

TAX INDUCEMENTS TO FOREIGN TRADE

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INTRODUCTION

Ever since the last years of World War I when the accumulation of rates on income flowing from one country to another reached in some cases more than 100 percent of the income, the United States has been a leader in unilateral, and later, bilateral measures for the prevention of international double taxation. As World War I was coming to a close in 1918, Congress adopted the sound policy of recognizing the prior right of a foreign country in which income arises to tax such income and of granting a credit for the foreign tax levied in the country of source against the tax payable by the United States citizen, or resident, or corporation to the federal government. The credit for foreign taxes now found in Section 131 of the Internal Revenue Code¹ has, through the years, been threatened with repeal; it has been encroached upon by amendments to the law and by court decisions, and has been in some cases limited and in others expanded in its application. Fortunately for our foreign trade and investments, the credit has survived and today it is in effect incorporated in our treaties for the prevention of international double taxation, concluded with France, Sweden, Canada, and England.

UNILATERAL RELIEF IN UNITED STATES LAW

Instead of outlining the history of Section 131 and its various amendments, a summary will be made of its provisions as they are found today in the Internal Revenue Code. The significance of this section could be thrown more sharply into relief if space permitted a discussion of the measures adopted by other important

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¹ 26 U. S. C. (SUPP. IV, 1941-1945) §131, hereinafter, in text and footnotes cited as Internal Revenue Code or I. R. C. or simply by section-number.

commercial countries in their tax laws for preventing international double taxation, as well as to describe the general nature of the clauses which accomplish the same purpose in bilateral conventions for the avoidance of international double taxation. At the outbreak of World War II there were more than sixty treaties of a general nature and over two hundred of a limited scope. In short it may be noted that whereas other countries have, on the whole, been much more liberal in according exemption for income allocable to a permanent establishment in a foreign country, our Congress has from the beginning been very loathe to accord an outright exemption, and whatever relief has been adopted has been circumscribed in scope, subjected to rigid conditions precedent, and generally framed in a fashion to avoid any suggestion of an exemption except to a very limited degree.

In formulating the credit for foreign taxes in the 1918 Act,² and in framing the successive amendments thereto, Congress has consistently endeavored to carry out the policy that a tax levied in the foreign country should be allowed as a credit against the United States tax on entire net income without, however, reducing the United States tax on domestic income. This means that the tax on foreign income allowed as a credit is subject to a ceiling of the amount of the domestic tax corresponding to the foreign income. For a period of years the excess of foreign tax over the domestic tax on the foreign income was allowable as a deduction, but this oversight in our law was removed when Congress realized that such an allowance was tantamount to giving a subsidy to foreign trade to the extent that the deduction reduced the United States tax on domestic income.

Taxpayers still have the right of electing whether they will take a deduction of foreign taxes from gross income under Section 23(c)(1)(C) of the Internal Revenue Code or a credit against the tax under Section 131, but the election must be made with regard to the taxes paid or accrued in all foreign countries in the same taxable year, so that the taxpayer cannot elect to take a credit for certain taxes and a deduction for the others.

Direct Credit for Taxes Paid by Recipient of Income

The credit provisions in Section 131 are sometimes described as including a direct credit and an indirect credit. Under Subsection (a) citizens and domestic corporations are allowed the direct credit against normal tax and surtax in respect of any income, war profits and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States. The credit is also given to an alien resident in the United States provided the country of which he is a citizen grants a similar credit to an American citizen residing in its territory. In order to prevent a credit from encroaching on the tax from domestic income, it is subject to limitations in Subsection (b), which are described as the "per country" limitation and the "overall" limitation. The effect of the "per country" limitation is to limit the credit for taxes paid in a given foreign country to the same proportion of the recipient's United States tax as his net income from sources in a foreign coun-

² 40 STAT. 1057 (1919) §222.

try bears to entire net income. The same limitation applies in the case of a domestic corporation, except that it is expressed in terms of the ratio of the taxpayer's normal-tax net income from sources within a given foreign country to its entire normal-tax net income for the same taxable year.

It sometimes happens that a taxpayer will derive net income from one country and a loss in another and if the "per country" limitation alone applied the taxpayer would be able to get credit for the tax payable in the first country even though it realized a loss in the second country. This possibility is prevented by the second limitations in Subsection (b), known as the "overall" limitation, which requires the lumping of income and losses from all foreign countries. Thus, an individual must limit his credit for all foreign taxes by the proportion of his United States tax which his net income from all sources without the United States bears to his entire net income for the same taxable year. In the case of a corporation, the credit is limited by the same proportion of the United States tax which its normal-tax income from sources without the United States bears to its entire normal-tax net income for the same taxable year.

