1954, § 1248(a).

11. Section 1248 of the Internal Revenue Code excludes amounts already taxed to the shareholder under § 951, dealing with the imputation of certain foreign income to controlling United States shareholders on an annual basis. See INT. REV. CODE OF 1954, § 1248(d)(1).

Section 1248(d)(4) of the Internal Revenue Code excludes from the earnings and profits taxed to the shareholder upon sale or exchange of the stock any amount already taxed to the foreign corporation as United States income if the corporation is engaged in a United States trade or business.

income was concerned.<sup>12</sup> Any hope that the taxation of operating income of foreign subsidiaries in developed countries would make investments in less developed countries more attractive would have been lost.<sup>13</sup>

Since there was no policy to tax operating income from businesses in less developed countries at United States rates, either annually or upon liquidation of a shareholder's investment, an exception was inserted upon the Treasury's recommendation.<sup>14</sup> The sale or exchange of stock owned for a continuous period of ten years in a corporation which was a less developed country corporation is not to be taxed at ordinary income rates.<sup>15</sup>

Unfortunately, the "ten year exception," designed to insure long-term investment, is more likely to discourage investment altogether.<sup>16</sup> The inapplicability of the Investment Guarantee Program to many business risks, such as inflation and political instability, makes a businessman wary of an investment if he is "locked in" for ten years.<sup>17</sup> Furthermore, it is

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12. A similar pattern recurred with the proposals to eliminate the foreign income exclusion for foreign residents and those abroad for 17 out of 18 months; INT. REV. CODE OF 1954, § 911. In the original proposal by the President to Congress, only those living in less developed countries were entitled to any exclusion at all, but the final bill treated those in less developed and developed countries alike, 1962 S. REP. 74.

13. It had been urged during the Senate hearings that impeding investment in developed countries was no way to help less developed countries, 1962 S. HEARINGS 2492. A special limitation is also provided by § 1248(b) of the Internal Revenue Code which limits the tax on individuals to the tax that would have been paid if the foreign operating income had been earned by a United States corporation, taxed at United States corporate rates, and then distributed at capital gains rates to the shareholders.

14. 1962 S. HEARINGS 4443-44. Complaints had been received from less developed countries such as the Philippines, 1962 S. HEARINGS 2450-51, 3280.

15. INT. REV. CODE OF 1954, § 1248(d)(3). For purposes of § 1248 the act not only includes a corporation engaged in an active trade or business in a less developed country within the definition of a less developed country corporation, but it also includes a company owning at least 10% of the stock of an active less developed country corporation. In an earlier Senate version of the bill the definition of a less developed country corporation in § 1248 to which the ten year exception applies did not encompass a company owning at least 10 per cent of the stock of an active less developed country corporation. It was limited to a narrower definition such as that set forth in § 955(c). Later, however, the definition which included a holding company was adopted from § 902(d) and became a part of § 1248.

This added exception for a holding company is of use in only one situation, since the holding company subject to § 1248(a) is likely to earn income includable in its controlling United States shareholder's gross income under § 951, which inclusion prevents the application of § 1248(a) in any event. However, in the case of a parent holding company of an active subsidiary incorporated within the same country, the dividends and interest received from the subsidiary would not be taxed to its parent's controlling United States shareholders on an annual basis under § 951. See INT. REV. CODE OF 1954, § 954(c)(4)(A).

16. 1962 S. HEARINGS 4723 (suggestion that a three year, not a ten year, holding period be provided and that a privilege of reinvestment of the proceeds of sale prevent the application of § 1248(a)); and 1962 S. HEARINGS 4772 (possible expropriation not considered).

17. 1962 S. HEARINGS 712-13 (since the Investment Guarantee Program is inadequate, United States shareholders won't risk investment in less developed countries); see

not unlikely that a businessman will have to sell some of his stock as his business becomes more successful. Local pressures for increased participation will grow as the capabilities, wealth, and inclination to make capital investment within less developed countries increase.<sup>18</sup> The "ten year rule" may then penalize those who make an honest effort to comply with the local desire for equity participation, a step which has the full support of United States foreign policy.<sup>19</sup>

#### B. *Tax Haven Income*

Tax haven corporations, also known as base companies, are foreign corporations used by a controlling corporation, incorporated elsewhere, to siphon off profits from activities in yet a third country without payment of tax by the controlling corporation and with the payment of little or no tax in the "tax haven" country. The controlling corporation in this triangle need not be a United States corporation under the act in order for a United States tax to be imposed; it may be a foreign subsidiary of a United States parent.<sup>20</sup> In either case the profits are not being returned to the proper country and a United States corporation is in control of the result.<sup>21</sup>

Various non-tax advantages are derived from use of a tax haven corporation, such as the withdrawal of profits from the source country into a country with a stable currency and stable politics<sup>22</sup> and the ability to reinvest such funds in a manner which is subject to less scrutiny by United States shareholders than would otherwise be true.<sup>23</sup> Tax reasons

Miller, *Protection of United States Investments Abroad; The Investment Guarantee Program of the United States Government*, 32 GEO. WASH. L. REV. 288 (1963). By contrast, the Interest Equalization Tax Act shows a marked awareness of the problems of instability in less developed countries. Thus, if the government of a less developed country threatens a seizure of property or takes action having the effect of a seizure, any reinvestment of the proceeds of sale required by the contract relating to the seizure is exempt from the excise tax even if it does not meet the specifications for exemption for an original investment in less developed countries. Interest Equalization Tax Act, § 4916(a) (4), 78 Stat. 809 (1964) (14 U.S. CODE CONG. & AD. NEWS 3570 (1964)).

18. FRIEDMAN & KALMANOFF, JOINT INTERNATIONAL BUSINESS VENTURES 3-4, 130, 155-74 (1961).

19. 1962 S. HEARINGS 2827.

20. Section 958(b) (2) of the Internal Revenue Code attributes to a United States parent, owning 51% of its foreign subsidiary, all of the stock owned by its subsidiary. Thus a United States parent is deemed to control a second-tier foreign subsidiary, which may be a tax haven corporation, even though the first-tier subsidiary may be a foreign operating company.

21. 1962 H.R. REP. 58 ("[tax haven corporations are] . . . designed to avoid either U.S. tax or tax imposed by the foreign country").

22. Brudno, *Tax Considerations in Selecting a Form of Foreign Business Organization*, in 1 PROCEEDINGS OF THE 1959 INSTITUTE ON FOREIGN INVESTMENT ABROAD 116-22 (1959).

23. This point was raised frequently in the Senate hearings as an argument to support an exemption from United States tax for income from developed country sources reinvested in less developed countries, 1962 S. HEARINGS 2825, 4623.

usually provide the primary motive for using tax haven corporations, however, and the "base company sales and service income" provisions of the act are the primary means designed to correct this abuse.<sup>24</sup>

Under the House version of the bill base company sales income<sup>25</sup> was to be taxed to controlling United States shareholders unless it was reinvested in certain corporations in less developed countries.<sup>26</sup> However, the Senate took away the reinvestment privilege for this type of tax haven income<sup>27</sup> at the same time that it removed the requirement that operating income be reinvested in order to avoid an annual United States tax,<sup>28</sup> and the House ultimately concurred.

Since the main objective sought by the Treasury was to eliminate deferral of taxation on all income from developed country sources, the compromise which allowed deferral of taxation on operating income but abolished the deferral of taxation on sales and service base company income by denying the privilege of reinvestment was a reasonable compromise. From the point of view of less developed countries, however, this compromise is disastrous, for it removes the burden upon operating income from developed countries while eliminating the privilege of investing tax haven income in less developed countries in order to avoid United States tax. Furthermore, in depriving tax haven income of the privilege of reinvestment, no distinction was made between tax haven income arising from developed and less developed country sources. Thus, the pre-1962 tax haven device has been completely removed as to income from both sources.

The primary justification for the total elimination of the privilege of reinvestment, even as to tax haven income from less developed countries, was the prevention of tax avoidance.<sup>29</sup> However, this is just name calling. If there is a policy of encouraging investment in less developed countries, the allowance of "tax avoidance" is a legitimate tool for implementing that policy,<sup>30</sup> especially when there is no clash between such a

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24. INT. REV. CODE OF 1954, §§ 954(a) and 954(e). Foreign personal holding company income (INT. REV. CODE OF 1954, § 954(c)) is also tax haven income if it is received from a related corporation. 1962 S. Hearings 4417-18.

25. The "base company service income" provisions of the act did not appear in the House version of the bill, but were added later by the Senate, 1962 S. REP. 84.

26. Sections 952(d) and 952(e) (2) of the House version of the bill. See note 12 *supra*, for a definition of a controlling United States shareholder.

27. *But see* text accompanying notes 33-39 *infra*, for a discussion of the Senate's treatment of certain tax haven dividend income.

28. 1962 S. Hearings 4420 (Secretary Dillon).

29. In the President's message to Congress, he had urged removal of tax havens, even when used in less developed countries, 1962 S. REP. 79.

30. The use of tax havens for doing business in less developed countries was the subject of some comment in the Senate hearings, 1962 S. Hearings 4220 (India), 4662 (South America). Compare the continued tolerance of tax avoidance in the "Export

policy and discouraging business in developed countries.

There is, in fact, an indication of some favor for tax haven income from less developed countries as a valid means for encouraging business there. For example, different rights of election to distribute and receive an amount of foreign income have been given to a controlling United States shareholder so that he may avoid the unfavorable tax haven provisions of the act. One such election applies to *all* controlled foreign corporations in which he is interested. However, in an apparent recognition of the investor's need for flexibility in dealing with tax havens in less developed countries, Congress has given the shareholder the right to exclude certain corporations active in less developed countries from this group without disqualifying the election as to the remaining corporations.<sup>31</sup>

Since the inability to use tax havens to protect against the dangers of unstable currency and political conditions is most damaging to less developed countries, it is hard to understand the failure to provide exceptions in this area. It can only be supposed that the President's adverse recommendation to Congress and a reluctance on the part of some senators to implement foreign policy extensively through the tax structure produced this result.<sup>32</sup>

### C. *Passive Income*

Passive income dealt with in the act is defined to be foreign personal holding company income, with certain modifications.<sup>33</sup> It does not include such holding company income received from related corporations, which is considered to be tax haven income. However, passive income shares with tax haven income the characteristic of being withdrawn from the source into a United States controlled foreign corporation or into a foreign subsidiary of a United States controlled foreign corporation without tax in the country in which the controlling corporation is organized.

Except for royalties derived from certain United States-created

Trade Corporation" provisions of the act (INT. REV. CODE OF 1954, §§ 970-72), designed to encourage exports by continuing ". . . tax deferral in the case of corporations engaged in export trade who are selling abroad products produced, grown or extracted in the United States." 1962 S. REP. 91.

31. INT. REV. CODE OF 1954, §§ 963(a)(3), 963(c)(3) and 963(c)(4)(A).

32. 1962 S. HEARINGS 454. It is clear that Secretary Dillon would have preferred not to confuse tax policy with foreign policy, 1962 S. HEARINGS 454. The State Department seems, as usual, to have waived its interest in using tax incentives to implement foreign policy, see Kust, *Tax Concessions for Private Enterprise Abroad*, in 1 PROCEEDINGS OF THE 1959 INSTITUTE ON FOREIGN INVESTMENTS ABROAD 147, 159 (1959).