Indirect Credit for Income of a Foreign Subsidiary

The indirect credit previously mentioned is found in Section 131(f) of the Internal Revenue Code. Paragraph (1) of this provision recognizes that a domestic corporation with a foreign subsidiary should, in effect, be given the same treatment as a domestic corporation with a branch abroad. Hence, it provides that a domestic corporation, which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year, shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the foreign corporation's accumulated profits from which the dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits. However, the tax so deemed to have been paid by the American corporation is subject to the same limitations as a domestic corporation having a direct branch abroad would be under Section 131(b).

Paragraph (2) of Section 131(f) carries the relief for taxes deemed to have been paid even by the foreign subsidiary which holds a majority of the voting stock of another foreign corporation.

An important amendment to the Revenue Act of 1942 extended the relief allowable as a credit under Section 131, or as a deduction under Section 23(c)(1)(C), by providing that the term "income taxes" includes foreign taxes paid in lieu of a tax upon income, war profits or excess profits taxes otherwise generally imposed by any foreign country or by any possession of the United States. This amendment was made necessary by reason of the fact that in some foreign countries the tax administration finds such difficulty in verifying the net income of a foreign corporation which is attributable to local sources that it resorts to a tax on gross income at a low rate in lieu of a higher rate of tax on net income. Congress decided that the credit

should be allowed for such "in-lieu-of" taxes, inasmuch as the credit would be subject to the same limitations as the credit for taxes on net income.³

Corporations Deriving the Major Part of Income from a Possession of the United States

While the credit for foreign taxes is the general regime for relief from double taxation applicable to income from all foreign countries and possessions of the United States, special relief for citizens and domestic corporations deriving the major part of their income from sources in a possession of the United States is found in Section 251 of the Code. For the purposes of this section, the term "possession of the United States" includes Puerto Rico, the Philippine Islands (until their emancipation on July 4, 1946), the Canal Zone, Guam, Samoa, Wake, and Midway Islands. In contrast to the credit for foreign taxes in Section 131, which requires that the foreign income be included in the taxpayer's entire net income, Section 251 provides relief from our tax by excluding from gross income the income attributable to the foreign possession, or, in other words, limits gross income only to income from sources within the United States. This is done where (1) 80 percent or more of the gross income of the American citizen or domestic corporation for the three-year period immediately preceding the close of the taxable year (or for such part of such period as may be applicable) was derived from sources within a possession of the United States, and (2) provided 50 percent or more of the gross income of such citizen or domestic corporation for such period was derived from the active conduct of a trade or business within the possession of the United States.

In the case of a citizen, the trade or business may be conducted on his own account or as an employee or agent of another.

Dividends received from a corporation whose income was derived from the active conduct of a business within a possession of the United States, or by a citizen who was actively engaged in the management of such corporation, do not represent income derived from the active conduct of a trade or business within the possession of the United States either on the taxpayer's own account or as an employee or agent of another.⁴

A corporation meeting the requirements of Section 251, and therefore subject to United States taxes only on the part of its income which is attributable to United States sources, is treated as a foreign corporation for the purposes of the credit for foreign taxes. Hence, a corporation entitled to the benefits of Section 251 is not allowed the direct credit for the taxes paid in a possession by virtue of this express provision in Subsection (g)(1) of Section 131. However, by virtue of the fact that such corporation is treated as a foreign corporation, if a majority of its voting shares are held by another United States corporation, the latter would be entitled to the credit under Section 131(f) for the part of the taxes paid by the subsidiary which the parent was deemed to have paid, namely, the part corresponding to the dividend dis-

³ INTERNAL REVENUE CODE §131(h).

⁴ TREAS. REG. 111, §29.251-1.

tributed by the subsidiary company to the parent. However, the dividends-received credit which is ordinarily allowed under Section 26(b) to a domestic corporation receiving dividends from another domestic corporation is specifically denied in the case of dividends received from a corporation entitled to the benefits of Section 251.

Western Hemisphere Trade Corporations

The 1942 Revenue Act introduced in the Code a new Section 109 which took cognizance of the fact that the average rates of income tax throughout Latin America were at the time lower than our normal tax and therefore granted an exemption from our surtax which at the time was 16 percent. The general theory advanced for justifying this exemption was that the relief from surtax would cover various types of taxes levied in Latin-American countries which are not allowable as credits, and would also cover losses of capital, and losses on exchange due to the fluctuation of exchange rates, as well as other losses and expenses that are usually incurred in developing business in a foreign country.