33. INT. REV. CODE OF 1954, § 954(c). Generally, the modifications are designed to exclude what is normally "passive income" received in an active trade or business or received from subsidiaries engaged in an active trade or business in the same country as their parent. However, rents are not automatically excluded if they are 50% of gross income. Compare INT. REV. CODE OF 1954, § 954(c)(2) with INT. REV. CODE OF 1954, § 553(a)(7).

property,<sup>34</sup> passive income was originally given the privilege of reinvestment in less developed countries by the House in order to avoid United States tax to controlling United States shareholders, just as in the case of tax haven income.<sup>35</sup> The Senate greatly limited this privilege by providing that only dividends and interest derived from certain investments in less developed countries and sales or exchanges of such investments in less developed countries could avoid being taxed to controlling United States shareholders of the controlled foreign corporation by reinvestment in less developed countries. The investing corporation must own ten percent of the voting equity in the corporation from which it derives income and in which it reinvests its gain for its shareholders to avoid United States tax.<sup>36</sup>

We have already questioned the wholesale reversal of the pre-1962 law as it applied to tax haven income from less developed countries. The question now arises as to what justification the Congress could have in accepting the Senate proposal, thereby distinguishing between certain kinds of passive income derived from less developed countries on the one hand and tax haven income and other passive income, especially royalties derived from other than United States-created property, on the other hand.

It may be that considerations of the ability of the controlling corporation to withdraw profits from their source in the less developed countries into a controlled corporation and the permanence of the investment in the less developed countries were persuasive in the decision to make this distinction. In the case of the sales and service type of tax haven income, the controlling corporation has complete power over withdrawal of profits into the tax haven corporation. The sales or service contract simply calls for payment to the tax haven corporation from the source country, and there need be no delay in payment unless credit is extended. Capital investment is not a necessary ingredient in producing such tax haven income. In the case of a royalty, the contract will no doubt call for payment outside the less developed country, although the relationship of a royalty to future sales may foster a stronger commitment to the country's future. A guarantee by way of an advance reduces this "commitment," but payment of the advance in stock may have the contrary effect.

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34. See text accompanying notes 40-54 *infra*.

35. Section 952(d) of the House version of the bill.

36. INT. REV. CODE OF 1954 955(b) (1). In addition, corporate bonds must have at least one year until maturity at the time of acquisition as well as being obligations of corporations in which the investor owns 10% of the equity. Bonds issued by less developed countries themselves also qualify regardless of maturity date. Royalties were not accorded this privilege, even if not derived from United States-created property, although the question was raised in the hearings, 1962 S. Hearings 4496.



A default in payment will probably result in a termination of any license, thereby terminating any investment in the country.

However, in the case of interest, the payments are more subject to the risk of inflation than in the case of royalties based on sales. Furthermore, the investment giving rise to the interest is a permanent part of the corporation's capital.

With dividends, the equity investor's commitment to the corporation may be considered greater than that of a creditor. However, the power to withdraw profits may be more or less. In the case of 10 percent ownership, terms can hardly be dictated. But if the investor has majority control, the dividends might be withdrawn more easily, although the partner in the less developed countries may exert strong pressures to reinvest.

Although these arguments may lend support to Congress' distinction in granting the reinvestment privilege, a more realistic appraisal of what occurs in less developed countries will undermine this support. The sale of a product, the rendering of a service, or the licensing of a patent or process may be of great permanent value to the country, even if it is not a "permanent" investment.<sup>37</sup> Furthermore, the profits from sales, services, and royalties, received by a tax haven corporation, may provide the incentive for making a capital investment in the less developed country as a means of securing or maintaining the market for the product or service.<sup>38</sup>

While power over profit withdrawal seems greater in the case of tax haven and royalty income, the power to sell stock which has appreciated greatly due to the profits of the corporation may prove a more sudden drain on the country's resources than periodic payments.<sup>39</sup> The granting of the privilege of reinvestment to the gain on the sale of such stock is inconsistent with any policy of encouraging permanent investment, the fruits of which are not subject to the investor's control. Of course, the inconsistency of the act is even more glaringly pointed up by the fact that dividend income from a subsidiary corporation in a less developed country is accorded the privilege of reinvestment, even though it is tax haven income.

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37. Kust, *Minority Ownership in the Context of Sound Finance for Developing Countries*, in *INTERNATIONAL FINANCING & INVESTMENT* 503 (1964).

38. Cutler, *Joint Ventures with Foreign Business Associates, Investors and Governments*, in 1 *PROCEEDINGS OF THE 1959 INSTITUTE ON PRIVATE INVESTMENT ABROAD* 261, 264 (1959); *FRIEDMAN & KALMANOFF, op. cit. supra* note 18, at 110-11, 163-64. Conversely, the less developed countries may encourage some equity investment to insure that the foreign licensor maintains a continuing interest, Kust, *supra* note 37, at 513.

39. Kust, *supra* note 37, at 513.

#### D. *Sale of Patents, Secret Processes, etc.*

Section 1249(a) taxes at ordinary rates the sale or exchange of a patent, invention, model, design, copyright, secret formula or process, or other similar property by a United States person to a foreign corporation in which he owns more than 50 per cent of the voting stock.<sup>40</sup> It is only by understanding the purpose of this section that we can appraise the validity and effect of its application to less developed countries.

Section 1249 had its origin as a proposal to tax controlling United States shareholders on royalty income from the license and use of United States-created patents, copyrights, and exclusive formulas and processes by a controlled foreign corporation.<sup>41</sup> The House version of the bill, while according the privilege of reinvestment to avoid United States tax to royalty income derived from foreign created property, denied this privilege in the case of the royalty derived from United States-created property.<sup>42</sup>

The Senate had no trouble dealing with royalties from the license of United States-created property since all royalty income received by a controlled foreign corporation was denied the privilege of reinvestment. However, the "hypothetical royalty" derived from the *use* of property in manufacturing operations by a controlled foreign subsidiary was severely criticized as an unworkable concept, based as it was on a presumed payment by an unrelated person for a similar use of the property.<sup>43</sup> As a substitute for this hypothetical royalty the Congress accepted section 1249, which had been proposed by the Senate<sup>44</sup> and which contains no reinvestment privilege to avoid ordinary income treatment.

It is certainly true that the "hypothetical royalty" shares with tax haven income the characteristic of being completely controllable by the

40. INT. REV. CODE OF 1954, § 1249(b). Stock ownership is determined by the attribution rules of § 958 of the Internal Revenue Code; United States person is defined in § 7701(a)(30) of the Internal Revenue Code.

41. Section 952(c) of the House version of the bill. Although the House version of the bill taxed the income from the license and use of certain know-how property acquired by the controlled foreign corporation from a United States parent, subsidiary, or affiliate, even if the know-how property was not created in the United States the House report makes it clear that United States-created property conveyed by United States persons was the primary concern, 1962 H.R. REP. 58.

42. Section 952(e)(4) of the House version of the bill excluded such royalty income from "base company income," which the House had afforded the privilege of reinvestment in less developed countries in order to avoid United States tax on controlling United States shareholders.

43. 1962 S. REP. 110.

44. Although the Senate version of the bill was not limited to United States-created property either (see note 41 *supra*), the Senate report recognized that United States-created property was the main concern: "Your committee recognizes that the transfer of U.S. developed patent and similar rights by a U.S. corporation to a controlled foreign corporation causes a diversion of income from U.S. sources." See 1962 S. REP. 110.

United States parent. While the tax avoidance potential lies in causing the foreign corporation to retain the income rather than in withdrawing the income into a tax haven corporation, the result is the same insofar as foreign income is overstated and taxed at lower rates, while the person in control avoids a higher rate of taxation.

However, tax haven income may not be derived from services rendered by personnel of a United States corporation or from the sale or license of products manufactured in the United States. It may be derived from an active trade or business of a foreign subsidiary of a United States parent. The "hypothetical royalty," on the other hand, was designed specifically to deal with property created in the United States. The origin of the property itself in the United States justifies characterization of the fruits of such property as United States income,<sup>45</sup> less entitled than tax haven income to the privilege of reinvestment in order to avoid United States tax.<sup>46</sup> Any argument in favor of a privilege of reinvestment in less developed countries for royalties derived from the exploitation of United States-created property in less developed countries cannot, therefore, rest simply on the theories previously advanced for tax haven or passive income. In support of such a privilege, however, are considerations of United States foreign policy over and above a consideration of the value of such "know-how" property to the economy of less developed countries. For, in the wake of the conveyance of such property come the United States technicians needed to train the people of the host country in its use, a sort of Peace Corps without government assistance.<sup>47</sup>

One important effect of the Senate's change in the House's method of taxing the "hypothetical royalty" may be of some benefit to less de-

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45. The characterization by Congress of the source of royalty income in terms of the place of creation of the property yielding such income rather than the place of exploitation is in contrast to the rigid "passage of title" test used by the courts in the case of sales income, see, *e.g.*, *Frank v. International Canadian Corp.*, 308 F.2d 520 (9th Cir. 1962); *Barber-Greene Americas, Inc. v. C.I.R.*, 35 T.C. 365 (1960).

46. The special potential for avoidance of United States tax upon the sale of a United States patent or similar rights seems confirmed by the fact that § 4914(c) (3) of the Interest Equalization Tax Act provides an exception for just such a sale even if made to a controlled foreign corporation. Interest Equalization Tax Act, § 4914(c) (3), 78 Stat. 809 (1964) (14 U.S. CODE CONG. & AD. NEWS 3570 (1964)). This indicates that tax avoidance, and not balance of payments, is the primary concern of § 1249. See note 58 *infra*.

Income from the insurance of United States risks was also denied the privilege of reinvestment by the House (§ 952(e)(4) of the House version of the bill) and, of course, by the Senate.

47. The President's Foreign Aid Message, 110 CONG. REC. 5546 (daily ed. March 19, 1964), contained a suggestion for an "Executive Service Corps" designed to encourage United States businessmen to furnish technical and managerial advice in less developed countries with a minimum of governmental participation.

veloped countries. By taxing a sale or exchange of property at ordinary rates, instead of at capital gains rates, the Senate has opened up the possibility that the sale or exchange itself will take place in a non-taxable transaction. For the creation of a corporation or a transfer to an 80 per cent controlled foreign corporation is tax free, if the Commissioner rules under section 367 that one of the principal purposes of the conveyance is not tax avoidance.<sup>48</sup> The House version of the bill would have created, in effect, a conclusive presumption of tax avoidance in the case of United States-created property conveyed to a controlled foreign corporation for manufacturing use. Thus, while the Senate did not provide for a privilege of reinvestment to avoid ordinary income treatment in the case of a transfer to corporations in less developed countries, it may have provided a broader avenue of escape of greatest utility to the riskiest investments.<sup>49</sup>

It remains to be seen whether the Treasury will go along with the Conference Committee Report<sup>50</sup> which affirmed that a section 367 ruling may be obtained on any sale or exchange made under section 1249.<sup>51</sup> While the application of section 367 may not be logically justifiable in view of section 1249's original purpose, it does have support as a Congressional compromise. For the Senate completely reversed the House and specifically provided that a conveyance for manufacturing use to a foreign subsidiary was exempt from section 1249,<sup>52</sup> forgetting that the tax avoidance potential lay in just such a conveyance, instead of a license

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48. Section 367 of the Internal Revenue Code provides that common tax-free transactions such as corporate organizations and reorganizations may be treated as a taxable event if a foreign corporation is involved, unless a prior ruling is obtained that tax avoidance is not one of the principal purposes of the transaction.