However, Congress subjected this exemption from surtax to limitations which were even tighter than those which had been previously imposed in according the relief from excess profits taxes under Section 727(g), which now is only of historical interest. When the excess profits tax was introduced it was recognized that inasmuch as its main purpose was to capture excess profits due to the large expenditure of government funds in the United States, it was hardly fair to apply the tax in the case of a domestic corporation which was carrying on almost its entire business in a foreign country. Hence, under Section 727(g), provision was made for exempting the domestic corporation from the excess profits tax if 95 percent of its income was from sources outside of the United States and 50 percent was derived from the active conduct of a business. In these limitations one finds a reflection of the limitations long imposed on the relief granted under Section 251, except that the limitation in respect to income was increased from 80 percent to 95 percent.

In granting the relief from surtax for Western Hemisphere trade corporations, Congress tightened the conditions precedent for relief by not only requiring that 95 percent of the income for the three-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources other than sources within the United States, but also by advancing to 90 percent the proportion of the gross income for such period or part thereof that was derived from the active conduct of a trade or business. Furthermore, the provisions are subject to the general limitation in the preamble of the section to the effect that all of the business of the corporation must be done in any country or countries in North, Central, or South America or in the West Indies or in Newfoundland. For reasons of practical expediency, the regulations construed the foregoing provision so as not to prevent a corporation which would otherwise qualify from taking the precaution of retaining title to goods

shipped from its establishment in the Western Hemisphere to a point outside the Western Hemisphere to insure payment for such goods.⁵

To show that it is entitled to the exemption, a domestic corporation must attach to its income tax return a statement showing that its entire business is done in one or more of the designated countries, and for the three-year period immediately preceding the close of the taxable year (or for such part thereof during which the corporation was in existence) the statement must show: (1) its total gross income from all sources; (2) the amount thereof derived from the active conduct of a trade or business; (3) a description of such trade or business and the facts upon which the corporation relies to establish that such trade or business was actively conducted by it; (4) the amount of its gross income, if any, from sources within the United States.

The principles of allocation for determining whether the income is from sources without or from sources within the United States are found in Section 119, I.R.C., and Section 29.119 of Regulations 111. However, these provisions are of little help in determining where income from the sale of goods arises, and, obviously, to qualify for the exemption, the corporation must be able to show, if it buys in the United States and sells, for example, in a South American country, that the goods are actually sold there. Then it can take advantage of the provision in Section 119 that if goods are purchased in the United States and sold in a foreign country the entire profit is allocable to the place of sale, and therefore the corporation can meet the requirement of deriving 95 percent of its income from the active conduct of its trade or business from sources outside the United States but in the Western Hemisphere.

Tests have been laid down in a number of court decisions, notably that of the Supreme Court in the *Compañía General de Tabacos de Filipinas* case⁶ and that of the Circuit Court of Appeals, Fifth Circuit, in the *East Coast Oil Company* case.⁷

The case of *Compañía General de Tabacos de Filipinas* involved a Spanish corporation which maintained its principal office in the Philippine Islands and from time to time sold tobacco, sugar, and other products in the United States through an agency, but the sales were made subject to confirmation and absolute control by the Philippine branch as to price and other terms and conditions. The United State Supreme Court held that if the Philippine branch gave the confirmation in each case, the final acts making effective the sales, which were the source of the profit, took place in the Philippine Islands as an incident to and part of the business conducted there.

In the case of the *East Coast Oil Company, S.A.*, a Mexican corporation engaged in the business of producing, buying and selling oil, made three classes of sales. The first class included sales pursuant to oral or memorandum agreements made in Mexico, the oil being delivered there to the purchasers, and it was conceded that any income arising from such sales was not subject to the United States tax.

⁵ TREAS. REG. 111, §29.109-1.

⁶ *Compañía General de Tabacos de Filipinas v. Collector of Internal Revenue*, 279 U. S. 306 (1929).

⁷ *Commissioner of Internal Revenue v. East Coast Oil Co.*, 85 F. (2d) 322 (C. C. A. 5th, 1936).

The second class included sales made under written contracts drawn and executed in the United States, but the oil was delivered by the petitioner at the wharf near Tampico, Mexico, to tank ships owned or supplied by the purchasers.

The third class of sales included sales under written contracts with corporations organized in the United States, which were drawn and executed in the United States, but deliveries were specified as c.i.f. wharf tanks at Galveston, Texas, or Algiers, Louisiana. The Board of Tax Appeals, when considering the case, pointed out that when the various contracts were drawn the oil to be delivered had, for the most part, yet to be produced or purchased by the corporation. The Board also considered that the decision in the *Compañía General* case in no wise varied the established rule that the place where the title passes is the place of sale. It stated that for many years the Bureau of Internal Revenue had upheld the rule that the sale is consummated when and where property passes, and that where sales were made under c.i.f. contracts the seller has performed his part when he has loaded his goods on the carrier, secured the insurance, and forwarded to the purchaser the proper shipping documents. At that time and at the place of shipment title passes to the purchaser who thereafter bears the risks. Consequently, the Board held that the petitioner had fully performed in Mexico all of its obligations under the contracts, and that the income arose there and was not subject to tax in the United States. Likewise, according to the Board, in the case of f.o.b. contracts, property in the goods passes when the sale is completed upon delivery of the goods by the vendor to the carrier in Mexico. Consequently, the income arising from such contracts was held to be attributable to Mexico.

The Circuit Court of Appeals, Fifth Circuit, when affirming the Board's decision declared that, "It is well settled that under either form of contract [f.o.b. or c.i.f.] title to the goods passes from the seller to the buyer on delivery of the goods to the carrier and delivery to the buyer of the bill of lading and other documents essential to show the sale."⁸ Furthermore, the Circuit Court held that in this connection the Supreme Court decision in the *Compañía General* case tended to support the decision of the Board and summarized its holding as follows: "In this case the important question is when and where were the profits earned. The company is a Mexican corporation, necessarily domiciled in that country. The property sold was produced in Mexico. The contracts provided for firm sales. No profit resulted from the mere execution of the contracts. The oil was delivered to the buyer in Mexico. The title passed to the buyer in Mexico. When title passed the profit was earned in Mexico. Collection of the price in the United States was incidental and did not earn the profit."⁹

It may have been due to the foregoing decision to the effect that income arises where title passes that the Treasury inserted the saving clause in the regulations, which precludes a corporation, otherwise qualified, from losing the exemption from surtax if it retains title to goods shipped outside the Western Hemisphere in order

⁸ *Id.* at 323.

⁹ *Ibid.*

to insure payment. Nevertheless, it seems obvious that this provision was not intended to apply unless the shipment was made from a branch establishment of the domestic corporation situated outside the United States and in another country of the Western Hemisphere.

Inasmuch as the Bureau of Internal Revenue is reported to have adopted the policy of not making any rulings in advance in particular cases and as there are not yet any decisions specifically interpreting Section 109, any company seeking to take advantage of it should consider the spirit and intent of this section and not rely merely on legal technicalities as to where title passes.

Comparison of Various Types of Unilateral Relief

The three types of relief for prevention of international double taxation allowed by the Internal Revenue Code which have been examined previously may be summarized as follows:

1. The general relief which includes foreign income in the taxpayer's entire net income but allows the credit for the foreign tax up to the amount of the American tax on the foreign income.

2. The relief for companies deriving most of their income from possessions of the United States which consists in excluding, unless received in the United States, the income attributable to the possession from gross income and thereby freeing it from United States taxes.

3. The relief granted to Western Hemisphere trade corporations which consists in exempting them from surtax and granting the credit against normal tax for foreign taxes.

Another type of relief for the prevention of international double taxation is the relief granted in the case of China Trade Act corporations, which consists in subjecting the income from China to normal tax and surtax and in granting a credit for such income against net income usually comprising the entire income of the corporation, provided a special dividend is declared and certified by the Secretary of Commerce to the Commissioner of Internal Revenue sufficient in amount to cover the United States tax which ordinarily would have been paid.

Considered from the viewpoint of a domestic corporation with a wholly owned domestic subsidiary corporation, the net effect of the four different systems of relief can be summarized as follows:

In the first case, under the system of relief in Section 131, the domestic subsidiary gets full credit for foreign taxes paid up to the point of offsetting the entire United States tax on the foreign income. The dividends that are distributed to the parent corporation are included in the income of the parent corporation only to the extent of 15 percent thereof, as a result of the dividends-received credit under Section 26(b). Consequently, the parent corporation will itself bear on the dividends received from the subsidiary only a tax of 38 percent (the present combined rate of normal tax and surtax) multiplied by 15 percent of the dividends, which equals

5.7 percent. To compute the total burden this rate would, of course, have to be added to the tax paid by the domestic subsidiary which would be the United States rate of 38 percent, or the foreign rate, whichever is the higher.

If the domestic subsidiary is entitled to the benefits of Section 251, it pays the possession tax with a rate of, let us say, 22 percent, and pays no tax to the United States on its income from that possession. However, when the income is distributed to the parent, the parent is not entitled to the dividends-received credit, and, therefore, the income bears the full rate of 38 percent. However, inasmuch as a corporation operating in a possession is treated as foreign in Section 131(g)(1), I.R.C., the parent corporation would be entitled under Section 131(f) to the same proportion of the tax paid to the possession as the dividends which it receives bears to the accumulated profits of the subsidiary corporation. This would cover the part of the possession tax corresponding to the dividends.