49. The Senate also may have unintentionally provided a broader area of taxation, since § 1249 of the Internal Revenue Code taxes a conveyance to a foreign subsidiary for the purpose of licensing as well as use, even though this section was intended only to deal with a conveyance for use. Royalties from licensing operations by controlled foreign corporations may then be taxed again to controlling United States shareholders. See INT. REV. CODE OF 1954, § 951. The proposed exception to § 1249 should not have been for a conveyance for manufacturing use (see text accompanying note 52 *infra*), but for a transfer for licensing purposes.

50. Conference Report No. 2508, 87th Cong., 2d Sess. (1962) at 2 U.S. CODE CONG. & AD. NEWS 3761 (1962).

51. 1962 S. Hearings 4486; there were fears that the Treasury interpreted the new § 1249 to preclude a § 367 ruling. 1962 S. Hearings 4562, 4726. The proposed regulations under § 1249 are silent on this question, although the proposed regulations under § 1248 specifically allow a § 367 ruling. Compare Proposed Treas. Reg. 1.1248-1(c), 29 Fed. Reg. 10589-90 (1964) with Proposed Treas. Reg. 1.1249-1(a) and (b), 29 Fed. Reg. 12734 (1964).

52. Section 1249(c) of the Senate version of the bill. In the act, as passed, the reference to subsection (c) was not even deleted from subsection (a). The conveyance which would have been exempted by the Senate bill included a contribution to capital. It was probably thought that a shareholder would be deemed to have received stock in exchange for the contributed property, see REV. RUL. 64-155, 1964 INT. REV. BULL. No. 21, at 17.

by the United States parent yielding a royalty from the foreign subsidiary. This exemption, which was deleted in conference, may have arisen from a mistaken assumption that the original "hypothetical royalty" was a United States tax on foreign operating income,<sup>53</sup> rather than an attempt to prevent tax avoidance. The applicability of section 367 may emerge, therefore, as a not altogether rational midway point between the House and the Senate positions.<sup>54</sup>

#### E. *Foreign Investment Companies*

The act was not exclusively aimed at direct investment of 10 per cent or more by United States shareholders in foreign business. It had been noticed that investment companies specializing in foreign stocks and securities were incorporating in foreign countries instead of incorporating in the United States where they might be subject to the accumulated earnings and regular corporate tax.<sup>55</sup> United States stockholders of the investment company thereby gained greater flexibility in controlling the distribution of earnings and could realize on those earnings by selling the stock at capital gains rates. Although only fourteen such companies were registered, there was suspicion that there were many more such unregistered companies.<sup>56</sup>

The device used in the act to impose tax on the earnings of such corporations is similar to that used in section 1248, *i.e.*, the removal of capital gains treatment for stock of a foreign investment company<sup>57</sup> to the extent of the shareholder's pro-rata share of earnings and profits. However, unlike the provisions of section 1248 and the sections dealing with tax havens, the shareholder need not own 10 per cent of the corporation's stock for the tax to apply.

Insofar as the purpose of these provisions is to prevent the outflow of United States gold reserves, the failure to grant an exception for portfolio investments in less developed countries by the foreign investment

53. 1962 S. Hearings 4624 (testimony that § 1249 property might be used for manufacture, *rather than* tax avoidance).

54. A § 367 ruling would be especially useful in view of the Treasury's recent ruling that much "know-how" property may qualify as a capital asset, so that its transfer will not be treated as an assignment of income. This would be true even if the transfer were limited to use in one country. REV. RUL. 64-65, 1964 INT. REV. BULL. No. 8, at 9.

55. 1962 S. REP. 101-02; 1962 S. Hearings 248.

56. 1962 S. REP. 101.

57. INT. REV. CODE OF 1954, § 1246(a). Over 50% voting control or ownership of over 50% for the value of the stock by United States persons is required unless the company is registered under the Investment Company Act of 1940 (INT. REV. CODE OF 1954, § 1246(b)). Section 1247 of the Internal Revenue Code allows such corporations to elect a course of action similar to that available to Regulated Investment Companies (INT. REV. CODE OF 1954, §§ 851-55) in order to avoid the rigors of § 1246 for its shareholders.

company is inconsistent with the exception for such investments in the recent "Interest Equalization Tax Act," the avowed purpose of which is to prevent adverse balance of payments arising from portfolio investments.<sup>58</sup> However, if the purpose of section 1246 is to prevent tax avoidance, our prior discussion of tax haven and passive income becomes relevant.

Since the passive income earned by a controlled foreign corporation and granted the privilege of reinvestment must be derived from a 10 per cent investment in less developed countries, it may be said that the act looks unfavorably upon portfolio investment. However, the act deals with portfolio investments yielding income to a controlled foreign corporation which either earns over 40 per cent of its gross income from an active trade or business or is controlled by a United States corporation.<sup>59</sup> This is very different from a specialized investment company owned by the general public. The rigors of the foreign personal holding company provisions prevent the base of stock ownership of any investment company from being too narrow.<sup>60</sup> Furthermore, the investment company may be required to reinvest its income from less developed countries in order to avoid the consequences of section 1246 for its shareholders. Certainly the resultant diversity of investment and the expert guidance which such an investment company would bring to investment in less developed countries deserve special encouragement, in view of the present apathy and apprehension among the general public.<sup>61</sup>

#### F. *Gross-up of Dividends*

Before the act, a corporation owning 10 per cent of a foreign corporation's voting stock and receiving dividends therefrom was entitled to a credit for a certain percentage of the income taxes paid or accrued to a

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58. 1962 H.R. Rep. No. 1046, 88th Cong., 2d Sess. 3-10, 14-15 (1964).