If a domestic subsidiary were a China Trade Act corporation, it would pay the Chinese tax on its income from China which, for purposes of comparison, let us suppose is 22 percent. The subsidiary would pay no tax to the United States if it distributed a dividend to cover the 38 percent tax on its Chinese income, but it itself would not be allowed any credit for the Chinese tax against the American tax under Section 131(g)(2), I.R.C. However, as the China Trade Act corporation is treated as a foreign corporation by virtue of said provision, the parent corporation is entitled under Section 131(f) to take as a credit the proportion of the Chinese tax which it has been deemed to have paid on all the dividends received from the China Trade Act corporation against its tax of 38 percent without, of course, any abatement through the dividends-received credit, which is specifically denied by Section 26(b), I.R.C. Assuming all the Chinese net income remaining after payment of the Chinese tax was distributed as a dividend, the American corporation would therefore bear a tax of 38 percent on such income.

If the domestic subsidiary qualifies as a Western Hemisphere trade corporation, it would bear only the normal tax of 24 percent, against which the foreign tax would be credited. The parent corporation would pay 5.7 percent on dividends received, making a total burden on the income earned abroad and distributed of 29.7 percent.

Carrying the summary still further, if we assume that in all four cases the rate paid abroad is 22 percent and that in each case the income from the wholly owned subsidiary is distributed to the parent, then in the first case under the credit provisions in Section 131 the subsidiary bears a tax of 38 percent (against which the 22 percent foreign country or possession tax is credited) and the parent bears an additional burden of 5.7 percent.

In the second case of a parent with a subsidiary operating in a possession and entitled to the benefits of Section 251, I.R.C., the subsidiary bears the 22 percent tax and the parent bears a tax of 38 percent against which the 22 percent tax is credited.

In the third case of a parent with a subsidiary qualifying under the China Trade

Act, 1922, the subsidiary bears the Chinese tax of 22 percent and the parent bears a tax of 38 percent against which the 22 percent tax is credited.

Under the Western Hemisphere trade corporation provisions in Section 109, there is a decided advantage over the other provisions as the tax burden would be only the 24 percent borne by the subsidiary plus the 5.7 percent borne by the parent, making a total rate of 29.7 percent.

However, from the viewpoint of developing trade which involves the plowing back of earnings, both Section 251, involving income from possessions, and Section 261, involving a China Trade Act corporation, are more advantageous than the credit system in Section 131 because, where Section 251 is involved, the income which is kept in the possession is excluded from United States gross income and therefore bears only the possession rate, and in the case of a corporation within the purview of Section 261, its tax liability can be limited to only the Chinese tax, provided that the China Trade Act corporation distributes a special dividend sufficient to cover the United States tax of 38 percent which would otherwise be paid.

BILATERAL RELIEF FROM DOUBLE TAXATION

While the United States Government was proceeding along the lines previously described to accord unilateral relief from international double taxation, many of the European countries, especially those in central Europe, were solving the same problem through bilateral treaties defining the tax jurisdiction of each of the contracting states and stipulating relief from double taxation. In most cases, the principle adopted was the same as that inherent in the American provisions for unilateral relief, namely, recognition of the prior right of the country in which income is produced to tax that income. However, in adopting this principle, most of these countries recognize not merely the prior right but the exclusive right of the country of source to tax most classes of income produced in its territory, and therefore the other country in which the recipient of the income resided exempts such income from its tax.

This principle of exempting foreign income was generally followed in connection with income attributable to a permanent establishment in one country of an enterprise having its principal seat in the other, income from real estate and mortgages, income from personal services, and income in the form of dividends and interest which were subject to tax by withholding at source. However, recognition was frequently given to the principle of taxing income from securities and bank deposits at the residence of the recipient where the country of source did not withhold tax from such income. In some cases the two principles were applied and the country of residence granted a deduction from its tax for the tax paid at source.

The principle of exemption at source and taxation at residence was also frequently extended to patent and copyright royalties unless the owner of the patent or copyright resident in one country exploited them in the other country through a permanent establishment there.

An important exception to the permanent establishment principle for taxing business enterprises was recognized in the case of income from maritime shipping and air navigation enterprises. This was due to the fact that most of the service of such enterprises was rendered on the seas or in the air, and therefore not actually in the territory of the respective states, and that, furthermore, such types of transportation are ordinarily supported to a large extent by government subsidies in the form of mail contracts or otherwise. Hence, the principle adopted was that such enterprises should be exempt from tax except in the country in which the enterprise was resident whether through having been organized under the law of such country or through having its central management and control therein.

The movement for solution by treaties had been encouraged by the meetings of technical experts under the auspices of the League of Nations which reached an important stage at the General Meeting of Governmental Experts on Double Taxation in Geneva, Switzerland, in October, 1928, at which official representatives of twenty-eight countries drafted three model conventions for the avoidance of double income taxation, one model convention for the avoidance of double taxation of estates, and two other model conventions on mutual assistance in the assessment and collection of taxes.

Reciprocal Exemption of Shipping Profits

The first experience of the United States in this field was limited to the effecting of Executive agreements for the reciprocal exemption of shipping profits as foreseen by specific authorization for such agreements first incorporated in the Revenue Act of 1921 and now found in Sections 212(b) and 231(d), I.R.C. These provisions state in substance that the United States will exempt the income from the operation of ships documented under the laws of the foreign country of which their owners (whether individuals or corporations) are nationals if such countries in turn exempt from their tax the income from the operation of ships documented under the laws of the United States and belonging to citizens and corporations of the United States.

Tax Treaty Between the United States and France

In the 1920's France began to subject American corporations with subsidiaries in France to a double tax on dividends, that is, first by withholding at source from dividends paid by the French subsidiary to the American parent, and then by direct assessment against the parent when the income was redistributed in the United States. There was no basis in our law for prevailing upon the French Government to forego this form of double taxation. Hence, the efforts of a group of officials sent to France in May, 1930, to persuade the French Government to give up the second tax on a unilateral basis were fruitless. It was necessary to enter into negotiations for a bilateral treaty with France in which the French administration might find some reciprocal concessions under our law. These negotiations¹⁰ continued through the summer and an agreement was reached on all but a few points. After

¹⁰ The writer was a participant in these negotiations as a special attorney for the Treasury Department.

a long interval, the treaty was concluded on the basis of the American proposals, and was signed on April 27, 1932.¹¹ It was promptly ratified by the United States, but France did not ratify it until after Congress had enacted Section 103, I.R.C. This section, in substance, authorizes the President to double the rate of American tax (but subject to a maximum rate of 80 percent) in the case of the citizens and corporations of a foreign country which subjects American citizens and corporations to discriminatory or extraterritorial taxes. This provision envisaged particularly the second application of the French tax on dividends distributed by the American parent of a French subsidiary, because it was extraterritorial—being levied on income distributed in the United States by an American corporation, and discriminatory—inasmuch as French law specifically precluded the double taxation of dividends distributed by a French company out of income received in the same year in the form of dividends from a French subsidiary.

Influence of Work of League of Nations Committees

The negotiation of the Franco-American convention was facilitated by the fact that representatives of both countries had previously attended meetings of governmental and other experts on the prevention of double taxation, called by the League of Nations. Through their joint efforts to formulate model conventions for the prevention of double taxation they developed an understanding of principles of tax jurisdiction and a common language. The negotiations in Paris were interrupted so that some of the participants could attend in Geneva a meeting of the Fiscal Committee of the League which had been created in 1939 and was carrying on the pioneer work in the prevention of double taxation.

Informal conversations between officials convening on the shores of Lac Lemman had already led to the conclusion of a number of treaties between pairs of European states, and they conducted not only to the formulation of our first treaty with France but also to the conventions subsequently concluded by the United States with Sweden, March 23, 1939,¹² and the second treaty with France, signed July 25, 1939.¹³ The ratification of this latter treaty could not be effected until after the termination of hostilities in Europe, with the result that it did not come into effect until January 1, 1945. The meetings at Geneva and, later, the regional sessions of the Fiscal Committee in Mexico City in 1940 and 1943 led to the conclusion of not only the income tax convention with Canada, signed March 4, 1942,¹⁴ but also the death tax convention with Canada, signed June 8, 1944.¹⁵ All these meetings and negotiations laid a

¹¹ Convention and Protocol between the United States and France, signed April 27, 1932. 49 STAT. (pt. 2) 3145, Treaty Series No. 885 (1935).

¹² Convention and Protocol between the United States and Sweden, signed March 23, 1939. 54 STAT. 1759, Treaty Series No. 958 (1940).

¹³ Convention and Protocol between the United States and the French Republic, signed July 25, 1939, effective January 1, 1945. 59 STAT. —, Treaty Series No. 988 (1945).

¹⁴ Convention and Protocol between the United States and Canada, signed March 4, 1942. 56 STAT. 1399, Treaty Series No. 983 (1942).