59. The act was never intended to deal with a controlled foreign corporation if 60% of its gross income was passive income unless it was controlled by a United States corporation since the foreign personal holding company provisions of the code were sufficient to handle such a situation; INT. REV. CODE OF 1954, §§ 951(d) and 552(a). The only case where individual control of an investment company which is a controlled foreign corporation would not be handled by the foreign personal holding company provisions is the unlikely case of non-voting common or preferred stock equal to 50% or more of the value of the corporation's stock being held outside the circle of the controlling group.

60. INT. REV. CODE OF 1954, § 552(a)(2). Five or fewer United States individuals cannot hold more than 50% of the value of the foreign corporation's stock without the investment company achieving foreign personal holding company status, INT. REV. CODE OF 1954, §§ 553(a)(1) and 553(a)(2).

61. On the other hand, it had been suggested in the Senate hearings that portfolio investment in less developed countries deserved encouragement, 1962 S. Hearings 3549.

foreign government by the foreign corporation<sup>62</sup> and paid United States tax only on the amount of dividends after foreign taxes. Now the general rule is that a shareholder, in order to be entitled to a credit, must include the foreign taxes in United States income unless the dividend is from a less developed country corporation.<sup>63</sup> If the foreign tax is so included, however, the total credit available is no longer limited to a percentage of foreign taxes but is the full amount of such taxes if all income after taxes is distributed.<sup>64</sup>

The exception for less developed countries was granted because the greatest burden of the "gross-up" would have fallen on less developed countries, whose tax rates were often close to 26 per cent, the point at which the prior law gave the greatest tax advantage.<sup>65</sup>

However, it should be emphasized that not all less developed countries have corporate rates less than ours. If these rates are higher, the exemption from the gross-up provisions may be a disadvantage. For the full amount of the foreign tax might have been available as a credit against United States tax, either through the election of the "over-all limitation"<sup>66</sup> or the use of the tax credit carryover provisions.<sup>67</sup> Furthermore, it is not the nominal foreign rates with which a United States taxpayer is concerned, but the effective foreign rates based upon United States concepts of taxable income. A foreign rate of 45 per cent may be an effective rate of over 50 per cent in the *final* years of depreciation of assets, if United States income is figured on straight line depreciation, but foreign income is figured on an accelerated basis.<sup>68</sup> This may often happen with less developed countries anxious to give initial tax incentives to foreign investors.

### G. Legislative Regulations

In our previous discussions we have mentioned that income from in-

62. *American Chicle Co. v. U.S.*, 316 U.S. 450 (1942). If income of the foreign corporation were \$100 and foreign taxes thereon were \$25, the total credit prior to the act would have been \$18.75, or 75% of \$25, if all income after taxes had been distributed.

63. INT. REV. CODE OF 1954, § 78.

64. INT. REV. CODE OF 1954, § 902(a)(1).

65. 1962 S. REP. 67.

66. INT. REV. CODE OF 1954, §§ 904(a)(2) and 904(b). Normally, there is a "per-country limitation" on the foreign tax credit, designed to disallow the credit to the extent that the tax rates of the foreign country are higher than United States rates. The "over-all limitation" allows the taxpayer to "homogenize" foreign countries in determining whether the limitation on the tax credit is applicable. Thus if one country has rates higher than the United States, no credit is lost if the over-all tax rate of all foreign countries on the taxpayer's foreign income is not higher than United States rates. This right to "homogenize" was made inapplicable by the act to certain interest income, INT. REV. CODE OF 1954, § 904(f).

67. INT. REV. CODE OF 1954, §§ 904(d) and 904(e).

68. REV. RUL. 62-67, 1962-1 CUM. BULL. 128; G.C.M. 22556, 1941-1 CUM. BULL. 310.

vestments of 10 per cent or more in corporations in less developed countries may be exempted from United States tax if reinvested.<sup>69</sup> The act specifies, however, that 80 per cent of the gross income of the corporation yielding such income and in which the taxpayer reinvests his gain must be from within the less developed countries.<sup>70</sup> If the normal criteria were applied in determining whether income was from within less developed countries, the "passage of title" test might exclude an export company whose value in bringing foreign exchange to the country is unquestioned.<sup>71</sup> Congress, therefore, accepted a Senate suggestion that the Secretary or his delegate be empowered to determine what is derived from within less developed countries.

The proposed regulations under this section did not resolve this issue favorably for less developed countries. Gain from the sale of tangible personal property was derived from within less developed countries only if the property was produced there.<sup>72</sup> Production within the less developed countries was a necessary but not a sufficient cause for the source of gain to be from within less developed countries. However, the final regulations have corrected what was probably an oversight, stating that gain from a sale of tangible personal property is derived from within less developed countries "if and only if" the property was produced there.<sup>73</sup>

The Senate also decided that the House provision, allowing income subject to the privilege of reinvestment to be reinvested within 75 days after the taxable year in which it was earned,<sup>74</sup> was too restrictive. The Treasury suggested a one year period after the year in which the income was earned for determining the amount reinvested,<sup>75</sup> and Congress ultimately gave the Secretary or his delegate the power to allow a year or more.<sup>76</sup>

The regulations provide for more than one year in only one situation.<sup>77</sup> First, a shareholder must actually elect to have his reinvestment determined as of one year after the income is earned. If he does so, he is eligible for a special two-year reinvestment period in the following situation. His election must have been made in the first taxable year of the corporation in which the electing shareholder acquires the 10 per cent ownership required to impute income to him under section 951 and in

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69. See text accompanying notes 33-39 *supra*.

70. INT. REV. CODE OF 1954, § 955(c) (1) (A).

71. 1962 S. Hearings 4723.

72. Proposed Treas. Reg. § 1.955-6(d) (1), 28 Fed. Reg. 3547 (1963).

73. Treas. Reg. § 1.955-6(d) (1) (1963).

74. Section 952(f) (2) of the House version of the bill.

75. 1962 S. Hearings 4420.

76. INT. REV. CODE OF 1954, § 955(b) (3).

77. Treas. Reg. § 1.954-5(b) (2) (1964).



which the corporation has income from qualified investments in less developed countries. If these conditions are met, the amount is determined not by the amount invested in the year after the income was earned but by the difference between the investment one year after the income was earned and the investment which existed *at the beginning* of the year in which the income was earned. This special two-year reinvestment period is only available for the income of the year for which a valid election is made.

Inadequate as this is, it is a decided improvement over the proposed regulations.<sup>78</sup> It had been proposed that any two-year election had to be made in the first year in which *any* shareholder had sums imputed to him under section 951, thus excluding from the right of election the latecomer to the corporation and excluding even original investors if there was income includable under section 951 in a year prior to the earning of income from qualified investments in less developed countries.

The election by a shareholder to have his reinvestment determined as of one year after the taxable year in which the income was earned is irrevocable without the Commissioner's consent.<sup>79</sup> Thus if income is earned in one year and reinvested that same year, but a forced liquidation of the investment takes place the following year, the election results in the income being treated as uninvested as of the close of the year after it arises. This could be handled by a consent to withdrawal of the election for that year or by extending the period for reinvestment in the case of a forced liquidation.<sup>80</sup>

### III. CONCLUSION

The full impact of the act on investments in less developed countries is impossible to gauge. It may be that the expense of lawyers and accountants resulting from the sheer complication of the act, rather than any specific provision discussed above, will prove most prohibitive where

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78. Proposed Treas. Reg. § 1.954-5(b)(2), 27 Fed. Reg. 12769 (1962).

79. Treas. Reg. § 1.955-3(c)(1) and (3) (1963).

80. Another area of concern to less developed countries is income which would be taxed to controlling United States shareholders but for the fact that currency or other restrictions block any possible distribution to the United States shareholder. Regulations on "blocked income," specifically authorized by § 964(b) of the Internal Revenue Code, have not yet been proposed. Their impact will be greatest on less developed countries and it may be hoped that the normal rule, *i.e.*, "unblocking" causes a sudden bunching of income, will not be applied in the context of the act; MIM. 6475, 1950-1 CUM. BULL. 50, 51 as amended, MIM. 6494, 1950-1 CUM. BULL. 54 and MIM. 6584, 1951-1 CUM. BULL. 19. Section 1248(b) of the act, allowing an individual to be taxed on the sale of stock in a controlled foreign corporation as though a United States corporation had received operating income and liquidated, was designed to prevent the sudden bunching of ordinary income. 1962 S. REP. 107-08.

risks are greatest, *i.e.*, in less developed countries.<sup>81</sup> In any event, the dampening effect of the act on investment in less developed countries due to the removal of pre-1962 deferral devices and the failure to grant adequate exceptions is certain.<sup>82</sup>

Specific proposals for amendment of the act within the basic framework of the act itself would include the following: (1) granting the privilege of reinvestment to avoid United States tax on controlling United States shareholders of a controlled foreign corporation for *all* tax haven and passive income from less developed countries; (2) allowing capital gains treatment under section 1248 upon the sale or exchange of investments in less developed countries without regard to a holding period; (3) providing for capital gains treatment upon the sale or exchange of United States created "know-how" property to less developed countries, upon condition that the income after capital gains taxes is re-invested; (4) granting the privilege of reinvestment for income from portfolio investments of a foreign investment company earned in less developed countries in order to prevent the sale or exchange of stock in such a company from resulting in ordinary income.

This catalogue of shortcomings of the act from the point of view of less developed countries should not be taken, however, as an indication of Congressional hostility towards future tax incentive legislation. The exceptions granted by the act do represent an awareness by Congress of the need for special tax treatment for investments in less developed countries. The principle has been recognized even if its implementation has left something to be desired.

Previous attempts at broad tax incentives for less developed countries have failed.<sup>83</sup> Certain limited legislation of use to less developed countries, such as the bills assisting students, teachers and technicians

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81. 1962 S. Hearings 2465. Perhaps only large firms can afford the expense (1962 S. Hearings 4724), thereby foreclosing the medium-sized firm, even though such a firm may have the least to worry about in a joint venture from an anti-trust point of view, see FRIEDMAN & KALMANOFF, JOINT INTERNATIONAL BUSINESS VENTURES 245-57 (1961).

82. Kuhn, *United States Tax Policy with respect to Less Developed Countries*, 32 GEO. WASH. L. REV. 261, 277 (1963) ("In fact, in light of the tightening effect of the Revenue Act of 1962 the call for more sympathetic tax treatment of income earned in less developed countries may be even stronger (than in 1960)."); N.Y. Times, October 11, 1963, p. 53, col. 5.