¹⁵ Convention between the United States and Canada, signed June 8, 1944, effective June 14, 1945. 59 STAT. —, Treaty Series No. 989 (1945).

foundation for the income and death tax conventions with the United Kingdom, of Great Britain and Northern Ireland, signed April 16, 1945, which have been ratified by the United Kingdom and approved on June 1, 1946, by the United States Senate.¹⁶ Model conventions which may serve as the basis for the negotiation of future treaties on the avoidance of double taxation in the field of income, property, and estate taxes, and the prevention of tax evasion, were prepared at the final meeting of the Fiscal Committee in London, March, 1946.

Space is lacking to discuss the detailed provisions of all these treaties, but one may signalize the special features of the recent treaty with France and the pending treaty with the United Kingdom. The outstanding fact in regard to both of these treaties is that they not only provide for the avoidance of international double taxation in accordance with generally accepted principles, but they also amend certain features of the tax laws of one of the contracting states which operate unfairly when they come into conflict with the provisions of the laws of the other contracting state.

*Second Franco-American Tax Convention*¹⁷

Allusion has already been made to the extraterritorial and discriminatory aspects of the French "double dividend tax." The treaty between the United States and France restricts the application of that levy to a purely territorial basis, providing that in the case of an American corporation with a subsidiary in France, the French dividend tax shall be limited to dividends distributed by a French subsidiary to its American parent and also to any profit which has been diverted by the French subsidiary to the American parent by transactions on other than an arm's-length basis. (Convention, Art. 16.) An American corporation with a branch in France is freed from the requirements of the French Decree of December 6, 1872, by virtue of which the corporation would have to pay the tax on the same proportion of dividends distributed as its assets in France bear to its entire assets, and the tax is applied on three-fourths of the profits actually derived from the branch in France and determined for the purposes of the industrial and commercial profits tax. (Convention, Art. 15.)

*British-American Income Tax Convention*¹⁸

One of the principal purposes of this treaty with the United Kingdom is to overcome the double taxation of interest and royalties which resulted from the Treasury extension of the Supreme Court's reasoning in *Biddle v. Commissioner*.¹⁹ The Court endeavored to fit the British method of taxing dividends at the source into our basic concept that a corporation is an entity distinct from its members. The result was that American individuals receiving dividends from a British corporation, who under

¹⁶ Convention between the United States and the United Kingdom of Great Britain and Northern Ireland Respecting Income and Estate Taxes, signed April 16, 1945. Senate Executives D and E, 79th Cong., 1st Sess.

¹⁷ *Supra* note 13.

¹⁸ *Supra* note 16.

¹⁹ *Biddle v. Commissioner of Internal Revenue*, 302 U. S. 573 (1938).

British law bore a tax first paid by the British company and then passed on to them as shareholders by deduction at source, were regarded as not being the taxpayers contemplated by the provisions for allowing a credit for foreign taxes in Section 131 of our Internal Revenue Code. Hence, the British standard rate of tax which was paid in the first instance by the British corporation was assimilated to our corporation tax and therefore not regarded by our Supreme Court as a tax payable by the shareholder who was intended to bear it under British law. The denial of the credit for the British tax deducted at the source from dividends led to its disallowance by the Bureau of Internal Revenue (later upheld by the courts) in the case of tax deducted at the source from interest and royalties under essentially similar language in the United Kingdom income tax act. Consequently, the operation of Section 131, I.R.C., which was intended to prevent international double taxation, was frustrated as a result of our Supreme Court construing the British law in the light of American concepts rather than in accordance with British concepts. The only solution was to reconcile the conflicting tax concepts by a treaty.

The convention with the United Kingdom turns back the clock to the time before the Biddle decision by permitting the recipient of dividends from an English corporation to take as credit against the United States tax the amount of the United Kingdom income tax appropriate to the dividends, provided the recipient elects to include in his gross income for the purposes of United States tax the amount of such United Kingdom income tax. (Convention, Art. XIII.)

Interest and Royalties

Interest on bonds, securities, notes, debentures or any other form of indebtedness derived from sources within the United Kingdom by a resident of the United States who is subject to United States tax on such interest, and is not engaged in trade or business in the United Kingdom, is to be exempt from United Kingdom tax on such interest and therefore taxable exclusively in the United States. However, to preclude companies from taking an unfair advantage of this provision, it is specifically provided that the exemption shall not apply to interest paid by a corporation resident in the United Kingdom to a United States corporation controlling directly or indirectly more than 50 percent of the entire voting power in the paying corporation. (Convention, Art. VII.)