83. For an outline and discussion of these proposals see Kuhn, *supra* note 82, at 261; Kust, *U.S. Tax Concessions for Private Enterprise Abroad*, in 1 PROCEEDINGS OF THE 1959 INSTITUTE ON PRIVATE INVESTMENTS ABROAD 145-64 (1959); Anthoine & Bloch, *Tax Policy and the Gold Problem: An Agenda for Inquiry*, 61 COLUM. L. REV. 322, 329-31 (1961).

from all countries,<sup>84</sup> and Peace Corpsmen,<sup>85</sup> have passed. However, there is reason to believe that the unfortunate association of tax incentives for less developed countries with windfalls for business in developed countries<sup>86</sup> and with the highly controversial "tax-sparing" proposal<sup>87</sup> was a basic cause of the failure of earlier tax incentive legislation.<sup>88</sup>

Furthermore, it was the Senate which failed to pass major tax incentive legislation in 1960.<sup>89</sup> And yet many of the specific sections of the act which help less developed countries were inserted by the Senate as modifications of the House version of the bill.<sup>90</sup>

Now that the Revenue Act of 1964<sup>91</sup> is also behind us, Congress has again been asked to consider special tax incentives for investment in less developed countries. President Johnson has suggested a credit against

84. INT. REV. CODE OF 1954, § 871(d) (regular United States tax laws, not flat 30% rate, applies); INT. REV. CODE OF 1954, § 872(b)(3) (salaries from home country exempt from United States tax); INT. REV. CODE OF 1954, § 1441(c)(4)(B) and Treas. Reg. 1.1441-4(b)(2)(i) (1956) as amended, T.D. 6592, 1962-1 CUM. BULL. 160, 163 (no withholding under § 1441 from personal service income); INT. REV. CODE OF 1954, §§ 1441(b)(1) and (2) (reduced withholding on certain scholarship and fellowship amounts not excludable under § 117). All four amendments, effective as of January 1, 1962, apply only to non-resident aliens temporarily present in the United States as non-immigrants under subparagraph (F) or (J) of § 101(a)(15) of the Immigration and Nationality Act. At the same time, § 117(b)(2)(A) of the Internal Revenue Code was amended to allow an exemption from gross income for scholarship and fellowship grants from foreign governments or international organizations, as well as from domestic organizations.

85. INT. REV. CODE OF 1954, § 1303(b)(4) (back pay of Peace Corpsmen relieved from bunching; effective March 1, 1961); INT. REV. CODE OF 1954, § 3401(a)(13) (no withholding for Peace Corpsmen; effective September 23, 1961).

86. Kust, *supra* note 83, at 145, 148, 154-55, 156.

87. "Tax sparing" is the giving of a credit for foreign taxes which would have been paid but for tax concessions by the foreign country designed to stimulate investment. This proposal created a storm of controversy, apparently out of proportion to its real benefit to less developed countries. Kust, *supra* note 83, at 148-52. *But see* Kuhn, *supra* note 82, at 263-68, pointing to the psychological importance of tax sparing to less developed countries.

88. On the other hand, the opposition of labor groups may have been a crucial factor. The second Boggs Bill (H.R. 5, 86th Cong., 2d Sess. (1960)) was all but emasculated by the requirement that no more than 10% of the produce of the foreign business could be imported into the United States and that the minimum labor standards of the less developed countries had to be met before the United States corporation doing business abroad would be entitled to tax advantages, 106 CONG. REC. 10570, 10576-77 (1960).

89. Anthoine & Bloch, *supra* note 83, at 331.

90. *E.g.*, (1) deleting the requirement that reinvestment of income in less developed countries had to be in a corporation, more than 50% of which was owned by five or fewer persons; (2) granting to the Treasury the power to give an expansive definition of "within less developed countries" and to allow more than one year for the reinvestment of income derived from within less developed countries; (3) inserting the "ten year holding period" exception to § 1248 of the Internal Revenue Code for investments in less developed countries and the exception for less developed countries from the gross-up provisions.

91. Revenue Act of 1964, 78 Stat. 19 (1964).

United States tax in the year of investment in less developed countries,<sup>92</sup> a suggestion which focuses on the need for initial incentives, rather than annual benefits in the form of deferral, reduced rates, or tax-sparing.

Whether this "hypodermic" approach would be effective may be questioned.<sup>93</sup> More modest proposals which would cover a broader range of problems, such as forced liquidations of investment,<sup>94</sup> annual loss,<sup>95</sup> tax-free incorporation,<sup>96</sup> tax-credits,<sup>97</sup> and the problems raised by the act itself, might be more useful. There is a body of opinion questioning the efficacy of any tax incentives,<sup>98</sup> but the entire history of our tax laws indicates that Congress does not share this view.<sup>99</sup>

In any event, the time seems ripe for a reconsideration of the question of tax incentives for less developed countries, divorced from the question of discouraging investment in developed countries. It remains to be seen whether the special treatment in the act for investments in less developed countries merely indicates an unwillingness to make things worse or whether it foreshadows more substantial tax incentive legislation.

92. The President's Foreign Aid Message, 110 CONG. REC. 5546 (daily ed. March 19, 1964).

93. Kuhn, *supra* note 82, at 278-79, 287. Cf. § 38 (investment credit).

94. Cf. INT. REV. CODE OF 1954, § 1033(a) (proceeds from involuntary conversions tax free if reinvested).

95. Consolidated returns are an inadequate solution to this problem. The 80% ownership requirement in § 1504(a) is unrealistic in view of the growth of joint ventures in less developed countries and in view of the risk that gain will be included if consolidation is elected. Allowing ordinary loss upon sale of investments in less developed countries might be some investment incentive, just as § 1248, taxing gain at ordinary rates, serves as some deterrent. See INT. REV. CODE OF 1954, § 1244.

96. A § 367 ruling is now required; see note 48 *supra*.

97. See note 87 *supra*.

98. BARLOW & WENDER, FOREIGN INVESTMENT AND TAXATION (1955) (known as the Harvard Study); but see Kust, *supra* note 83, at 158-59.

99. *E.g.*, INT. REV. CODE OF 1954, §§ 970-72 (Export Trade Corporations); INT. REV. CODE OF 1954, §§ 921-22 (Western Hemisphere Trade Corporations); INT. REV. CODE OF 1954, §§ 38, 46-48 (Investment credit); INT. REV. CODE OF 1954, §§ 1242-44 (small business losses); INT. REV. CODE OF 1954, § 1235 (capital gain upon sale of patents, etc.).

# INDIANA LAW JOURNAL

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Volume 40

FALL 1964

Number 1

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