Similarly, patent and copyright royalties derived from sources within the United Kingdom by a resident of the United States who is subject to United States tax on such royalties and is not engaged in trade or business in the United Kingdom shall be exempt from the United Kingdom tax. (Convention, Art. VIII.) Of course, both these articles are reciprocal.

Permanent Establishment Rule

As regards enterprises of one country operating directly in the other, the principle adopted is that they shall not be subject to tax in the second country except in respect of business income directly allocable to a permanent establishment in the second

country. The term "permanent establishment" is very carefully defined so as to include any fixed place of business such as a branch or factory, but it is not to include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise or has a stock of merchandise from which he regularly fills orders on its behalf.

In contrast to the foregoing, a permanent establishment shall not be deemed to exist if an enterprise of one state has in the territory of the other merely business dealings through a bona fide commission agent, broker or custodian acting in the ordinary course of his business as such.

The definition reflects an addition to the definition of a permanent establishment adopted by the Fiscal Committee of the League of Nations in the light of the interpretation adopted by the French administration in the 1920's, namely, the fact that a corporation of one contracting party has a subsidiary corporation which is a corporation of the other contracting party or which is engaged in trade or business in the territory of the other contracting party (whether through a permanent establishment or otherwise) shall not of itself constitute that subsidiary corporation a permanent establishment of its parent corporation. [British-American Convention, Art. II (1) (e).]

Still another exception to the permanent establishment rule is the provision that the income from the operation of ships and aircraft documented under the laws of one state and belonging to an enterprise of that state shall be taxable only in such state. (Convention, Art. V.)

Another important provision in the treaty with the United Kingdom which is helpful in the carrying on of business is found in Article XI. Thus, an individual who normally resides in the United States will be exempt from United Kingdom tax upon his earnings for personal services performed within the United Kingdom in any year of assessment if (a) he is present within the United Kingdom for a period or periods not exceeding in the aggregate 183 days during that year, and (b) such services are performed for or in behalf of a person resident in the United States.

CONCLUSION

While the conclusion of the tax convention is the ideal way of preventing international double taxation, hitherto the progress made each year has been relatively slow. Ratification of the British-American tax treaty will clear the way for a series of negotiations, including a death tax convention and an addendum to the income tax convention with France, and conventions of both types with Belgium, the Netherlands, South Africa and various other countries. However, while these conventions generally provide for the reciprocal exemption of certain classes of income, and consolidate the credit for taxes payable in the other state on income from other defined sources therein, and in some instances, provide for a reduction in rates of tax withheld from dividends and interest, and remove a number of tax barriers to the flow of investments and trade, they do not take the place of the provisions for

unilateral relief such as that provided for corporations operating principally in possessions of the United States, for China Trade Act corporations, and Western Hemisphere trade corporations. There is a definite need for relief along these lines for corporations operating in other areas.

While citizens who go abroad in the interest of American business are entitled to an exemption in respect of their income earned abroad, it is subject to the rigid condition that they must be "bona fide residents of a foreign country or countries during the entire taxable year," according to the provisions of I.R.C. Section 116(a).

Literally construed, this means that the bona fide residence abroad must begin as of January 1 and run until December 31 of a given year, but there are indications that if a man goes abroad to spend only one year, or even three years, with the intention of then returning to the United States, the Bureau is inclined to hold he does not become a bona fide resident in a foreign country or countries. Thus an individual who goes abroad under a three-year contract for a United States corporation and who plans to return to the United States at the expiration of the contract may be considered to reside in the United States during his entire stay abroad. This is especially true if the individual goes from country to country so as not to incur tax liability in any one country, and is even more true if he maintains in the United States a home to which he expects to return.

While the Bureau should not permit abuses of Section 116(a), I.R.C., such as those which occurred prior to the 1942 amendment,²⁰ nevertheless the revival of foreign trade would be facilitated if the provision could be amended so as to permit its operation to begin when an individual leaves the United States to become resident abroad and to continue until his return at any time during a subsequent taxable year, provided his residence abroad has been for a minimum of one year, starting from the date of his departure from the United States. Furthermore, with the present restrictions on travel and lack of living facilities in many areas, men sent abroad on business have to leave their families in the United States, and they should not be deprived of the benefit of Section 116(a), I.R.C., for that reason.

If amendments such as these could be adopted by Congress, and if more tax conventions can be rapidly concluded, there is no doubt that all such measures will help to encourage the development of our foreign trade.

²⁰ Before the 1942 amendment the exemption was extended to "a bona fide non-resident of the United States for more than six months during the taxable year." 26 U. S. C. (1940 ed.) §116(a).